Economic Update United Kingdom

1 November 2011

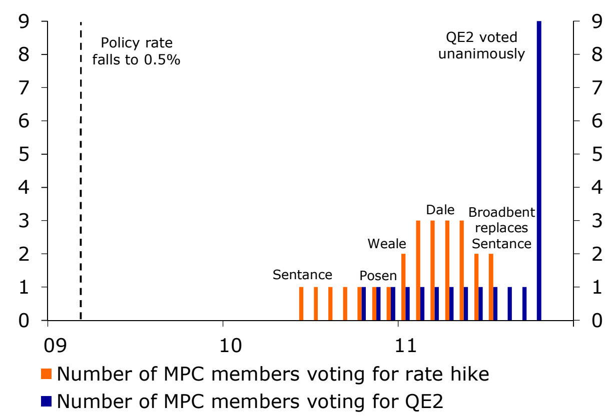
QE2 arrives: should we pop the champagne corks?

Year-on-year change (%)	'10	'11	'12
Gross Domestic Product	1.4	1	1
Private consumption	0.7	-½	¼
Government expenditure	1.3	½	-1¼
Private investment	3.7	1¾	5
Exports	5.2	6¼	5¼
Imports	8.8	1¼	2
Inflation	3.3	4¼	2
Unemployment (%)	8.0	7¾	8¼
Government balance (% GDP)	-10.4	-8½	-7
Government debt (% GDP)	77.2	83	85

Source: Reuters EcoWin, Rabobank

- The much-awaited QE2 was finally launched in October after Adam Posen, the arch-dove MPC member, convinced everyone to get on board.
- On first assessment, the programme does not seem to be a success. As we explained before, more QE won't materially change the outlook without fiscal rethink.
- Growth in 11Q3 (0.5%) was in line with expectations. Waning global demand has led us to lower UK's growth forecast for 2011 and 2012.
- September's inflation (5.2%) was a negative surprise. But we believe that it has peaked.
- The labour market has decidedly turned for the worse. The jobless rate has increased to 8.1% (from 7.9%) and we expect it to rise further.

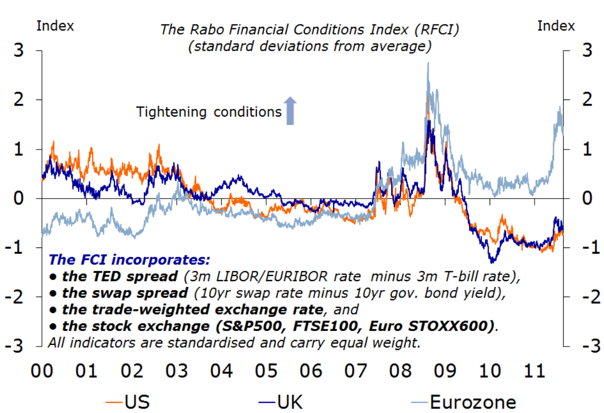
All hawks down!



Source: Bank of England, Rabobank

Since mid-2010, a number of hawks in the Monetary Policy Committee (MPC) of the Bank of England voted to raise policy rates to battle inflation. In the meantime, the arch-dove Adam Posen took the opposite position and continously voted for relaunching quantitative easing (QE2) to fight economic stagnation. For what it's worth, we also sided with Mr. Posen last year and argued that the UK economy can use a new dose of QE given the strong headwinds (see our Special Report 2010/16). After months of debate, all MPC members finally concluded that Mr. Posen was right all along – that the economy is too weak to be left to its own devices – and therefore unanimously voted for QE2.

Is the MPC getting any 'bang for its buck'?



Source: Reuters EcoWin, Rabobank

The MPC shocked and awed the investor community by launching QE2 one month ahead (October) of market expectations (the asset purchase programme is extended by GBP 75bn to GBP 275bn). It is still too early to assess its success but we are disheartened by the fact that the Rabo Financial Conditions Index (RFCI) has hardly budged even though GBP 15bn have already been purchased. Disappointingly, 10-year gilt yields rose from around 2.3% to 2.6% during October. Given the faith the Bank has in QE (they estimated that QE1 had a strong positive effect on GDP growth), they may further extend the programme in 2012. We doubt, however, that even more QE will materially change the outlook without fiscal rethink.

www.rabobank.com/economics

Shahin Kamalodin
Tel. +31 (0)30 – 2131106
S.A.Kamalodin@rn.rabobank.nl

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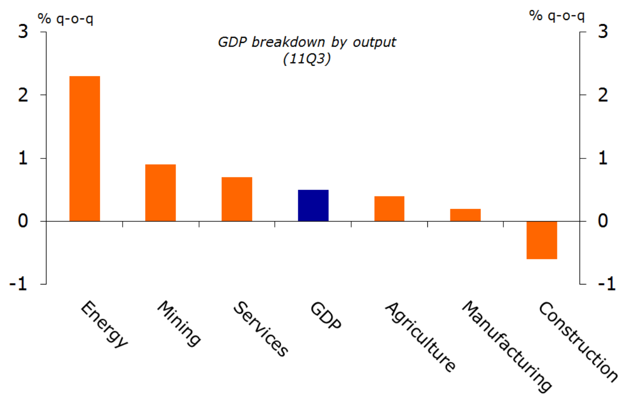
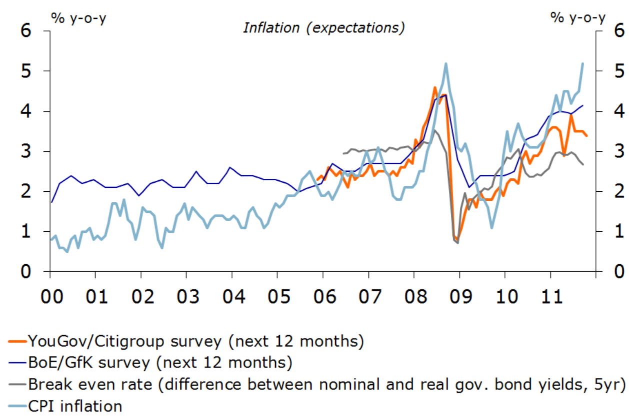
11Q3 GDP growth bang in-line with expecations



Source: Reuters EcoWin, Rabobank

The 0.5% q-o-q rise in GDP in 11Q3 was largely driven by a 0.7% jump in services output. The pickup in activity was anticipated because some of the negative forces in 11Q2 (e.g the extra royal wedding bank holiday) were expected to unwind. As such, this growth figure does not alter our view on the outlook. In fact, the recent plunge in October's manufacturing PMI (from 50.8 to 47.4) suggests that the industrial sector is unlikely to repeat the 0.5% rise in output seen in 11Q3. Overall, the recent weakness in major leading indicators together with our expectation for slower global growth going forward has led us to lower UK's GDP growth forecast to 1% in 2011 and 2012 (previously 1.25% and 1.5%, respectively).

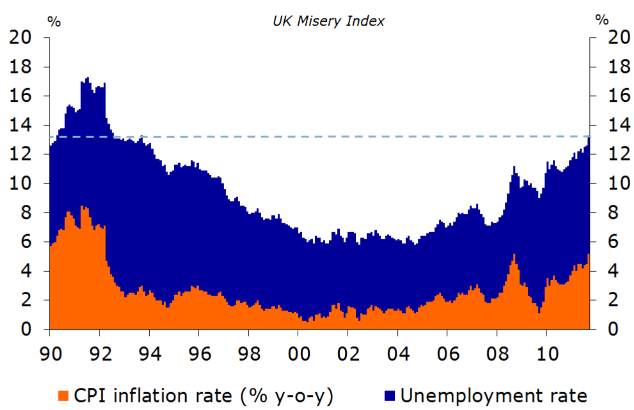
Inflation most likely peaked in September



Source: Reuters EcoWin, Rabobank

Some argue that QE2 would have been delayed if the Bank had seen September's inflation figure (5.2% y-o-y), which was posted only days later. But we do not believe this would have altered the MPC's decision. For one, the Committee already expected inflation to peak above 5%. Secondly, in an interview following the announcement of QE2, Governor King said that he expected the September CPI reading to represent the peak in inflation. We agree with that view. As we have reiterated time and again, inflation in the UK will drop considerably next year owing to weaker domestic demand growth, falling commodity prices and mechanical 'base effects'. This is why inflation expectations remain relatively well-anchored.

Misery rising



Source: Reuters EcoWin, Rabobank

Consumers are not only facing higher prices, but they are also suffering from worsening job market conditions. The ILO measure of unemployment rose by 114,000 (to 2.57m, its highest level since 1994) in the three months to August. As we suspected in the past, the private sector seems to be struggling to offset the ongoing government job cuts (105,000 public sector jobs were axed in Q2, up from 38,000 in Q1). By looking at the UK Misery Index – inflation plus unemployment rate – we cannot realistically expect households to support the recovery until inflation decisively drops and job market conditions improve. Until then, the ball remains strictly in foreign courts (i.e. don't expect too much from domestic demand).

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