Investing Opportunities in the UK

October 2011

- ***Short-term interest rates will be low for some time but need to rise***
- ***Bond yields are unsustainably low and will rise with global yields***
- ***The pound is extremely low and may appreciate substantially***

After the sharp contraction of 2008, economic activity resumed its expansion in 2009 and 2010 as some private sector expenditures moved back up towards more "normal" levels. In the past twelve months, economic momentum has faltered again. Extraordinarily loose macroeconomic policy initially supported economic activity but policy has become less supportive this year and will be even less so next year. Economic growth is likely to be only moderate. Inflation has been higher than the central bank's target for the past two years but generalised inflation pressures should remain constrained (see table of key forecasts).

Monetary policy settings are extraordinarily loose with the Bank of England having embarked upon various "emergency" measures. Despite renewed growth and stubborn inflation, the central bank has kept interest rates very low and is now discussing further easing in light of the current financial market turbulence and poor economic data. Futures contracts suggest that short-term interest rates are expected to remain steady for the next two years (see top chart). The Bank of England has stressed that it believes inflation will return to target and that the downside risks to growth merit the emergency stance remaining for some time. Short-term interest rates will probably remain unchanged into 2012 but when policy makers judge that the policy stimulus should be reduced, interest rates may rise quite rapidly.

Ten year bond yields have fallen rapidly in recent months mirroring the general downward trend around the globe. The current level of yields represents a multi-decade low (see middle chart) and real bond yields are negative. If inflation declines and then is well contained, yields are likely to remain much lower than the levels of the 1980s and 1990s but the current level is unsustainably low. Sharp rises in bond yields are likely if the economic environment unfolds in line with our expectations, particularly if global yields rebound. Ten year Gilt yields could head towards 5% through the course of the coming year.

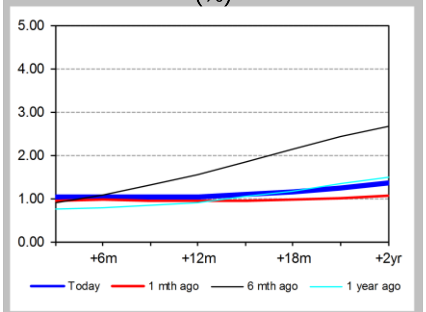
Sterling declined sharply in 2008 and since then it has remained well below the levels prevailing during most of the previous decade (see bottom chart). Against many of the major currencies, Sterling is now at multi-decade lows. The stubborn current account deficit, large fiscal deficit and accommodative macro policy have probably been important factors underpinning this weakness. The currency may remain "low" for some time but if UK firms can capitalise on the competiveness gains resulting from the lower currency then upward pressures on the currency will emerge in the coming year.

The equity market has fallen sharply in recent months but has still delivered positive returns during the past year. The competitiveness gains from the low level of the currency have assisted. Equities may be boosted when the current turbulence in financial markets ends but, in general, the economic environment is likely to become less favourable for the corporate sector.

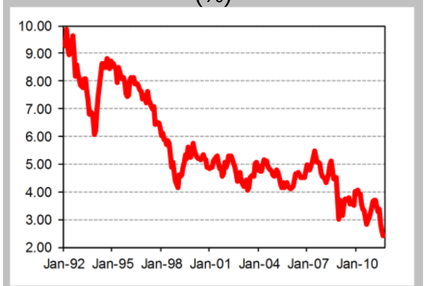
Key Forecasts

	Dec-12	Dec-13	Dec-14
GDP	3	2	2
CPI	2	2	2
Base Rate	1.00	3.75	5.00
Gilts	4.50	5.00	5.00
EUR/STG	0.70	0.70	0.70
STG/USD	1.79	1.71	1.64
STG/YEN	179	189	181

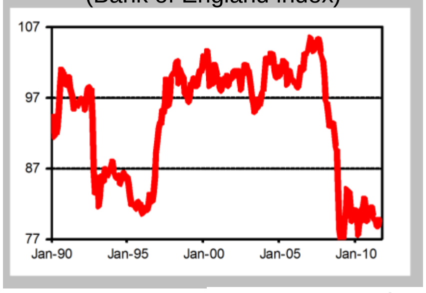
90 Day Futures
(%)



10 Year Bond Yields
(%)



Trade Weighted Exchange Rate
(Bank of England index)



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