

## United Kingdom

UOB Economics Projections	2008	2009	2010F	2011F
GDP	0.5	-4.9	1.2	2.3
CPI (average, y/y)	3.6	2.2	2.6	1.9
Unemployment rate (%)	5.6	7.5	7.9	7.7
Current account (% of GDP)	-1.6	-1.3	-1.4	-1.0

- *Although latest figures show the British economy emerging from the recession at a faster pace than previously estimated, the UK has not embarked on a strong recovery as compared to its US and EU counterparts.*
- *The country's mountain of fiscal debt is certainly worrying the rating agencies, and with the country heading for a general election that may not produce a strong governing majority, the soft outlook for the Cable is almost inevitable.*
- *It is difficult to say with conviction that the Bank of England will hike its rates soon until some sort of clarity is seen in the economic recovery. In our opinion, a rate hike by the BoE would only take place in 1Q11 at the earliest.*

### Out of the Recession but Rating Agencies Are Waiting for the Election

The UK was the sole superpower of the world in the 19th Century, leaving many colonial states in her globalization and imperialism drive. In the 20th Century, it ceded its throne as the economic Goliath and took a backseat to the US. One would find it hard to imagine that in the 1st decade of the 21st Century, the UK finds itself mired in a deep economic quagmire, saddled in huge fiscal deficits and debts, compounded with a rapidly weakening currency. It is amazing how fortunes of a country that was so rich and powerful just 200 years ago can change.

4Q09 real GDP rose 0.4% from the third quarter, compared with a previous calculation of 0.3%. According to the statistics office, the upward revision to growth came as output of services, construction and agriculture were revised "slightly" higher. A slower pace of destocking contributed to growth in the third quarter from the third. Gross capital formation added 0.3 percentage point, with government and household spending each providing 0.2 percentage point. Year-on-year, real GDP was 3.1% lower in the fourth quarter compared with a previous estimate of 3.3%. Although these latest figures show the British economy emerging from the recession at a faster pace than previously estimated, with respect to the broader economy as a whole, the UK has not embarked on a strong recovery as compared to its US and EU counterparts. Recovery remains somewhat sluggish and unconvincing from a slew of disappointing and conflicting data.

Besides, there will be tremendous interest in the upcoming elections between the Conservative Party (led by David Cameron) against the incumbent Labour Party (led by Prime Minister Gordon Brown). As it is not within our jurisdiction to discuss about the electoral chances of the respective parties, it is difficult to deny that tough fiscal measures had not been implemented thus far, largely due to votes-garnering right before the elections. However, one can be fairly sure that once the elections is out of the way, whichever party that comes to power will have to endorse a dose of "bitter medicine" in the form of tough fiscal measures in order to bring down the bludgeoning fiscal deficit that is threatening the UK's AAA rating.

### Year Ahead May be a Challenging One for the Sterling

Indeed, the focus is currently on whether the UK can keep its AAA credit rating. There is great uncertainty and doubt whether the UK can actually service its own huge amount of outstanding debts. As a matter of fact, the UK has the highest level of deficit as a percentage of GDP after Latvia and Ireland. Consequently, many investors are expressing serious doubts about the credibility of the UK government. To complicate matters, around 30% of UK's debts (about 220bn) are being held by foreign investors who will most probably set off a rapid sell off in gilt in the event of a downgrade.

As of writing, the 10-year yield on the gilt is at approximately 85bps and 50bps spread over the 10-year yield on the bunds and 10year French bonds. Another evidence of declining

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confidence in the gilts can be best summed up by the 10-year UK swap spread crossing into negative territory on 5th Feb 2010 and reaching an unprecedented low of -27bps on 19th Feb 2010. Special attention should be heeded to both the 10yr swap spread and the spread over the equivalent maturity bonds in the coming months as tough measures are implemented to combat the fiscal deficit and restore some credibility to the UK government.

Attaining lows of 1.4784 in early March, GBP/USD was on a decline for most of the quarter. With its aforementioned mountain of fiscal debt which is certainly worrying the rating agencies, and with the country heading for a general election that may not produce a strong governing majority, we expect that the soft outlook for the Cable is almost inevitable. Nevertheless, the UK had done it before in the 1980s during the Thatcher years and we believe that the winner of the upcoming elections will do what is necessary in administering the dose of "bitter medicine". We are looking for the GBP/USD to trade around the 1.520-levels by the end of the second quarter.

### **The BoE Has Not Ruled Out Undertaking More Stimulus Measures**

The winner of the upcoming election faces a real battle on hand to pare down the ridiculously unsustainable fiscal deficits to a reasonable level where investors can find comfort and confidence in holding the gilts again. Having said this, it will be an uphill task and painful year ahead

for the country as they grapple with every Keynesian's nightmare of a huge fiscal deficit and a country in recession where the government's hands are pretty much tied.

It is far from certain that the BoE will put an end to its stimulus efforts just yet, especially with the economy running the risks of a lack of credit availability, a ballooning budget deficit and persistently high unemployment levels. As of the present moment, the considerable slack in the economy, coupled with deflationary pressures will allow some sort of leeway in leaving the stimulus in place for a longer while than they should. As such, with respect to the yield seekers, it is tough to expect that the UK will be among one of the first few countries to hike its interest rates as it is still pretty much unclear if the economy is safely out of the woods. In our opinion, a rate hike by the BoE would only take place in 1Q11 at the earliest.

Another interesting point to add at this juncture would be the repercussions of the 50% bonus tax levied on banks for all bonus payments of more than 25,000 pounds. The tax was effective on December 9, 2009 and was estimated to affect approximately 20,000 bankers and bring in about 500million pounds. We feel that such a one time tax would not have far-reaching effects in reducing the gigantic debts UK owes its creditors. On the other hand, it might worsen recovery in a country where financial services account for 50% of its GDP as financial institutions will abandon the UK in an exodus of bankers in response to this levy.