

# ■ United Kingdom

UOB Economics Projections	2006	2007	2008F	2009F
GDP	2.9	3.0	1.3	1.0
CPI	2.3	2.3	3.6	2.3
Unemployment (4Q avg)	5.4	5.4	5.5	5.7
Current account (% of GDP)	-3.9	-4.3	-3.3	-3.0

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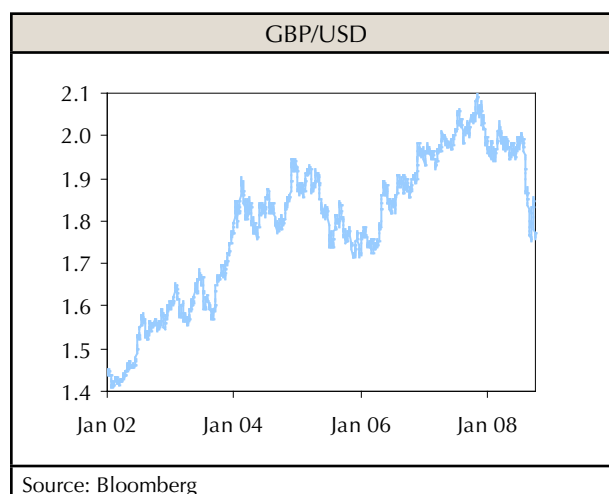
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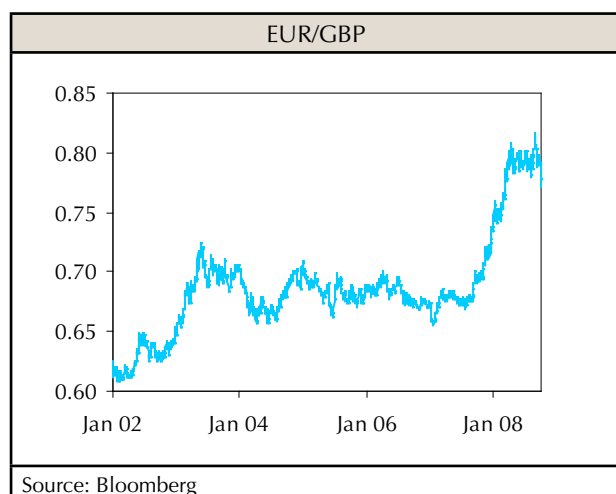
Cable traded in a wide range across the quarter exhibiting significant volatility, trending lower over the longer term but with periodic rebounds when data come in less soft than expected, with GBP/USD trading in the range of 1.7260-2.0058 over the course of the quarter. We had reiterated in our reports that Cable above or near \$2 was in clear defiance of fundamentals and Cable fell decisively below the \$2 level in 3Q08. Cable touched a 2.5yr low of 1.7260 on the back of arch dove Blanchflower's comments as well as continued signs of trouble in both the UK and European banking sector. Blanchflower had pointed to a deeper than forecast decline in the UK economy and a large rise in unemployment with several months of 60,000+ rises in unemployment and said that there was too much concern over 1 mth's inflation number and that it will fall sharply in the coming months.

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### Data Points Undoubtedly to Weaken Growth Although Inflationary Pressure Remains Elevated

2Q GDP data for the UK came in below expectations at 0.0%qoq (1.4%yoy) against expectations for a 1.5% qoq (0.1%yoy) reading and slowing from a 1Q reading of 0.3%qoq (2.3%yoy). Both private consumption and gross fixed capital formation showed signs of pressure and 2Q Business investment also slipped -1.9%qoq, way softer than the -0.7%qoq expected.

More timely data from the UK has continued to affirm the extent of the slowdown in the UK economy with the latest PMI survey data showing an unexpected improvement but continuing to point to contraction. Aug PMI manufacturing came in at 45.9 from 44.3 in Jul, PMI services ticked upwards to 49.2 from 47.4 and PMI construction also turned in higher at 40.5 from 36.7. Latest Sep PMI construction number however fell to 38.8 from 40.5, in line with the longer term trend of continued weakening. Jul Industrial production also came in soft at -0.4%mom (-1.9%yoy) against expectations for a -0.1%mom (-1.4%yoy) decline and from a prior revised numbers 0.1%mom (1.7%yoy).

The housing market continued to be under pressure with no clear sign of bottoming out. Aug Rightmove house prices fell a further -2.3%mom (-4.8%yoy) after falling -1.8%mom (-2.0%yoy) in Jul in its first annual fall since the series were started 6yrs ago. Aug Nationwide house prices fell for a 10th consecutive month registering yet another record drop since 1991 when the series began, falling -1.9%mom against expectations for a -1.5%mom fall and from a revised Jul reading of -1.5%mom, the yoy

rate came in at -10.5%yoy against expectations for a -9.6%yoy reading and from a -8.1%yoy reading. The latest Sep number also registered further declines coming in at -1.7mom. Another measure of the housing market also showed signs of slowing. Aug HBOS house prices fell -1.8%mom from -1.7% in the prior month, bringing the 3mth/yr rate down to -10.9%yoy from -8.8%yoy. The market also dismissed a government plan to exempt properties worth less than GBP175k from Stamp Duty for the next 12mths, up from GBP125k currently, as insufficient to address the property slump. The fall in house prices to their lowest in 2 yrs continues to prevent the BoE from raising rates despite rising inflation. With home ownership at about 2/3 of households, this is likely to show up on consumer spending.

The UK consumer continued to be under pressure as the housing market continued to deteriorate and Aug Jobless claim change rose for a 7th consecutive month by 32.5k from an upwardly revised 27.8k in Jul, above consensus for a 23.0k increase. The Jul Unemployment rate also edged higher to 5.5% from 5.4%. The Aug GfK index of UK consumer confidence also fell to a record low at -36 from -39, well below expectations for a -41 reading and 3Q BoE credit conditions survey showed that lending institutions cut back secured lending to households by more than expected in 3Q and expect to continue to scale back lending in 4Q. Aug retail sales however saw a rebound on back to school spending of 1.2%mom (3.3%yoy) from a 0.9%mom (2.0%yoy) reading in Jul after the surprise collapse in Jun UK retail sales falling -3.9%mom against expectations for a decline of -2.5%mom. The surprise collapse of Jun UK retail sales had initially added to worries that the credit tightening, housing market collapse as well as the high primary products inflation was spreading quickly to UK consumption.

Signs have also emerged that the UK has not been spared the credit fallout in the US. The UK FSA announced new provisions amid the global equity market sell-down in Sep to prohibit active creation or increase of net short positions and required daily disclosure of net short positions above 0.25% from Sep23 till 16Jan09 on publicly quoted financial companies. The UK government also gave the go ahead for the merger of Lloyds and HBOS, promising to rewrite competition laws to allow the \$22b all share deal to go through. UK bank HBOS Plc struck an all stock deal with Lloyds TSB to create a £28b mortgage giant. HBOS had come under increasing pressure as it was more reliant on wholesale markets to fund its business than other UK banks. HBOS is the largest mort-

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gage lender in the UK while Lloyds ranks 4th. The merger of Lloyds, UK's 5th largest bank and HBOS, 6th largest bank would have a 28% share of home loans and the biggest taker of savings and provider of current accounts. As a sign of the extent of the pressure faced by the UK economy, UK's finance minister said that at economic conditions were at their worst in 60yrs and the OECD singled out the UK economy as the only 1 of the G7 economies expected to contract in both 3Q and 4Q.

More recently, the UK also announced a £300b bailout plan for its banking system. UK said it would make £50b of new capital immediately available to retail banks using taxpayers' funds. The plan guarantees interbank lending by £250b with the aim of unfreezing wholesale markets and extends a BoE scheme which swaps banks' risky assets for government debt to provide £200b of cash to the system. 7 UK banks, Abbey, HSBC, RBS, HBOS, Barclays, Lloyds TSB and Standard Chartered as well as the UK's largest building society, Nationwide, have committed to increase their total Tier 1 capital by £25b in total as part of the government's scheme which would provide the UK government with a preference share capital interest in each of the banks but will in return give the UK government the right to require banks to meet certain terms and conditions that will include commitments to support small businesses and home buyers.

Against the backdrop of weakening growth, inflation continues to remain elevated. Aug CPI came in at an annual rate 4.7%yoy, the highest in a decade and more than double the mid-point monetary policy target. The month on month rate also rose above expectations to 0.6%mom against expectations for a 0.5%mom reading. Core CPI came in slightly above expectations at 2.0%yoy.

### **BoE Surprised the Market with a 50bps Cut to 4.50% on 8 Oct**

The BoE was among 6 major central banks to deliver a surprise collective policy cut of 50bps on 8Oct. The BoC, BoE, ECB, Fed, Risksbank, SNB lowered policy rates each by 50bps to end at 2.5%, 4.5%, 3.75%, 1.5%, 4.25% and a target range of 2-3% respectively. The Bank of China also cut its benchmark 1yr rates by 0.27%. The BoJ did not join in the action but said that it strongly supported the coordinated action.

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Prior to the coordinated policy move, the BoE had held interest rates steady across the quarter, as it held back cuts on the back of elevated inflationary pressures despite being weighed down by weak economic data from the UK which suggests that the BoE would eventually have to cut rates to revive the rapidly contracting economy.

There had also been little surprises from both the BoE rates or minutes with the Sep voting pattern coming in as expected 8-1. The BoE August minutes also registered an as expected 7-1-1 3-way split with Blanchflower inclined to a cut and Besley hike once again. The Jul BoE MPC minutes also showed a 3 way split vote of 7-1-1 with arch hawk Tim Besley voting for a 25bps rate hike and dove Blanchflower continuing to call for a cut. The 3 way split in our view had suggested that UK rates would be unlikely to move downwards as quickly as the market may have anticipated. We had opined that the absence of further support for either a hike or a cut means the BoE will remain on hold in the short term. However with the recent turmoil in credit markets and the failure and nationalization of financial institutions worldwide, we now bring forward our call for a rate cut and expect UK rates to be cut an additional 25bps by end of the year with risks tilted to rate cuts rather than hikes and expect more pressure on Cable as UK economic data continues to be dismal. We see the BoE as stuck between 2 devils and watch out for any deviation from the 7-1-1 or 8-1 voting pattern going forward with any additional support to the dovish Blanchflower camp likely to see Cable tumble further.

The latest BoE quarterly inflation report also surprised on the downside. The Aug BoE Inflation Report revised downwards the inflation profile for Y2, although the Y1 profile was revised sharply upwards. Growth projection for Y1 was revised down sharply but a recovery was expected towards trend in Y2. The BoE said that it saw economic growth as 'broadly flat over the next year or so' and Governor King said that there was a possibility of a 1quarter or two of falling output. We think the BoE will still be cautious in delivering aggressive cuts since should the projected inflation profile materialize, the BoE would have to write to the Chancellor again. Despite this, we are calling for an additional 25bps cut by year end in light of the recent financial market turmoil.