



Economics Weekly

15 February 2010

UK Inflation Report implies no rate hike this year

Lower growth projection implies more spare capacity...

The Bank of England's projections in the February 2010 Quarterly Inflation Report (QIR) for economic growth (GDP) and for consumer price inflation (CPI) are lower than those made in November last year. This has resulted in financial market expectations of rate rises being pushed out further into the second half of this year. But, as the charts below show, there is still an expectation - derived from overnight index swap (OIS) rates - that Bank Rate will rise to 1% by the end of 2010, to 1¾% in June 2011 and to 2½% at the end of next year. That view is not borne out by the implied path of consumer price inflation in the Bank of England's latest QIR forecasts, *whether based on market implied interest rates or unchanged rates at 0.5%*, see charts a and b. In the Report, the Bank says that: 'On balance, the Committee judges that.... it is more likely than not that inflation will be below the target for much of the forecast period...' The implication is clear, there is a strong probability that Bank Rate may remain at the current record low of 0.5% well into 2011 unless economic conditions improve more than currently expected by the Monetary Policy Committee (MPC).

...so inflation is likely to undershoot the 2% target even though it will rise further above it in the near term...

...meaning that UK Bank Rate could remain at 0.5% well into 2011

Reasons for the Bank of England to lower its growth forecasts are not hard to find. The UK economy expanded by just 0.1% in Q4. This means that there is more spare capacity in the economy and so medium-term inflationary pressure is even more muted than previously expected. Prospects for growth in the first half of this year look very challenging, with the re-imposition of VAT at 17½%, the end of the car scrappage scheme and higher taxes from April.

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Chart a: Inflation to undershoot the 2% target on unchanged interest rates...

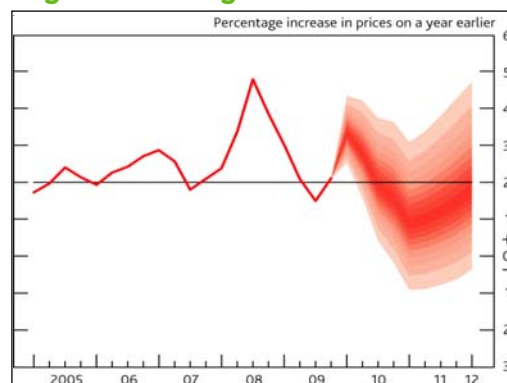
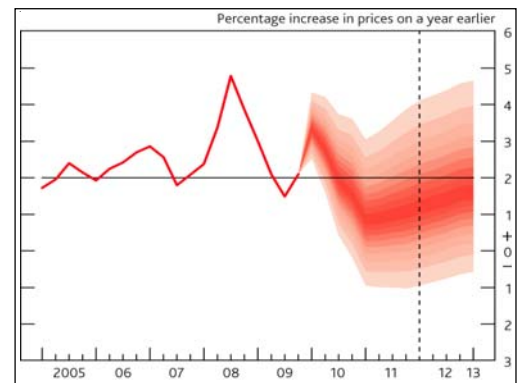


Chart b: ...and even based on market rates

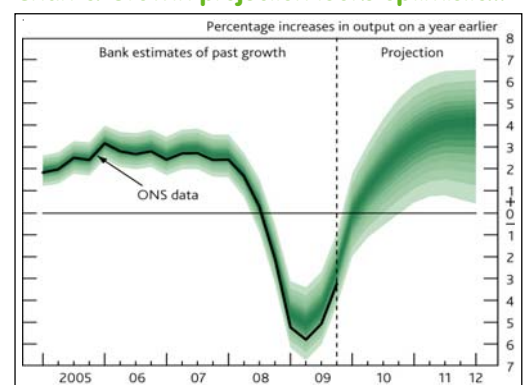


World growth is recovering and that helps UK growth prospects, but the evidence so far is that the trade balance is not improving as much as is required to impart the positive net contribution to the economy that would deliver the Bank of England QIR projection of 3% annual GDP growth by the end of the year, see chart c. Part of the reason for that could be that the fast growing countries are those in which the UK has a low market share of imports, and that UK firms are not cutting export prices in order to gain market share; rather, they are maintaining them (i.e. raising export prices) in order to boost profit margins.

The view from the latest Consensus Forecast publication (for February) is that the UK will grow by 1.4% this year and by 2.2% in 2011. Of course, the QIR forecast could turn out to be correct, but that would still mean that inflation undershoots the 2% target in 2 years' time on official projections, see chart b.

Although inflation is expected to undershoot the

Chart c: Growth projection looks optimistic...



2010 calendar of central bank meetings

European ECB (1.00%)
4 March, 8 April, 6 May,
10 June, 8 July
US FOMC (0-0.25%)
16 March, 28 April, 23 June
UK MPC (0.50%)
4 March, 8 April, 6 May, 10
June, 6 July

Rolling calendar of UK data releases and events

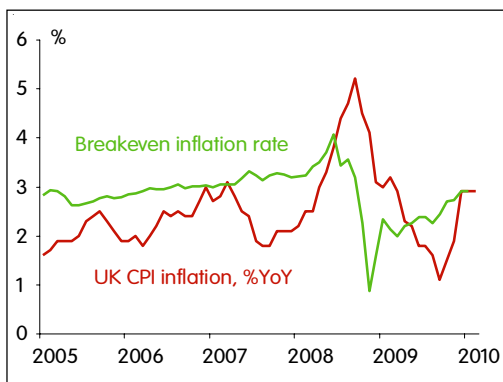
CPI inflation (16/02)
BoE MPC minutes (17/02)
Labour market stats (17/02)
Public finances (18/02)
M4 money supply (18/02)
Retail sales (19/02)
Q4 GDP (26/02)
Mortgage approvals (01/03)
PMI manufacturing (01/03)

Rolling calendar of US data releases and events

TIC capital flows (16/02)
Housing starts (17/02)
Industrial production (17/02)
FOMC minutes (17/02)
Producer prices (18/02)
Consumer prices (19/02)
Consumer conf (23/02)
New home sales (24/02)
Durable goods (25/02)

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg, and Thomson Datastream

Chart d: Inflation spike to be temporary



2% target in the medium term, however, the Committee expects the annual rate to rise over 3% first (the annual rate was 2.9% in December 2009). Our forecast is that this will happen as soon as this month, with January annual CPI inflation hitting 3.5% and triggering a public letter by the Governor explaining to the Chancellor why it has happened, what he is doing about it and when it will be back to the target. In that letter, the Governor is likely to say that the rise was due to one-off effects associated with the 2½% rise in VAT and petrol prices, and that it will be well below 2% within the target period of 2 years.

In the QIR, the Bank states that: 'The pick up in inflation is largely the impact of one-off adjustments to the level of prices which should have only a temporary effect on inflation. Downward pressure from the persistent margin of spare capacity is likely to cause inflation to fall

Chart e: CPI to fall well below target next year...

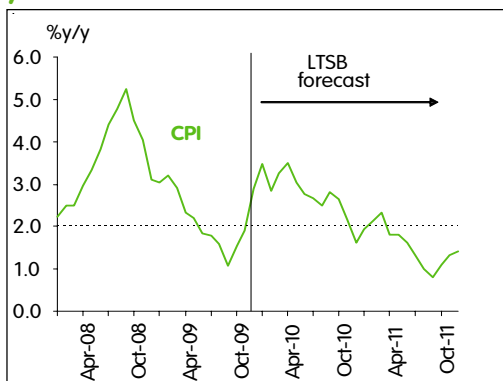
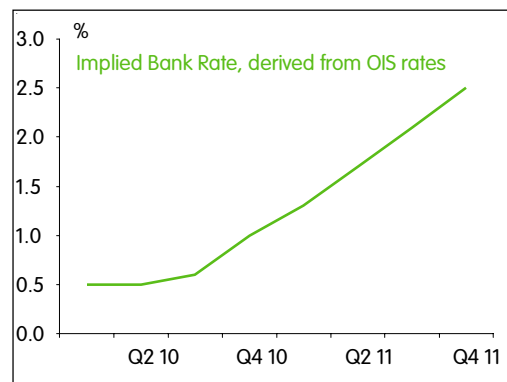


Chart f: ...so when will official rates rise?



back below the target for a period as these temporary effects wane... it is more likely than not that inflation will be below the target for much of the forecast period, but the risks are broadly balanced by the end.' Our forecasts of the monthly path of annual UK consumer price inflation over the period to the end of 2011 show that it will fall well below 2%, hovering around 1% for much of 2011.

If our forecast turns out to be accurate, the key short term UK policy interest rate could stay low for an extended period, and much lower than is currently being priced into financial market expectations. This will be especially likely if UK economic growth disappoints, as it has so far in the recession. Bank of England forecasts of UK growth in 2010 and 2011 are higher than the average of independent forecasters. If the latter are right, and the MPC acknowledges this by lowering its inflation projections even further below 2%, then UK Bank Rate could remain at 0.5% well into 2011.

From a financial market perspective, this implies plenty of scope for market volatility, and perhaps opportunity as a result, in the months ahead. As mentioned in our last Weekly, much of the future prospects for the UK depend on how firms adjust away from slower growing traditional export markets into stronger growing emerging markets, helped by a cheaper currency.

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Weekly economic data preview

15 February 2010

Governor King to play down inflation threat

- Following on from a dovish Quarterly Inflation Report (QIR), attention in the UK will shift this week to the details of the February MPC minutes (Wednesday). Although the tone of the minutes are likely to echo key the messages emanating from the report – chiefly, that should the evolution of the recovery disappoint, a renewed dose of quantitative easing will be implemented – the vote will also be of interest. We expect a three-way split to have emerged on the MPC, with three members favouring an extension to the Asset Purchase Facility, a majority of five voting for no-change and one voting for a reduction. Turning to UK data flow, we expect a 0.1% monthly decline in the CPI for January (Tuesday), pushing the headline annual rate of inflation up by six percentage points (pp), to 3.5%. A reading above 3% will prompt a letter from Governor King to the Chancellor, explaining why inflation is more than 1 pp above the 2% target and how the MPC envisages a moderation in inflation occurring. We forecast a 2k decline in the January claimant count, while the headline measure of average weekly earnings is expected to rise by two-tenths to 0.9% in the three months to December, versus a year earlier. Nonetheless, that would be a very weak outturn compared to the long-run average of 3.8%. Indeed, weak income growth is likely to bear down on consumption and in January, the combination of inclement weather and price rises linked to VAT increase are likely to have pushed retail sales volumes (Friday) 1% down in the month.
- The main focus in the US will be the Fed's 'exit strategy' and the gradual normalisation of monetary policy. Following the testimony by Fed chairman Bernanke last week on the potential methods the Fed may adopt to withdraw the substantial monetary stimulus in place, attention will fall on a host of other Fed speakers this week. The list includes Hoenig, the first dissenter on the FOMC for twelve months in January. The minutes of the 26-27 January FOMC meeting will also be published on Wednesday. However, it is a quiet start to the week for data and events, with US financial markets also closed for the Presidents' Day holiday on Monday. The central theme for data releases this week will be inflation, with a succession of reports published. We look for robust increases in import prices (Wednesday) and producer prices (Thursday), primarily reflecting higher fuel & energy prices in January. The consumer price index (Friday) is forecast to rise by 0.3%, lifting the annual rate slightly to 2.8%, while the core rate is expected to be unchanged at 1.8% on the year. We expect to see a rebound in January housing starts (Wednesday), mainly reflecting more favourable weather conditions, while building permits are likely to remain close to year-highs. After the larger-than-expected fall in initial jobless claims data last week, another improvement on Thursday will fuel speculation of a gain in non-farm payrolls in February. We also expect to hear this week of another robust gain in industrial production in January (Wednesday), while the Empire (Tuesday) and Philadelphia (Thursday) Fed surveys should point to a further pick-up in activity in February.
- Weak public sector finances in the 'peripheral' euro-zone countries has been the dominant theme in financial markets. For us, last week's pledge from the EU of "determined and co-ordinated action if needed to safeguard stability" seems too vague to placate bond markets. A bailout does not sit easily with the Maastricht Treaty - which states that financial assistance is only available to a Member State seriously threatened by "...*exceptional circumstances beyond its control*". Greece does not obviously fall into this category. A high degree of supervision, along with possible additional fiscal consolidation measures, seems the likely way forward for Greece, although it may be too soon to rule out some kind of *non-EU* financial assistance. This week's euro-zone economic data highlights include the February German ZEW survey and preliminary February PMI reports. A ZEW economic sentiment reading of 40.0 is expected from 47.2 previously, reflecting more volatile equity markets and the tentative return of risk aversion. Meanwhile, we look for the PMI surveys to register a modestly faster pace of expansion in both the manufacturing and services sectors.

Jeavon Lolay, (Senior Global Macroeconomist, Mark Miller (Global Macroeconomist), George Johns (UK Macroeconomist)

Chart 1: Survey data point to a fall in UK retail sales growth in January...

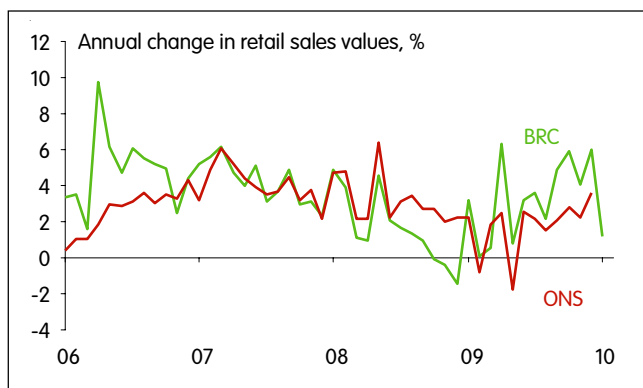
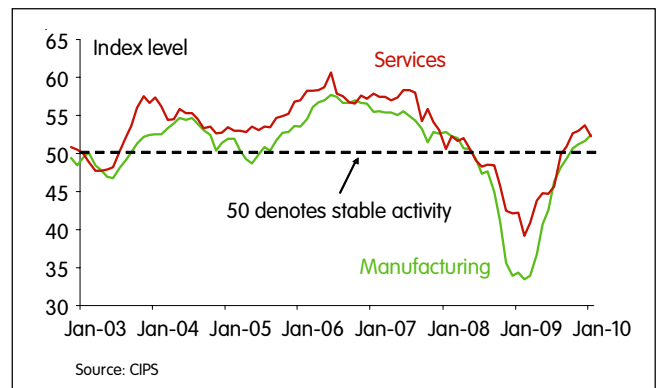


Chart 2: Euro-zone PMI surveys continue to suggest a modest expansion in activity...





15 - 19 February 2010

Country	Time	Event	Actual	Consensus	Forecast	Previous
Mon 15th						
UK	00:01	Rightmove house prices (Feb)		n/a	n/a	0.4% (4.1%)
JN	04:00	Industrial production (Dec F)		n/a	2.4% (5.5%)	2.2% (5.3%)
Tue 16th						
UK	09:30	CPI (Jan)		0.0% (3.6%)	-0.1% (3.5%)	0.6% (2.9%)
UK	09:30	Core CPI (Jan)		(3.2%)	(3.2%)	(2.8%)
UK	09:30	RPI (Jan)		0.0% (3.8%)	0.0% (3.8%)	0.6% (2.4%)
UK	09:30	RPI Ex Mort Int.Payments (Jan)		(4.6%)	(4.6%)	(3.8%)
UK	09:30	DCLG UK house prices (Dec)		(1.2%)	(0.5%)	(0.6%)
GE	10:00	ZEW Survey (Econ sentiment) (Feb)		41.0	40.0	47.2
US	13:30	Empire manufacturing (Feb)		17.70	18.00	15.92
US	13:30	Net Long-term TIC Flows (Dec)		\$50.0B	n/a	\$126.8B
Wed 17th						
UK	09:30	Claimant count rate (Jan)		5.0%	5.0%	5.0%
UK	09:30	Jobless claims change (Jan)		-10.0K	-2.0K	-15.2K
UK	09:30	Weekly earnings w/bonus 3mth (Dec)		0.9%	0.9%	0.7%
UK	09:30	ILO unemployment rate (3mths) (Dec)		7.8%	7.8%	7.8%
EC	10:00	Euro-Zone trade balance sa (Dec)		3.9B	n/a	3.9B
US	13:30	Import prices (Jan)		0.8% (10.7%)	0.8% (10.4%)	0.0% (8.6%)
US	13:30	Housing starts (Jan)		580K	600K	557K
US	13:30	Building permits (Jan)		620K	660K	653K
US	14:15	Industrial production (Jan)		0.8%	0.6%	0.6%
US	14:15	Capacity utilisation (Jan)		72.6%	72.5%	72.0%
Thur 18th						
JN		BOJ target rate		0.10%	0.10%	0.10%
JN	05:00	Leading index CI (Dec F)		n/a	n/a	94.0
JN	05:00	Coincident index CI (Dec F)		n/a	n/a	97.6
UK	09:30	Public finances (PSNCR) (Jan)		-20.0B	-22.0B	23.6B
UK	09:30	Public sector net borrowing (Jan)		-2.6B	-5.0B	15.7B
UK	09:30	M4 money supply (Jan P)		0.5% (4.6%)	0.5%	-1.1% (6.4%)
UK	11:00	CBI industrial trends (Feb)		-36	n/a	-39
CA	12:00	Consumer prices index (Jan)		0.3% (1.9%)	0.2% (1.8%)	-0.3% (1.3%)
CA	12:00	Core CPI (Jan)		0.0% (1.9%)	-0.1% (1.8%)	-0.3% (1.5%)
CA	13:30	Int'l securities transactions (Dec)		n/a	7.5B	10.5B
US	13:30	Producer prices index (Jan)		0.8% (4.4%)	0.8% (4.4%)	0.2% (4.4%)
US	13:30	PPI ex food & energy (Jan)		0.1% (0.8%)	0.1% (0.8%)	0.0% (0.9%)
US	13:30	Initial jobless claims (Feb 13)		445K	430K	440K
US	15:00	Philadelphia Fed survey (Feb)		17.5	17.0	15.2
US	15:00	Leading indicators (Jan)		0.5%	1.0%	1.1%
Fri 19th						
GE	07:00	Producer prices (Jan)		0.3% (-4.0%)	0.1% (-4.1%)	-0.1% (-5.2%)
FR	07:45	Business confidence indicator (Feb)		94.0	93.0	92.0
FR	08:00	PMI manufacturing (Feb P)		55.2	55.5	55.4
FR	08:00	PMI services (Feb P)		56.3	56.5	56.3
GE	08:30	PMI manufacturing (Feb P)		53.8	54.0	53.7

**15 - 19 February 2010**

Country	Time	Event	Actual	Consensus	Forecast	Previous
GE	08:30	PMI services (Feb P)		52.4	52.5	52.2
EC	09:00	PMI manufacturing (Feb P)		52.8	52.5	52.4
EC	09:00	PMI services (Feb P)		52.5	52.7	52.5
EC	09:00	ECB Euro-zone current account sa (Dec)		n/a	n/a	0.1B
UK	09:30	Retail sales (Jan)		-0.5% (1.1%)	-1.0% (0.6%)	0.3% (2.1%)
CA	13:30	Retail sales (Dec)		n/a	+0.5%	-0.3% (0.0%)
US	13:30	Consumer prices index (Jan)		0.3% (2.8%)	0.3% (2.8%)	0.1% (2.7%)
US	13:30	CPI ex food & energy (Jan)		0.2% (1.8%)	0.2% (1.8%)	0.1% (1.8%)

Key events of the week

Mon 15th	EC	Euro-area finance ministers meet in Brussels (16:00)
Tue 16th	EC	EU finance ministers hold meeting in Brussels (08:30),
	US	Fed member Hoenig speaks in Washington (17:00), Fed member Lockhart speaks in Atlanta (17:30), Fed member Kocherlakota speaks in Minnesota (17:45)
Wed 17th	EC	ECB member Quaden presents Belgian annual report (05:00) , Germany to sell €7bn of 2yr notes (10:15)
	UK	Bank of England releases its MPC meeting minutes (09:30)
	US	Fed member Plosser speaks in Philadelphia (17:45), Fed releases FOMC meeting minutes (19:00)
Thu 18th	EC	France to sell €8bn of notes (10:00), France to sell €2bn of index linked bonds (10:00),
	US	Fed Governor Duke speaks in Virginia (23:00)
Fri 19th	US	Fed member Lockhart speaks in Georgia (time tbc), Fed member Bullard speaks in Memphis (01:30), Fed member Dudley speaks in Puerto Rico (13:00)
	EC	ECB member Gonzalez-Paramo speaks in Dublin (12:30)

Source: Bloomberg

NB: Data in brackets denote YoY. Market consensus estimates are taken the preceding Friday.