United Kingdom

UOB Economic Projections	2009	2010	2011F	2012F
GDP	-4.9	1.3	1.0	1.7
CPI (average, y/y %)	2.2	3.3	4.5	2.6
Unemployment rate (%)	7.5	7.8	7.9	7.8
Current account (% of GDP)	-1.3	-2.4	-2.0	-1.6

- *Data out of the UK has been exceptionally bleak. The country's limited economic expansion comes as consumer spending continues to be affected by a number of factors, including higher inflation and job losses.*
- *Overall, we see the hurdle for sanctioning a second round of QE at this point as being high, but the sharp shift in sentiment has reinforced expectations that interest rates will remain at their record low.*
- *With growth in the UK shifting into lower gear, and with the global slowdown hitting the island nation, the outlook for Sterling only becomes murkier.*

Economic Docket Reinforces A Weakened Outlook For The UK

The second estimate from the Office for National Statistics (ONS) showed that the UK economy grew by just 0.2% in the second quarter of 2011 against a previous print of 0.5% in the first quarter. The year on year figure was even bleaker with a read of 0.7% from a previous print of 1.6% yoy. Nevertheless, the press release reaffirmed that growth could have been stronger had it not been for "one-off" factors such as the Royal Wedding bank holiday, Olympic ticket sales, as well as supply disruptions from Japan. In the first release, it was estimated that growth may have been around 0.7% qoq had it not been for these temporary factors.

Whilst we may see these temporary effects dissipating, the country's limited economic expansion comes as consumer spending continues to be affected by a number of factors, including higher inflation, job losses and limited wage rises. Inflation in August rose to 4.5% from 4.4% in July, way more than double the 2.0% target rate. Meanwhile, on the jobs front, public sector payrolls plunged 111,000 in the 2Q; while private sector employment rose 41,000. For the month of August, jobless-benefit claims increased 20,300, which is the sixth straight increase and the highest claims total since January 2010.

It is without doubt that policymakers are facing lots of difficulties in balancing the risks for the economy – rising unemployment and inflation against a backdrop of weak growth and consumer confidence. Where goes the European financial and economic trends, so to generally does the UK. Those are not good connections to have for an economy that is mired in austerity efforts. Hence, we do have to bear in mind that a European crisis would include the UK.

Also adding to the uncertainty surrounding the UK economy at present is the decision by the ONS to delay the first estimate of the expenditure breakdown due to major methodological changes emanating from the upcoming Blue Book. The expenditure breakdown will now not be released until October 5, and the decision to delay has resulted in widespread speculation that significant revisions could be seen. We now see GDP growth in 2011 to come in at 1.0% and 1.7% for 2012.

BoE Turns More Dovish

The BoE left its monetary policy settings unaltered in September, maintaining the official Bank Rate at 0.5%, and keeping the program of asset purchases, financed through reserves issuance, paused at GBP200 billion.

In fact, it was during the August MPC meeting that saw both former hawks Spencer Dale and Martin Weale falling back into the neutral camp by dropping their votes for a 25bps hike in interest rates. It was the first time the committee had been unanimous since May 2010. In fact, just three months before that, three members were voting for an increase, including a half-point hike from Andrew Sentance, who has now left the MPC. Any increase in rates is seen now as too risky given the fragile state of the economy.

As far as expansion of the asset purchase program was concerned, whilst the vote on asset purchases

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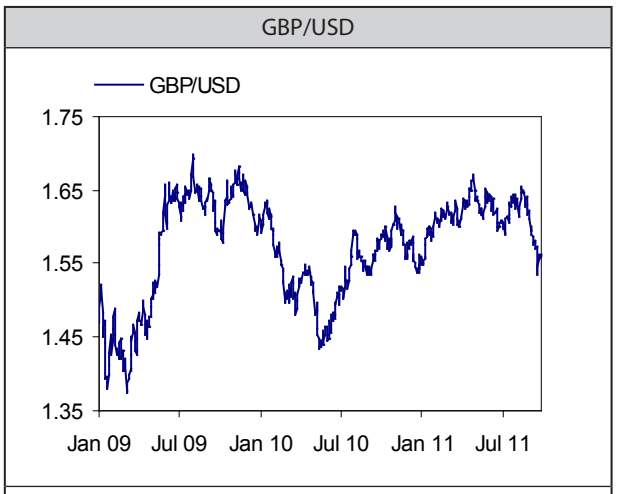
was unchanged at 8-1 in September (with Adam Posen remaining the sole dissenter calling for an immediate GBP50 billion extension), it was clear that other members were starting to lean in that direction. The minutes revealed an increasingly dovish tale as the central bank said it reviewed a range of actions available to loosen policy, including the possibility of cutting rates further to 0.25%, although it was decided that when further easing is called for asset purchases would be the "preferable option". The central bank added that the debate on stimulus in the September meeting was finely balanced as the MPC made note of the "significant downside news" in the previous month.

With the BoE mulling its options to ease policy, it seems that the more dovish drift in the tone of the MPC will continue, with the expansion of QE a clear possibility ahead. At this juncture, we are with the view that the Bank Rate, held at 0.5% since March 2009, will likely be on hold at least until the middle of next year. As for the possibility of further QE, we think that more active discussion will be seen within the market. If no additional members vote for further asset purchases in the interim, the November Inflation Report remains the next major focal point. Of course, apart from domestic factors, monetary policy in the UK will be more reliant on developments abroad.

Sterling - It All Comes Down To The BoE

Over the last few weeks, downward pressure in the GBP/USD has intensified. From the highs of 1.6618 (August 19) attained in the previous quarter, prices have fallen to below the 1.5400-levels. A worsening economic backdrop in recent weeks has seen the British currency lose much of its appeal as interest rate expectations from the BoE continue to diminish amid fears that the economy may slide back into recession.

In light of the recent comments by the BoE, members of the committee may side with Adam Posen's call to increase QE, and speculation for additional monetary support is likely to bear down on the GBP/USD as policymakers continue to see a risk of undershooting the 2% target for inflation. As a result, a big market mover looming on the horizon for the sterling would be the MPC. With the BoE seen holding on rates for the foreseeable future and talk of further quantitative easing measures on the horizon, the pound is likely to remain under pressure against the greenback.



Source: Bloomberg, UOB Economic-Treasury Research

Apart from the economic backdrop and monetary policy expectations, the landscape in the GBP/USD is always complicated by the re-emergence of a significant link to broad-based risk sentiment. Adding to pound weights is the sovereign debt crisis, although problems in the UK is still, to a certain extent, better off than the US or Eurozone. Hence, it is true to say that whilst the UK has managed to stay out of the spotlight, realistically, GBP/USD is likely to be affected by problems surrounding the Euro area due to trade links and banking sector exposure. Hence, we need keep a close eye on the country's exposure to EU's ongoing financial troubles.

So until the currency finds a serious fundamental driver that can overwhelm the larger broad trends in risk appetite, GBP/USD is vulnerable to further downward pressure, and we are looking for a year-end target of around 1.5300. Nonetheless, we do expect bouts of US dollar declines as we expect further stimulus measures from the Fed. This will potentially lead to risks for temporary, corrective upticks along the way, especially with the longer-term view that UK interest rates will likely increase before US rates.