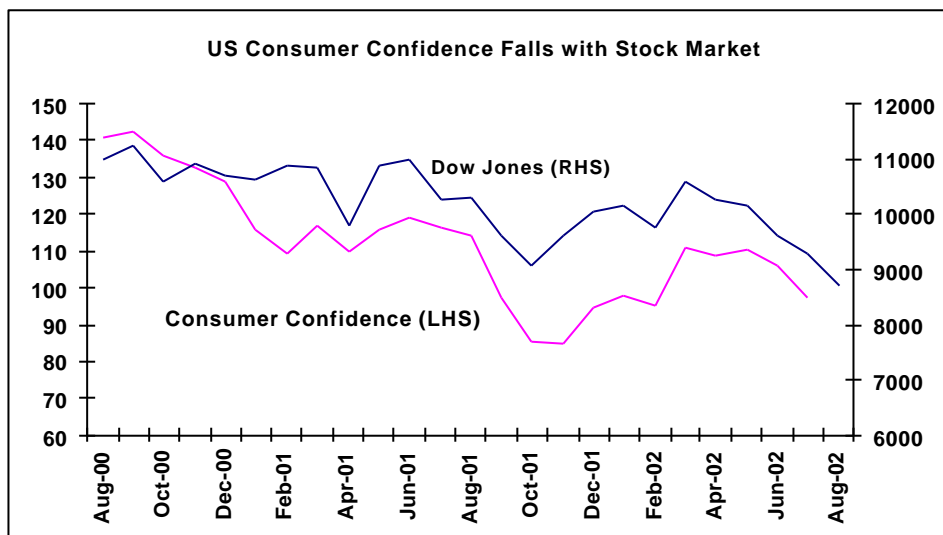


US Economic Risks Are Rising

With speculation of a new round of rate cuts in the US running high, the main focus of the week will be Tuesday's FOMC meeting. Clearly the outlook for the US economy has deteriorated since the Fed's last meeting in late June and Chairman Alan Greenspan's subsequent address to Congress. At that point Mr. Greenspan felt confident that the economy could achieve an above potential growth rate in the region of 3.50-3.75%. Now, the growth rate seems more likely to be in a 2.0-2.5% range, which is even below our original 2.7% forecast.

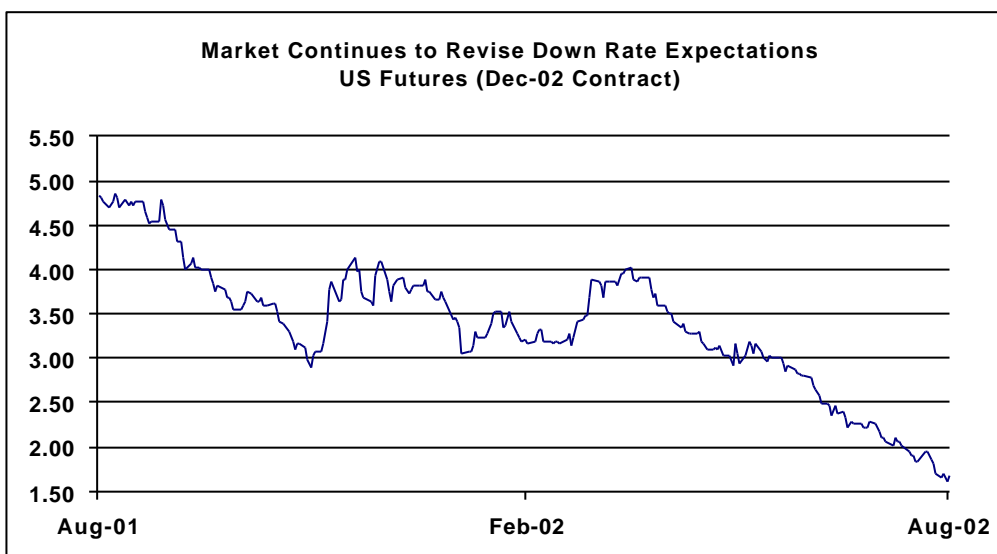
Business and consumer confidence levels have fallen back in line with the stock market, the manufacturing sector is barely expanding and there is no sign of the much hoped for pick-up in capital spending. The ongoing slide in investor confidence is a substantial threat to a recovery in this sector. A large number of corporate bond issuers have been forced to postpone issuing new debt given the lack of interest. This could result in liquidity problems as bank lenders becoming increasingly reluctant to extend credit in such an uncertain environment. Although rates are at very low levels, the spread between corporate debt and official rates has widened significantly.



The US consumer is showing no signs of retrenchment, despite the wealth erosion from the falling stock market. However, spending is being underpinned by heaving discounting, particularly in the auto sector, and there is a risk that spending will yet fall back as consumers increase their savings rate in response to lower stock prices and an uncertain labour market. In this regard indications from the labour market are not overly encouraging. July's non-farm payrolls report showed virtually no increase in the numbers at work. Furthermore, there was a drop in both the workweek and over-time hours.

All of this has raised concerns about the prospects of a double dip recession in the US. Fears for the outlook for the economy were heightened by the release of Q2 GDP data, which showed a sharp dip in growth in the April-June period. A downward revision to Q1's data indicated that the bounce back in activity earlier in the year was not as strong as anticipated. Furthermore, downward revisions for 2001 show that the economy contracted in each of the first three quarters of last year. As a result, growth for whole of last year was just 0.3%. Growth for 2000 was revised down to 3.8%, from 4.1%, taking some of the gloss of the US economic success story.

Reduced growth prospect and ongoing volatility in stock markets means that the odds have clearly moved in favour of a rate cut. In the early part of this year, hopes for a swift rebound in the US and global economies meant that financial markets were discounting as much as a 2.0% increase in US official rates to 3.75% by the year end. Significant tightening was also anticipated in the UK and eurozone. However, over recent months we have seen significant downward revision to these expectations. Over the last month sentiment alone has reversed to the extent that markets are now discounting a rate cut of at least 0.25% in the US. Members of the Fed have given no indication of that it is considering a rate cut. While a surprise move cannot be ruled out at Tuesday's meeting, we do not believe the Fed will cut rates at this point. Instead, the committee is likely to move to an easing bias, highlighting the increased risk to the economy going forward, thus opening the door to a rate cut should economic conditions deteriorate further.



Speculation of Fed easing has raised the specter of rate cuts from the Bank of England and ECB. Rhetoric from both banks has become less hawkish of late but at the same time neither has indicated that it is about to cut rates. In its August monthly bulletin the ECB indicated a neutral stance with regard to monetary policy. Recent development continue to sent mixed signals but the risks to price stability have become more balanced. Inflation should fluctuate around its 2.0% ceiling over the coming months but this is partly due to statistical effects. This month's statement is in contrast to its July bulletin, when it said that the medium-term inflation risks "remain tilted to the upside". It also failed to repeat its prediction that the eurozone economy would be back at potential growth (2.0-2.25%) by year end. While the ECB appears more relaxed regarding the near term outlook, there are still concerns about the longer term. Wage increases, the pace of growth in money supply and service prices do not point to weaker inflation over the longer-term. Therefore, we expect unchanged policy to the year end but at this point the balance of risk still remains that the next move in eurozone rates will be upwards.

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