

Monday, 10th August to Wednesday, 19th August 2009

United Kingdom

12/8 Bank of England Inflation Report

Chart 5.4 CPI inflation projection based on market interest rate expectations and £175 billion asset purchases

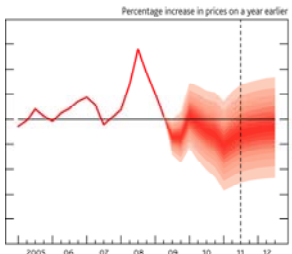
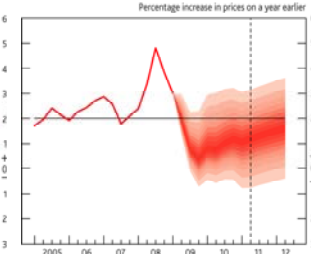


Chart 5.5 CPI inflation projection in May based on market interest rate expectations and £125 billion asset purchases



Charts 5.4 and 5.5 The fan charts depict the probability of various outcomes for CPI inflation in the future. Charts 5.4 and 5.5 have been conditioned on the assumptions that the stock of purchased assets (tracked) by the issuance of central bank reserves reach £175 billion and £125 billion respectively, and remain there throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the shaded central band on only 10 of those occasions. The fan charts are constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red bands on 10 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48-49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents. The dashed line are drawn at the respective two-year points.

Source: Bank of England

The main reason why the Monetary Policy Committee decided, at its meeting the previous week, to increase its asset purchases by £50bn is shown in the above two charts, both taken from the August *Inflation Report*. The chart on the right shows the Bank of England's expectations for the path of inflation over the medium term made at the time of the May *Report* on the assumption that interest rates follow market expectations and that asset purchases total £125bn. On the left, we have the Bank's revised expectations on the same assumption about interest rates but with increased asset purchases amounting to £175bn. The striking feature is that the revised profile shows a lower central expectation at the two year time horizon – which is also below the 2% target – than was the case in May. This tells us two things. First, had the MPC not increased its asset purchases, the central inflation expectation would have been even lower (although, rather unhelpfully, the *Inflation Report* doesn't tell us by how much). But secondly, given inflation is still expected to be beneath target on the basis of the new policy settings, it must therefore follow that the Bank is likely to increase its purchases further still in the months to come.

But why should this be necessary? The simple answer is that the recession has been deeper than the Bank was expecting and so consequently the economy will need to recover more robustly than previously expected in order to eliminate the excess capacity that has developed during the downturn. True, the Bank's central growth forecast shows a more pronounced rebound in the annual growth rate, but as Mr King was at pains to point out, this will be from a much lower level ("it's the level stupid!"). The Governor also provided a clue as to when the next move was likely to be. Responding to criticism from journalists that the increase in quantitative easing had wrong-footed the market, Mr King said he found this rather strange as the minutes of the July meeting had made it clear that a full assessment of the situation would be made in August when the growth and inflation forecasts would be revisited. As a result, barring something untoward happening to growth or inflation in the interim, we expect the asset purchase programme to proceed as planned over the next three months, when, in the absence of a pronounced acceleration in underlying M4, it will be increased by a further £50bn.

12/8 Labour Market (Jun/Jul)

Claimant count (change)	24,900 (21,500)
Total count	1,582,700
LFS unemployment (change Apr-Jun)	220,000
LFS unemployment	2,435,000
Unemployment rate (%)	4.9 (7.8 LFS)
Headline avg earnings (%yoy, Apr-Jun)	2.5 (2.3)
Excluding bonuses (%yoy, Apr-Jun)	2.5 (2.6)
Employment (change Apr-Jun, LFS)	-271,000

Source: ONS

Labour market conditions continue to deteriorate, but there are tentative suggestions this is happening at a decelerating pace. First, the claimant count rose by an additional 24,900 in July – slightly more than in June, but less than expected by the consensus as well as being sufficient to drive the average rise over the last three months to a 12 month low. Second, whilst the LFS measure of unemployment rose 220,000 in the three months to June, this compares with 244,000 in the three months to March. That said, employment fell by a larger than expected 271,000 over the same three month period, the largest decline so far of the present cycle. Within this, the number of full time employee jobs plunged by 309,000, whilst part-time employee working rose 38,000. The fact

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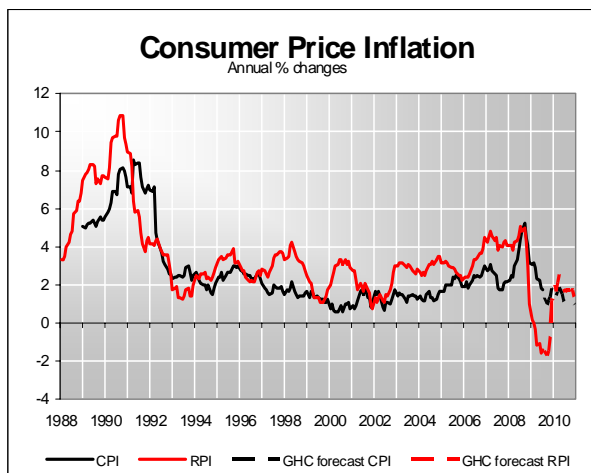
Economic data roundup

that employment is falling faster than unemployment is rising is suggestive of a “disenchanted worker effect” within the UK labour market, whereby newly redundant workers become so disillusioned with job prospects that they leave the labour market altogether. Nevertheless, and with full time employee working accounting for all of the economy’s job losses in the three months to June it is easy to see why wage inflation has been so modest in recent years and why it continues to pose no threat to the sustainability of low inflation. But having said that, headline (average in the last three months) annual average earnings growth ticked up from 2.3% in May to 2.5% in July, although excluding bonus effects it eased slightly to a record low of 2.5%. However, if we allow for the effects of falling prices and temporary favourable taxation effects, both measures of average post tax real employment incomes are currently rising by 5.1% a year. This should enable the household sector to carry on increasing its precautionary savings balances and facilitate modest support for consumer demand.

18/8 Consumer Prices (Jul)

(Previous month in brackets)	mom%	yoy%
CPI	-0.1 (0.3)	1.8 (1.8)
CPI ex energy, food, alc & tob.	0.0 (0.2)	1.7 (1.5)
Overall RPI	0.0 (0.3)	-1.4 (-1.6)
RPIX	0.0 (0.3)	1.2 (1.0)

Source: ONS



Source: ONS, GHC

The July inflation figures surprised on the upside, with the annual rate of change in consumer prices unchanged at

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1.8% (although only on rounding), whilst the headline RPI and RPIX annual rates moved higher to -1.4% (from -1.6%) and 1.2% (from 1.0%) respectively. However, it is ludicrous to suggest, as one BBC economics correspondent stated immediately after the release of the figures) that this was evidence that inflationary pressures are already starting to increase. Indeed, the level of consumer prices actually edged down 0.1% on the month. Admittedly, there was a surprise 1.3% rise in vehicle prices, but the single biggest factor putting upward pressure on the annual rate came from clothing and footwear, where prices continued to fall (down 3.3% on the month) but not quite as much as they had in the corresponding month a year ago. The best guide to underlying inflationary pressures is provided, as ever, by the annual rate of change in the CPI excluding energy, food, alcohol and tobacco, which edged up slightly but at 1.7% remains comfortably beneath the government’s 2% target. What’s more with the economy, thanks to the severity of the recession, operating substantially beneath its productive potential, the core rate is likely to resume its downtrend over the remainder of the year and all the way through 2010. True, the headline rate will pick up from September as last year’s oil price falls start to drop out of the annual comparison and again in December when VAT is returned to 17.5% but the pull from the lower core rate will ensure it remains beneath 2% for at least the next two years.

19/8 Minutes of August MPC meeting

The minutes revealed a surprising split on the Committee with six members voting to extend the Bank of England’s asset purchase programme by £50bn with the remaining three, including Bank Governor Mervyn King preferring a £75bn extension. The news provided a lift to government bonds but undermined sterling, as investors reasoned that the chances of the asset purchase programme being increased again at some stage had grown. The rationale behind the minority view was that “the potential adverse consequences of adding another large monetary stimulus might be less than the possible costs of acting too cautiously”. Central here was the concern that not doing enough now increased the risk that inflation would remain significantly beneath target for “a sustained period of time”. However, the majority were not convinced, especially given the apparent diminution of some of the near term downside risks to the economy. Given the considerable uncertainties involved surrounding the precise transmission mechanism of the asset purchase programme, we believe too much has been read into the



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difference of views. With the £50bn extension due for completion in November, the Committee will have a chance to review its decision at the next *Inflation Report* forecasting round. If monetary growth hasn't picked up materially by then, the MPC will countenance additional asset purchases.

United States

12/8 FOMC meeting

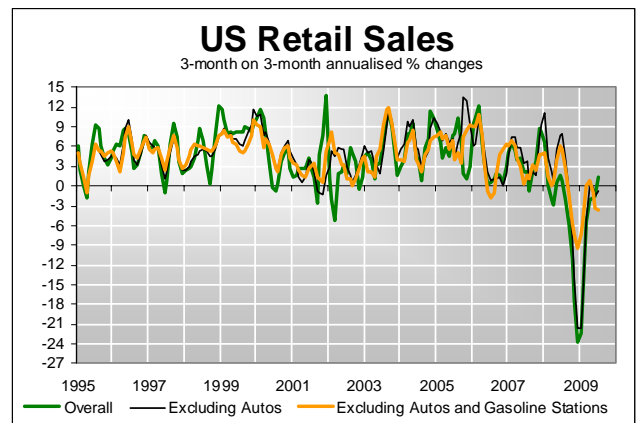
The Committee, as expected, maintained its target for the federal funds rate at 0-0.25% and stressed again that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period". That said, the Fed had detected signs of a levelling out in economic activity and an improvement in conditions in financial markets. Although household consumption was being constrained by ongoing job losses, sluggish income growth, lower housing wealth and tight credit whilst businesses were still cutting back on fixed investment and staffing, companies were making progress in "bringing inventory stocks into better alignment with sales. Against such a backdrop, the Committee did not consider it necessary to extend its asset purchase programme beyond that already announced, which involved up to \$1.25 trillion of agency mortgage-backed securities and \$200bn of agency debt by the year-end, plus \$300bn of Treasuries. Indeed, such had been the degree of improvement that the Fed announced it would be slowing the pace of its Treasury purchases, pushing back the completion of the process to the end of October. The dollar rallied as the FOMC statement was released, as investors interpreted the announcement as an indication that the Fed would not be following the MPC's lead and adding to its programme of quantitative easing.

13/8 Retail Sales (Jul)

(Previous month in brackets)	mom%	yoy%
Total sales of retail and food services	0.6 (0.5)	-9.0 (-9.8)
Total excluding autos	0.3 (0.4)	-7.9 (-7.6)
Total ex autos & gasoline	-0.2 (-0.1)	-4.0 (-3.4)

Source: US Census Bureau Retail spending was weaker than expected in July, with overall nominal sales edging down 0.1% albeit after an upwardly revised 0.8% increase in June. To make matters worse the figure was boosted by a fourth successive rise (2.4%) rise in car sales, which means that the traditional core sales measure (which excludes autos) fell an even larger 0.6%. In fairness, sales were suppressed by the first decline in gasoline sales (down 2.1%) in three months, so exclude these as well spending was down a more modest 0.4%. This

brought the three month on three month annualised rate of change down from -3.3% in June to -3.6%, suggesting that our preferred measure of underlying retail spending is losing momentum. However, in overall terms, on the same basis spending has actually strengthened, rising 1.4% in July compared with a decline of 1.5% in June and -5.5% in March – hence the Fed's assertion household consumption was "stabilising". What's more, barring falls averaging more than 0.6% a month in both August and September spending in Q3 will show positive growth.



Source: US Census Bureau

14/8 Consumer Prices (Jul)

(Previous month in brackets)	mom%	yoy%
Consumer prices	0.0 (0.7)	-1.9 (-1.2)
Core consumer prices	0.1 (0.2)	1.6 (1.7)

Source: Bureau of Labor Statistics

The July report on US consumer prices was more benign than expected. True, the overall price level was flat on the month in line with market expectations, but with energy prices down 0.4% (after having risen 7.4% in June) and food prices dropping 0.3%, the core index, which excludes both food and energy edged up a smaller than expected 0.1%. As a result, both the headline and the core annual rates of change continued to decline, the former to -1.9%, the lowest since January 1950, and the latter to a five year low of 1.6%. whilst the headline annual rate fell to a new five year low of -1.9. From here, whilst the headline rate is likely to rebound through the final months of this year as last year's energy price falls start to drop out of the annual comparison, the core rate should continue to

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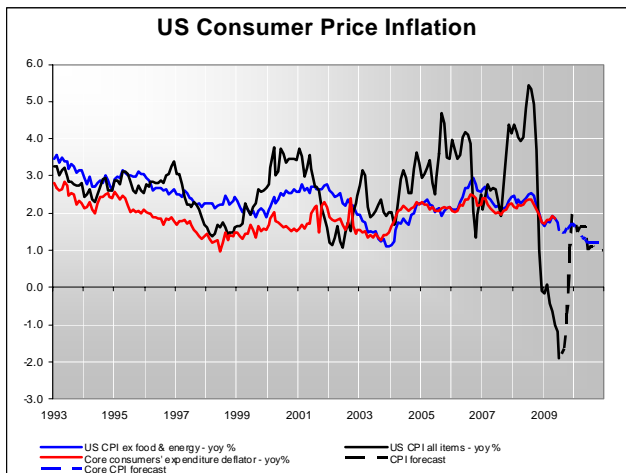
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trend lower, thanks to the vast amount of spare capacity that already exists within the US economy, which will increase further during the remainder of 2009 until above trend growth is restored.

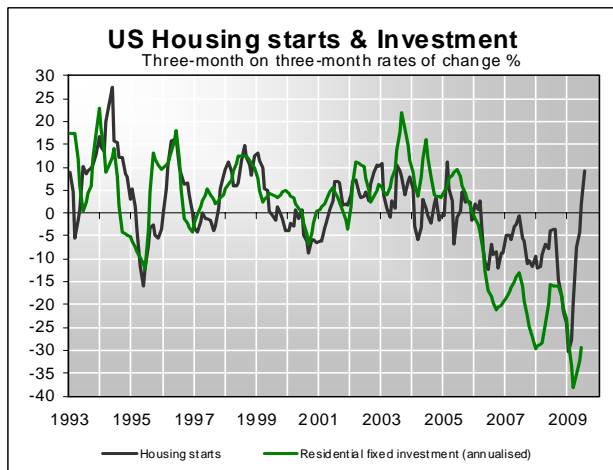


Source: Bureau of Labor Statistics/Bureau of Economic Analysis

18/8 Housing Starts (Jul)

Previous month in brackets	mom%	yoy%
Private sector housing starts	-1.0 (6.5)	-37.7 (-45.5)

Source: Census Bureau



Source: US Census Bureau, BEA

For the first time in three months the July report on new privately-owned housing units started disappointed market expectations by posting their first decline (down 1.0%) since April. However, not only did this not prevent the annual rate of change from continuing to recover, more importantly the three month on three month rate of change moved further into positive territory as it climbed from 2.1% in June (and before that -19.8% in March and -24.2% in December) to 9.2%, the highest since the beginning of 2005. The clear implication is that residential fixed investment, which has fallen by some 57% since the final quarter of 2005, looks set to start growing again in the third or fourth quarter of the year.

Eurozone

15/5 Eurozone GDP (Q1 initial estimate)

(% quarter-on-quarter)	Q2	Q1
Eurozone	-0.1	-2.5
Germany	0.3	-3.5
France	0.3	-1.3
Italy	-0.5	-2.7
Netherlands	-0.9	-2.7
Portugal	0.3	-1.8
Greece	0.3	-1.2

Source: Eurostat

The "flash" second quarter GDP figures for the Eurozone were significantly stronger than expected. Not only was the contraction in the single currency area as a whole much smaller than expected at just 0.1% compared with a decline of 2.5% in Q1, but the region's two largest economies, Germany and France both surprised investors by expanding by 0.3%. For the record Portugal and Greece also registered the same rate of growth, whilst Italy contracted by 0.5% and the Netherlands by 0.9%. As ever at this stage no detailed expenditure based split is available for the overall zone or for Germany, although in the case of the latter the Federal Statistical Office helpfully reported that "household consumption, government consumption and fixed investment in construction all exerted a positive impact" on growth and that with imports falling "far more sharply than exports" net trade also had a positive effect. However, declining inventories had a negative effect on growth".

In France the story was similar with consumer demand expanding for a fourth consecutive quarter (little sign of any balance sheet adjustment in the French household sector then). In addition government consumption continued to trend higher, but within the domestic

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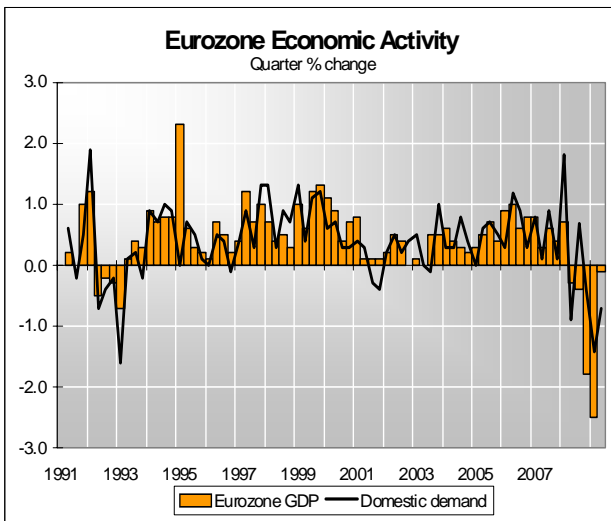
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economy this was more than offset by further declines in investment and an accelerated rate of decline in business inventories. Fortunately, the external sector rode to the economy's rescue, with a 1.0% jump in exports and a 2.3% drop in imports combining to raise GDP by a full 1-percentage point.



Source: Eurostat

The news that France and Germany had "left recession" prompted many commentators to conclude that the European model for dealing with the financial crisis and the ensuing recession was "clearly" superior. We would agree in part. Certainly, it has long been our view that large-scale fiscal stimuli was the not way to go, but apart from the temporary VAT cut last December and the car scrappage scheme the UK government hasn't really gone down this route. True, the budget deficit has ballooned alarmingly, but this has been due mainly to the various bank bailout and recapitalisation packages rather than a classic fiscal injection. Moreover, it would be wrong to

suggest that the German and French administrations haven't done any fiscal loosening themselves; indeed, much of the rebound in Germany can be attributed to its own (and much more successful) car scrappage scheme, which explains most of the surge in industrial production in Q2, whilst the labour market is being supported by government subsidies to companies who keep employees working short-time rather than making them redundant. Consequently, there is very real danger that Q2's bounce will turn out to be just that, especially when one considers that monetary growth in the Eurozone has ground to a complete halt because of declining lending and the ECB seemingly powerless to compensate by introducing quantitative easing measures. Germany and France may have beaten the UK out of recession, but in our view they are much more likely than the UK to find themselves back in it again in 2010.



Source: Bundesbank

Thursday, 20th August to Friday, 21st August 2009

United Kingdom

20/7 Retail Sales Volumes (Jun)

Retail spending surprised on the upside in June, unexpectedly rising 1.2% on the month, although this was after a larger than initially reported 1.0% decline in May.

Food store sales continued to advance (up 0.7%), but this time they were joined by the non-food sector where sales volumes surged 1.7%. Within this, the rebound was led by the clothing and footwear stores, who reported a jump of 4.7%, with non-specialised (department) stores and "other"

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stores staying theirs rose 0.7% and 0.9% respectively. The rise in sales in June appears to have been driven by a sudden drop in prices, with clothing and footwear stores reporting the biggest reductions at 1.5% on the month and 7.5% on the year. However, after an extended run of rises, even the food stores nudged their prices down 0.1% on the month, thereby cutting the annual rate of increase from 5.1% in May to 4.0%. Whilst we cannot extrapolate one-for-one changes in developments in retail sales to overall consumer demand, but with the volumes in the second quarter up 0.7%, there is a strong possibility that household consumption will register a modest rise in Q2. The consensus expects volumes to have risen 0.4% in July.

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