Tracking the MPC –

Signposts for a Shift in Monetary Policy

The Bank of England (BoE) has held the bank-rate steady at a record low 0.50% since March 2009, despite continually overshooting expectations. It now stands at 3.6% versus a target of 2%. In our view, February's Inflation Report shows that the MPC is on hold for the foreseeable future with a bias towards more Quantitative Easing (QE).

Indeed, according to the report, "Inflation should continue to fall sharply … as the impact of past rises in VAT and petrol prices drop out of the comparison" and "is judged somewhat more likely to be below the target than above it for the forecast period."

So, what needs to change to trigger a rate rise? We believe there are several signposts we can monitor as we look for a turning point in monetary policy, including:

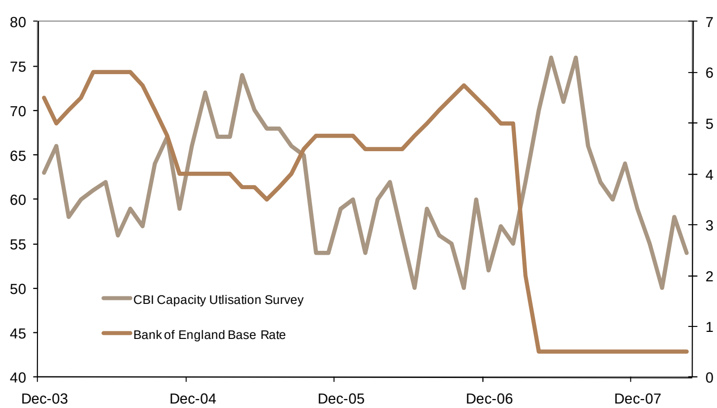
- Resource Utilization
- Inflation Expectations
- Credit Growth

As illustrated below, the signposts continue to indicate the MPC will remain on hold. "GDP growth is likely to remain weak … the drag on domestic spending from tight credit conditions and the fiscal consolidation is likely to persist; and, the substantial challenges faced by the Euro area continue to pose a significant threat to the domestic recovery."

Resource Utilization:

- Capacity utilization is one measure of slack in the manufacturing and – importantly for the UK – service sectors.
- The BoE sees substantial spare capacity within the labor market, while the margin of spare capacity within companies is wider than normal.
- Although surveys indicated a widening in spare capacity in the recession, they now suggest that there is considerably less.

Survey Measures of Capacity Utilization

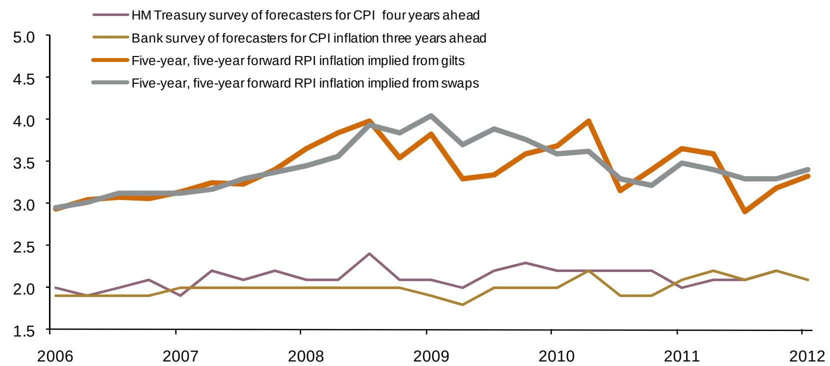


Source: Confederation of British Industry via Morgan Stanley

Inflation Expectations

- The BoE views current inflation strength as temporary and expects it to decline further in 2012.
- The gap between nominal and real yields on gilts (i.e., one indicator of inflation expectations) has increased over the past year. By contrast, an estimate derived from inflation swaps has remained stable.
- Most measures of near-term inflation expectations fell back in 2011 Q2, reversing some of their increases over the past year.

Market-Based Indicators of Inflation Expectations and Selected Forecasters' Inflation Expectations

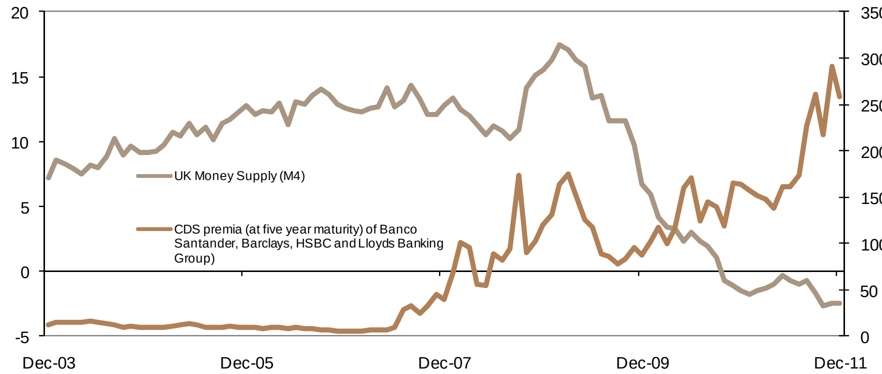


Source: Bank of England

Credit Growth

- Credit conditions for households and smaller businesses remained tight, while weakness in broad money and credit growth persists.
- Broad money growth has remained subdued despite BoE projections of a boost from the asset purchase program.
- The long-run average is 8.5. This currently stands at (2.5%).

UK M4 and CDS Premia (at five year maturity) of Banco Santander, Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland



Source: Bloomberg

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