GBP/USD surged to 1.9080 as the weaker USD, juxtaposed by other factors such higher interest rates, carry trades and M&A flows pushed the local unit higher over Q3-06. Gain in GBP was broad-based, with GBP/JPY jumping to 223.58 while EUR/GBP slipped to 0.66964 in Q3-06. Resilience of the UK housing and consumer spending markets has been surprising, resulting in markets pricing in tighter monetary conditions in the months ahead. That, coupled with the USD under pressure as the Fed appears increasingly likely to cut Fed funds rates by year-end (25bps cut to 5% by Dec), the positive GBP/USD bias remains intact. Our central scenario is for GBP/USD to target 1.90 and 1.91 by end Q4-06 and Q1-07 respectively.

### Above Trend Growth in 2006

Since our last report, economic activity in UK has outperformed our expectations. The economy expanded 2.6% in Q2, led by household spending expanding 2.4% on back of increase in retail sales in the run-up to the World Cup. GDP is expected to rise towards 3% towards year end, before easing towards its long-term trend of 2.75% over next 2 years. Resilience in the housing market has been surprising. Despite past rate hikes, pace of expansion in the housing failed to falter, with Rightmove reporting a 9.8%y/y increase in housing prices in Sept vs 9.0%y/y in Aug. Activity appears supported by an increase in buying interest and standstill in housing supply. Strongest gains were led by area such as by Scotland, London and the South East where robust city bonuses have added to housing demand. In addition, BBA’s mortgage lending rose by a record GBP6.2bn in Aug vs 5.82bn in July, well above the 6-month average of GBP5.4bn. This is consistent with CML’s report showing gross mortgage lending surging 21%y/y to a record high of GBP32.79bn in Aug. This suggests borrowing rates are relatively attractive, despite past rate hikes. After 2 years of softer housing inflation, there appears to be increasing buying interest at recent prices. Other than the housing market, consumer spending was

### Summary
- **Carry Trades Underpinning Support for GBP/USD, Targeting 1.90 by end Q4-06**
- **Above Trend Growth in 2006, Resilience in Housing and Consumer Spending Surprising**
- **BoE To Raise Rates by 25bps to 5% by end Q4-06. Rates likely 5.25% by end Q3-07**
- **Increasing Reliance on Imported Oil Supplies to Worsen Trade Balance**

### UOB Economics Projections

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006f</th>
<th>2007f</th>
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<tbody>
<tr>
<td>GDP</td>
<td>3.1</td>
<td>1.8</td>
<td>3.0</td>
<td>2.75</td>
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<tr>
<td>CPI (average, y/y)</td>
<td>1.3</td>
<td>2.0</td>
<td>2.6</td>
<td>2.2</td>
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<tr>
<td>Unemployment (Q4, average)</td>
<td>4.7</td>
<td>4.7</td>
<td>5.1</td>
<td>5.6</td>
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<tr>
<td>Current account (% of GDP)</td>
<td>-2.0</td>
<td>-2.6</td>
<td>-2.5</td>
<td>-2.0</td>
</tr>
<tr>
<td>Fiscal balance (% of GDP)</td>
<td>-3.1</td>
<td>-3.3</td>
<td>-3.0</td>
<td>-2.6</td>
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</tbody>
</table>

### Acceleration in House Prices After 2 years of Moderation

### Recovery in Retail Sales Volume Matched by Rise in Retail Value. Bodes Well for Domestic Demand

Source: CEIC, Bloomberg
supported by increase in jobs as well as the stimulus from World Cup. Retail sales (by value) jumped 3.9%y/y in Aug vs 3.7%y/y in July, pointing to increasing willingness of consumers to spend. Over past 2 years, retailers depended on heavy discounting in order to boost spending. Significantly, Aug average prices dipped just 0.1%y/y, marking the smallest level of discounting since Jan-02. This reinforces the view of recovery in consumer spending taking hold. On balance, current developments in UK point to above-trend growth over in 2006. With domestic spending and housing market, coupled with conditions such as high credit and excessive liquidity posing upside risks to inflation, the BoE is widely expected to deliver an increase in interest rates by Dec-06.

Potential 2nd Round Effects To Keep BoE Edgy
At the recent Sept MPS meeting, the BoE council members were clearly concerned over the potential pickup in 2nd round effects of past energy increases on wages and headline inflation. While pay growth has remained relatively benign so far (3mth average earnings up a tad at 4.4%y/y in Jul vs 4.3%y/y in June), the risks were towards expectations of higher inflation to push up compensation demands further out. According to the BoE’s regional agents, a growing number of companies expect tougher negotiations for the next annual pay review. The retail price index (RPI), which is used as a benchmark for pay negotiations, rose to an annual 3.4% in Aug, marking the highest level since Dec 04. At the same time, CPI accelerated 2.5%, persisting above the CB’s target of 2%.

In its Aug Inflation Report, the BoE projected CPI to peak near 3% before gradually easing back in 2007, but remaining above the CB’s inflation target of 2% over the forecast 2-year period. Over the next few months, CPI is also expected to edge higher on cost of food, changes in utility prices and university tuition fees though such effects a partly offset by lower energy prices. Manufacturers are also reportedly finding it easier to pass on higher costs to retail prices. Hence, with headline CPI likely to remain above target for some time, coupled with risks towards a pickup in wage inflation, the BoE is likely to err on the side of caution, by tightening monetary conditions further. The BoE surprised markets by raising interest rates by 25bps to 4.75% in Aug, and has retained a gradualist tightening bias. Markets are presently pricing a further 25bps rate hike to 5% in Nov, followed by a similar move to 5.25% in Q3-07 in consideration of inflation risks as well as improvement in domestic growth.

Increasing Reliance on Imported Oil Supplies
UK has emerged as a net oil importer since 2005 on sharp decline in output from the ageing Northsea oilfields. The economy produced 10% less oil from its offshore oil fields in 2005 compared to 2004. UK oil output peaked in 1999, and since then, has fallen an average 8-10% every year. Net oil balance worsened to GBP1.53bn over Jan-July 06 compared to GBP1.23bn for full year of 2005. Shortage of domestic gas supplies, and rising import bills have also pushed up oil and gas prices in UK. The petrol and oil RPI averaged around 11% this year compared to 9.8% and 6.1% in 2005 and 2004 respectively. The trend towards increasing reliance on imported oil supply appears set to continue, with the British government projecting oil imports to hit about 80-90% of its gas supply by 2020. This is likely to weigh on overall trade balance. On inflation, with new projects to import gas supplies due on stream, energy prices in UK are expected to ease over next few years, thus providing some cheer for consumers.