## Forecast for Interest Rates - June 2011

### SUMMARY OUTLOOK

The key question is how quickly, and strongly, will the UK economy respond to the positive stimulus from low Bank Rate, quantitative easing and the devaluation of sterling?

Negative growth of -0.5% in Q4 2010 was a huge shock; +0.5% (quarter on quarter) in Q1 2011 meant that growth had been flat for six months. A marginal upgrading of Q1 growth figures will have only a marginal effect on the big picture for the UK but there is considerable uncertainty as to how the UK economy will evolve in the coming months.

US Q1 growth of only 1.8% (on an annualised basis) was also a disappointment despite non-farm payroll data showing improvement.

China and India have embarked on a major thrust to cool their over-heating economies and so may depress the rate of world economic growth.

An anaemic economic recovery is probably the most likely outcome in the UK and US, after the initial rebound in 2010, for the next three to four years; recovery is likely to be slower and more protracted than normal business cycle recoveries as this is a financial crisis recovery where lack of credit is still stifling growth.

The Bank of England is likely to determine that further increases in CPI in 2011, towards 5%, as being due to one off factors that will drop out of the index within 12 months, so underpinning the view that inflation will be back to near target within a two to three year time horizon.

This does assume that raised inflation expectations do not feed through into a significant increase in the general level of wage settlements.

There has been a significant erosion of the confidence of financial markets in the EU handling of the peripheral debt crisis. There is now a major and escalating risk that the Greek, Irish, Portuguese debt crisis may not be contained and could lead to debt restructurings that could do significant damage to banks which already have weakened balance sheets. It is worth noting that many western governments have already exhausted their capacity to increase government debt to again bail out banks further damaged by any such future events and to counter the dampening of economic growth that would follow.

### UPSIDE RISKS TO CENTRAL FORECAST

Bank Rate cuts do finally succeed in feeding through to stimulate a strong economic recovery.

A major increase in UK exports due to the circa 20% depreciation of Sterling over the last two years and import substitution by UK produced goods and services - assuming a reasonably strong economic recovery in US, EU and emerging markets

Corporate profitability has improved considerably since the recession due to cost cutting; many larger corporate balance sheets are now awash with cash. This could fuel an increase in investment expenditure and also M&A (merger and acquisitions) activity i.e. drive share prices higher and give investors a feel good factor (to spend more?)

### DOWNSIDE RISKS TO CENTRAL FORECAST

Chinese and Indian economies are now over-heating; Chinese authorities spooked by inflation over 5%. The Chinese central bank has raised the central rate four times and increased bank reserve requirements six times since October 2010 to curtail bank credit

creation capacity. This could lead to increased volatility or an outright fall in commodity prices.

UK emerging market funds are finding it difficult to place the huge investment cash flows they are receiving; Chinese investors with surplus cash are investing it in property and shares as if it is a one way bet! Ideally, there needs to be a rebalancing of Chinese spending on retail sales as opposed to the creation of asset price bubbles in property and shares.

US economy has disappointed in Q1 2011 limping along at 1.8% annual growth rate after a strong Q4 2010 at 3.1%

US (and UK) have exhausted their capacity for any further fiscal stimulus for their economies

US is still not even on the starting line for dealing with cutting back a massive annual fiscal deficit; cut backs to come are likely to dampen the economy further

Banks have major risk exposure to a fraught housing market where house prices have gone down 8.2% in the 12 months to April 2011, have fallen 29.5% since the peak in June 2006, where 29.5% of mortgages are now in negative equity and there is no imminent turn around in sight for the housing market

Peripheral European economies' crisis requires the European Central Bank to adopt a more pragmatic stance to debt restructuring: the longer the delay, the bigger the potential fallout.

UK consumer confidence at very low levels whilst major cuts in Government expenditure and public sector jobs still to feed through fully into the economy and to dampen growth over the next few years.

Despite the private sector creating more jobs than the public sector is cutting, the high current total level of unemployment of around 2.5m means that it will take several years to reduce total unemployment down to pre recession levels.

No significant growth in personal disposable income likely for a couple of years due to:

- Continuing wage freezes / low pay settlements
- Inflation exceeding wage increases so disposable income is being eroded
- Increases in taxation The UK growth forecast for 2011 was downgraded from 2.6% to 2.0% in the latest Inflation Report.
- Mortgagors coming off cheap fixed rate mortgage deals onto standard variable rates.

House prices have fallen to their lowest level since July 2009 and no turn around is in sight in the current economic climate.

Consumers are focused on reducing over-borrowing by repaying debt rather than spending and are fearful of eventual increases in Bank Rate sending mortgage standard variable rates (SVRs) up in parallel; rebuilding of consumer balance sheets will increase the savings ratio and depress consumer expenditure.

Banks are still heavily focused on rebuilding their balance sheets – RBS and Lloyds still have massive maturing wholesale borrowing to refinance; the Bank of England Special Liquidity Scheme (SLS) ends in Jan 2012; the BoE has lent £185bn to banks and building societies which must be repaid. The BoE has indicated there will be no extension of this timeframe for the SLS.

Eventual reversal of Quantitative Easing by selling gilts etc will take cash out of the economy and restrict credit growth; gilt sales will need to be sensitively timed considering the huge level of gilt sales already planned just to fund each year’s deficit.