Rabobank

Economic Update United Kingdom

3 May 2011

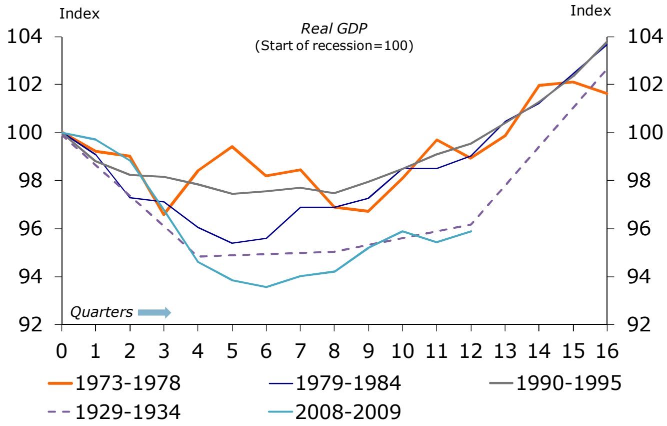
Stagflation will put off the rate hike in the near-term

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: EcoWin, Rabobank

- The preliminary GDP growth figure for 11Q1 (+0.5% q-o-q after -0.5% in 10Q4) shows that the UK economy has completely ground to a halt since last autumn. The biggest culprit was the construction sector, which managed to knock 0.3%-point off quarterly growth.
- The disappointing growth figure together with the fall in inflation in March will empower the doves in the Bank of England.
- The rise in commodity prices suggests that March's fall in inflation may be only a temporary respite.
- But there are still good reasons to argue that inflation will fall back in the medium-term. Therefore, we continue to believe that the BoE will postpone the rate hike until 11Q4.

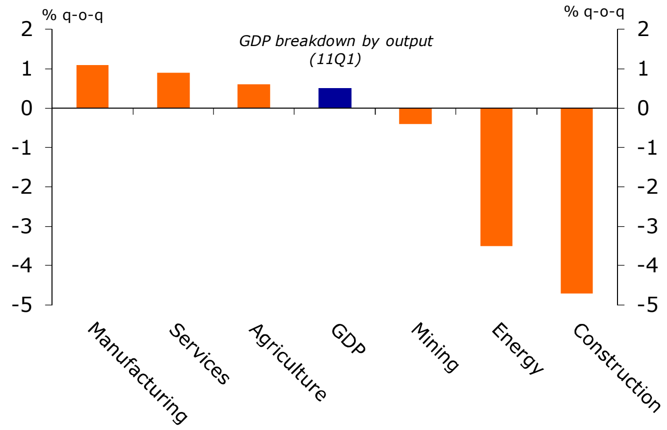
Real GDP moving sideways...



Source: Reuters EcoWin, Capital Economics

Yet another disappointing growth figure in 11Q1 (+0.5% q-o-q) serves as a reminder that the UK economic recovery is still struggling. The preliminary figure shows that the economy has completely ground to a halt since last autumn, with underlying activity broadly stagnant over the past 6 months. In fact, if 11Q1 was pure 'catch-up' of output lost in 10Q4 amid snow-related disruptions, then underlying GDP growth in 11Q1 may even have been slightly *negative*. Indeed, note that the growth figure is weaker than the 0.8% rise that both the Bank of England (BoE) and the government had pencilled into their forecasts. Even the leading indicators overestimated the strength of activity.

...mostly due to a huge drag from construction



Source: ONS

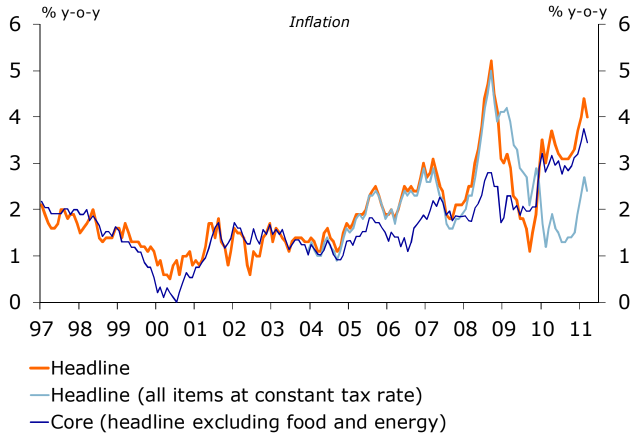
A closer look at the GDP breakdown shows that the construction sector acted as the major drag on activity. A 4.7% drop in construction output in 11Q1 meant that the sector knocked 0.3%-point off quarterly growth. More favourable weather conditions resulted in a sharp drop in energy supply compared to the unseasonally cold fourth quarter of 2010. However, this sector only subtracted 0.1%-point off growth given its relatively small size in the overall economy. Meanwhile, the services sector (accounting for 78% of gross value-added) managed to rebound strongly and added 0.7%-point to the headline growth figure. The manufacturing sector managed to add a meagre 0.1%-point to growth.

www.rabobank.com/kennisbank

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

3 May 2011

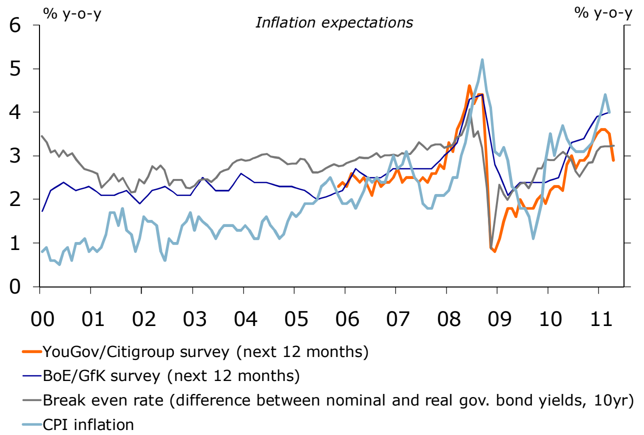
Supermarket sales push down inflation in March...



Source: Reuters EcoWin

Admittedly, one cannot draw strong conclusions based on preliminary growth figures given the large revisions to the GDP figure in the past. Then again, the weak preliminary growth figure together with the strong drop in the headline inflation (from 4.4% in February to 4.0% in March) will empower the dovish camp in the BoE. As far as inflation is concerned, the 0.4%-point decline between February and March was primarily driven by sales in supermarkets, according to the Office for National Statistics. Apparently, the weakness of high street spending is dampening retailers' pricing power. A squeeze on profit margins is being tolerated in order to retain market share.

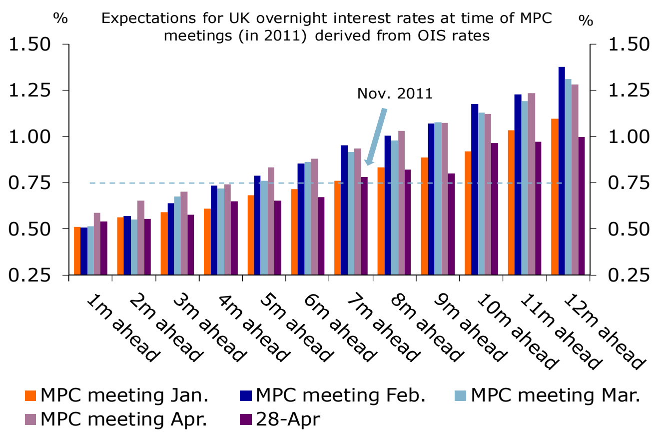
...but prices may pick-up again in the short run



Source: Reuters EcoWin, Bloomberg

March's fall in inflation may be only a temporary respite as past rises in commodity prices can push inflation higher going forward. In fact, the output prices balance in the PMI manufacturing survey stood at 64.2 in April. This points to a significant pick-up in output price inflation going forward. Nevertheless, the doves can argue that the fall in annual average earnings growth (excluding bonuses) from 2.3% to 2.2% in February provides more reassurance that (core) inflation is not running out of control. Similarly, the weakness of the money supply growth figures and the drop in household inflation expectations (based on YouGov/Citigroup survey) all point to a fall in inflation in the medium-term.

The BoE will probably postpone the rate hike until Q4



Source: Bloomberg

There are more reasons to believe that inflation will fall back in 2012. For one, we must not disregard the mechanical 'base effects' (i.e. recent increases in energy prices and the January VAT hike will drop out of the 12-month comparison). What's more, with leveraged households retrenching (retail sales ex. food fell by 1.9% between January and March), the UK economy is unlikely to experience demand-pull inflation while the austerity measures are beginning to bite. Against this backdrop, we believe the BoE will keep rates on hold until 11Q4. Accordingly, in shifting back their expectations of the timing of the first rate hike to November, we think that markets are moving in the right direction.

www.rabobank.com/kennisbank

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