Novus Capital Markets

Novus Capital Markets Research

Bored already

5 January 2012

What a difference a year makes: my opening blog of 2011 was entitled 'global economy to the rescue'. I noted the all-round strength of the manufacturing PMIs and concluded that UK manufacturing was in its best condition since the 1990s. There were some major near-term headwinds (the fiscal consolidation and rising inflation at home and problems in the euro area, though at the time these seemed confined to the periphery) which looked likely to hold back demand in the first half of 2011 but the second half looked better. My central forecast was for 2% growth though the rebalancing of demand away from the consumer in favour of investment and exports and rising unemployment would not make it feel like a 2% year. What I did not see was the inability of policy-makers in the euro area to get on top of the sovereign debt crisis which dragged on into the second half of the year and is still hanging over us.

Upward revisions but downgrades all the way: the ONS has again revised up growth in 2010 which is estimated at 2.1% against 1.4% a year ago. But growth in 2011 looks to have been less than 1% and after the sharp fall in output in October GDP may have contracted in Q4. The latest survey indicators have surprised on the upside but there are obvious fears about the near-term outlook. The big unknown continues to be how the euro area sovereign debt crisis will play out, in particular whether it will lead to a disorderly break-up of the euro area and how this will feed through to the european banking system. Against this the US economy appears to be on the mend with unemployment at its lowest level since March 2009. In a presidential election year – it's only January and we've only had the Iowa primary but I'm bored already – with policy still extremely easy, the one thing I feel sure of is that the US recovery will gather some momentum. In the UK the consensus has downgraded its growth forecast such that growth this year is expected to be less than in 2011. My instinct is that it won't be.

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What a difference a year makes

This time last year the global background was very supportive (my opening blog for 2011 was entitled 'global economy to the rescue'). World trade, which had collapsed in the recession, had rebounded strongly – to the benefit of exports and manufacturing industry in most economies. The December 2010 readings of the manufacturing PMIs were uniformly strong (57.0 in the US, 57.1 in the euro area and 58.3 in the UK). UK manufacturing industry, I was able to write, was in its best state since the recovery of the 1990s.

There were clouds on the horizon, notably the budgetary problems in a number of the smaller euro area economies, the looming fiscal consolidation in the UK, rising inflation and an ongoing concern about whether the banks would be able to supply the credit that would be needed to finance a cyclical upturn. My central forecast for 2011 was for a year of two halves – a difficult H1 as the fiscal consolidation took hold and problems in the euro area periphery held back UK exports but a better H2 which I expected to be 'supported by the momentum that is evident in the global economy (including core Europe)'. I identified a number of downside risks to the central scenario which could restrict growth to 1% or 'possibly even derail the recovery' but even here I thought the second half of the year would be better than the first. (I also identified an upside scenario, the central plank of which was the strength of the global economy!)

What I did not foresee was that the sovereign debt crisis in the euro area would drag on, getting worse rather than better in the second half of 2011. A year ago the problem seemed confined to the periphery and core economies like Germany were enjoying an export-led boom. At that stage it seemed almost inconceivable that the fiscal and monetary authorities would not have got on top of the problem by now. (Even as I write this I realise inconceivable is never a word to apply to european politicians.)

Yet instead of the strong core giving a helping hand to the periphery, the problems of the latter have spread to the core and what was a solvency problem in a limited number of countries has become a potentially very damaging banking crisis across the whole of the euro area. Worse, as I wrote before Christmas, with Germany seemingly bent on writing fiscal austerity into the very constitution of the EU, the euro area seems likely to maintain a deflationary bias over the medium term.

As an aside: why are the fiscal/debt negotiations in the euro area so one-sided? Why is all of the adjustment lumped onto the deficit countries (Ireland, Greece, Portugal, Italy, Spain) and none onto the surplus economies? Without some fiscal easing from Germany and the other surplus economies, the net effect is deflationary, negative for the area as a whole. Have I missed something but in the protracted negotiations which Greece has gone through why didn't the Greeks get any fiscal carrots from their trading partners, only the big stick?

It is clear from a brief reading of the economic commentary in early January that worries and fears over the euro area are dominating the short-term outlook. This is very much the message of Chris Giles's annual survey of (83) economists in the FT while David Smith in the Sunday Times describes a disorderly breakdown of the euro area scenario which produces 'a very nasty outcome for the eurozone and Britain'. He attributes what to me is a scarily high 20-25% probability to the euro area armaggedon scenario. His central forecast is familiar: a year of two halves in which the drag from the euro area is slowly offset by the boost to real incomes and consumer spending that comes with falling inflation.

Over the brow of the hill

While there is very little by way of good news from Europe (though German unemployment did fall to 6.8% last month, its lowest since reunification), the US cavalry appears to be riding over the brow of the hill. I have long since believed that the US authorities are completely focused on getting employment up and unemployment down to more normal levels. They are beginning to see some signs of progress. Non-farm payrolls rose 120k in November (December's data, which are released tomorrow, are forecast to show a rise of 150k) and the unemployment rate fell from 9% in October to 8.6%, the lowest rate since March 2009.

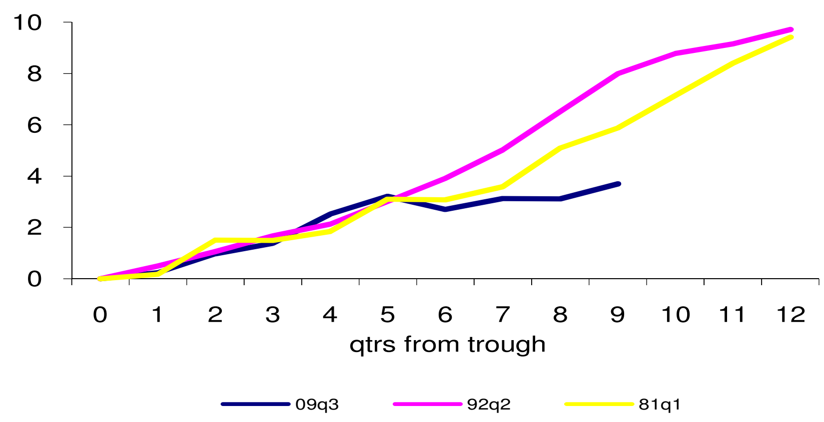
Forward-looking indicators point to a further improvement. The manufacturing ISM rose from 52.7 in November to 53.9 in December, its highest level since June, spurred by a jump in the employment component to 55.1 and a rise in new orders to 57.6. In a Presidential election year, helped by a very easy monetary policy (this week's announcements from Fed Chairman Benanke are aimed at making policy even easier) and little or no progress on measures to reduce the budget deficit, the US economy should continue to improve.

The usual upward revisions

Most of the focus on the Q3 National Accounts released on 22 December was on the upward revision to Q3 GDP growth from 0.5% to 0.6%. While this was a pleasant surprise (no City economist had predicted an upward revision – they never do), its significance was offset by a similar downward revision to Q2 from 0.1% to flat. As a result the y/y increase was unchanged at 0.5%.

There was less attention paid to upward revisions to the GDP data from 10q1 onwards. In January of last year when the preliminary Q4 GDP number was released, the ONS estimated GDP growth in 2010 as a whole of 1.4%. After the release of the 2011 Blue Book (which moved the base year to 2008 from 2006 and adopted the 2007 SIC) growth was revised up to 1.8%. Now the ONS tells us that growth in 2010 was 2.1%, half as high again as its original estimate. (The MPC's forecasts include a 'backcast' of the recent data to allow for ONS revisions invariably being upwards). As a result, growth in the first year (3.2% between 09q3 and 10q3) or more of the recovery was exactly in line with the experience of the 1990s and 1980s (Chart 1).

Chart 1: Growth in the recovery



Source: ONS, Novus

But starting with the severe winter weather of December 2010 the recovery has faded badly. A year ago my central forecast for GDP growth in 2011 was 2% (though I said it would not feel like a 2% year since growth would be concentrated on investment and exports while consumers would struggle in the face of rising inflation and unemployment would rise). With only patchy data available for Q4, growth appears to have been less than 1% in 2011 as a whole. The official output data for October make for depressing reading. Both industrial production and services fell sharply (0.7%) from September and, unless they rebound in Nov-Dec (or a large part of the October fall is revised away), GDP will fall in Q4. Even a flat outturn would leave GDP rising only 0.9% in 2011 as a whole.

The biggest drag has come from consumer spending which has fallen in three of the last four quarters and was down 1% y/y in 11q3. The cash spend has risen 3.2% but this has been more than offset by inflation (4.2% on the CED measure) and the squeeze which this has imparted to real incomes. Some drag was always expected from consumption but the looked-for offset from investment and exports has failed to materialise. Exports fell in each of the last two quarters (though it is up 3% y/y) and investment is down 1.8% y/y (business investment is up 4.4%).

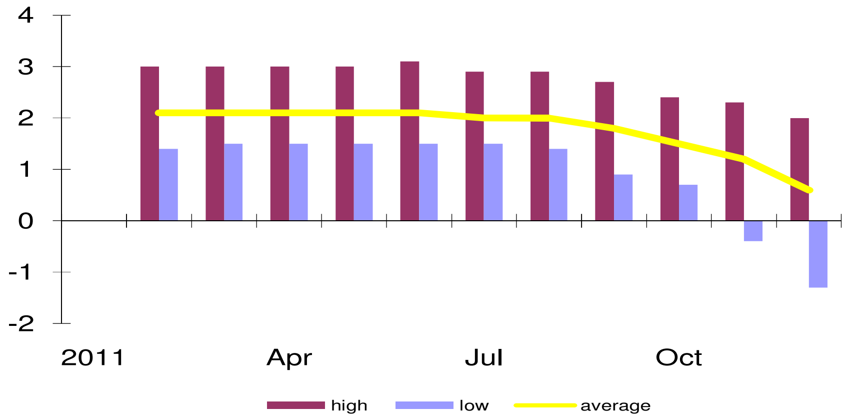
Downgrades all the way

At the start of 2012 the UK picture is very mixed. The weakness in the October manufacturing data had been signalled by the PMI which fell to its lowest level since June 2009 in October (47.7). But the weakness in services had not been picked up by the PMI which continued to point to a modest rate of expansion (51.3). Since then the manufacturing PMI was unchanged in November but stronger in December, though still signalling contraction (49.6). The services PMI rose to 52.1 in November and to 54.0 in December, its best reading since July. The construction PMI is also in expansion territory (53.2 in December from 52.3 in November) as all three components (civil engineering, housing and commercial) moved into positive territory for the first time in nine months.

Indicators from the High Street point to some resilience over the Christmas period. On the ONS data retail sales fell 0.4% in November but that was after a 1.6% increase in Sep-Oct combined. The CBI distributive trades survey surprised on the upside in December when retailers reported the first y/y increase in sales volumes in seven months (a balance of +9 after -19 in November). John Lewis, bellwether of the British middle class, reported record (cash) sales in the week of 10 Dec and again in the week of 17 Dec when sales were up 10.6% y/y.

Against this backdrop the forecasters have become progressively more pessimistic. At the start of last year the consensus was for 2% growth in both 2011 and 2012. Now 2011 is likely to be just below 1% and 2012 is expected to be worse still (0.6% on the current consensus). The most pessimistic forecast is for GDP to contract by 1.3% (Chart 2).

Chart 2: GDP forecasts 2012



Source: HMT

There are of course some positives which will kick in this year – the Queens's Diamond Jubilee, the Olympics and Dickens 2012 to name but three obvious boosts to UK tourism. But the key, it would seem, is what happens in the euro area. Consumers will benefit from falling inflation, which will ease the squeeze on real incomes, and demand for exports from outside Europe is likely to remain relatively strong. Inside the euro area Germany and other core countries are still looking ok though leading indicators are deteriorating. What I guess should never be underestimated is the ability of politicians – and European ones in particular – to screw up. As 2012 gets under way, that remains the big unknown.

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