



UKView

A monthly analysis of UK markets

UK economy in sustained recovery mode, but pace of growth very uneven

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Second quarter UK growth figures were far stronger than expected, with gross domestic product (seasonally adjusted) rising by 1.1%, equivalent to many leading analysts forecasts of UK growth for the entire year. The only exceptional factor was the impact of extreme weather conditions on first quarter output, which delayed construction, production and expenditure until the second quarter. Even allowing for this factor, the economy appears more resilient than previously forecast. Strong growth was apparent in most sectors, with private service sector output rising by 0.9% and industrial production output rising by 1.0%. Growth was also boosted by a significant contribution from the health sector and by a surge in construction output – since revised even higher to 8.6% (Q2). The overall data must be placed in perspective. UK gross domestic product declined by 6.2% in the recession, with six quarters of negative growth from 2Q 08 to 3Q 09. It will be a considerable time before real (inflation adjusted) GDP returns to the level of 1Q08 – we anticipate that this will occur in first half 2012. Whilst there is still substantial scope for stock rebuilding, the key driver of economic growth is predicted to be net exports, especially exports to the rapidly expanding Asian economies. There is also likely to be momentum from private sector infrastructure expenditure, business investment, and to lesser degree, the private and social sector housing markets.

One key factor that will limit the pace of economic recovery from 2011 onwards is the degree of fiscal tightening. There are leading analysts who warn that this factor could produce a brief double dip recession. The experience of western countries that have embarked on robust fiscal policy tightening (including Canada, New Zealand and the UK post 1981) is that fiscal policy reform, following a period of excessive public sector borrowing, increases the trend rate of growth. Should the UK economy show signs of stalling, we anticipate that the authorities would quickly respond with an increase in asset purchases under the Bank of England's quantitative easing policy and by a temporary relaxation of fiscal policy tightening. Stronger 2Q data has led to a moderate upward revision of our 2010 UK growth forecast. We remain of the view that UK growth will be circa 2 ¼% next year, rising to 3% in 2012. The path of economic recovery, as evidenced by second quarter statistics, is likely to be uneven, with significant variances in quarterly GDP data.

Data and Forecasts

Data	30-Jun	31-Jul	Change	Year End view
£ wtd index	81.4	81.7	0.4%	84.0
US dollar	1.4960	1.5695	4.9%	1.56
Euro	1.2200	1.2023	-1.5%	1.25
Yen	132.6	135.7	2.3%	140
Base Rate	0.50	0.50		0.50
5 year swap rate	2.45	2.42	-0.03	3.00
FTSE 100	4917	5258	6.9%	5900
S & P 500	1031	1102	6.9%	1200
Eurostoxx 50	2573	2742	6.6%	3100
Nikkei 225	9383	9537	1.6%	11000
Crude Oil \$/ bl)	72.50	78.20	7.9%	\$87/ bl

Foreign Exchange Market

Page 2

Sterling rise reflects temporary uncertainty over the rate of Eurozone and US growth

Interest Rates

Page 2

MPC unlikely to tighten monetary policy before Fed or ECB move

Equities

Page 2

Underlying trend in global equities remains positive

Commodities

Page 2

Commodity prices in upward mode in response to strength of global growth

Commercial Lending

Page 3

Interest rate climate supportive of commercial property market

The Housing Market

Page 3

Underlying trend in housing market is positive, but significant variance between sectors

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Foreign Exchange Market

Sterling rise reflects temporary uncertainty over the rate of Eurozone and US growth

The past few weeks have seen a moderate rise in sterling against both the euro and the US dollar. This reflects exceptionally strong second quarter UK growth data and a degree of unease over the strength of southern Eurozone and US economic recovery. We anticipate that UK growth in second half 2010 will moderate to a level that is similar to that of the USA and Eurozone, circa 0.3% to 0.4% per quarter. Given this view and the probability that benchmark interest rate differentials are likely to remain unchanged for several months, the underlying trend in sterling during the coming weeks is likely to be neutral, but with significant variations in response to specific economic data and central bank policy statements. A key factor in foreign exchange movements in the coming months is the path of Asian asset allocation. The Asian economies, notably Japan, continue to experience a high level of excess savings, a significant percentage of which currently balances the high US balance of payments deficit. As Asian growth gathers momentum, an increasing percentage of Asian net savings is likely to be invested in the rapidly expanding Asian economies. Given the risk averse nature of many Asian funds, the rate of public sector deficit reduction will have a significant bearing on Asian asset allocation, and hence the rate of exchange of sterling, the euro and especially the US dollar.

Interest Rates

MPC unlikely to tighten monetary policy before Fed or ECB move

There is a growing consensus that UK bank rate will remain on hold for several months. This reflects the recent comment from the US Federal Reserve Board (FRB), stating that US economic conditions are "likely to warrant exceptionally low levels of federal funds for an extended period". In our view, the Bank of England is unlikely to tighten monetary policy until there is a comparable move by the FRB and (probably) the European Central Bank. UK sustained recovery is dependent upon a significant increase in net exports. The Bank of England, in acknowledging that it cannot manage the sterling exchange rate, is unlikely to take action that would impact negatively on UK overseas trade. This policy is compatible with the Bank of England's financial stability mandate. Inflation is likely to remain above target until end 2011, based on central projections in the recent Bank of England Inflation Report. The Bank's economists do not foresee a medium term inflation risk given the level of spare capacity in the economy, in terms of infrastructure and labour supply. There are, however, signs of a slight upturn in pay settlements and bonuses. The trend in bank rate is expected to be a gradual upward move in 2011, as central bank focus moves from financial stability to inflation control against a background of 4% plus world economic growth.

Equities

Underlying trend in global equities remains positive

The longer term trend in equities is marginally upwards, despite temporary setbacks in recent weeks, reflecting unease over the scale of western government deficits and the impact of deficit reduction on economic growth. The underlying upward trend reflects stronger than expected corporate earnings, most notably in the US. A large number of major US corporations have exceeded analysts' expectations in respect of first half profits, in part due to strict cost control. The early stages of economic recovery are normally a positive period for company profitability, as spare capacity is utilised. This recovery has been characterised by a significant increase in labour productivity, hence the lack of momentum in the US labour market. Other key drivers of equity markets are real interest rates and global economic growth. The majority of leading forecasters expect global growth to exceed 4% next year following an anticipated increase of circa 4½% this year. The interest rate climate is likely to remain positive for several months. The central banks of the UK, USA and Eurozone have no inclination at present to raise benchmark interest rates or reverse quantitative easing policy. Real benchmark interest rates (in CPI terms), may well remain in negative territory throughout 2011, whilst real long term rates are likely to remain supportive for business investment during the next twelve months. Whilst there is likely to be considerable volatility in equity markets in the coming months, we still anticipate that FTSE 100 will close the year in the region of 5800-6000.

Commodities

Commodity prices in upward mode in response to strength of global growth

Commodity prices are currently in consolidation territory, in response to the current fine balance between supply and demand. The underlying trend remains upwards, reflecting the high rate of global growth, which this year is predicted by the IMF to be 4.6%, followed by a 4.3% increase in 2011. Copper prices are primarily driven by Asian demand. In the first half of the year, there was substantial stockpiling of copper in China. The high level of stocks led to a reduction in copper prices during the early summer months. These stocks are very gradually being run down and the upward trend in copper prices is likely to recommence. The Chinese authorities are expected to adopt fiscal, monetary and foreign exchange policies that maintain GDP growth in the region of 10% per annum. We expect copper prices, 1 month delivery, to rise to around \$8,000 / tonne by year end. There is also upward pressure on oil prices. OPEC has the capacity to increase oil production, but at present production quotas remain unchanged. Despite the strength of global recovery, a number of OPEC members appear willing to maintain current production until at least year end. The underlying trend in non OPEC production is fractionally upward - insufficient to meet peak winter demand, when we anticipate that Brent crude will peak at circa \$90/ barrel.

Commercial Lending

Interest rate climate supportive of commercial property market

The current economic climate is supportive of the commercial property market, given record low interest rates, and the prospect of longer term sustained economic growth. Whilst the prospect of fiscal tightening will limit domestic demand, the key driving factor in many sectors of the economy is the level of global demand. The world economy, based on the most recent IMF Global Economic forecast, is projected to grow by 4.6% in 2010 and by 4.3% in 2011. This factor is especially important to the financial services sector in London, hence the rise in London property prices and rents. Global economic recovery is also supportive of the manufacturing sector, with property demand greatest for modern specialist manufacturing and distribution units, with good transport access. The market for office accommodation is more subdued, although Bank of England Agency Reports indicates an upturn in the financial and business sector, the key driver of demand for office accommodation. The interest rate climate is supportive of the commercial property sector. Period rates beyond 2 years are likely to remain near record lows (in both real and nominal terms) for several months. The Bank of England Governor has indicated that any reversal of quantitative easing policy (the prime factor behind ultra low period rates) will occur after a time lag following the first increase in bank rate.

The Housing Market

Underlying trend in housing market is positive, but significant variance between sectors

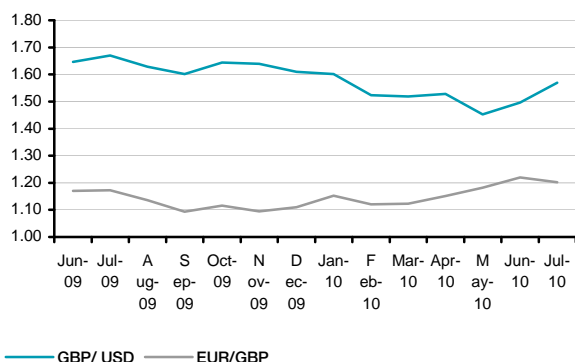
Recovery in the owner occupied housing market has stalled due to unease over the impact of fiscal tightening on average earnings and employment. The outlook for the housing market varies with sector. The current environment is one where there is significant demand for rented accommodation, hence the increase in buy to let mortgage activity to its highest level since fourth quarter 2008 (source: Council of Mortgage Lenders). First time buyer market activity is subdued, due to the impact of prospective fiscal tightening - although a significant downturn in first time buyer demand is unlikely given the increased availability of higher loan value mortgages. The upper end of the housing market in London and the south east will be boosted by the increase in financial sector employment and remuneration. Downside in house prices is limited by the lack of housing supply. In 2009, UK housing completions in England fell to 118,000, the lowest level since the mid 1940's, and first quarter completions (seasonally adjusted) showed no sign of improvement. The figure for housing starts was even lower. The strength of the construction sector in second quarter GDP (seasonally adjusted) suggests that there was a substantial increase in house building activity in Q2. The shortage of housing accommodation is most pronounced in southern England - there is better balance of housing supply and demand in Northern Ireland, Scotland, Wales, and the Midland and Northern English regions. We therefore believe that downside on average national house prices is limited. Housing construction, for owner occupier, private rented and social housing sectors, is likely to be supportive of economic growth in the coming years given the sharp decline in house-building activity in the recession and the continuing rise in the UK population due to net migration and longevity.

Monthly calendar and key charts (changes on the month)

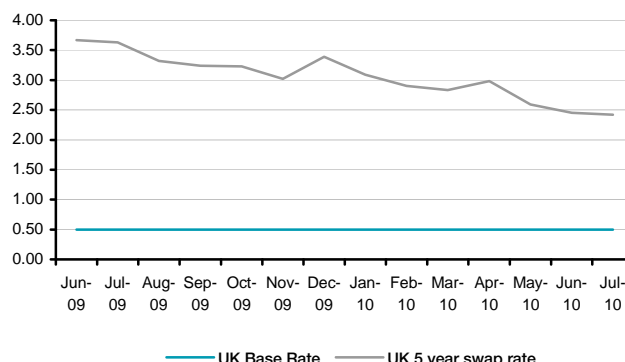
Key data releases for August

Date	Data	Period	Forecast	Previous
27-Aug	UK Growth (GDP)	2Q 2010	1.2% qoq	1.1% qoq
31-Aug	Net mortgage lending	Jul-10	£0.9bn (s.a.)	£0.7bn (s.a.)
31-Aug	Net consumer credit	Jul-10	£0.2bn	minus £0.1bn
01-Sep	PMI Manufacturing Index	Aug-10	56.8	57.3
02-Sep	PMI Construction Index	Aug-10	52.5	54.1
03-Sep	PMI Service Index	Aug-10	53.0	53.1
08-Sep	Industrial Production	Jul-10	1.4%	1.3%
09-Sep	Bank of England MPC bank rate	Sep-10	0.5	0.5

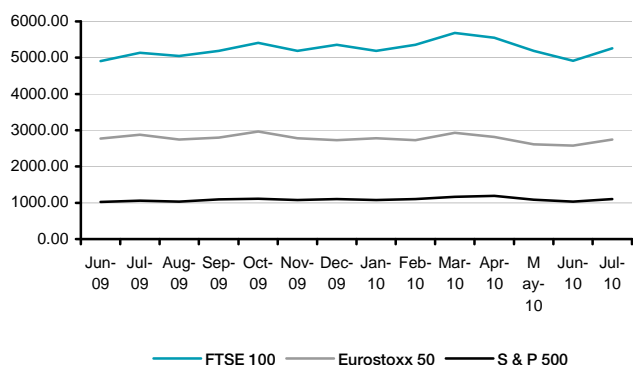
Foreign Exchange Rates vs GBP



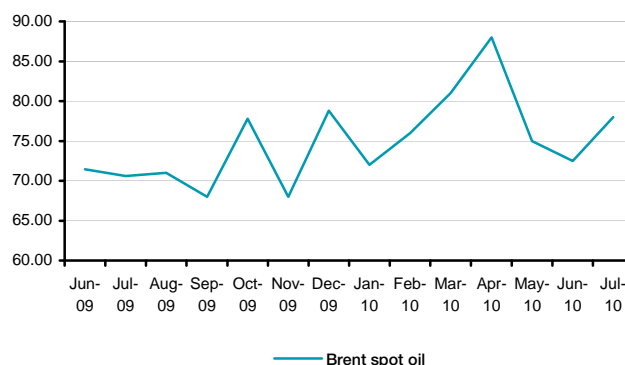
UK Base Rate and 5 Year Swap Rates



World Equity Indices



Brent Spot Oil



Market data supplied by Thomson Reuters

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