

Novus Capital Markets Research

UK economic outlook

9 February 2012

- **The mood is lifting:** in 2011 UK GDP rose 0.9%, only half what was expected a year ago and, on the preliminary data it was falling again by the end of the year. Confidence and spending have fallen away as politicians in the euro area have not just failed to get on top of a crisis largely of their own making but, through their austerity policies and ill-advised fiscal compact, are actively making the near-term outlook worse. Nevertheless, so far in 2012 the mood, particularly in forward-looking equity markets, has lifted somewhat, partly as a result of a more flexible approach to monetary policy on the part of the new ECB Governor, Mario Draghi and the hope that the worst downside risks can be avoided, and partly because of some signs of recovery in the US which, in a Presidential election year, remains committed to boosting growth and reducing unemployment.
- **Another year of two halves:** the near-term outlook for the UK is poor. Q4's 0.2% fall in GDP should be reversed in Q1 if the early survey data are correct. But growth is unlikely to get to trend until the second half. The main bullish feature is that inflation, the unexpected strength of which proved to be the main drag on demand last year, has already fallen 1pp from the September peak and could fall as much again in January as last year's VAT hike drops out of the annual rate. By the spring it should be at 3% with the 2% target or below in sight by the end of the year. So where household incomes were squeezed by rising inflation last year, they will be boosted by falling inflation in 2012. A recovery in consumer spending and stronger business investment as the year progresses are the mainstay of my above-consensus forecast for 1% GDP growth in 2012. By contrast net exports will be held back by weak global demand and may make no contribution to demand this year.

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Summary

The key features of my forecast, which is based on a gradual US-led recovery in the global economy and a continuing fall in UK inflation, are:

- UK GDP rises 1% in 2011. This is above the consensus which has progressively cut the 2012 outlook to 0.4%. Growth is sluggish in the first half as exports suffer from the drawn-out crisis in the euro area and a general downgrade to global growth prospects. Growth picks up in the second half as the US recovery continues apace and falling UK inflation boosts real household incomes and spending.
- The rebalancing of demand away from domestic consumption (private and public) in favour of net exports and investment, which the Governor tells us is vital and necessary to the UK economy over the medium term, is on hold this year. Held back by the weakness in Europe, net exports make little or no contribution to demand. Consumer spending and business investment are the main drivers of growth as the year progresses.
- Inflation, which has fallen from 5.2% to 4.2% in the last three months, falls sharply in January as last year's VAT hike drops out of the annual rate and is at 3% by the spring. Progress in the second half of the year will be slower but on the basis of wage settlements remaining at very low levels, CPI inflation should get to the 2% target and beyond by the end of the year.
- With private sector job creation slowing to a crawl and public sector job-shedding picking up speed, employment was falling and unemployment rising in the second half of last year. That trend is unlikely to change while growth is weak and unemployment will head up towards three million.
- Despite the weakness of the real economy, the public finances have continued to improve in line with the OBR forecasts. In November the OBR forecast a decline in borrowing from 9.3% of GDP in 2010-11 to 8.4% this year and to 7.6% in 2012-13. Even with another significant increase in the personal tax allowance scheduled for this year's Budget, I would expect these forecasts to be in the right ballpark.
- The MPC retains an easing bias. Bank Rate was held at 0.5% all through last year and from October onwards a new £75bn round of QE was launched. This was followed up this week by another £50bn. On my forecast that is likely to be the last round of QE though Bank Rate is likely to stay at 0.5% all through this year and probably all through 2013 as well.

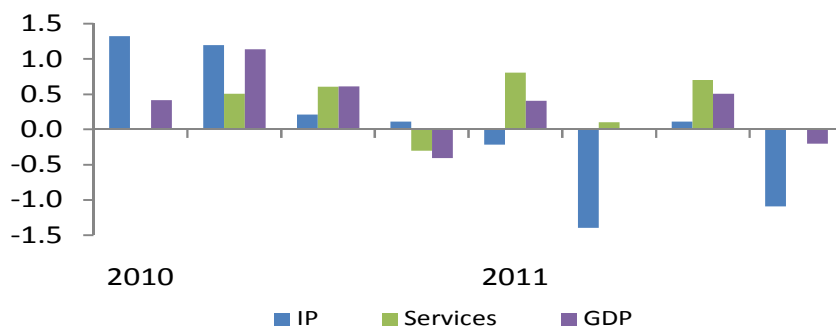
The economy in 2011

1. Output

A year ago the outlook for 2011 looked difficult. I identified a number of serious headwinds, of which the upcoming fiscal consolidation and the euro area debt crisis were the most obvious. I expected the economy to make good the losses from the severe winter weather of December 2010 in the first quarter but underlying growth looked likely to be weak at least in the first half of the year. But by the second half I expected a more solid recovery and for 2011 as a whole I forecast GDP growth of 2%. At the same time I warned that it would not feel like a 2% year since growth would be concentrated in the trade and business investment sectors while consumer spending would be restrained by high inflation and rising unemployment due in large part to job losses in the public sector.

In the event 2011 proved far more difficult than I (and most others expected). Growth was less than 1% for the year as a whole and on the ONS preliminary estimate for Q4 GDP was falling again at the turn of the year (Chart 1). What we all missed was the inability of policy-makers to get on top of the euro area crisis which continued to deepen as the year progressed. This has undermined confidence in the euro area and produced a widespread downgrading of prospects for 2012 across the EU as a whole. Even in Germany, which started 2011 in very good shape as global recovery produced a strong demand for its exports, GDP appears to have fallen in the final quarter.

Chart 1: GDP (% q/q)



Source: ONS

At the start of 2010 I identified a possible upside scenario based on the strength of the global recovery which, problems in the euro area notwithstanding, appeared to be gathering momentum. UK manufacturing output had risen 5% during 2010 and another (though less) good year was in prospect. The recovery in manufacturing continued in the first half but output peaked as long ago as May and has struggled since. Even so, on the ONS preliminary data manufacturing rose 2.1% in 2011. Industrial production as a whole has fared far worse than manufacturing as the long-term decline in oil & gas production has continued. IP was down 1.3% in 2011 on a 15% decline in its mining & quarrying sub-component.

Output in the service sector was on a rising trend until September but fell back in October, rebounded in November and on the preliminary data was flat in Q4. In 2011 as a whole services rose 1.4%.

Construction by contrast recovered strongly from the severe weather of late-2010 and was up 3.1% in 2011 as a whole (Table 1).

Table 1: Output in 2011

%	Q4/Q3	Q4/Q4	2011
GDP	-0.2	0.7	0.9
Agriculture, forestry & fishing	0.1	11.5	2.3
IP	-1.4	-3.2	-1.3
Manufacturing	-0.8	-0.2	2.1
Mining & quarrying	-2.0	-14.6	-15.5
Electricity & gas	-5.1	-10.9	-5.7
Water	-1.3	1.2	3.1
Construction	-0.5	1.3	3.1
Services	0.0	1.6	1.4
Distribution, hotels & restaurants	-0.5	0.7	0.6
Transport, storage & communications	-0.1	-0.1	0.7
Business services & finance	0.0	2.1	1.9
Government & other services	0.4	2.5	1.7
GDP ex-oil & gas	-0.2	1.1	1.4

Source: ONS, Novus

2. Demand

A year ago I was looking for consumer spending to rise 1% in 2011 as a whole. The outlook for real household disposable income (RHDI) was poor since inflation was forecast to rise above 4% and to remain elevated all year; wages were expected to lag behind inflation resulting in a full-year fall in RHDI. My forecast of a positive year for consumer spending was based on a decline in the saving ratio. With data for the first three quarters to hand, the consumer fared rather worse last year than expected. Spending fell for three successive quarters (10q4-11q2) and even though it was flat in Q3 consumption was down 1% from the previous year, as an increase in the cash spend of 3.2% was crowded out by inflation (on the consumer expenditure deflator) of 4.2% (Table 2). There were some signs of a pick-up in spending in Q4 but for the year as a whole consumption is likely to have fallen around 0.6%. The saving ratio may have fallen by 1% but this has been outweighed by a 2% drop in RHDI.

Table 2: GDP & demand (11q3 % y/y)

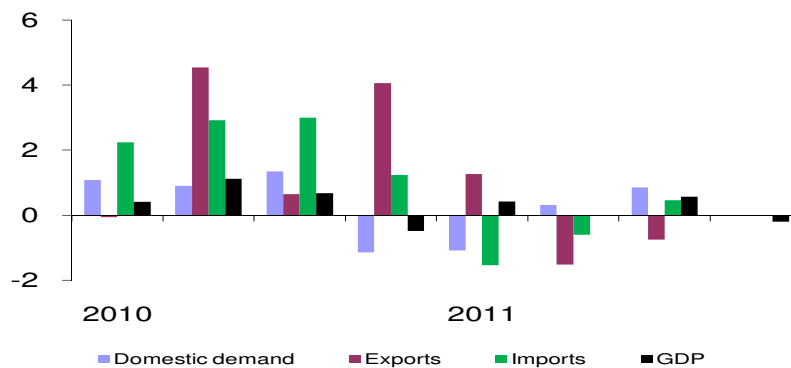
	Nominal	Inflation	Real
Household consumption	3.2	4.2	-1.0
General Government consumption	5.6	4.6	1.0
Fixed investment	-1.5	0.3	-1.8
Domestic demand	2.5	3.6	-1.1
Exports	10.2	7.0	3.0
Imports	7.6	8.1	-0.5
GDP	3.0	2.5	0.5

Source: ONS

Despite all the plans for sharp cuts in public spending, general government consumption has risen steadily. On the latest national accounts data it rose 5.6% in cash terms, ahead of inflation of 4.6% giving a y/y volume increase of 1%. For the year as a whole it is likely to have risen by about 1%. Business investment has moved erratically on a quarter by quarter basis but the underlying trend is upwards. In the year to 11q3 it rose 4.4% and in 2011 as a whole a rise of 1-2% is likely. With investment thus far bearing the brunt of public sector cutbacks, whole economy investment may have fallen last year by as much as 2½%. Stockbuilding may have been broadly neutral for the year as a whole so that domestic demand may have fallen by around ½%.

That means that for 2011 as a whole all of the growth will have come from the trade sector. The rebalancing story appears intact, though the quarterly data tell a different story. Exports actually fell back in 11q2-q3 and annual growth has slowed sharply as the crisis in the euro area has deepened. In 2010 export volumes rose 7.4% but by 11q3 growth had slowed to 3%. Growth picked up again in Q4 when exports of goods rose 3.7% in volume terms from Q3 so that for 2011 exports may have risen by a little over 4%. Imports have been weaker, held back by sluggish domestic demand, and may have risen 1½% in 2011 (Chart 2).

Chart 2: GDP and components of demand (% q/q)

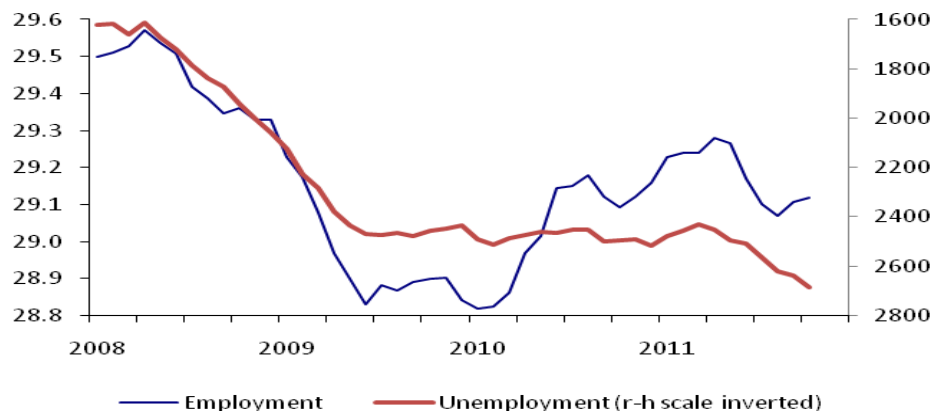


Source: ONS

3. Labour market

My forecast for the labour market was, like GDP, for a year of two halves. In the first half I saw public sector job-shedding outweighing any gains in the private sector so that unemployment would rise. In the second half any job losses would be broadly reversed. The outturn was precisely the opposite. The recovery in employment which had begun early in 2010 got going again late in 2010 and continued into the first part of 2011. Rising employment, which peaked at 29.3m in April, was enough to keep unemployment steady / slightly falling (it troughed at 2.4m in March). Since then the labour market has deteriorated with employment falling steadily to 29.1m and unemployment rising by ¼ million to 2.7m (Chart 3).

Chart 3: Employment (m) and unemployment (000s)



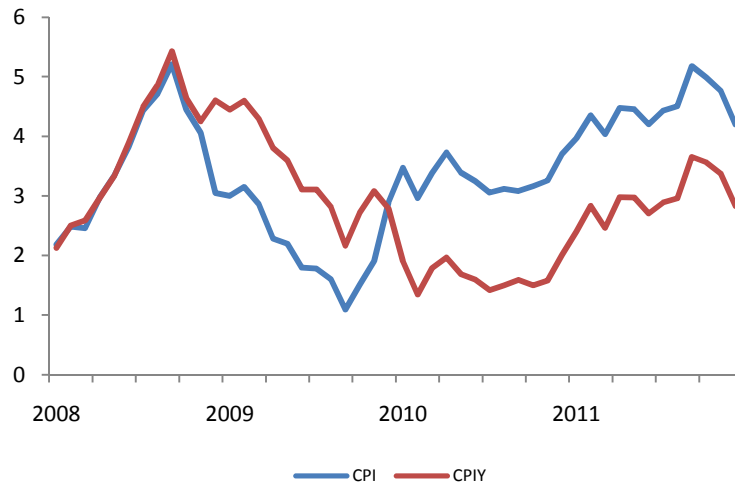
Source: ONS

Private sector employment has continued to rise steadily since the end-2009 low. On the latest data it stands at 23.1m, up 630k from the low. Over the same period public sector employment has fallen 365k for a net gain in employment of 265k. The more recent trends are adverse with public jobs falling 67k in the latest quarter while private sector gains have slowed to only 5k.

4. Inflation

This time last year I wrote 'inflation rises above 4%, possibly all the way to 5%, in the coming months following the rise in VAT to 20%'. The direction was right but it should have read all the way to 5% and higher. Underlying inflation as measured by CPIY (which excludes taxes) was on a rising trend from about the middle of 2010 and peaked in September 2011 at 3.7%. The peak in CPI came in the same month at 5.2%, with VAT accounting for most of the 1.5pp difference. Aside from VAT, the main upwards pressure on inflation came from energy prices – petrol price inflation peaked at 17.8% in September, gas & electricity inflation at 20.9% in November. There was also upward pressure from food price inflation which reached 6.4% in September. Since September, with petrol prices falling in cash terms and food prices benefiting from lower seasonal fruit & vegetable prices, inflation has fallen back – it ended the year at 4.2% with CPIY at 2.8% (Chart 4).

Chart 4: Consumer price inflation



Source: ONS

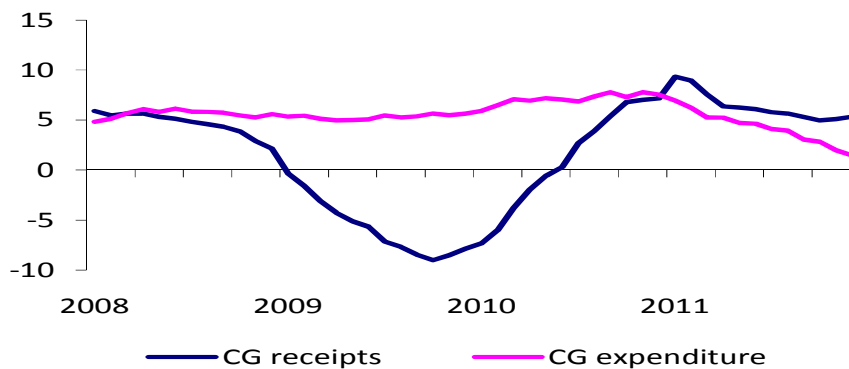
5. Public sector finances

Despite disappointing growth in the real economy the public finances have continued to improve. The cumulative deficit in the first nine months of 2011-12 on the measure that excludes financial interventions (PSNBex) was £103.3bn, down from £114.6bn a year earlier. Simple extrapolation over the final three months of the financial year suggests a full-year deficit of around £121bn, some £6bn below the OBR's November forecast (and almost exactly in line with the OBR forecast made at the time of the March Budget) and £15bn below the 2010-11 outturn.

The improvement in the public finances reflects the expected trends on both sides of the account. Central government receipts rose 5% in the first nine months of the financial year against the same period a year earlier, in line with the OBR's full-year forecast of 4.9%. Growth in expenditure slowed to 1.5%, half the OBR's full-year forecast of 3.1%. A year ago I reported that the underlying trend in receipts had finally closed the gap on spending that the recession had opened up. A year on the trend in receipts is some way ahead of the trend in spending (Chart 5). On the revenue side the biggest gain is on VAT receipts which, following the hike in January to 20%, are up a cumulative 16% so far this year. On

the spending side the slowdown is most obvious in other (departmental) spending which is running a cumulative 1.5% down on the previous year.

Chart 5: Central Government Receipts & Expenditure (rolling 12m total, % y/y)



Source: ONS

6. Money and credit

The focus of the MPC continues to be the weakness of the real economy which they believe will eventually produce on- or even sub-target inflation. Bank Rate has been maintained at its historically low level of 0.5% since March 2009 and more recently the MPC has voted to inject another round of QE into a faltering recovery. In October £75bn of QE was announced (on top of the original £200bn) followed this week after the publication of the disappointing Q1 GDP data by a further £50bn.

Despite low interest rates credit demand has remained weak. Lending to individuals has risen only 0.9% in the last year with mortgage borrowing up 0.8%. Towards the end of the year there were some signs of a modest pick-up in mortgage approvals which reached 52.9k in December, their highest level since 2009. House prices have been flat-to-falling over the last 12 months. On the Halifax measure they ended the year down 2.2% over 12 months; on the Nationwide series they rose 1%.

The outlook for 2012

1. The global economy

In the face of the seeming inability of euro area policy-makers to deal with a crisis of their own making, the outlook for the global economy has deteriorated. The IMF has lopped 0.7pp off its 2012 growth forecast (3.3% from 4%) and 0.6pp off 2013 (3.9% from 4.5%). This primarily reflects a much weaker outlook for the euro area where the IMF has lowered its 2012 forecast by 1.6pp. As a result it now sees the euro area contracting by 0.6% in 2012. All countries are affected though, of the major ones, the outlook for Italy is particularly poor – a two-year contraction is the price of the extreme orthodoxy imposed by the fiscal compact¹ (Table 3).

Table 3: IMF forecast

	2011	2012	2013
World	3.8	3.3	3.9
Advanced economies	1.6	1.2	1.9
USA	1.8	1.8	2.2
Euro area	1.6	-0.5	1.8
Germany	3.0	0.3	1.5
France	1.6	0.2	1.0
Italy	0.4	-2.2	-0.6
UK	0.9	0.6	2.0
Japan	-0.9	1.7	1.6
Emerging & developing economies	6.2	5.4	5.9
China	9.2	8.2	8.8

Source: IMF

Elsewhere the outlook is brighter. The US economy grew by nearly 2% in 2011 and, according to the IMF, something similar is in prospect for 2012. In a Presidential election year, when the Fed has virtually promised to keep interest rates at ultra-low levels for another three years, I would be more optimistic. There are already signs that the labour market is beginning to generate new jobs and the survey

¹ For my thoughts on the fiscal compact: <http://www.novus-cap.com/blogs/1215weekly%20blog.pdf>

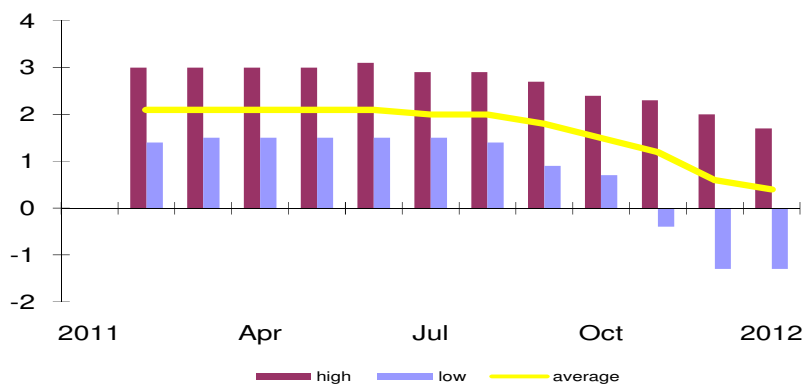
indicators are picking up some momentum. I would look for 2%+ growth rather than 2%- . Outside the more advanced economies it is business as usual. A modest slowdown is in prospect for 2012 as they too are affected by the downturn in Europe but growth rates, notably in China, remain impressive.

While the global forecasts are being downgraded, the mood in the markets has lifted. The euro area crisis has not gone away but there is hope that the ECB under Mario Draghi might be getting on top of the problems. In the US too there are growing signs of optimism. It may prove to be the case that the international forecasters have over-egged the downside.

2. UK outlook

As the outlook for the global economy has deteriorated, forecasts for the UK have been progressively downgraded. The OBR lowered its 2011 GDP forecast from 1.7% at the time of the Budget to 0.9% in its November update with 2012 cut from 2.5% to only 0.7%. Following its downgrade of the global outlook the IMF has cut its 2012 UK GDP forecast from the 1.6% it reported only last September to 0.6% in its new-year update. The latest consensus as reported by HMT is even lower at 0.4% with a wide range from 1.7% at the top to an outright recession scenario of -1.3% at the bottom (Chart 6). Of the forecasts released in January five (ex 27) are for UK GDP to fall in 2012 as a whole.

Chart 6: UK GDP forecasts



Source: HMT

In the near term the outlook for the UK is poor. The survey data have improved since October and output moved ahead in Nov-Dec but the effects of the euro area crisis on the real economy are only just beginning to come through. On my reading of the surveys, which were surprisingly strong in January, GDP is likely to recover its Q4 losses in Q1, which at least will avoid the so-called technical recession. But growth is likely to remain anaemic in the first half of the year though some pick-up should be visible by the second half.

The main reason for optimism is that inflation is falling quite sharply and should be down to 3% by the spring. It should continue to fall more gradually over the summer and autumn months and could be below 2% before the end of the year. Whether inflation stops falling at say 2½% as some of the pessimists suggest, or whether it falls below 2% as the MPC and other optimists are forecasting, a significant fall in inflation is in prospect. That is the main underpinning of a relatively more optimistic outlook for consumer spending.

If that is correct, and barring a total disaster in the euro area, I would expect GDP growth of close to 1% in 2012 with growth picking up in the course of the year to the 1½%-2% range by the end of the year.

(i) Consumer spending

Consumer spending accounts for around 60% of domestic demand / GDP so it is hard for the economy to expand when the consumer is going backwards. That is what happened for most of last year as a cash-strapped consumer was hit by rising inflation (which was concentrated on essential items such as food and energy). As the OBR accepted in November, it was the unforeseen strength of inflation and its damaging effects on consumer spending that was the main reason for its having to downgrade the 2011 outlook.

In 2012 this process will partly go into reverse – to the benefit of household real incomes and spending. In addition I would expect the Chancellor to raise the personal allowance by rather more than the £630 allowed for in the Autumn Statement (as Nick Clegg has recently argued for). Together these should underpin a recovery in RHDl and with it consumer spending. In the first three quarters of 2011 the saving ratio averaged just over 6%, down from a little over 7% in 2010 and a peak of 9.4% in 09q2. As households are still showing no sign of wanting to take on more borrowing, I would expect the saving

ratio to hold steady in 2012 so that consumption rises in line with income. The consensus endorses this latter point but sees only 0.2% on both RHD1 and consumption. With the consumer showing some signs of life in the run-up to Christmas, I would expect something nearer 1% on both income and spending.

(ii) Government consumption

A year ago I wrote that there was not much evidence of fiscal consolidation in the monthly public finances data, rather more in the quarterly national accounts numbers for general government consumption. This year it is the other way round. The latter rose 1% in the year to 11q3 in volume terms while on the monthly data central government current spending was down 0.7% in the year to 11q4 (in cash terms). At the same time the labour market data show public sector employment falling so it is fair to say that the long-awaited squeeze on public spending is under way.

The latest OBR forecast based on the cash limits set out by the Government and its own forecast of public sector inflation is for government consumption to fall 0.1% in 2012. The consensus is a little lower (-0.5%). Somewhere in the -½% to flat range seems reasonable.

(iii) Investment

According to the OBR forecast, general government investment is likely to fall even more rapidly this year than it did last (-9.4% vs -6.8%). Despite this they expect total investment to rise 3.5% with business investment up 7.7% and private residential investment rising 2.5%.

The big unknown is always business investment. On the one hand it is supported by low borrowing costs, the series of cuts in the corporate tax rate that were announced in the June 2010 Budget and a strong corporate cash flow. On the ONS data PNFC (private non-financial company) profits outside the North Sea rose 9.7% in the year to 11q3 and in the first three quarters of the year PNFC savings (after tax and dividends have been paid) topped £50bn. Shortage of cash does not appear to be a problem as far as investment is concerned. On the other hand, UK plc is invariably reluctant to invest unless it anticipates that the demand will be there for its output.

The January CBI manufacturing survey was inconclusive. There was a positive balance for investment authorisations over the next 12 months (+27 for product and process innovation and +17 for training)

but a negative balance for the 12-month forecast of capital expenditure (-18 for buildings and -6 for plant & machinery). Overall I expect business and total investment to rise in 2012 though probably at a slower pace than the OBR is expecting. Inventories, which may have been run down in 11q4, should also make a positive contribution to GDP growth in 2012.

(iv) Net trade

For an economy that is looking to rebalance demand away from consumption (public and private) towards exports and investment, the possibility of recession among its largest trading partners is bad news. Even if the worst of the downside risks are avoided, the deflationary fiscal stance that has been forced on most of the euro area periphery can only reduce demand. The threat of recession is real but it has been hanging over us for the last year yet UK exports to the euro area have been buoyant – in cash terms they rose 7.4% in Q4 from the previous year, some way below the 14.4% increase in non-EU exports over the same period.

With other areas of the global economy still relatively buoyant and the US recovery gathering momentum, I expect another reasonable year for UK exports. But imports will also be boosted by a better performance from the UK consumer and some rebuilding of inventories. On balance net trade may make only a modest contribution to growth in 2012.

(v) The labour market

With the economy stagnating through the turn of the year and not expected to show much growth until the second half of the year the outlook for the labour market is poor. Employment may have stopped falling at the end of last year but even if job creation in the private sector can keep ahead of job losses in the public sector (which is by no means obvious), it is unlikely to keep pace with the growth in the population of working age. Unemployment has already risen by over ¼ million from its low point at the start of 2011 and there is nothing to stop it continuing to rise rapidly in the months ahead. A pick-up in GDP growth in the second half of the year may be enough to stop unemployment breaching the 3m mark, though it will be touch and go.

(vi) Inflation

Inflation has started falling and will continue to do so virtually all year. There will be a big drop in January as last year's VAT hike drops out of the annual rate and the downward trend should continue in February and beyond as (a small) part of last year's energy hikes is reversed. By the spring CPI inflation should be down to 3%. Thereafter progress will be slower and there is a debate about how low inflation gets before it settles. The hawks see a natural floor to inflation in the service sector which will keep inflation above the 2% target; the optimists (which include the Bank of England) see inflation getting below 2% before the end of the year and staying at this low level in 2013 and beyond. My forecast, based on wage inflation remaining at very modest levels, sides with the optimists.

(vii) The public finances

Despite the weakness of the real economy public borrowing is falling more or less in line with the OBR's forecasts. In its November forecast the OBR projected a decline in borrowing on the definition which excludes financial interventions (PSNBex) from £137bn (9.3% of GDP) to £127bn (8.4%) in the current financial year and to £120bn (7.6%) in 2012-13. On the basis of an undershoot in departmental spending, the IFS Green Budget projects lower outturns – by £3bn this year and by as much as £9bn by 2016-17. Given the magnitudes concerned, these are very small differences – the OBR's forecast of a gradual decline in borrowing as a % of GDP seems in the right ballpark.

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