



3rd Quarter 2011

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 the continued improvement over expectations of CPI (now standing at 5%). In our view, November's Inflation Report shows that the MPC is on hold for now and will continue to increase Quantitative Easing (QE).

According to the report, "Inflation is likely to fall back sharply through 2012 as the contributions of VAT, energy and import prices decline; and, downward pressure from slack in the labor market persists" and "inflation is judged more likely to be below than above the 2% target at the forecast horizon."

As illustrated below, the signposts continue to indicate the MPC will remain on hold. "The prospects for the UK economy have worsened. Global demand slowed. And, concerns about the solvency of several Euro-area governments intensified, increasing strains in banking and some sovereign funding markets."

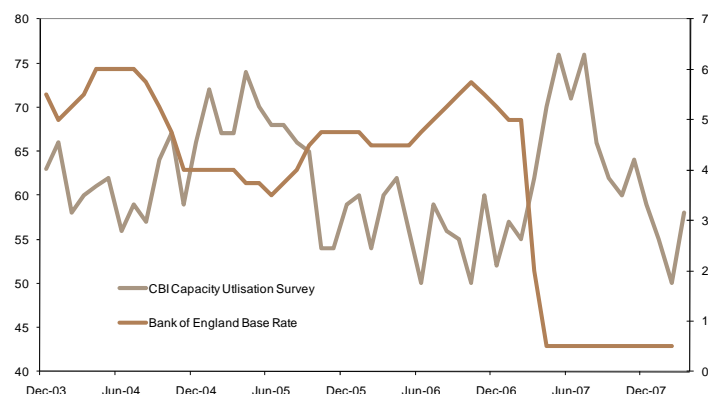
What must change to trigger a rise in rates? We believe there are several signposts to monitor as we look for a turning point in monetary policy, including:

- Resource Utilization
- Inflation Expectations
- Credit Growth

Resource Utilization

- Capacity utilization is one measure of slack in the manufacturing and – importantly for the UK – service sectors.
- The BoE sees a substantial amount of spare capacity and believes labor productivity is well below its pre-crisis trend.
- Surveys suggest more spare capacity opened up in Q3 as companies saw demand weakening.

Survey Measures of Capacity Utilization

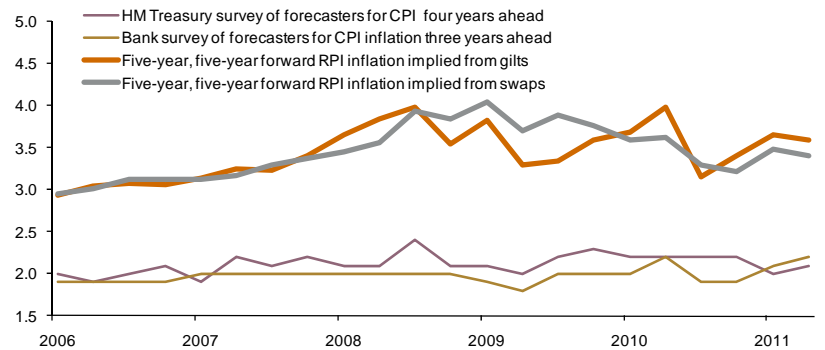


Source: Confederation of British Industry via Morgan Stanley

Inflation Trends

- The BoE views current inflation strength as supply-side, rather than demand-side driven.
- The gap between nominal and real yields on gilts (one indicator of inflation expectations) has increased over the past year. By contrast, an estimate derived from inflation swaps has declined.
- 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

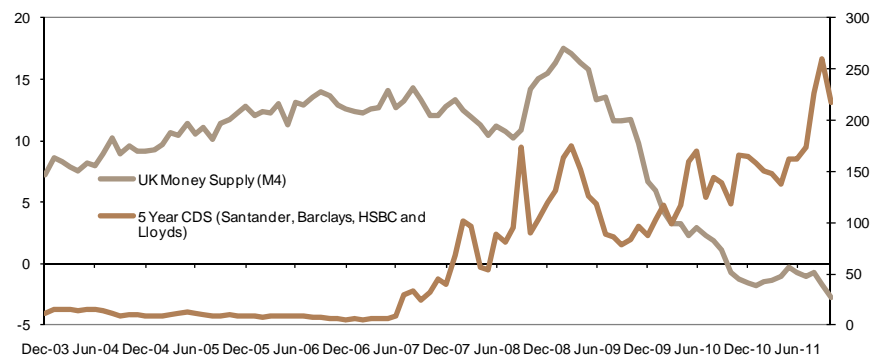


Source: Bank of England

Credit Growth

- Credit conditions for households and smaller businesses remained tight, while weakness in board money and credit growth persisted.
- Broad money growth has remained subdued; however, this should be boosted by the expansion of the asset purchase program.
- The long-run average is 8.5. This currently stands at (1.7%).

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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