

Novus Capital Markets Research

Revoke no dispositions

9 February 2012

Did someone fire the starting gun? Four months ago the mood was sour. The euro area crisis was no closer to solution and global forecasts were being lowered on the back of recession in Europe. Financial markets reflected this gloom and in early October the FTSE-100 index dropped below 5000. The turnaround in sentiment since then is impressive. Buoyed by two rate cuts from the ECB and an aggressive lending policy, which is perceived to have cut the risk of another major credit crunch, clear signs that the US economy is gaining momentum and creating jobs, and a run of stronger than expected survey data, the FTSE-100 has bounded up to 5900. In the UK, although the 2012 GDP forecasts are still being lowered, the January PMIs suggest that Q1 will make good Q4's 0.2% decline in GDP and that a double-dip recession will be avoided. I suspect that for both the global and UK economies forecasters are over-egging the downside and that from here on the trend in the forecasts will be upward.

Should there be a short-term fiscal boost? Commentators such as Martin Wolf and Jonathan Portes are convinced that the outlook is dismal and requires a credibly temporary fiscal expansion that boosts demand in the short run and adds to supply longer term. They dismiss the idea that any such boost will undermine the UK's credibility on financial markets and raise long-term borrowing costs. As a child of the 1960s I have always favoured the old Budget judgment approach to fiscal policy. If after today's extra £50bn of QE from the MPC the OBR's judgment is that the outlook remains too weak to halt the rise in unemployment, I would support a fiscal expansion that was both credible and temporary. As I wrote in the Sunday Times two years ago, where the deficit gets to at the end of the Parliament is more important than the route it takes to get there. My one reservation is that, if someone has fired the starting gun, the judgment on 21 March may well be that no net fiscal injection is required.

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Did someone fire the starting gun?

Four months ago all seemed lost. Europe had pressed the self-destruct button and was threatening to drag us all down with it. Forecasts everywhere were being downgraded. In the UK the talk was of a double-dip recession with a number of forecasters predicting a drop in GDP in 2012 as a whole. Since then virtually every number has been positive. It is as if someone fired the starting gun at the end of October and the economy has come bounding back to life.

It is hard to know why the mood has changed so markedly in such a short period of time. The euro area is still trying to work out the least damaging way of dealing with Greece and its politicians remain in thrall to Germany's single-minded pursuit of fiscal austerity (though Angela Merkel seems to recognise that austerity by itself is not enough and that growth is also needed). But there is a growing view that the ECB under Mario Draghi is on the case and that, with the successful launch of the new three-year loan deal for banks and two 25bp cuts in the refi rate, the worst-case scenarios will be avoided.

Nevertheless the forecasters are busily downgrading their numbers for 2012 and beyond. 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 2012 forecast has been cut by 1.6pp. As a result the IMF now sees the euro area contracting by ½% in 2012 (Table 1).

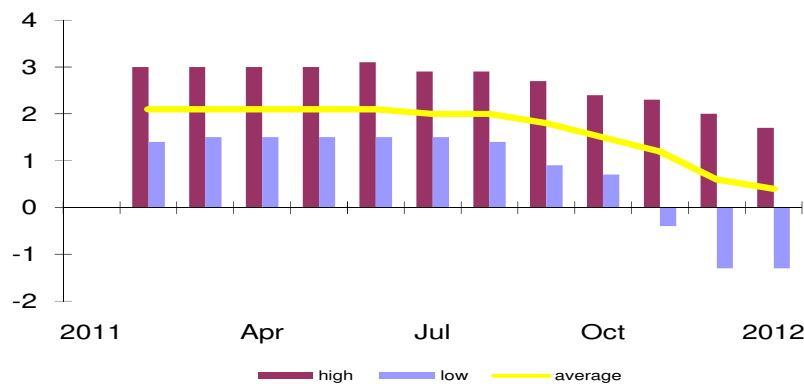
Table 3: IMF forecast

	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

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%. It suggested that the chances of a recession (on the two-quarter decline in GDP definition so loved by the media) were as high as one in three. Similarly the IMF, following its downgrade of the global outlook, 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 January consensus as reported by HMT is even lower at 0.4% with a wide range from 1.7% (Beacon) at the top to an outright recession scenario of -1.3% (Standard Chartered) at the bottom (Chart 1). Of the forecasts released in January five (ex 27) are for UK GDP to fall in 2012 as a whole.

Chart 1: UK GDP forecasts



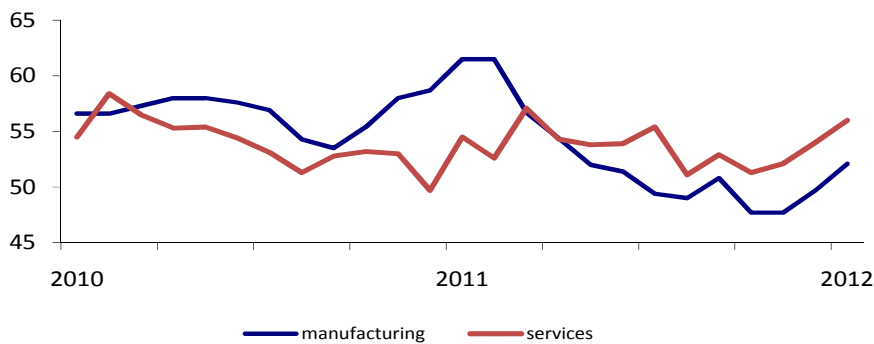
Source: HMT

Two weeks ago, on the publication of the preliminary Q4 data, which showed GDP down 0.2% q/q, I argued that October was the trough. The ONS reported that the 0.6% drop in the service sector in October had been fully reversed in November and that services output was unchanged between the third and fourth quarters (which implied that services held steady at the November level in December). Industrial production was down 1.1% in Q4 but again this was on the basis of a sharp fall in October and November and implied a modest recovery in December.

The December IP data show a slightly different picture. Downward revisions to the data in earlier months reveal a weaker picture of IP in 2011 – the year as a whole has been revised down from -1.1% to -1.3%. But from this weaker underlying position the turnaround in December was impressive. Manufacturing output rose 1% in the month (though the seasonal adjustment process is always suspect in a month where factories take extended breaks) and IP was up 0.5%. As a result the level of IP in December was 0.2% above the Q4 average which by itself cuts the odds of a negative Q1 outturn.

I made my assessment not just on the basis of the ONS data but also because the surveys had been uniformly more positive since October. Manufacturing bottomed out in Oct-Nov at a contractionary 47.7 and services hit their low in August at a still-expansionary 51.1, recovering in September but dipping back again to 51.3 in October. Since then both sectors have rebounded strongly – to 56.0 in January in services and to 52.1 in manufacturing (Chart 2). The services reading was a 10-month high and the (4.7pp) improvement since October was the strongest since 2009. Within services the employment index rose at its fastest rate in four years while business confidence had its biggest one-month jump in the 15-year history of the survey. Similarly the manufacturing PMI was at an eight-month high in January with its output sub-component the strongest in ten months. It is a slightly different story in construction where the index fell back in January though it was still in expansionary territory (as it has been for 13 months) and confidence in the sector was at an eight-month high.

Chart 2: Manufacturing & services PMIs



Source: Markit

The rebound in the UK purchasing managers' surveys is matched by a similar trend in the US. The non-manufacturing ISM rose 3.8pp to 56.8 in January, an eleven-month high. There were considerably bigger gains in some of its components, notably employment which jumped 7.6pp to 57.4, taking it well into positive territory after December's sub-50 (contractionary) reading. The manufacturing ISM rose a more modest 1pp to 54.1 but again this was the fastest rate of expansion since June.

Even in the euro area, where the overall services PMI logged a modest expansion (50.4) in January the trend is improving. Germany (53.7) was at a seven-month high and France (52.3) was the best in five months. The manufacturing survey was weaker (48.8) but it has improved in each of the last two months and Germany is back into positive territory for the first time in six months.

Back in the UK the CBI January industrial trends survey was much more downbeat than the manufacturing PMI. Business and export confidence were both negative and only slightly less negative than in the previous (October) survey. Order books were reported to be some way below 'normal', especially on the export front. But despite this, the question on output expectations over the next three months was strongly positive, rebounding to +15 in January from -8 in December and a low of -11 in October. The CBI distributive trades survey was predictably gloomy. December's positive reading, the first in six months, was not repeated in January when a net balance of -22% of retailers, the lowest since 2009, reported sales volumes down in y/y terms. This was replicated by the BRC which reported sales growth of 2.1% in cash terms, below the inflation rate.

It will be interesting to see in two weeks time whether the Bank of England's Agents' scores for January (which were available for today's MPC meeting) capture some of the upturn that is evident in the PMIs. There was no sign of any improvement in the December scores where the trend is down in almost every category.

The labour market, which typically lags developments in the real economy, was also deteriorating in the second half of last year. Unemployment on the LFS measure was rising at a rate of about 40k a month in the second half of the year where for a few months at the start of the year it had been falling. But even here the surveys provide some scope for optimism. The January REC (recruitment and employment confederation) survey reported a small net positive balance (51.2) on recruitment of permanent staff for

the first time since September with six out of the eight sectors reporting higher demand for labour. Demand for temporary staff was down though at a slower rate in January than December.

In the US, where the prime aim of policy-makers in a Presidential election year is to cut unemployment, the data have been improving for several months. Non-farm payrolls rose 243k in January, some way above forecasts, and the unemployment rate fell to 8.3%, a 0.8pp decline from August and a 1.7pp fall from the 2009 peak.

The signs of improvement in the real economy (in the US as much as the UK) have been reflected in financial markets. The FTSE-100 share index bottomed out at the beginning of October below the 5000 level; this week it has hit 5900, a near-20% increase. Across Europe equity prices have risen by a quarter. Gilt yields have gone in the opposite direction, rising from a low of just below 2% at the ten-year benchmark to 2.2%.

Putting this all together, I conclude not just that October was the trough but that the rebound since then has been more robust than seemed at all likely. This is reflected in some of the City forecasts, such as Goldman Sachs, which have switched their Q1 GDP call from a small negative to a small positive. Unless the surveys are way off beam, or go rapidly into reverse in Feb-Mar, my bet would be that Q1 will at least make good the 0.2% drop that the ONS found for Q4 (and that in the fullness of time that fall will be revised away). Overall I reckon the forecasters have over-egged the downside and look forward to the downward trend in the 2012 GDP forecasts that Chart 1 shows turning round in the next few months.

Should there be a short-term fiscal boost?

Even if the latest surveys are telling us something about the near-term outlook that the forecasters have missed, 2012 is not going to be a year to write home about. GDP growth may pick up to trend by the end of the year but for 2012 as a whole GDP growth of about 1% might still be the best we can hope for. If that is the case, unemployment will continue to rise for several months. Against this background, and with the MPC having okayed another £50bn of QE, what should the stance of fiscal policy be? In particular, should there be, as a number of commentators are arguing, a short-term fiscal boost.

Martin Wolf ('End this masochism in economic policymaking', Financial Times, 3 February), says that the economy's current performance is dismal and the 'task is to devise action that is effective and preserves credibility'. He sets out four 'facts' which underpin his argument:

- (i) Q4 GDP was 3.8% below the 08q1 peak;
- (ii) the economy is stagnant: Q4 GDP was only 0.3% above its level in 10q3;
- (iii) the UK 'depression' (defined as the period in which output remains below its previous peak) is longer than during the Great Depression;
- (iv) it could be many years before this slump end.

The first two facts are unanswerable: the recovery from the recession that followed the financial crisis has been slow, intermittent and may have come to a (temporary?) halt in Q4. The third fact he attributes to Jonathan Portes, the director of the National Institute, who shares many of Wolf's views, including the case for a fiscal stimulus¹. The fourth 'fact' is no such thing though that does not make it untrue; it could be many years or it could be very few years before we get back to pre-recession levels of output (if that is what it takes to end a slump).

For Wolf and Portes monetary policy has done what it can but it may now be pushing on a string. That leaves fiscal policy which, they argue, should be used to provide a short-term, but temporary, boost to demand. This should take the form of tax cuts or infrastructure spending – but not extra current spending, since the cuts that the coalition government has put in place are needed to bring spending into line with our (permanently) lower national income. Needless to say, infrastructure spending and tax cuts should be directed at ways of improving the supply side of the economy.

¹ 'The UK economy currently suffers from deficient demand; the current stance of fiscal policy is contributing to this deficiency. A temporary easing of fiscal policy in the near term would boost the economy. The credible commitment to a sustainable fiscal policy over the longer term provides the Government with the flexibility to provide a clearly defined and temporary boost to near-term demand. An increase in government investment would not have a significant impact either on long-run sustainability or – given the way they are defined – the likelihood of the Government meeting its fiscal targets', National Institute forecast, 2 February, from Portes' blog 'Not the Treasury View'.

Anatole Kaletsky agrees ('The US feels sunny again while Britain shivers', The Times, 8 February). He observes many similarities between the US and the UK and one obvious difference. Where the UK has embraced the fiscal deficit reduction agenda, the US has not – yet. With fiscal and monetary policy both very supportive of demand, the US, Kaletsky believes (and I would not disagree – the IMF forecast of 1.8% GDP growth this year looks on the low side) that the US economy is growing rapidly and creating jobs at the fastest rate since the early 1990s.

The counter-argument to the fiscal boost is that it would damage our credibility with financial markets and push up long-term interest rates and make government borrowing more expensive. Wolf and Portes give this short shrift. They argue that the Government's credibility would not be put at risk by measures that are temporary or which bring forward infrastructure spending or tax cuts that were scheduled to happen anyway, but at a later date. Specifically, they could argue that since the present Budgetary plans include a 1pp cut in the main rate of corporation tax this year, next year and in 2014-15, they might just as well do all 3pp this year. The end result will be the same but we will have had all the benefits of a measure designed to boost business investment up front with the beneficial effects on the real economy to boot. Alternatively they could move more rapidly on the (LibDem) aspiration of raising the personal tax allowance to £10k.

It may be because I am a child of the 60s but I have always favoured the idea of the 'Budget judgment', the notion that each year, on the basis of the (now-independent) official forecast, the Chancellor decides whether the economy needs a fiscal injection or withdrawal. This is an approach which fell out of favour with the Thatcher Government in the early 1980s and has been largely, though not totally, sidelined ever since.

On the spending side there were and are very good reasons for setting targets over the medium term and, more importantly, sticking to them. There were equally good reasons for making monetary policy (under an independent MPC) the main tool for managing demand across the cycle. But with interest rates effectively at their floor and QE arguably having less effect with long-term interest rates already at very low levels, it is not obvious that monetary policy can or will have much of an impact on demand at this point in the cycle.

Where does all that leave me? I would be more worried than Wolf-Portes on the risk to our credibility. We know that credibility is hard won, easy to lose and once lost difficult to regain. The ratings agencies are onside at the moment but it might not take a great deal for them to threaten the UK's AAA status. But equally they hint that our rating is at risk if the economy does not grow and produce the tax revenues that are needed.

I believe the Government is right to set out its detailed plans for eliminating the deficit within the timescale of a single Parliament. I also believe that the OBR was too pessimistic in its assessment of the output gap last November and that eventually it will have to upgrade its assessment of the economy's supply potential. I am also very aware of the hysteresis arguments under which, without work, people's skills are lost. In a similar vein something really does need to be done about very high levels of youth unemployment.

If we put these arguments together, and with one reservation, I would endorse the case for a carefully targeted one-off fiscal boost that essentially brought forward investment spending or tax cuts that were scheduled to happen anyway². My one reservation is that the survey data (and possibly the December manufacturing data) are telling us that something may already be stirring on the growth front. It is only six weeks away but that is still time for the Budget judgment to change. So where today I can be persuaded of the case for some sort of fiscal boost, come 21 March I might not be.

² I reached a similar conclusion two years ago – 'as the 1990s experience reminds us, postponing the serious deficit reduction until the recovery is well established minimises the risk of derailing the recovery in its early stages. In terms of assuring any Government's credibility, where we get the deficit to by the end of the next Parliament is probably more important than the path by which we get there', 'Three lessons from the 1990s', Sunday Times, 21 February 2010.

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