Economic Update United Kingdom

5 July 2011

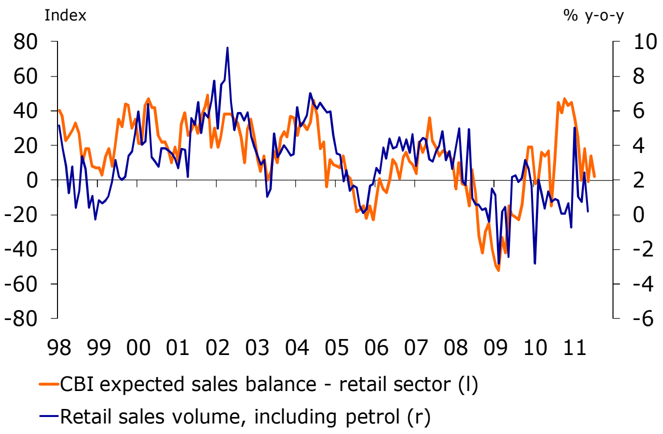
Recent bad data point to weaker consumption growth

Year-on-year change (%)	'10	'11	'12
Gross Domestic Product	1.3	1½	1¾
Private consumption	0.8	½	¾
Government expenditure	1.0	-2½	-2
Private investment	3.4	5½	5
Exports	5.8	7½	5½
Imports	8.5	4	¾
Inflation	3.3	3¾	2
Unemployment (%)	8.1	8¾	8¼
Government balance (% GDP)	-10.1	-7¾	-6¾
Government debt (% GDP)	75.0	80¾	84¼

Source: Reuters EcoWin, Rabobank

- Recently released data related to consumer spending are pointing to very weak private consumption growth in 2011.
- Of note is the drop in consumer confidence, which comes on the back of a weaker housing market, tighter fiscal policy and falling real wages.
- Inflation remains uncomfortably high and the previous rise in commodity prices will push it further towards 5%, or possibly beyond.
- Despite this, we continue to expect no rate hike before February 2012 as the economy hits a soft patch.
- The recent slowdown of manufacturing production is dashing hopes for a much-needed economic rebalancing.

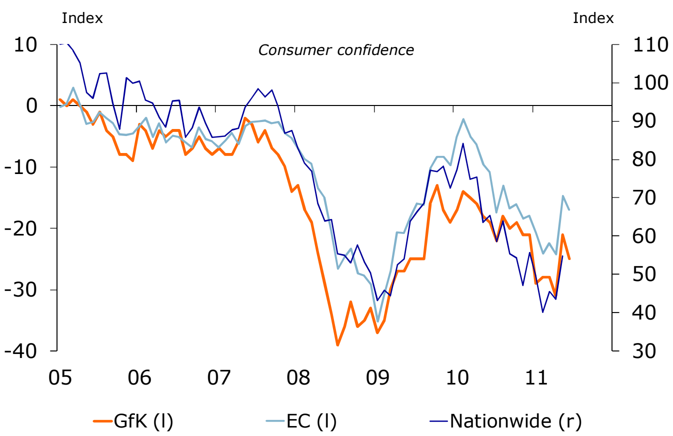
Consumers are reluctant to spend more...



Source: Reuters EcoWin

A slew of bad data related to consumer spending suggests private consumption growth in 2011 will remain very weak. The release of the National Accounts for 11Q1 showed that households had to even run down their saving to stop spending falling further. The saving ratio dropped to 4.6% from 5.1% in 10Q4. The 1.4% monthly drop in retail sales volumes in May was an important reminder that April's pick-up in high street spending was just a temporary reflection of the unseasonably warm weather, Royal Wedding and extra bank holiday. June's UK CBI distributive trades survey provided further evidence that retail sales growth has fallen back after its temporary improvement during the spring.

...and are becoming even more gloomy...



Source: Reuters EcoWin

Other data related to consumer spending are also painting a rather dark picture. The BRC reported that like-for-like sales growth was -2.1% in May. Meanwhile, Ernst and Young reported that 14 profit warnings were issued by general retailers during Q1, the highest since 08Q1. Consumers are understandably gloomy (see figure) because they are suffering from a triple whammy in the shape of tighter fiscal policy, weaker housing market and falling real wages. The only piece of good news they are receiving is the resilience of the labour market. In the three months to April, employment rose by 80,000. Thankfully, the private sector is creating enough jobs to compensate for public sector job cuts.

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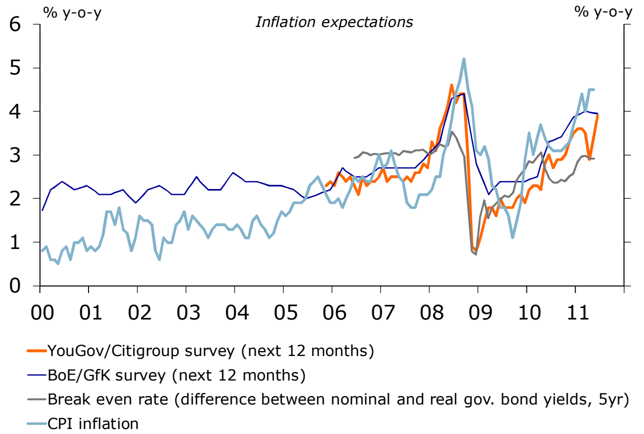
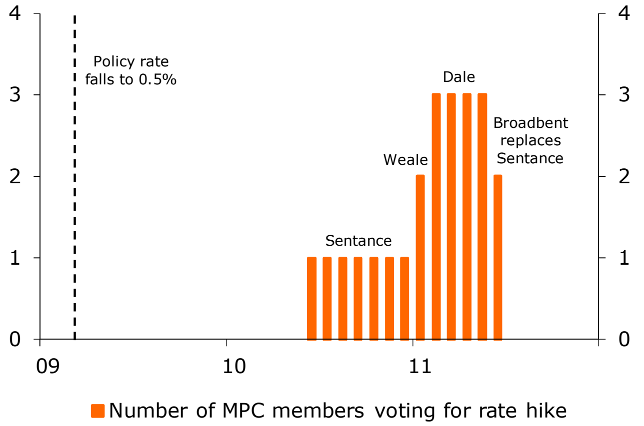
...for a large part thanks to rising inflation



Source: Reuters EcoWin

The inflation rate in May (4.5%) was unchanged from April. But this is most likely a temporary respite. The big utility price increases announced by Scottish Power (19% rise in gas and 10% rise in electricity prices) last week raised the possibility that inflation could rise even further above the 5% in the coming months. Note that Scottish Power has only a small market share (around 10%) but once one supplier changes prices, the rest usually follow suit. Even more worrisome perhaps is the significant rise in households' expectations for inflation over the next 12 months (YouGov/Citigroup survey). Nevertheless, the historical relationship between inflation expectations and pay growth has been very weak.

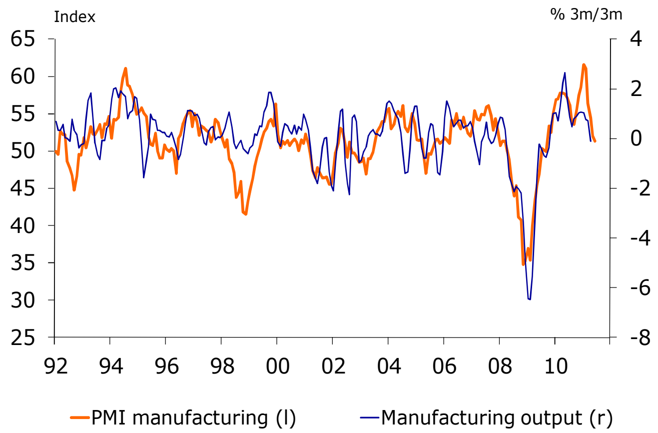
1 hawk down, 2 to go?



Source: Bank of England

The hawks on the Monetary Policy Committee (MPC) may use the rise in household inflation expectations to claim that the MPC is losing its inflation-fighting credibility. However, MPC arch-hawk Andrew Sentence has been replaced with a dove (Ben Broadbent). In their June meeting, 7 members voted for maintaining the exceptionally accommodative monetary stance while 2 voted for a hike (the ratio was 6 to 3 in May). What's more, the tone of the June MPC minutes marked a distinctly dovish shift. As such, we pushed back our rate hike expectation to Feb. 2012 (from Nov. 2011 previously). If the weakness of demand persists, policy tightening may be delayed further.

Drop in manufacturing dashes hope for rebalancing



Source: Reuters EcoWin

The concerns of the dovish camp are well-grounded, in our view. Manufacturing production, which was the only bright spot in the UK economy until now, has decidedly taken a turn for the worse (-1.5% m-o-m in April). Of course, the disruption to supply chains caused by the Japanese earthquake may be the reason behind this. But the drop of PMI in the manufacturing sector to its lowest level since September 2009 (51.3 in June) suggests that the slowdown could be more entrenched. The weakness of new (export) orders and employment sub-indices are particularly concerning in this regard. Against this backdrop, hopes of economic rebalancing towards the industrial sector are fading fast.

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