Focus on Markets

Ulster Bank

Overview

- Fragile global recovery loses momentum but double dip unlikely
- Rate hikes off the agenda, for now at least
- Euro shrugs off debt woes but vulnerable to renewed intensification of the crisis

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History tells us that recoveries which follow major financial crises tend to be sluggish and vulnerable to setbacks. While the major advanced economies have been in recovery mode for over two years, the fragility of this expansion has become a focus following a significant loss of momentum in recent months.

Second quarter growth was weaker than expected across the US, UK and euro zone economies and the soft patch has sparked widespread downgrades of growth forecasts. Moreover, the near-term outlook is still very much subject to downside risks. The disorderly handling of the debt ceiling issue by the US Congress dealt a blow to confidence of both investors and US businesses and households alike, while the European landscape has been defined in recent months by the failure of the authorities to find a comprehensive solution to the European debt crisis. The result has been a major deterioration in financial conditions over the summer, fuelling concerns about forward-looking growth prospects as the threat of the re-emergence of negative feedback loops between financial markets and the real economy resurfaces.

While ECB buying of Spanish and Italian debt has calmed European sovereign debt market tensions to a degree, we anticipate renewed deterioration in the months ahead as markets press EU policy makers for a more decisive and comprehensive policy response to the debt crisis. In terms of the growth dynamic, a further loss of activity momentum in the third quarter is apparent in recent business surveys in the euro zone.

While some of the latest business survey results are also painting a glum picture of recent trends in the US, other incoming news has offered encouragement. In particular, July consumer spending and industrial production numbers were better than expected.

The Japanese earthquake also dampened GDP growth in the UK in the second quarter, as did the extra bank holiday arising from the royal wedding. So GDP growth should recover modestly in the third quarter as those distortions wash out, an expectation given fundamental support by a healthy rise in the July services PMI.

Overall, the recent weakness in growth goes beyond what can be readily explained by identifiable temporary factors. Plus, there is considerable uncertainty as to just how big the dent to growth stemming from the markets-related hit to business and consumer confidence will be. Nonetheless, it is beginning to become clear, in the US at least, that two negative factors that held the economy back earlier in the year (the energy price spike which sapped spending power, and the Japanese earthquake which caused major disruptions to the supply chain in many industries including the auto sector) are now reversing, lifting growth performance in the process. So we do expect the US economy to adopt a modestly firmer tone in the second half of this year relative to the first, a change in trajectory that should offer support to the global growth dynamic more generally.

The recent downside growth surprises have impacted the outlook for monetary policy in all the main economies. The Fed has indicated (though not promised) that rates may be on hold near zero for the next two years – a communication that itself amounts to a form of additional stimulus. The Bank of England has also hinted that UK rates are likely to be left unchanged at record lows for the foreseeable future. Indeed, with both monetary institutions eyeing downside growth risks, if there is to be a policy move in the next few months in the US or UK it will be a further loosening via more Quantitative Easing (though unfavourable inflation trends make this an unlikely scenario on balance in our view).

Having hiked rates twice already this year, the ECB had seemingly been intent on proceeding with a further normalisation of its policy stance. However, further ECB tightening now looks highly unlikely in the short term, and we anticipate the next hike in official rates in the zone will not now come until the latter part of next year at which point we expect there to be clearer signs of both a resolution of the debt crisis and a resumption of somewhat stronger economic growth.

In thinking about the risks to this base case, it would be wrong to rule out the possibility of a rate cut from the ECB in the interim, though it would likely take an extremely serious deterioration in economic and or financial conditions for this to materialise. In the other direction, history tells us to never underestimate the hawkishness of the ECB. So in the event that the macrofinancial environment proves more resilient than we currently expect, then a resumption of the ECB's hiking campaign will occur well before the back end of next year.

In terms of long-term rates, 5-year rates may well be subject to some further downward pressure in the period ahead reflecting the still-present risk of some further deterioration in incoming economic news and / or another bout of financial market turmoil linked to the European sovereign debt crisis. Thus while tactically we think that Treasurers may get better levels in the months ahead with which to hedge outstanding interest rate exposure, it is important to retain a strategic focus in managing interest rate risk and not to overlook the fact that 5-year swap rates are within touching distance of their all-time record lows.

In recent weeks there has been no shortage of volatility within financial markets, particularly equities and commodities. Currency markets, by comparison have been relatively more stable. Looking ahead, we anticipate that the euro zone's sovereign debt concerns will be placed back under the spotlight. This unwelcome attention will put the single currency under pressure over the next six months or so against the green back and sterling. Eur/USD is expected to return to $1.40 early next year before returning back to $1.45 by year-end as ECB rate hikes offer some support. As for Eur/Stg, we largely anticipate one-way traffic for the year ahead with 83p our target for Dec-12.

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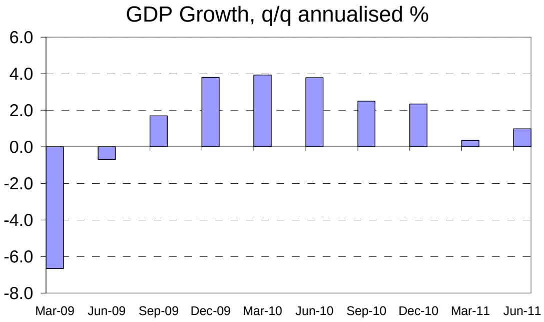
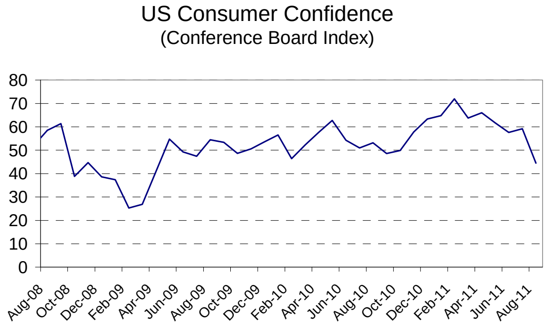
Forecasts (end period)						
	Latest	Dec-11	Mar-12	Jun - 12	Sep-12	Dec-12
Interest Rates						
Eur						
ECB Refi	1.50	1.50	1.50	1.50	1.50	1.75
5yr Swap	2.1	1.9	2.4	2.6	3.0	3.2
US						
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
5yr Swap	1.25	1.3	1.8	2.0	2.2	2.7
UK						
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.75
5yr Swap	1.9	1.7	2.2	2.4	2.8	3.2
Currencies						
EUR/USD	1.43	1.41	1.40	1.40	1.45	1.45
EUR/GBP	0.88	0.87	0.86	0.84	0.835	0.83
GBP/EUR	1.13	1.15	1.16	1.19	1.20	1.20
GBP/USD	1.62	1.62	1.63	1.67	1.74	1.75
EUR/JPY	110	108	105	101	106	108

The US Economy and Fed Outlook

US economy has lost momentum in the first half of 2011 …



…Concerns over the economic outlook, falling equity prices and increased levels of uncertainty have weighed on sentiment…



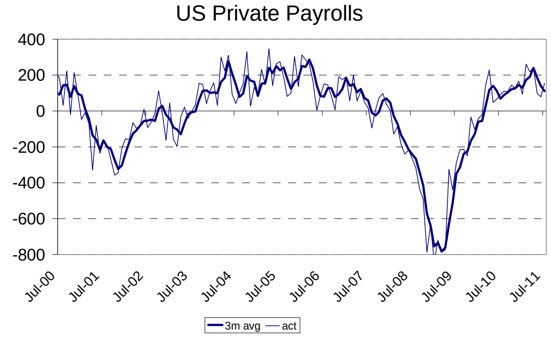
The latest update on the US economy showed that the economy grew at an annualised pace of 1% q/q in the second quarter of this year, representing a substantial slowdown from the same period a year ago, when the economy grew by 3.8% on an annualised basis.

A slowdown in the second quarter of 2011 had been anticipated given the negative effects from both the supply chain disruptions arising out of the Japanese earthquake and higher commodity prices. The supply chain disruptions resulted in auto production in the US being seriously curtailed in the second quarter and motor vehicle production was a drag on GDP growth during this period. The higher commodity prices, including the spike in oil prices (Brent Crude hit $127 a barrel in April) resulted in higher gasoline prices for US consumers and in the process hit consumers in the wallet and reduced their purchasing power.

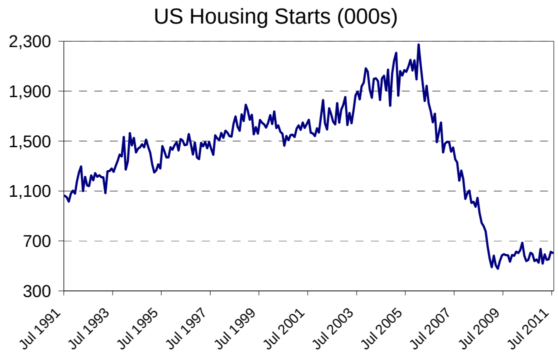
However, there is no denying that the US economy experienced much slower growth even allowing for the above factors. An added headwind to the recent economic environment has been the US debt ceiling debacle. A key point about the debt ceiling issue and the resulting uncertainty it created was that it could have been avoided if both the Democrats and Republicans had refrained from engaging in political brinkmanship and instead concentrated on coming up with a plan to restore the fiscal health of the US economy. The fallout from the debt ceiling debacle, the S&P downgrade of the US, sharp falls in equity markets and the ongoing sovereign debt crisis in the Eurozone have added to the level of uncertainty. This uncertainty impacts negatively on both business and consumer confidence. An uncertain fiscal policy environment makes companies more reluctant to hire or engage in new investment. This lack of hiring then has a negative impact on consumer spending.

The US labour market still remains a key headwind to the growth prospects for the US economy. A sustained improvement in the labour market is a key precondition to consumer spending acting as a driver to US growth prospects. Given that consumer spending accounts for ca. 70% of the economy, the persistently high level of unemployment (rate still above 9%) is acting as a drag on spending. Overall, the payroll data has disappointed, with nonfarm payrolls averaging just 132k in the first seven months of this year. For a sustained improvement in the labour market, payrolls would probably need to grow by 150k or more to result in substantial and long lasting falls in the unemployment rate. The high level of unemployment acts a cap on wage growth which combined with weak employment prospects dampens consumer spending. The labour market will continue to face a challenging outlook. However,

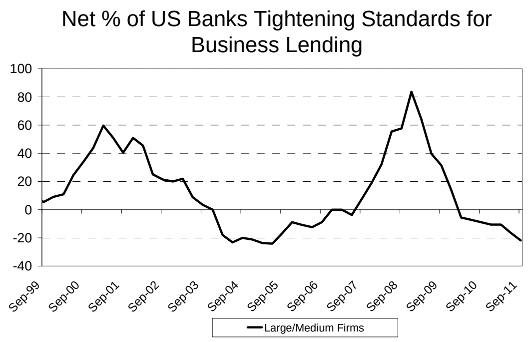
Labour market improvement is still sluggish…



…and housing market remains extremely weak…



But there has been an easing in credit conditions…



given the previous actions taken by US firms to repair their balance sheets, the improved cost profiles of their business and the resultant positive earnings have given them the financial ability to hire. As the economy shows signs of improving and the degree of uncertainty that currently exists starts to wane, companies will be more willing to hire and this should start to feed into some signs of improvement in the payroll data.

The housing market remains in a subdued state. The supply overhang from unsold properties combined with additional supply coming from release of distressed properties and tight credit conditions has seen new home construction activity remain at very low levels and is still 70% below pre crisis levels. On the demand side, the high level of unemployment, continued fall in house prices, and difficulty in obtaining credit has seen continued weakness in housing demand. Typically the housing sector has been a key driver in previous economic recoveries in the US, however given the origin of this crisis in the housing market and resultant credit crunch, the housing market is not in a position to drive the recovery forward.

When assessing the outlook for the US economy, the second quarter report on productivity and the revisions contained in the report have some important implications for the US economy in terms of the labour market and also the inflationary outlook. The report contained downward revisions to productivity over recent years. These downward revisions may impact on the potential GDP for the US economy in terms of downward revisions to it. This is due to the fact that productivity is one of the key determinants of potential GDP. So an extended revision to productivity may also lead to a rethinking on potential GDP. A lowering of the potential GDP trajectory in the US would mean that there is less slack (i.e. less spare capacity) in the economy than previously envisaged. The productivity revisions would imply than that the natural rate of unemployment is higher. Therefore the current conventional rate of 5% could now potentially be revised upwards to between 6% - 7%. The implication of less spare capacity in the economy could also indicate that at the margin there are more inflationary pressures. The latest PCE core deflator data for July showed a year on year increase of 1.6%, so despite high levels of unemployment, there is upward pressure on core inflation.

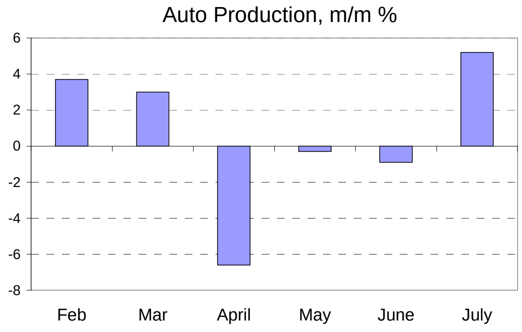
Whilst some of the recent weakness in economic data has lead to renewed talk of a double dip scenario for the US economy, we expect the US economy to avoid falling back into recession and will instead start to exhibit signs of improvement in the second half of this year and will build further on this in 2012. This positive outlook is based on a number of factors. These include the fact that the recovery is now in its ninth quarter. The banking system is better capitalised and credit availability conditions continue to improve as indicated by the latest Fed Loan Officer survey. Commodity prices have fallen back from their recent highs and this has added support to consumer spending with the latest update on spending showing a better than expected increase of 0.8% in July, representing is best monthly performance since February. Consumer spending is now on track to grow by an annualised 2% in Q3 (increased 0.4% in Q2). The supply chain disruptions are showing signs of reversal with the rebound in auto production helping overall industrial production surprise on the upside in July with a monthly increase of 0.9%.

At its August meeting, the Federal Reserve in response to the deterioration in the economic outlook for the US economy changed their policy guidance by giving a conditional commitment to keep rates low till at least mid 2013. However, it is important to note that this pledge is conditional on the economic circumstances continuing to warrant such low rates. The effect of the change in policy guidance has helped to provide a stabilising effect in these uncertain times in the macro economy and financial markets by removing the uncertainty over rate expectations and introducing some stability in one important area of the macro landscape. More directly of course the change in wording in relation to interest rates has also provided a stimulus by engineering a shift in interest rate expectations.

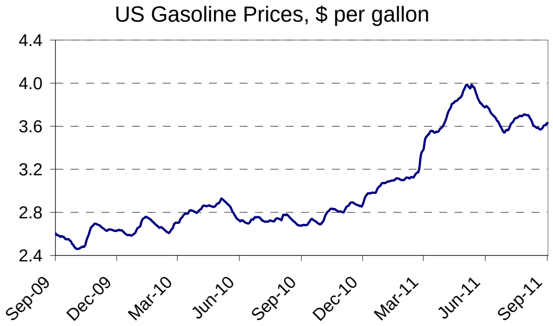
The signs that the loss of economic momentum have carried into the second half of the year has lead to increased expectations that the Fed will engage in another bout of asset purchases (i.e. QE3). This expectation has increased further after Bernanke's speech at Jackson Hole where he stated that the Fed will employ the necessary tools to promote stronger economic growth. The more dovish tone to the minutes from the August meeting, where some members of the FOMC had wanted to go further than just a change in wording in relation to interest rates and introduce further monetary policy stimulus has further increased the chances of QE3. However overall on balance we view a scenario of more monetary stimulus as unlikely. While the Fed has stated that it will do what is necessary to promote economic growth, this should not come as a surprise given its dual mandate on both employment and inflation. A complicating factor which did not exist last summer when the Fed contemplated QE2 and eventually introduced it, is inflation. Last summer, core inflation was running at multi year lows and there was still the risk of deflation. Now, inflation has returned and the cost/benefit of introducing further stimulus is perhaps now less favourable. Therefore it will be increasingly difficult for the fed to introduce additional monetary stimulus faced with this inflationary backdrop. Indeed, if the economic data starts to surprise on the upside during the remainder of this year and into 2012, the economic conditions that warrant rates remaining exceptionally low through to mid 2013 may start to dissipate. In an environment of an accelerating economy with sustained labour market improvement and increasing price pressures, the Fed may look to start to tighten monetary policy sooner than mid 2013.

There is no doubting that the economic recovery has been more sluggish in nature than previous cycles. Despite being two and a

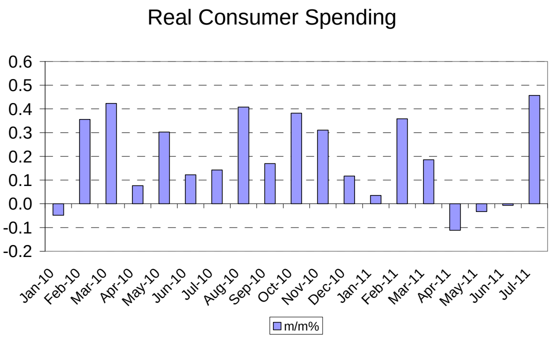
…..and headwinds are starting to reverse with auto production rebounding from previous supply chain disruptions



… gasoline prices have also eased



Helping to add support to consumer spending…



half years into its recovery phase, the US economy has still to return to its pre crisis size. However, this is not uncommon as post financial crisis recoveries tend to be more fragile and sluggish in nature given the need for both business and consumers to repair their balance sheets by engaging in a de leveraging process, along with constrained credit availability conditions. Overall, we see the economy continue to expand at a moderate pace with growth to average 1.7% in 2011, and accelerating to 2.1% in 2012. There are downside risks to this growth outlook. The risk of a systemic crisis in the Eurozone and the resulting contagion to financial markets would create serious downward pressures to growth in the US. Another bout of political gamesmanship and indecisiveness over fiscal policy would harm consumer and business sentiment and create heightened levels of uncertainty. However, the previous temporary headwinds from the first half of the year (supply chain disruptions and high commodity prices) are reversing and are in fact now tailwinds for the economy and should help the economy to show increasing signs of improvement.

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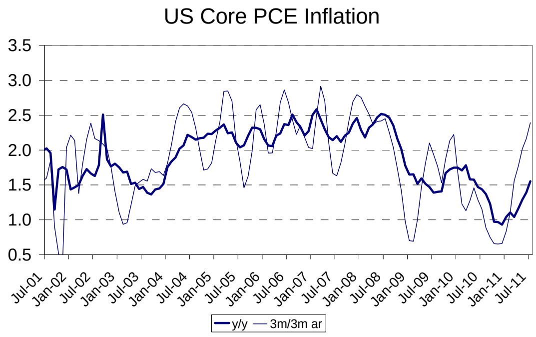
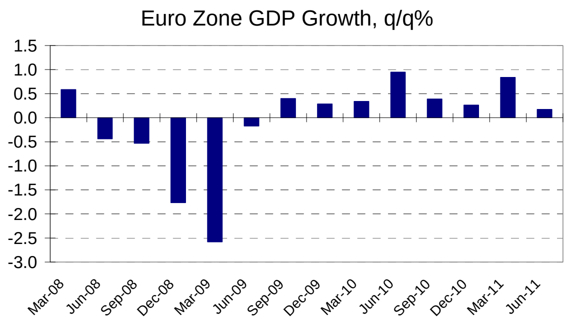
…upward trends in core inflation is a complication for Fed to consider when deciding on whether to implement additional monetary stimulus …



The Euro Area Economy and ECB Outlook

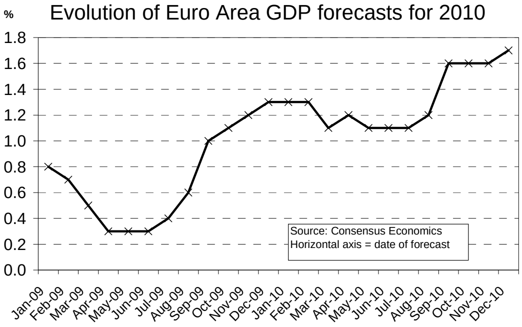
The second quarter of this year marked the eighth consecutive quarter of economic expansion in the euro zone, with the low point of the recession having been hit in the second quarter of 2009. In total, real GDP in the zone has risen by 3.9% since that point. While that represents a sluggish recovery relative to the 5.4% peak to trough decline in output experienced over the course of the recession, it has been the case, up to recently at least, that the performance of the euro area economy has proved to be somewhat stronger than expected. For example, at the end of 2009 the ECB staff projection for GDP growth in 2010 was centred on a mid-point of 0.8%. But as it turned out, the economy grew at over twice that pace last year, recording average annual growth of 1.7%.

The euro area economy has been in expansion mode for two years now …



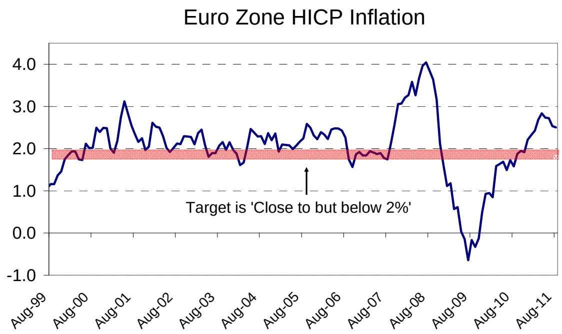
Strong momentum was carried into the first quarter of this year, reflected in multi-year highs being reached in several reliable business cycle indicators including the composite PMI and the European Commission's Economic Sentiment Index (ESI). Official GDP also accelerated strongly in the first quarter, posting a quarterly increase of 0.8% which took the y/y rate to a three and a half year high of 2.5%. Exports were the strongest area of the economy, rising by 9.7% y/y though there was also an acceleration in investment which was up 4.2%y/y. Consumer spending was much more sluggish, but was still contributing positively to growth (up 1.1% y/y). In terms of the country performance, German strength was the dominant theme, with growth at a 4-year high of 4.6%. At the other end of the spectrum were Greece and Portugal which recorded annual GDP declines of 5.5% and 0.6% respectively.

… with the early phases of its recovery delivering faster than expected growth…



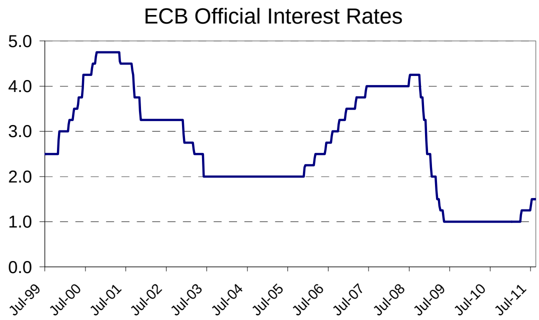
It hasn't been just the real economy dynamics that have surprised to the upside; measures of consumer price inflation have also been firmer than expected. Again, taking the December '09 ECB staff projection as an indicative benchmark, the prevailing expectation was that HICP inflation would average 1.3% in 2010. But the stronger growth dynamic which subsequently took hold both within but especially outside the euro area resulted in stronger upward pressure on price levels, with strong price rises in energy and other commodity prices playing an important role here. Inflation averaged 1.6% last year, and went on to hit as high as 2.8% in April of this year. Not only was this a strong turnaround from the cycle low point of -0.7% reached in mid'09, but it meant that inflation had accelerated to a level higher than the ECB's target of 'close to but below 2%'.

… while inflation pressures have also picked up



The ECB does not set interest rate policy by looking at today's inflation rate, as it rightly focuses on the medium-term picture which is the appropriate horizon at which its policy can exert influence. However, the reality that the ECB faced earlier this year was that the economic recovery was looking firmer than expected and that inflation pressures had also re-emerged to a degree that hadn't been anticipated. This set of circumstances prompted the ECB to begin the process of withdrawing the record amounts of monetary stimulus that had been provided via the lowering of official interest rates to all-time lows of 1%. In effect, the ECB took the view that while 1% rates might have been an appropriate setting for a financial and economic emergency, with that emergency seemingly having passed, it was time to embark on a process of normalising the policy stance. The policy shift was signalled via the now-familiar code phrase "strong vigilance" at the March post-meeting press conference, and a 0.25% hike duly followed in April, with a similarly-sized follow-up move delivered in July.

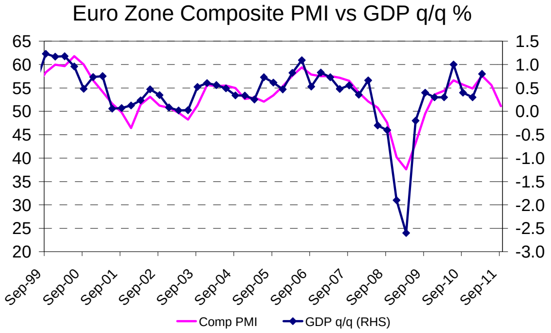
…a combination that resulted in the ECB embarking on a process of normalising its interest rate stance with two 0.25% hikes in April and July…



However, both the economic and policy outlook have become murkier of late. For one thing, the real economy looks to have lost quite a bit of momentum in recent months. Notably, the pace of quarterly GDP growth slowed sharply to a mere 0.2% pace in the second quarter. Some cooling in the pace of growth was always on the cards as the Q1 reading of 0.8% was unsustainably strong and was boosted by special factors (including a spike in construction activity). Moreover, some normalisation in the pace of global trade was always inevitable following an early-cycle snap back in activity levels, especially given the policy tightening implemented by authorities in many emerging economies (e.g. China has raised rates five times – by a total of 1.25% - over the past year). In addition, the global economy was hit by two important shocks earlier in the year in the form of the rapid run-up in energy prices (partly reflecting the strength of demand in emerging markets, partly reflecting concerns about oil supplies in the face of an escalation of geopolitical risks in North Africa and the Middle East) and the Japanese earthquake and tsunami which had a material adverse impact on the global supply chain of a number of industries, most notably the auto sector.

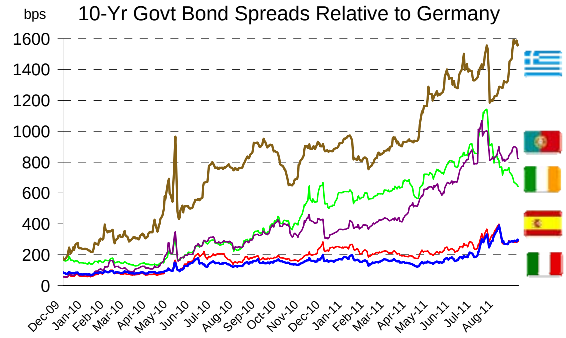
But even allowing for these factors, the extent of the growth slowdown that has become evident has been more pronounced than expected. One factor at play in this respect is the marked intensification of financial market strains linked to problematic public finance situations on both sides of the Atlantic. The shambolic handling of the debt ceiling issue by the US Congress dealt a blow to confidence of both investors and US businesses and households alike, while the European landscape has been defined by the failure of the authorities to find a comprehensive solution to the European debt crisis. The result has been a major deterioration in financial conditions, reflected in a surge in Spanish and Italian bond yields earlier in the summer, widespread declines in stock markets, and the re-emergence of strains in European bank funding markets. In turn, these developments have added further to concerns about forward-looking growth prospects, thereby raising the spectre once again of negative feedback loops between financial markets and the real economy.

… however, growth momentum has softened significantly in recent months…



With markets losing faith in the ability of politicians to move with the required speed, the ball was firmly in the court of the ECB as the only European institution with both the toolkit and the capability to respond quickly to rapid adverse market movements. And in fairness to the ECB, it reopened its Securities Markets (i.e. its bond buying) Programme last month and importantly extended it to include purchases of Spanish and Italian debt, buying a total of €42bn of bonds over the past three weeks. This has had a positive, calming effect, with Spanish and Italian yields having fallen by over 1% from early August levels of well over 6% in each case. However, the ECB is a reluctant buyer of last resort, and probably regards its role as a holding operation until the EFSF's more flexible powers (including the ability to buy government debt) become operational later in the year (presuming this gets approved by member states). But this then raises the question of the adequacy of the EFSF's €440bn of lending capacity, as available funding will quickly diminish if market stability is dependent on official buying at the current run rate.

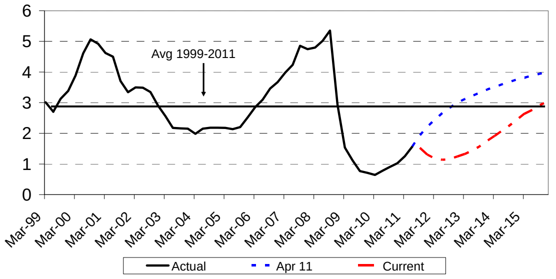
… partly reflecting the impact of an escalation of the debt crisis…



Thus, we struggle to view the current policy response to the debt crisis as comprehensive and fully credible, and a further significant deterioration in financial market conditions is likely to be required to galvanise enough pan-European political support for a more forceful and decisive policy response. European leaders do not have a good track record over the crisis in implementing bold measures on a pre-emptive basis. Rather, the response has tended to be characterised as behind-the-curve crisis management driven by the

… and market rate expectations have been scaled considerably in response. We see the ECB on hold for the time being and expect the next hike to come towards the end of next year.

Mkt Interest Rate Expectations:
3-Month Euribor



need to react to unfolding developments and market pressures, rather than anything that might be termed confidence-building 'shock and awe'. More radical steps could include a significant upsizing of the EFSF so that it has sufficient fire-power to credibly address the risk of contagion to Spain, Italy and perhaps France, and / or some of Eurobond which would harness the financial strength of the 'core' to generate an improvement in investor confidence in the periphery and other vulnerable countries. While we believe senior political leaders will do what is required to ensure the survival of EMU, the road to a comprehensive solution is not likely to be smooth. In the meantime, it will be up to the ECB to contain the market fallout which we think may take hold in the months ahead, possibly triggered by the potential for a further blow-up in Greece where agreement on the detail on the second bailout is proving difficult to achieve, and where there remains considerable doubt about the ability of the Greeks to deliver on its fiscal targets.

Meanwhile, incoming survey data confirm that the growth deceleration has extended into the third quarter. Both the ESI and composite PMI have fallen sharply in July/August relative to Q2 levels, with the recent deterioration suggestive of a hit to business confidence from the escalation of market tensions. The composite PMI – a reliable guide to the euro area business cycle - is now at levels that historically have been consistent with quarterly GDP growth of just 0.1%. Indeed, with indicators suggesting that growth may be hovering close to zero, it would be wrong to rule out the possibility of a quarterly contraction in GDP at some point in the near term.

It is against this backdrop that ECB staff are working on an update to their economic projections ahead of next week's September meeting of the Governing Council. As mentioned above, Trichet has already signalled that the inflation outlook is under review, and we also expect changes to the ECB view on the growth outlook. The latest set of forecasts was in June and revealed an expectation for GDP growth of 1.9% for 2011 and 1.7% for next year. The key one to watch here will be the view on growth for next year, as a downgrade to the 2012 outlook would be an important indication of a switch from a tightening to a neutral bias.

The prevailing consensus, which usually serves as a reasonable benchmark as to what to expect from the staff forecast, is currently for 1.4% growth next year pointing to an inevitable lowering of the staff projection. In fact, our own view is somewhat more cautious still at 1.1% for next year after an expected 1.6% for this year. That would correspond to average quarterly growth of 0.3-0.4% over the course of 2012. Despite a stronger headwind from additional fiscal tightening announced recently by a number of countries including France, Italy, Spain, Greece and Portugal, the outlook receives some support from the ongoing expansion of global activity, while consumer spending will receive some support from a boost to purchasing power arising from lower inflation (HICP looks set to fall to around 1.6% by next April from as high as 2.8% as recently as

April).

Nonetheless, this much more subdued outlook for the euro zone economy is consistent with the ECB abandoning its plan to normalise the interest rate environment and moving to a prolonged period of rates on hold. We now expect the ECB to leave official rates unchanged at their present level of 1.5% until the final quarter of next year. At that point, we expect there to be clearer signs of both a resolution of the debt crisis and a resumption of somewhat stronger economic growth – a combination that will see the ECB return to the path of policy normalisation.

In thinking about the risks to this base case, it would be wrong to rule out the possibility of a rate cut in the interim, though it would likely take an extremely serious deterioration in economic and or financial conditions to see the ECB reverse either or both of the two rate hikes it has implemented since April. In the other direction, history tells us to never underestimate the hawkishness of the ECB. So in the event that the macrofinancial environment proves more resilient than we currently expect, then a resumption of the ECB's hiking campaign will occur well before the back end of next year.

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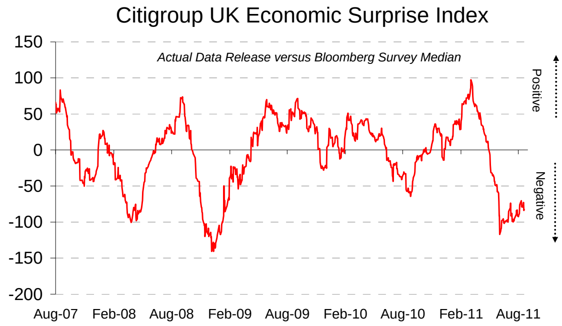
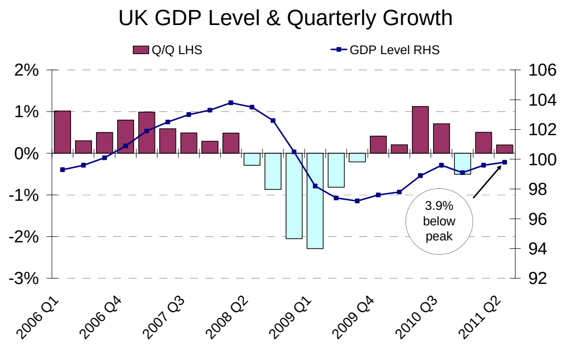
Since May UK economic data has steadily come in weaker than expected …



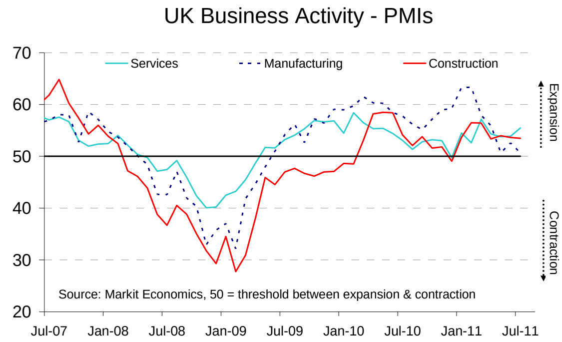
…with meagre GDP growth of just 0.2% q/q in Q2 2011…



The UK Economy and MPC Outlook

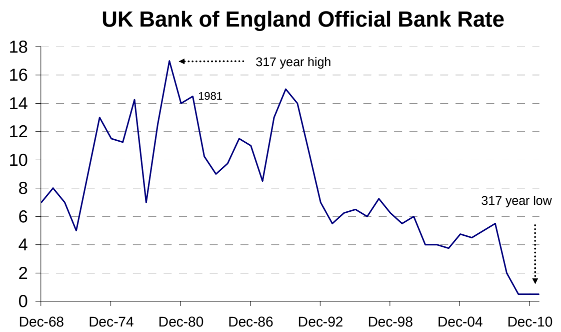
Like economies elsewhere, the UK economic recovery has proved to be much weaker than anticipated with the majority of economic releases over the last quarter surprising to the downside. Arguably the biggest disappointment has been the poor GDP economic growth data. Following the UK's shock decrease in Q4 2010 GDP of 0.5% q/q, the economy rebounded by the same amount in Q1 2011. However, this was followed with a rather meagre 0.2% q/q rise in Q2. Whilst this was in line with consensus opinion at the time, it remains well below the pre-recession trend rate of growth (0.7%). However, had it not been for some temporary factors *(the additional bank holiday for the royal wedding, the royal wedding itself, the after effects of the Japanese tsunami, the first phase of Olympic ticket sales and record warm weather in April)* the economic growth rate would have been a more respectable 0.7% q/q. Nonetheless, if the UK economy is to claw back the lost output from the recession in any meaningful sense it requires a sustained period of above trend growth. The UK economy is still waiting to record such a reading since the recession ended, which is uncharacteristically weak for any UK post-recession recovery. Indeed, looking ahead in the coming quarters we expect the weaker international environment coupled with the ongoing fiscal consolidation to keep this sub-trend profile of 0.4 / 0.5% q/q well into the second half of 2012.

…but poor Q2 performance due to temporary factors. Modest acceleration in growth anticipated in Q3…



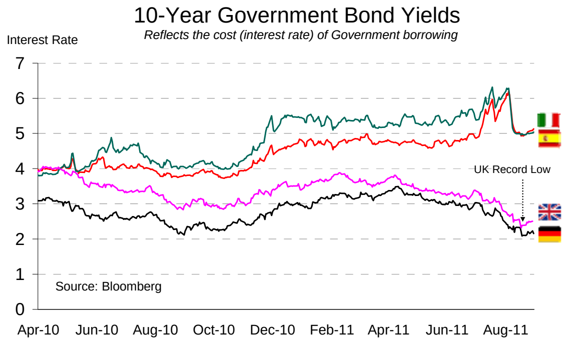
At an industry level, the main driver for growth was the services sector which posted a 0.5% q/q rise in Q2. Although this represented a slowdown relative to the 0.9% print in the previous quarter. The construction sector also recorded a 0.5% q/q rise. Meanwhile, industrial production declined sharply (-1.6% q/q) largely due to a major decline in the energy component with UK manufacturing recording its first decline in seven quarters with a 0.5% fall. However, this was largely linked to the supply chain disruption stemming from the Japanese Tsunami. A rebound in Q3 is anticipated. Looking at the timeliest indicators of economic activity, the PMIs, it is clear that growth is continuing, albeit with some loss of momentum, particularly within manufacturing. This is hardly surprising given the wider slowdown in global manufacturing as a whole. It is noted that the new orders component of the manufacturing PMI has dipped below the 50 threshold *(denoting contraction)* for each of the last three months to July. Conversely, the new orders component within the construction and services PMIs signal continued and robust growth over the corresponding period. Looking ahead, with sterling set to strengthen over the year ahead, exporters will not have the same exchange rate tailwind that they have enjoyed over the last two years or so.

… a lack lustre recovery has led to calls for a fiscal 'Plan B'. Economic & fiscal parallels with Thatcher in 1980/81. But, back then Bank Rate was coming off a 317 year high…

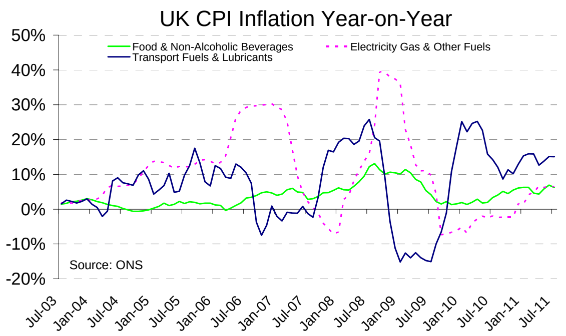


Given the lack lustre recovery there have been calls for further stimulus. Almost 31 years since Margaret Thatcher's uttered one of her most memorable lines *"The lady's not for turning."* Thatcher's determination to stand firm against opposition to her liberalisation of the economy radically re-shaped the UK. Today, the deficit – currently the largest ever in peacetime ever - is bigger than in 1980 but in many respects, George Osborne finds himself in a not dissimilar position to Thatcher. Like economies elsewhere, and as in 1981, the UK economic recovery has been much weaker than anticipated. Against this backdrop, a view in some quarters is that the public expenditure cuts are too deep and too fast with a clamour for a fiscal 'U-turn' or 'Plan B'. From the outset, however, it is worth noting that the UK's fiscal plans are much less draconian than those being implemented in other parts of the euro zone periphery. A difference between now and the early 1980s is monetary policy. When Margaret Thatcher came to power in 1979 the official Bank of England Bank Rate hit its highest level (17%) since 1694 and averaged 14.5% in 1981. The latter was above the prevailing RPI inflation rate at the time. Meanwhile, George Osborne has had the benefit of interest rates being at 317-year lows and below the rate of inflation.

… Osborne '*is not for turning'* as his fiscal plans have triggered a fall in debt interest to record lows. Monetary policy 'Plan B' already underway …



… UK households feeling the squeeze. Cutting VAT could make things worse, as a weaker currency would trigger a rise in imported inflation …



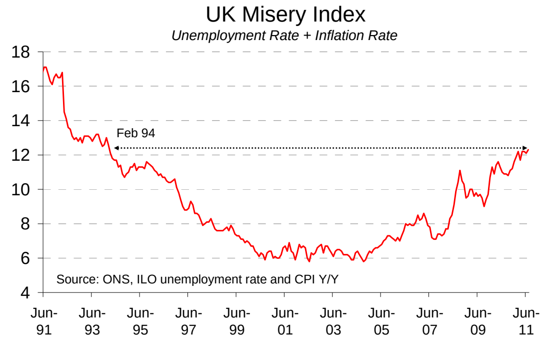
Speaking just a few weeks ago, the Chancellor stated that *"the events of the past month are a vindication of the Coalition's decision to get ahead of the curve, and they demonstrate the reckless folly of the alternative route…….The alternative of more spending and yet more borrowing is now frankly ludicrous and places those who advocate it on the outer fringes of the international debate."* This suggests that George Osborne will not radically change course in a hurry and any changes in next year's Budget are likely to be tweaking at the margins. Indeed, looking at the financial market chaos in the euro zone and the credit rating downgrades for the US and Japan; the UK, by comparison, has been a sea of tranquillity with sterling benefiting from this new found *'safe-haven'* status.

Clearly, there are compelling economic and financial reasons why Osborne should stick to his guns. At the time of the general election last year, the cost of issuing 10-Year government debt was around 4%. Now, it is 2.5%, a significant reduction of 1.5 percentage points on the UK's debt interest payments and recently hit a record low. This represents tangible payback for the UK's fiscal strategy so far. Conversely, over the same period, the cost of government borrowing within the euro zone *(excluding Germany*) has increased dramatically, increasing debt interest payments in the process. By way of comparison, the equivalent rates in Italy and Spain are 5.1% and 8.5% for Ireland.

It has been suggested that VAT should be reduced to act as a stimulus. However, VAT is one of the largest revenue generators and cutting VAT is simply not affordable and would lead to a loss of market confidence in the sustainability of the public finances. The same would hold true if the public expenditure cuts were softened. Arguably, such a scenario could trigger even greater difficulties. The likely chain of events would be as follows: the UK would lose its coveted *'Triple A'* credit rating, debt interest payments would rise significantly, sterling would weaken, imported inflation would increase *(notably food & energy),* the MPC would have to raise interest rates, the cost of mortgages would rise and disposable incomes fall. Essentially, the MPC keeping its bank rate lower for longer is the UK's 'Plan B'. That is, monetary policy will be set to ensure 'Plan A', addressing the largest peacetime deficit ever, is delivered. As Sir Mervyn King highlighted earlier this year tackling this deficit has to be Plan A.

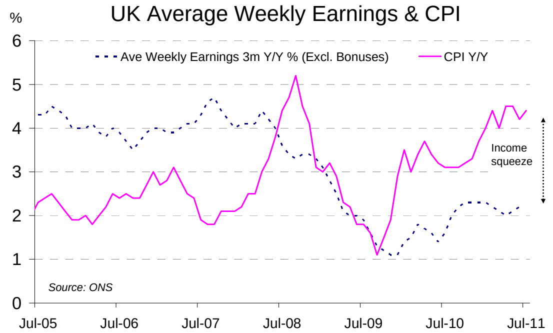
Interest rates lower for longer would be very much welcomed by a beleaguered UK consumer. Both inflation and unemployment continue to push higher with further increases anticipated during the months ahead. The 'Misery Index' refers to the sum of a country's inflation and unemployment rates. The UK Misery Index recently hit 12.3 its highest level since February 1994. This comprised of an ILO unemployment rate of 7.9% in Q2 2011 & CPI inflation of 4.4% for July. The misery index is further evidence of the ongoing human recession and explains why consumer confidence and spending are so subdued. Unemployment is set to climb higher and peak at or close to 8.5% next year. Both the claimant count *(dole)* and ILO unemployment measures have been above market expectations. For example, the claimant count has risen steadily this year and exceeded City forecasts in each of the past five months. A lack lustre recovery is only part of the story. The bulk of the increase in jobless claims can actually be traced to changes in welfare eligibility as opposed to job losses. This trend is set to continue with more changes to welfare reform still to feed through into the figures. As a result, UK unemployment is set to rise as individuals move from one welfare register onto another, but this should not necessarily be interpreted as a further deterioration in economic conditions.

… UK 'Misery Index' at its highest level since February 1994…



Nevertheless, the combination of unemployment remaining relatively high coupled with rising inflation will continue to act as a dampener on consumer spending with retail sales volumes remaining broadly flat over the last year. Even for those remaining in paid employment, it is clear that average earnings are not keeping up with inflation. For example, in the 3 months to July 2011, average earnings *(excluding bonuses)* increased by just 2.1% y/y. The net result of this is a squeeze on disposable incomes which is set to continue for some time yet. Indeed, according to the Bank of England's latest Quarterly Inflation Report *(August)* CPI inflation is expected to rise towards 5% y/y in the coming months as a result of energy prices feeding through.

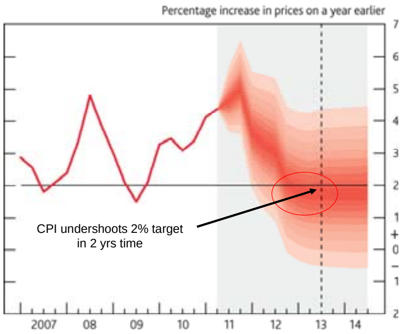
… Inflation-Earnings gap has been widening since recession ended …



Thereafter, inflation will start falling back at the turn of the year. A key difference between the August QIR and the previous report in May concerns the projection for CPI inflation at its target horizon – two year's ahead. Unlike in May, the MPC now expects an undershoot, rather than an overshoot, at the all important 2-yr target horizon. A CPI undershoot of 1.7% under the market rates assumption, which projected no change in bank rate until Q4 2012. The implication here being the BoE is now in no rush to raise interest rates. More recently, the August MPC minutes revealed that the balance of risks to inflation now lie to the downside with all nine MPC members voted unanimously in favour of no change in policy. It is noted that the BoE growth and inflation forecasts do not include the impact on the UK economy from a further serious economic and financial disruption. Such a scenario would incur an even greater undershoot and raise the possibility of further monetary stimulus in the shape of another round of asset purchases or quantitative easing (QE). Indeed, the August minutes reveal that some members, besides Adam Posen *(who currently advocates for more QE)* considered the case for additional policy stimulus and such a measure may become warranted if the downside risks materialise.

…but CPI inflation is set to undershoot MPC 2% target implying interest rates on hold for longer…

CPI inflation projection based on market interest rate expectations and £200 billion asset purchases



…CPI undershoot even with markets assuming no rate rise until Q4 2012. This has led some to believe interest rates are on hold until 2013…

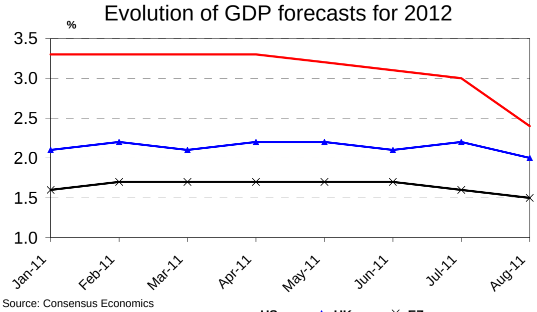
Conditioning path for Bank Rate implied by forward market interest rates[a]

Per cent

	2011		2012				2013				2014		
	Q3[b]	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
August	0.5	0.5	0.6	0.6	0.7	0.8	0.9	1.0	1.2	1.4	1.5	1.7	1.9
May	0.7	0.8	1.0	1.2	1.5	1.7	2.0	2.2	2.4	2.6	2.8	3.0	

(a) The data are fifteen working day averages of one-day forward rates to 3 August 2011 and 4 May 2011 respectively. The curves are based on overnight index swap (OIS) rates.
(b) August figure for 2011 Q3 is an average of realised spot rates to 3 August, and forward rates thereafter.

… UK forecasts revised down as external environment weakens…



Source: Consensus Economics
Horizontal axis = date of forecast

The latest BoE inflation report also downgrades the prospects for economic growth, which follows the steady stream of revisions by various independent economists. In the MPC's view the weakness in economic activity is likely to be more persistent than previously expected. We concur with the MPC view of a modest recovery in growth over the next four quarters. We do not foresee a 'double-dip recession' whereby the UK experiences two consecutive quarters of negative growth. However, avoiding a double-dip per se does not mean the recovery will be strong by any means. Overall, we expect UK GDP growth of 1.1% this year followed by 1.8% in 2012. An increase in exports, investment and modest growth in consumer spending (as inflation eases) will be the drivers of growth. However, the risks to this forecast lie to the downside. As noted by the MPC, the greatest risk to the downside stems from the euro-area, given the important trade and financial / banking inter-linkages between the UK and the euro area economy.

In our view, Plan B for the UK's economic recovery is already underway and it entails interest rates staying lower for longer while the Coalition deals with Plan A – the deficit reduction. Whilst recognising risks in both directions, we do not anticipate a rate hike until Q4 2012 (25bps). In our view, assuming rates will remain at their emergency low levels into 2013 is a bridge too far. However, should a change in policy be made within the next 9 months, it is more likely that it will be a further easing of policy (more QE) rather than a tightening. Should the recovery continue to falter 'Plan C' – more Bank of England asset purchases (*QE*) - will be implemented before any new fiscal policy measures are considered. Monetary policy will continue to do the heavy lifting for the UK's economic recovery.

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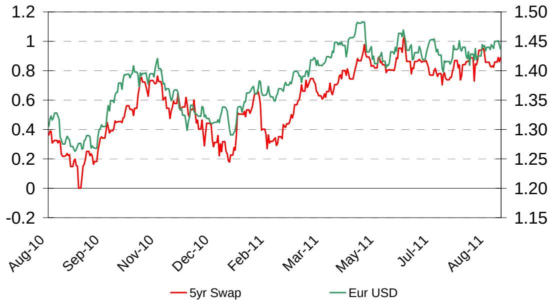
FX Outlook

Eur/USD

In recent weeks there has been no shortage of volatility within financial markets. However, this has been most apparent within equity markets and commodities. Currency markets, by comparison, have been relatively more stable. During the first half of 2011, the Eur/USD currency pair has been moving in one direction *(euro strength / dollar weakness).* A robust euro zone economic recovery, led by Germany, and above target CPI inflation fuelled rising interest rate expectations in the euro zone. In turn, this led to the ECB hiking rates in April, and again in July. By comparison, inflation pressures were not a concern in H1 in the US as the Federal Reserve not only kept its Fed funds rate on hold, but continued to provide additional monetary stimulus, in the shape of additional asset purchases (QE2) up until the end of June, to secure the economic recovery. Against this background, Eur/USD rose from $1.29 at the start of the year to a peak of $1.48 in May. Since May, however, the currency pair has broadly traded within a relatively tight trading range of between $1.40-1.45. The summer months saw sovereign debt concerns in the euro zone return to the fore with fears spreading beyond the periphery *(Portugal, Ireland, Greece and Spain)* to the core, namely Italy, which was euro negative.

Recent Eur/USD moves have been driven by interest rate differentials….

Eur/USD vs Interest Rate Differentials

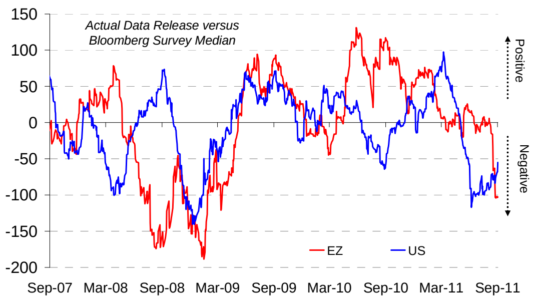


At the same time, a raft of weaker than expected economic data for the US, and more recently, the euro zone has led to a scaling back of economic growth expectations. As a result, interest rate expectations for the euro zone have been scaled back dramatically as the ECB pauses, temporarily, in its rate hiking cycle. For example, 5-yr euro swap rates fell by almost 90bps between early-July and mid-August. Meanwhile, the corresponding long-term interest rate for the US broadly fell by a similar amount. The key point, however, is that the relative change in US and euro zone interest rate expectations has largely stabilised. Thus one of the most important drivers of exchange rates, interest rate differentials, has been minimised, albeit temporarily.

US interest rate expectations are firmly pinned down at low levels for the years ahead following the FOMC's policy statement on 9 August. The latter signalled that the most likely outcome for the Fed funds rate target over the next two years is no change should the economic conditions warrant such a policy stance. In effect, this statement represents an easing in monetary policy, as expectations have been lowered over this 2-year time horizon. Whilst there is no change with the Fed funds rate for the foreseeable future, uncertainty remains over what additional policy options could be undertaken. Indeed, the latest FOMC minutes revealed that some committee members wanted to go further with a more aggressive policy response. This raises the possibility of a third round of quantitative easing, or QE III, should economic conditions deteriorate further in the months ahead. Such a move would clearly trigger a further bout of dollar weakness. But, it should be noted that financial markets have already partially priced in such a scenario. Therefore not embarking upon more QE would be dollar positive.

…US economic data has started to improve whilst the converse holds true for the euro zone…

Citigroup US & EZ Economic Surprise Index

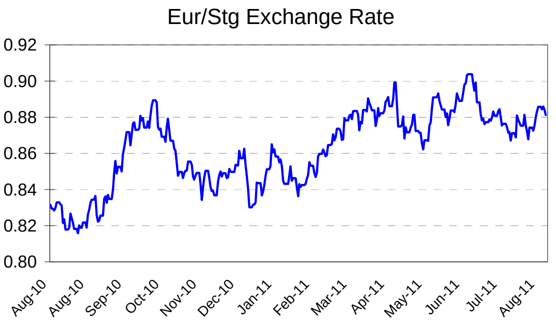


Whilst acknowledging that there is a significant risk of such a move we believe the hurdle for QE III is extremely high. Not least as the Fed's preferred measure of inflation is rising at 1.6% y/y. Furthermore, in our view, there is an overly pessimistic view of the strength of the US economic recovery which was triggered particularly by the surprisingly weak Philly Fed survey. Since then, however, there have been some stronger than anticipated economic data, not least in terms of the July consumer spending figures.

We anticipate further signs of improvement in the US economy in the coming months which will provide further support for the dollar as the prospect of more QE recedes going into 2012. The euro is also expected to come under more pressure over the next 6 months with a heightening of concerns over Greece and a credible policy resolution to the wider euro zone bailout fund. Forecasting when and what will be agreed enters the realms of forecasting politics. Ultimately, however, until credible action such as the creation of a joint euro zone bond, is undertaken the euro will remain under pressure. Against this backdrop we expect Eur/USD to push lower in coming months, $1.42 by year-end and sub-$1.40 by mid-2012. At this point, we expect a political resolution to the wider euro zone funding issues to be in place. This factor, alongside an increase in euro zone interest rate expectations relative to the US, will see the single currency strengthen against the dollar by year end and back around the $1.44 mark. Whilst we anticipate the ECB to resume its rate hiking in Q4 2012, there is a risk that the next move may come even earlier.

EUR/STG

Eur/Stg has remained within a 86p-90p trading range since March…

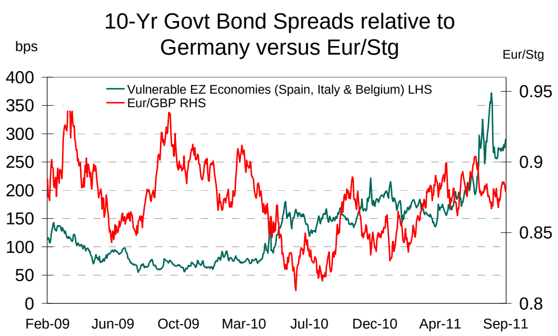


The broad direction of the Eur/GBP currency pair, as with Eur/USD, was upward during H1 2011. Interest rate differentials were the key driver during this period. With the euro zone experiencing a more robust economic recovery *(relative to the UK)* and a more hawkish central bank, the rising interest rate differential, or yield, pushed Eur/GBP to a 16-month high at the end of June (90.3p). As in July 2010, however, July 2011 witnessed renewed concerns over the sovereign debt issues in the euro zone. This time around the focus was not on the periphery but contagion had spread to Spain and Italy. This renewed stress, alongside signs of a slowing euro zone economy, pushed the euro back below 87p. However, the downward move in Eur/GBP was not as marked as last year, partly because the ECB remained in rate hiking mode *(July rise)*. Conversely, the BoE continued to sit on its hands. This dynamic was clearly more supportive of the euro than sterling with a trading range in recent months of 86.5-90p.

Looking ahead, we expect the Eur/GBP currency pair to embark on a downward trend during the coming quarters. There are a number of factors that support this view. With the ECB and BoE both expected to keep interest rates on hold for the foreseeable future, interest rate expectations are not going to be a major driver of the currency moves. Instead, there will be a greater focus on the economic fundamentals and wider public finance issues. The trajectories of the economic recoveries of the euro zone and the UK are beginning to move in different directions in Q3. Following the UK's meagre 0.2% q/q growth rate in Q2 this is expected to accelerate, albeit modestly, to around 0.4% in Q3. Conversely, the euro zone's growth rate is expected to slip from 0.2% to 0.1% over the corresponding period with a negative outturn a live possibility. Over the coming quarters this differential growth pattern is set to continue with euro zone growth expected to ease from 1.9% this year to 1.5% next year, according to the latest consensus forecasts. Meanwhile, the corresponding projections for the UK *(which are slightly above our own forecasts)* are for growth to pick-up from 1.3% in 2011 to 2.0% in 2012.

…Recently there has been a negative correlation between strains in vulnerable EZ economies *(Spain, Italy & Belgium)* and Eur/Stg, a feature that should continue going forward…

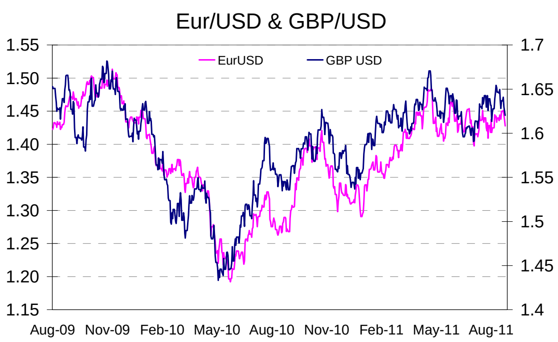
The other key difference between the UK and the euro zone concerns how their respective fiscal deficits are being tackled. Initially, the UK's fiscal austerity plans were viewed as a negative for sterling. However, financial markets still view UK as well ahead of the euro zone and the US in tackling its fiscal problems. Indeed, the UK section earlier highlighted the healthy demand for UK government debt, with 10-Yr gilts recently posting a record low. The euro zone, on the other hand, has not received a vote of confidence from the markets and a further intensification of its sovereign debt woes is expected in the coming months. As a result, we envisage a breakout of the recent 86.5-90p trading range in Q1 next year with 85p targeted. Even assuming a credible solution to the euro zone's fiscal difficulties is found within the next six months, we still anticipate Eur/GBP to push lower towards year-end 2012. Assuming the sluggish UK recovery continues as expected, and additional monetary stimulus is not required, interest rate expectations should begin to rise at a faster in the UK relative to the euro zone as we progress through 2012. After all, the ECB already has two rate hikes under its belt whereas the Bank of England has to play catch-up. In light of the analysis above, we target 83p by the end of 2012.



GBP/USD

…GBP/USD has largely followed the same pattern as Eur/USD……..

Over the last six months the bulk of the price action has seen the GBP/USD currency pair trading within the $1.60-1.65 range. During the summer months, the recent low in GBP/USD ($1.59) coincided with the recent dip below $1.40 for Eur/USD. Traditionally the dollar benefits when concerns over growth start getting shaky elsewhere. This was apparent last month during the roller-coaster ride on equity markets when the capital flight to US Treasuries provided support for the dollar. Dollar gains were also apparent in July when the euro zone sovereign debt issues came under the financial market spotlight again. Not surprisingly, concerns over the euro area's prospects, particularly when contagion spreads from the periphery to the core, are sterling negative. As Sir Mervyn King noted at the recent Bank of England Quarterly Inflation Report (QIR) press conference, *"the greatest risks to the prospects for global demand come from the euro area".* From a UK perspective, this is particularly relevant given its exposure to trade and banking



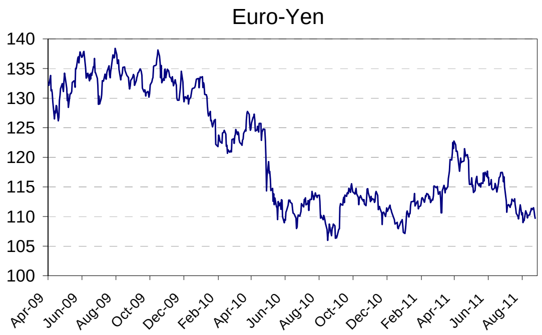
sector exposure within the euro zone. Indeed, the August QIR focussed specifically on the potential impact from the euro area. For example, almost half of UK exports go to the euro area. Furthermore, UK banks have substantial exposures to France and Germany, which in turn are exposed to the euro zone periphery.

We expect sterling to remain towards the lower end of its recent $1.60-1.65 trading range in the short-term. The major upside risk to this forecast is the Fed embarking upon QE III which would be dollar negative and therefore pushing GBP/USD higher. Looking further ahead into H2 next year, we anticipate GBP/USD to break out of its trading range and target $1.75 by year-end 2012. Two key factors will facilitate this. First, the Bank of England, in our view, will be actively tightening monetary policy at this stage, unlike the Fed, and this will be preceded by a widening in the interest rate expectations differential. Second, mounting concerns over the public finances of the world's largest economy are likely to put the greenback on the back foot moving into 2013.

EUR/JPY

The Eur/JPY currency is often seen as a barometer of risk appetite. During times of risk aversion, the Japanese yen and Swiss franc are traditionally the two currencies that prosper. In H2 2008, the global recession coupled with the collapse of Lehman Brothers pushed the Eur/JPY currency pair from Y170 in July to sub-Y114 in October of that year. Risk appetite remained strong during the first half of 2011, apart from a brief spike in risk aversion following the Japanese tsunami and nuclear reactor explosion. However, in recent weeks risk aversion has retuned with the euro zone sovereign debt crisis in July and subsequent slide in equities in August sending the Japanese currency higher and Eur/JPY therefore lower. The return of risk aversion saw Eur/JPY break out of its Y114-118 trading range in May and June to a low of Y109 last month. Given the fragile state of the Japanese economy, a strong yen is the last thing exporters need following the disruption from the tsunami earlier in the year. The Japanese authorities have responded by intervening in the currency markets in an effort to weaken the yen. To date, however, this has had limited effect with Eur/JPY struggling to stay above Y110. Given our expectation for renewed stresses and strains related to sovereign debt issues in the euro zone in the coming months, we anticipate a break out into a new lower trading range of Y101-108 for the next 12 months or so.

Eur/JPY continues to be closely correlated with risk appetite…



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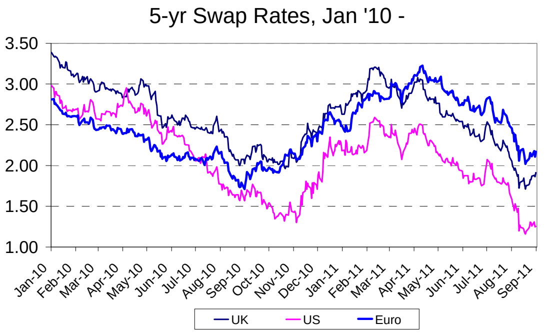
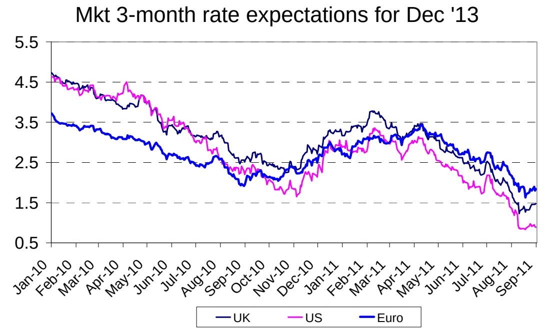
Long-term Rates Outlook

The past year has seen major swings in 5-year swap rates, with rates hitting all-time record lows across the board in the process …



…the big moves have their origins in large shifts in market interest rate expectations …



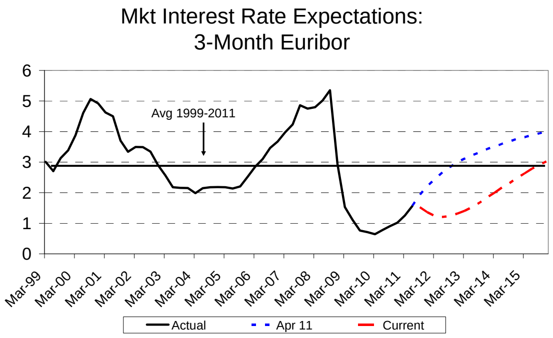
It has certainly been a volatile year for interest rate markets. About a year ago, markets were very much focussed on concerns about a mid cycle economic slowdown, and the possible implications for monetary policy in the major economies. The Fed did end up expanding its asset purchase programme by deciding at its November 2010 meeting to engage in a second bout of quantitative easing. As expectations mounted ahead of that announcement, long-term interest rates across the major markets tumbled as the prospect of Fed buying of US government debt resulted in sharp declines in bond yields in the US and elsewhere. While no additional policy easing took place in either the UK or the euro zone, long-term rates also fell sharply in these markets as markets pushed out into the future the timing of any policy tightening in these economies. The result was that 5-year swap rates fell to new all-time record lows of below 2% in euro and sterling markets while those in dollars also tumbled to new lows of sub 1.4%.

But the Fed policy loosening triggered an improvement in both financial conditions and the trajectory of the US economy which regained momentum over the latter part of last year and into the early months of 2011. Growth elsewhere also became better-established and global inflation pressures became increasingly evident as strong global demand (especially from emerging markets) was exerting strong upward pressure on energy and other commodity prices. Geopolitical tensions in North Africa and the Middle East added to the upward pressure on wholesale energy prices, with Brent crude oil prices hitting $127pb in April, up considerably from the $80-90 range which prevailed a year earlier.

Reflecting the signs of economic recovery in the euro zone and the emergence of stronger inflation pressures at the global level, the ECB became the first of the major central banks to begin the process of tightening its monetary policy stance, with two rate hikes of 25bps delivered in April and July. Having left rates on hold at their all-time record low of 1% for nearly the previous two years, the change in stance at the ECB generated large upward pressure in long-term interest rates in the euro zone as markets moved to price in both the moves which were duly implemented, and a further normalisation of the interest rate environment. With the average level of rates since the ECB was formed in 1999 at about 2.75%, markets had by the time of the first hike in April anticipated a continuation of a process of normalisation in the period ahead. Indeed, in early April 5-year euro swap rates had risen to over 3.2% from their record low in September 2010 of around 1.65% reflecting such expectations. Swap rates were also upward pressure elsewhere earlier in the year, with sterling 5-year rates breaching the 3.2% level in February, and those in dollars flirting with 2.6% at around the same time.

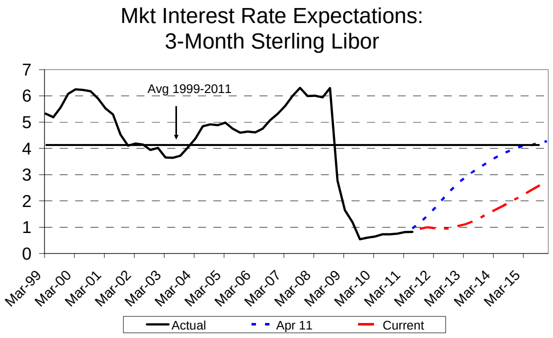
However, recent weeks and months have seen a deterioration in the incoming economic data, an escalation of the Eurozone debt crisis and a deterioration in global financial conditions more broadly. The early-August ECB press conference retained a hawkish slant as inflation risks were still seen to lie on the upside. However, in a late-August speech at the EU Parliament, Trichet stated that the inflation outlook was now under review, implying a rethink about the near-term outlook for policy. In our view, the combination of escalating risks from the sovereign debt crisis as well as an ongoing loss of momentum in the real economy both within and outside the euro area mean that the ECB will not be able to implement the rate normalisation process to the extent and timeframe that they had previously envisaged.

…Relative to earlier this year, markets are now priced for rates to be lower for longer in the euro area…



Markets agree and there have been sizeable shifts in market interest rate expectations over the past four months. At present, 3-month cash in euros for delivery in December 2013, for example, is priced at about 1.8% in the futures markets, down considerably from the levels of around 3.4% seen in early April, and a mere 0.25% higher than the current level of the 3-month Euribor rate itself. Equivalent sterling and dollar markets have seen even larger moves (of over 2%) from levels seen earlier in the year, supported by recent dovish guidance from the Fed and Bank of England and the possibility of more monetary stimulus in those economies.

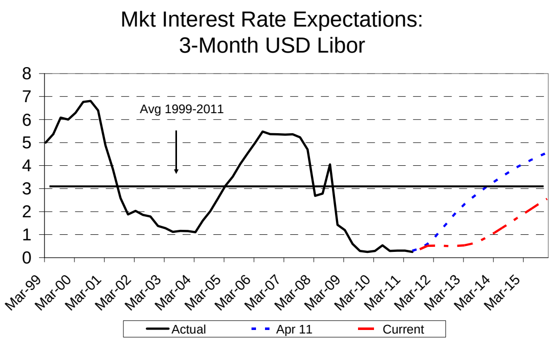
…in the UK …



Such shifts in interest rate expectations have imparted considerable downward pressure on long-term rates reflecting the likelihood of short-term rates being kept lower for longer. In euros, 5-year swap rates have fallen by about 1% in the past four months to stand at around 2.1% at time of writing. 5-year sterling and dollar rates have fallen by about 1.4% - moves which have taken them to 1.85% and 1.25% respectively, having hit record lows of below 1.7% and 1.1% respectively in mid-August.

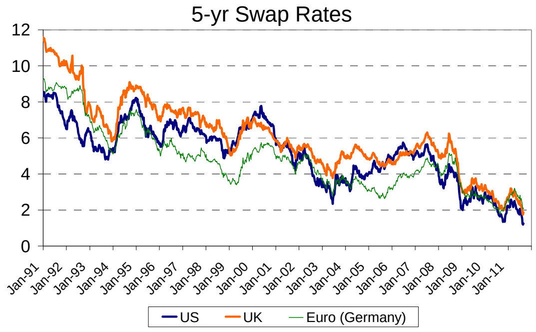
Looking head, 5-year rates may well be subject to some further downward pressure in the period ahead reflecting the still-present risk of some further deterioration in incoming economic news and / or another bout of financial market turmoil linked to the European sovereign debt crisis (see Euro section above). In particular, our expectation of renewed deterioration in financial conditions in the months ahead leaves us favouring a scenario in which both euro and sterling swap rates come under further downward pressure.

…and in the US …



We expect to see 5-year rates in euros return to below the 2% level by year-end, and sterling rates to get back to their record lows of around 1.7%. In both cases, such levels would in our view represent a strategic opportunity to hedge interest rate risk at what would be extremely low levels of long-term rates. Even at current levels of around 2.1%, 5-year euro rates are within 0.5% of their all-time record lows, and they are a full 1.7% below the average level which has prevailed since the euro was formed in 1999. Indeed, over the lifetime of the euro, apart from the dip to the record low last year they have never been lower (the previous low was 2.6% seen in 2005 and 2009). Similarly, the long-run (since 1999) average of sterling 5-year rates is 4.8% - nearly 3% higher than current levels.

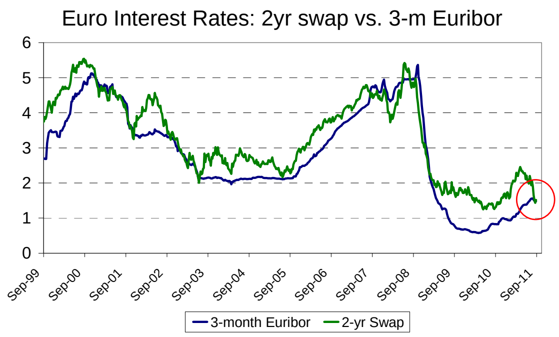
…while euro and sterling swap rates may come under renewed downward pressure in the short term, we expect them to rise over the course of 2012 from what are extremely low levels historically…



We don't expect such rates to be maintained indefinitely, however. And indeed, there is no guarantee that swap rates do decline as we currently think is likely. In particular, each time we contemplate a refresh of our forecasts for ECB interest rates we consciously force ourselves to repeat the mantra: "never underestimate the hawkishness of the ECB"! Earlier this year provided another example of its tendency to surprise in a hawkish direction, as the shock re-introduction of the phrase 'strong vigilance' at the March press conference jolted markets into another reality check given the prevailing expectation that any rate hike was unlikely until later in the year.

In any case, our expectation that global recovery (albeit a sluggish one) will be sustained into and through 2012, implies that markets are likely to gradually begin pricing in some degree of normalisation in the interest rate environment over time. Hence, our forecast anticipates that swap rates will be on a rising trajectory over the course of next year. We are pencilling in increases of about 1 to 1.5% in each of the three main markets. Even if markets remain convinced that any policy tightening from the central banks is some way off into the future, indications of recovery will likely prompt a re-pricing of longer-term rates well ahead of any explicit change in guidance from the central banks. After all, 5-year rates incorporate the current three month rate and the expected string of three-month rates over the following nineteen quarters. In this context, it is worth reiterating that it is simply not realistic to think that one can succeed in picking market turning points, with the volatility in rates markets over the past year offering a timely reminder on this front. In our view, the objective should not be to defer any hedging decision until one is convinced that the precise absolute low point in rates is upon us. So, in the current environment, while tactically we think that Treasurers may get better levels in the months ahead with which to hedge outstanding interest rate exposure, it is important to retain a strategic focus in managing interest rate risk.

…Unusually, 2-year swap rates (at around 1.5%) are trading slightly lower than 3-month Euribor offering a low-cost hedging opportunity for those looking to gain some certainty about their interest costs over the coming twenty four months



Finally, experience tells us that those with debt to hedge are sometimes put off by the fact that long-term rates are normally higher than prevailing short-term rates or cost of funds. In this respect, we note that current 2-year swap rates at around 1.5% are actually a touch lower than the prevailing three month Euribor rate of 1.55% offering a low-cost hedging opportunity for those looking to gain some certainty about their interest payments over the coming twenty four months.

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