Economic Update United Kingdom

5 June 2012

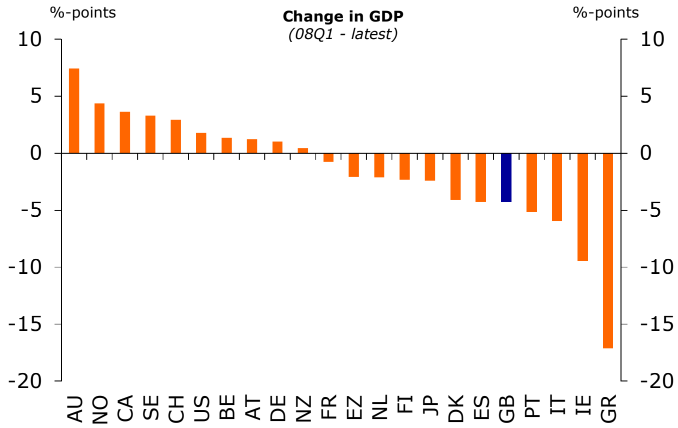
Assessing strength of recovery is getting complicated

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.7	½	1½
Private consumption	-1.2	½	1
Government expenditure	-0.9	-¾	-½
Private investment	0.8	-¼	5¾
Exports	4.6	3¼	5¼
Imports	1.2	1¼	3¾
Inflation	4.5	2¼	2
Unemployment (%)	8.2	8¼	8½
Government balance (% GDP)	-8.5	-7	-5
Government debt (% GDP)	80.7	84¼	86

Source: Reuters EcoWin, Rabobank

- UK GDP contracted by 0.3% q-o-q in 12Q1. This means a technical recession, which most (ourselves included) were not expecting, is now a reality.
- The contraction of GDP was largely thanks to the rapid pace of destocking by British firms.
- Going forward, output will bounce around over the next few quarters due to the Queen's Diamond Jubilee and the Olympics.
- The jawdropping deterioration in May's manufacturing PMI suggests that GDP may contract once again in 12Q2.
- Inflation resumed its downward trend in April. The drop in the headline rate to 3% took inflation to its lowest rate in over two years.

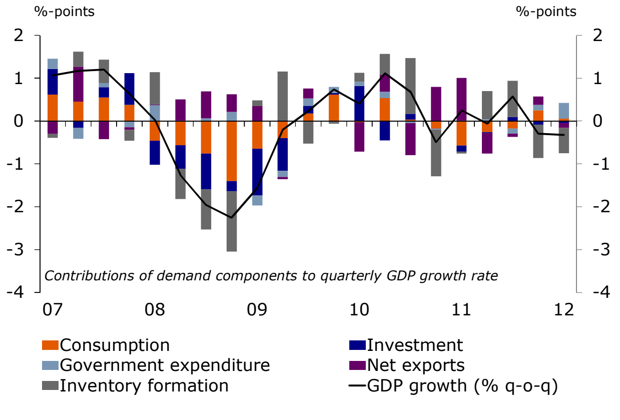
The UK surprisingly entered a technical recession…



Source: Reuters EcoWin, Rabobank

The UK's GDP release for 12Q1 (-0.3% q-o-q) was simply disappointing. The economy shrank for the second quarter in a row making a technical recession, which most (ourselves included) were not expecting, reality. Admittedly, over the past 20 years, the average revision to the initial estimate of UK quarterly GDP growth has been +0.2%. So we shouldn't be surprised if the growth figure would be revised upwards. In fact, the weakness in output is difficult to reconcile with some reliable leading indicators of activity that pointed to much stronger growth figures. However, barring a very large revision, which we deem highly unlikely, the big picture is that the economy remains exceptionally weak.

…largely due to the destocking process



Source: Reuters EcoWin

The GDP breakdown offered some good news. Business investment rose by 3.6% q-o-q. Household spending also contributed positively to growth, albeit marginally. Finally, the single biggest drag on growth came from inventory formation, which knocked 0.6% off quarterly GDP growth. Though this might indicate firms' lack of optimism about the outlook, it should be only temporary. To our regret, net exports subtracted from the headline growth figure due to a sharp slowdown in export growth (down to 0.1% q-o-q, from 1.6% in 11Q4). Obviously, the fact that the country's major trading partner, the eurozone, is mired in a debt crisis will further dent hopes for an export-led recovery in the near future.

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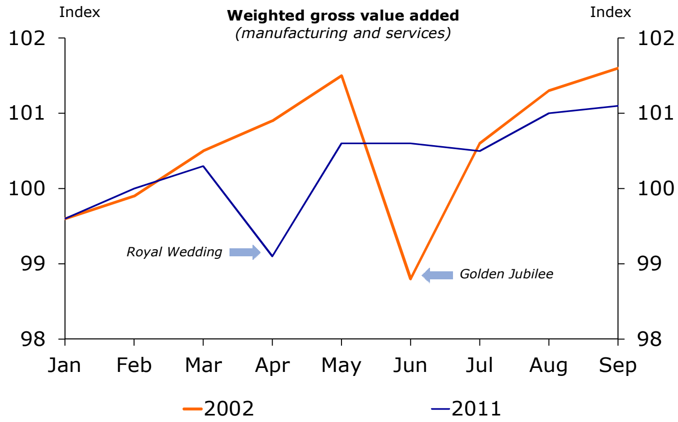
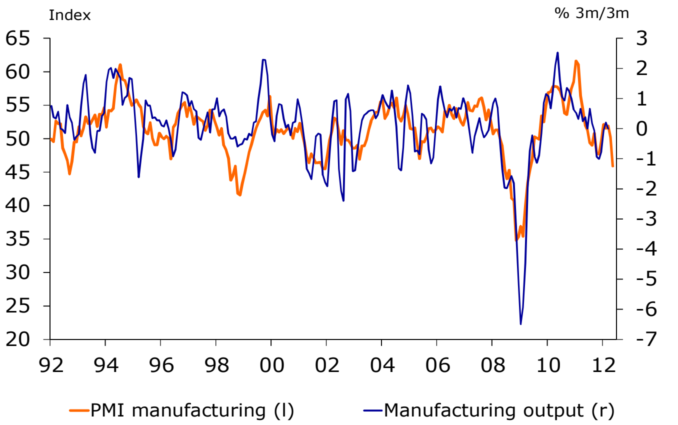
Zigzag year will result in poor economic visibility



Source: Bank of England

Going forward, output will bounce around over the next few quarters due to two factors – the Diamond Jubilee and the Olympics. There are two recent examples of additional bank holidays that have weighed on output: the Golden Jubilee in June 2002 and the royal wedding in April 2011. Similarly, the BoE expects the Diamond Jubilee to lower GDP growth in 12Q2 (their estimate is -0.5%-point). In the following quarter, GDP will rebound by a little more than that (partly due to the Olympics 'dividend') and fall once more in 12Q4 as output reverts to its underlying level. Against this volatile economic backdrop, it is extremely difficult to assess the strength of the recovery in the coming quarters.

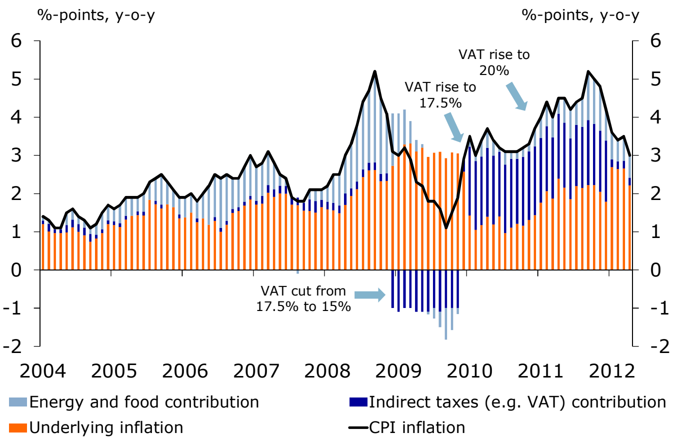
Warning! GDP may contract once again in 12Q2



Source: Reuters EcoWin, Rabobank

The UK economy will not only suffer from the extra bank holiday in June, but it is also facing renewed pressure from the downturn in the industrial sector. The sharp deterioration in May's manufacturing PMI is particularly worrying in this regard. The overall PMI fell from 50.2 in April to 45.9 – its lowest level since May 2009. This largely reflected a sharp drop in the output (from 51.7 to 47.6) and new orders (from 49.0 to 42.0) sub-indices. On past form, the PMI manufacturing is now consistent with quarterly falls in manufacturing output of at least 1%. We will need to wait for the incoming data in June – and perhaps July – to form a better understanding of the underlying economic momentum.

Inflation continues to head South



Source: Reuters EcoWin, Rabobank

Inflation resumed its downward trend in April. The drop in the headline rate from 3.5% to 3.0% took inflation to its lowest rate in over two years. The timing of Easter played a key role in lowering inflation as Easter Sunday fell outside the price collection period this year. This meant the holiday-induced fare increases that tend to boost the prices of air and sea travel were completely absent from April 2012 data. That said, other areas of core inflation fell as well, which suggests that the slack in the economy is also weighing on inflation. In the coming months inflation may hover around these levels given weak underlying price pressures this time a year ago, but the medium-term trend is still downwards.

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