

Economic update and outlook for the six months to 31 March 2013

Economic background

- 1 During the quarter ended 30 September:
 - Indicators suggested that economic growth returned after three quarters of recession;
 - Retail sales held up well and spending off the high street strengthened;
 - Employment continued to rise at a strong pace;
 - Inflation failed to make further downward progress;
 - The Monetary Policy Committee (MPC) announced more asset purchases;
 - UK equity and government bond prices rose;
 - The US economy continued to recover, but at a disappointingly slow pace.
- 2 GDP growth in quarter ended September looks set to be positive for the first quarter in a year. Although the CIPS/Markit business surveys weakened in July, they recovered in August to a level consistent on past form with quarterly GDP growth of about 0.2%.
- 3 In addition, the surveys seem to have been unaffected by the impact of the lost working day for the Queen's Jubilee, which will have shifted some production from June to July. Indeed, the official data improved significantly at the start of Q3. Following its 2.4% monthly drop in June, industrial production rose by 2.9% in July. The overall trade deficit shrank from £4.3bn in June to £1.5bn in July.
- 4 Furthermore, the CIPS surveys exclude the retail sector and high street spending has held up relatively well. The official measure of retail sales volumes grew by 0.3% in July. And while sales volumes fell by 0.2% in August – suggesting that the Olympics Games did not provide much of a boost to retail spending – retail sales should still support overall GDP growth in Q3. Even if sales volumes just hold steady in September, then sales will be 0.9% higher than in the second quarter.
- 5 Spending off the high street has also shown signs of recovering. In particular, private new car registrations were 26% and 12% higher than a year ago in July and August respectively. Moreover, Olympics ticket sales that occurred in previous quarters will be counted as household spending in the third quarter.
- 6 As a result, GDP growth could show a healthy quarterly rise to +0.6% in Q3. However, given that the level of GDP is likely to have been boosted by both the Queen's Jubilee and the Olympics, a renewed fall in output in Q4 seems likely.
- 7 Meanwhile, the labour market has continued to recover. The Labour Force Survey measure of employment rose by 236,000 in the three months to July and the claimant count measure of unemployment fell by 15,000 in August – the biggest fall since June 2010. That said, most of the rise in employment was driven by growing self and part-time employment, rather than full-time,. Moreover, 91,000 of the new jobs that were created were in London – around 40% of the total – despite the fact that the capital accounts for only 15% or so

of overall employment. The Olympics would therefore seem to have provided a temporary boost to the national employment figures.

- 8 Pay growth has remained modest. Annual growth of overall average earnings ticked up from 1.3% in June to 1.4% in July. Given the rate of inflation over this period, real pay continued to fall on an annual basis.
- 9 The underlying trend in house prices still seems to be broadly down. The Halifax measure of house prices fell by 0.7% in July and a further 0.4% in August. The Nationwide's measure fared better – although it fell by 0.8% in July, it then rose by 1.3% in August. Mortgage approvals for new house purchases have also remained weak. The total of 47,300 in July was below the average of 50,700 seen in the first half of 2012.
- 10 Banks' funding costs continued to ease over the quarter. This reflects the Bank of England's continued provision of low cost liquidity to banks in tranches of up to £5bn a month, the start of the Funding for Lending Scheme and the easing of tensions in Eurozone debt markets to which UK banks are exposed. But so far, quoted borrowing rates on most types of new mortgages have held broadly steady.
- 11 Meanwhile, the trend in public borrowing has continued to deteriorate. A continuation of the pattern seen in the first five months of the fiscal year (since April) would mean that borrowing in 2012/13 as a whole would come in at around £145bn, compared to the Office for Budget Responsibility's March forecast of £120bn. And while the Government announced some new measures to get credit flowing around the economy – including a £10bn guarantee to help housing associations and private developers raise funds to build new homes, and plans for a “business bank” – this largely amounted to tinkering at the edges of the fiscal austerity plans.
- 12 Inflation struggled to make further downward progress in Q3. Indeed, CPI inflation rose from 2.4% in June to 2.6% in July, before falling back to 2.5% in August. While inflation should drop to around 2% in September on the anniversary of last year's chunky rises in utility prices, further falls in inflation over the next few months look unlikely as a result of the recent increase in commodity prices. Oil prices rose from \$97 per barrel at the end of June to around \$113 per barrel at the end of September, while global agricultural prices have risen by around 25%.
- 13 The MPC voted in July to undertake £50bn additional asset purchases over the following four months. Although interest rate markets are pricing in a decent chance of a cut in official interest rates within the next few months, Mervyn King is opposed to this.
- 14 Asset prices in the UK and overseas largely continued to rise over the course of the third quarter. 10-year gilt yields fell from about 1.85% to 1.70% (although prices were volatile during this period), while the FTSE 100 recovered from 5,570 to 5,760. The pound also strengthened against both the euro and the dollar, from €1.23 to €1.25 and from \$1.56 to \$1.62 respectively.

- 15 The US economy's recovery has remained fairly weak. A weighted average of the manufacturing and non-manufacturing ISM indices points to annualised GDP growth of no more than 2.0% in the third quarter. Increases in total non-farm payroll employment were disappointing, up only 97,000 in July and 120,000 in August, compared to an average increase of 142,000 in the second quarter.
- 16 In the Eurozone, market sentiment improved following the ECB's pledge to buy "unlimited" quantities of peripheral government's sovereign debt in early September, provided that those countries have formally requested a bail out. However, peripheral Eurozone bond yields began to rise again at the end of the quarter due to Greece increasingly looking as if it will now have to ask for a third bail out and Spain continued prevaricating over making a formal request for a bail out when all the evidence indicates that this will be unavoidable. As for GDP growth, the composite Eurozone PMI points to a quarterly drop in GDP of about 0.4% in Q3.

Summary economic outlook

Eurozone

- 17 A new storm is brewing as Greece, yet again, is failing to meet the demands of the austerity programme in cutting government expenditure, increasing tax revenue and selling off public sector assets. German patience with this situation must be close to breaking point and without German support Greece will run out of cash within the next couple of months. Markets are currently predicting an end game where Greece is eventually forced to exit (dubbed "Grexit") the Eurozone and return to the drachma.
- 18 More worryingly, sovereign bond yields for both Spain and Italy rose sharply to levels previously deemed unsustainable. Spain is now actively looking at what might be acceptable terms for receiving a bailout and surrendering national sovereignty to external oversight by the IMF and Eurozone paymasters.
- 19 One possible, but very unlikely, solution to the Eurozone debt crisis would be the issue of Eurobonds. These would collectivise all debt in the Eurozone and reduce the Greek element in total Eurozone debt to an almost insignificant percentage.
- 20 Austerity programmes in various countries are reducing GDP growth rates.

US

- 21 GDP is weakening alongside the recovery in jobs growth.
- 22 The Federal Reserve predicts that current ultra-low interest rates may be warranted until at least mid-2015.
- 23 There is political gridlock ahead of the November 2012 Presidential elections, for major fiscal action.

- 24 The new President is unlikely to make a significant fiscal impact on the US economy in 2013 as the unsustainably high budget deficit will need to be urgently addressed.
- 25 The housing market is at last beginning to show tentative signs of picking up.
- 26 Confidence figures among US consumers rose to a seven month high in September as the Conference Board's index of optimism rose from 61.3 to 70.3.

China

- 27 There are increasing concerns that efforts to stimulate the economy could fail to avoid a hard landing. There are now many parts of the economy flashing distress signals.
- 28 A fresh round of support is widely expected. This could coincide with the change in the party hierarchy which is due to take place at the 18th Party Congress which begins in early November.

UK

- 29 The UK has suffered its worst and slowest recovery from recession of any of the five recessions since 1930.
- 30 The Bank of England August 2012 Inflation Report again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%.
- 31 40% of UK GDP is dependent on overseas trade; high correlation of UK growth to US and EU GDP growth means that the UK economy is likely to register weak growth in the next two years.
- 32 Consumers are likely to remain focused on paying down debt; weak consumer sentiment and job fears will all act to keep consumer expenditure suppressed.
- 33 It is likely to take a lot longer to eliminate the structural budget deficit than in the current plans of the Coalition government. These plans will need to be updated to incorporate the impact of weak growth in the Eurozone and US depressing UK GDP growth, and thus lower expectations for increases in tax revenues.
- 34 The Coalition Government and the Bank of England have put in place a programme of action to improve the availability of credit in the economy. However, it will take time for this to feed through into a significant positive impact on GDP growth in the economy.
- 35 There is little sign of a coordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.

- 36 Eurozone concerns and the potential for further Quantitative Easing (QE) to stimulate GDP growth are likely to keep gilt yields depressed during the next twelve months.
- 37 UK gilts are likely to retain safe haven status from Eurozone worries for some time. Eurozone politicians struggle to reach agreement on how to replace impressive sounding words with actually implementing an effective platform of measures to conclusively subdue the debt crisis.
- 38 However, there are improvements in the prospects for the UK economy, though there is still a long way to go:
- UK banks have made huge progress since 2008 in correcting their over-extended balance sheets, though credit availability still remains weak.
 - Consumers have also made progress in correcting their personal over-borrowed balance sheets so that personal debt relative to incomes is now down to the lowest level since 2004. However, at 146%, it still remains the highest of any G7 nation.
 - The car industry is well on track to increase production. This is expected to see an increase from about 1m cars per annum in 2009 to 2.25m by 2016, much of which will be exported. In addition, car component firms are moving production to the UK in order to cost effectively meet the consequent increase in demand for their products. The car industry has also made steady progress in reducing its labour costs to be below those of Germany, France, Italy and even Spain.
 - The fall in price inflation relative to increases in pay inflation meant that household disposable income was less affected in quarter ended June, the biggest improvement in three years.
 - Recent increases in employment also strengthen consumer expenditure, tax receipts and reduce Government expenditure on benefits.
 - The UK is less encumbered to hindrances to new investment and new employment than countries in the Eurozone and has a competitive currency.
 - The UK has a more effective approach to stimulating growth than in the Eurozone in the areas of monetary policy and direct action to improve the supply of liquidity to the real economy.

Sector's forward view

- 39 Economic forecasting remains difficult with so many external influences weighing on the UK. Key areas of uncertainty include:
- The impact of the Eurozone crisis on financial markets and the banking sector;

- The impact of the UK Government's austerity plan on confidence and growth;
 - Monetary policy action failing to stimulate growth in western economies;
 - The potential for weak growth or recession in the UK's main trading partners - the EU and US.
- 40 The overall balance of risks remains weighted to the downside. Sector believes that the longer run trend is for gilt yields and PwLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However, near-term, QE is likely to depress yields and further QE thereafter may lead to a reassessment of Sector's central forecast.
- 41 Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before early 2014 as very limited indeed. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.