

## Novus Capital Markets Research

### Q3 GDP to defy gloom?

1 September 2011

**Off to a flier:** all the doom and gloom notwithstanding, the monthly profile of output tells us that GDP should notch up a decent increase in Q3. GDP rose 0.2% in Q2, held down by a fall in output associated with the Royal Wedding and an extra bank holiday in April. The rebound in May-June puts the level of output going into Q3 around 0.5-0.6% above the Q2 average. At this stage we have no official data for Q3, only the surveys. While today's manufacturing PMI was not encouraging (a second successive sub-50 reading), the CBI survey showed output expectations picking up in August and the quantitatively far more important service sector PMI was surprisingly strong in July. The MPC's August forecast was for Q3 GDP to rise 0.8%, which requires as little as 0.1% a month in Jul-Sep. Output could easily slip back in manufacturing though stronger oil output should boost industrial production as a whole. Maybe for once the MPC won't have to downgrade its growth outlook come the November forecast.

**House prices – to soar or slump?** I've read both in the papers this week. Prices, I'm told are still overvalued and are about to slump (Allister Heath in City AM). Or, in what the Daily Express describes as fantastic news (as in pure fantasy?), prices are about to soar 21% over the next five years (Oxford Economics for the Housing Federation). Demand is likely to remain weak over the coming years as households on balance continue to pay down debt, But, if last year's performance (the lowest number of new houses built since the 1920s) is anything to go by, the supply response will be as tepid as demand, if not more so. Unlike their US counterparts, whose willingness to build new houses was a key feature of the unfolding of the sub-prime mortgage crisis, UK housebuilders have always been very cautious about expanding supply. It is commonplace to blame the UK's planning regulations but it has always seemed to me that it is in the interest of housebuilders to keep new supply tight and prices high.

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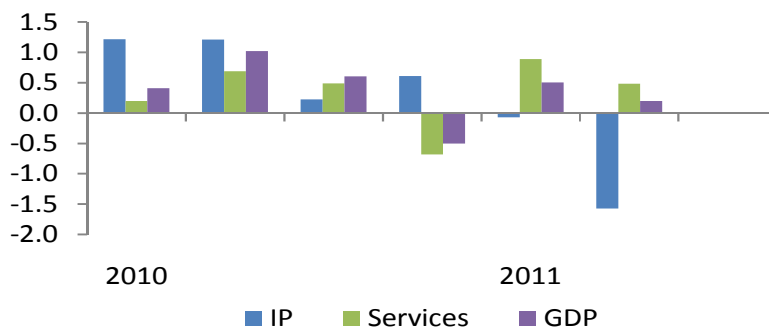
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### Q3 GDP – off to a flier

Amidst all the doom and gloom that pervades the economic commentary, it is worth noting that Q3 GDP should show a decent increase on Q2. This is because Q2 output was depressed by the Royal Wedding in April and the recovery in May-June will be built into the Q3 base – in exactly the same way as the boost to Q1 (such as it was) was partly just the recovery from December’s severe winter weather. If output is completely flat at the June level across the next three months Q3 GDP would still be up 0.6% on Q2.

GDP rose 0.2% in Q2, the combination of 0.5% increases in services and construction and a 1.6% decline in industrial production (Chart 1). Over and above the Royal Wedding, which held back output in all sectors, there was a very large drop in energy output (oil & gas production fell 8.1%, the combination of the long-term structural decline in the North Sea and an early start to summer maintenance programmes – GDP ex-oil & gas rose 0.3%).

**Chart 1: GDP and components (% q/q)**



Source: ONS

Output fell sharply in most sectors in April because of the Royal Wedding and the associated bank holiday (hotels & restaurants were the only exception). Industrial production (IP) fell 1.8% and services were down 1.2%. According to the eurostat (seasonally adjusted) series construction was down a massive 14.2%. Overall I estimate that GDP fell 2.2% in April. Output more than made good April’s losses in May in the service sector though not in IP (manufacturing fully recovered but energy output slumped)

or in construction. Output in June was flat in IP, down marginally in services and up 3.7% in construction (eurostat data). On my estimates GDP rose 1.5% in May and 0.2% in June. As a result the level of GDP in June was 0.6% above the Q2 level (0.3% for IP, 0.5% for services and 3.3% for construction – Table 1, where my estimate of GDP is an amalgam of the ONS YBEZ and CGCE series). Simple arithmetic tells us that, if output is unchanged from June in Jul-Sep, GDP will be up 0.6% in Q3 as a whole.

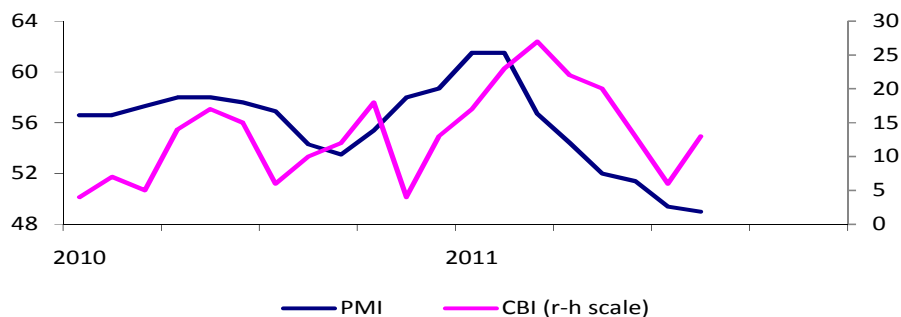
**Table 1: GDP estimates**

2006 = 100	11q1	11q2	Apr	May	Jun	Jun/Q2
Industrial production	89.8	88.4	87.9	88.6	88.6	0.3
Construction	96.8	97.2	94.5	96.8	100.4	3.3
Services	102.6	103.1	102.1	103.7	103.6	0.5
GDP	99.9	100.1	99.1	100.6	100.7	0.6
GDP (% 3m/3m)	0.5	0.2	0.9	1.4	0.2	
GDP (% m/m)			-2.2	1.5	0.2	

Source: ONS, Novus estimates (italics)

At this stage we have no ONS estimates for Q3, only survey data. Today's manufacturing PMI survey came in at 49.0, a second successive sub-50 (contraction) reading and was accompanied by a very downbeat assessment from Markit. By contrast the CBI showed output expectations recovering to +13 in August, above the long-term average (+6) but still below the highs reached earlier this year (Chart 2)

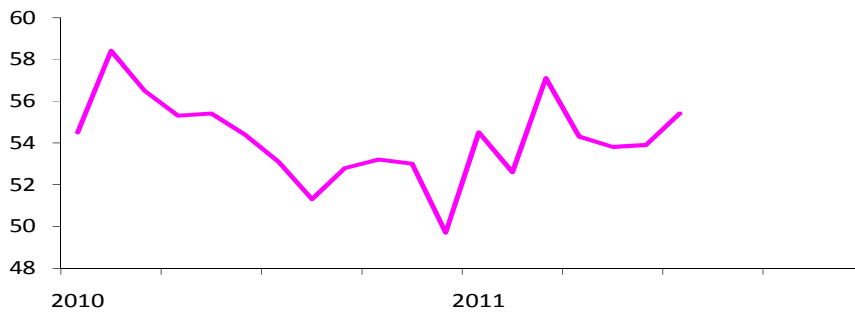
**Chart 2: Manufacturing surveys**



Source: Markit, CBI

The August service sector PMI will be released next week. It showed surprising (after the fall in the manufacturing survey) resilience in July, rising 1.5pp to 55.4 which (March apart) was its highest level in over a year.

**Chart 3: Service sector PMI**



Source: Markit

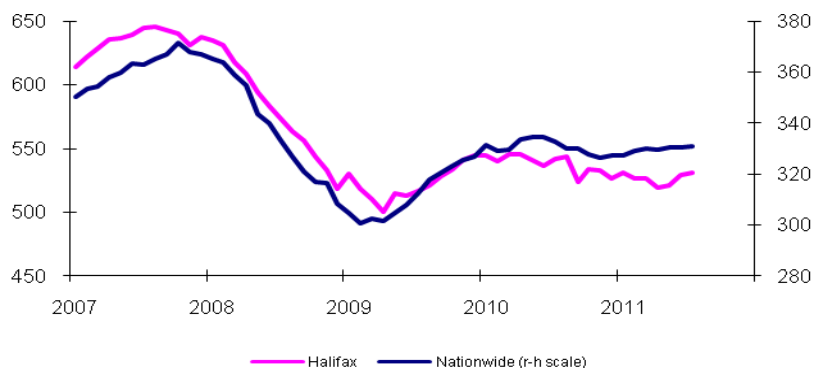
Services are far more important to GDP than manufacturing (76% of GDP vs 13%) so the bounce in the service sector PMI in July is encouraging. Since service sector output in June was already 0.5% above the Q2 average, any growth in July and beyond would give a solid platform for Q3 GDP. And even if manufacturing dips in the quarter in line with the PMI, there should be some recovery in oil output in the quarter so IP overall should be ok. At this early stage, Q3 GDP looks set for a rise of at least ½%, not brilliant but a lot better than might be expected given the prevailing climate in the markets and media commentary.

The Banks' August forecast was for a 0.8% increase, which 'only' requires 0.1% a month for Jul-Sep (0.2% a month would give a 1% q/q increase). That looks feasible, unless there is a serious hit to output from events in the global economy over the next few months. Maybe, just for once, the MPC will not have to admit to having overestimated GDP growth in its November forecast.

### House prices – about to soar or slump?

I've read this week that house prices are going to rise (a wonderfully precise) 21.3% over the next five years, according to an Oxford Economics Forecast for the National Housing Federation. (The Daily Express describes this as an 'absolutely fantastic forecast' – I'm not sure whether they mean fantastically good or pure fantasy). I've also read that, despite having fallen around 20% in the aftermath of the financial crisis (Chart 4), 'house prices remain overvalued' (Allister Heath in City AM, 31 August; Heath describes the price fall as 'a devastating reduction' which, as house purchasers are for the most part enjoying the housing services they willingly paid out for, seems to me way OTT).

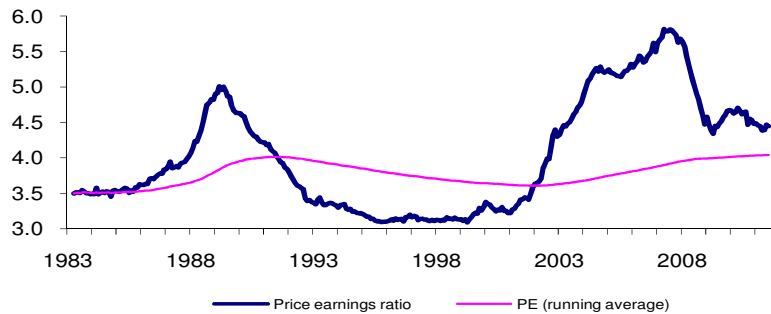
**Chart 4: House prices**



Source: Halifax, Nationwide

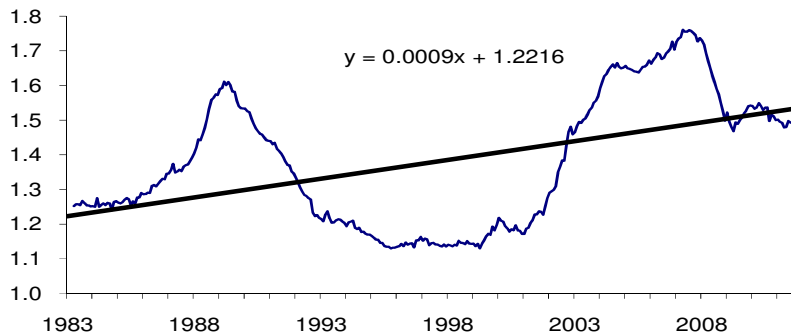
The argument that house prices are overvalued usually rests on the house-price earnings ratio being above its long-run average – the current ratio is just under 4.5 compared with the 'preposterous' (Allister Heath) 2007 peak of over 5.8 and the long-term average of 4 (Chart 5). I have argued before that over time house prices are likely to rise relative to earnings for the reason that as income rises we might be expected to allocate a greater proportion of our income to housing services. Over the long term house prices have risen about 1% a year faster than earnings and, measured against this trend, prices are fractionally on the low side (Chart 6). On this basis, and given the relative stability of prices over the last three years, it is not obvious to me that 'prices are bound to drop further', as Heath claims.

**Chart 5: House price – earnings ratio**



Source: Halifax

**Chart 6: House price – earnings ratio and long-term trend**



Source: Halifax, Novus

The argument that prices are going to rise (around 20%) over the next five years rests on a chronic shortage of supply relative to demand. The outlook for demand may not be brilliant – the Oxford Economics forecast is for home ownership in England to decline from a peak of 72.5% in 2001 to 63.8% over the next decade as home ownership becomes increasingly out of reach for many households – but the willingness of UK housebuilders to meet this demand is even more constrained. In 2010-11 we built 105k new houses, the lowest level since the 1920s and the consequence of a precipitous fall in housing

starts in 2009-10. Since then starts have risen about 50% from the 2009 lows but remain way adrift of pre-crisis levels.

It can be debated why the supply of new housing remains well below the demand. It is commonplace to blame the UK's complicated planning arrangements and to put the onus on Government to free up the planning process. But the unwillingness of housebuilders to meet the demand in full must be just as important – it is in their interest for house prices and the land that they already own not to fall in price. Unlike the US, where the willingness of the construction sector to build houses was an important part of the unfolding of the sub-prime mortgage crisis, UK housebuilders have been far more cautious over a lengthy period of time. I suspect we can free up our planning system as much as we like but the supply response will always lag behind demand. If house prices do fall further, it will be because there is not enough demand for the current stock of houses not because of any surge in new supply.

### **We're all doves now – Martin Weale's road to Damascus**

In a recent speech to the Doncaster Chamber of Commerce (who said life on the MPC lacked glamour?), Martin Weale explains why he voted for a rate hike every month from January to July and why he changed his mind and re-joined the doves in August. I quote the relevant paragraph in full<sup>1</sup>:

Our *August Inflation Report* showed, as best we could judge, that, if interest rates were to follow the market profile, we should expect inflation to be marginally below target in the medium term. That suggested there was no need either to tighten or to loosen monetary policy. In the past I have argued that an early increase could be thought of as a prudent insurance policy. In the economic circumstances of earlier in the year that was certainly the case; the market path for interest rates, which was then expected to bring inflation close to target, implied a fairly sharp rise in rates. An early increase would have put us in a better position to address things should the picture for inflation have worsened while it could have been reversed if inflationary pressures had reduced. Given the weaker economic outlook outlined above, and its implications for UK inflation, the need for insurance is less than it was; by the time we produced our August forecast the

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<sup>1</sup> <http://www.bankofengland.co.uk/publications/speeches/2011/speech514.pdf>

market path for interest rates consistent with keeping inflation close to its target was much less steeply sloped. Averaged over the next two to three years the interest rate did not need to be as high. As a result I did not see the case for an immediate increase in Bank Rate at our last meeting in August.

I never find these mechanistic arguments very convincing. Earlier in the year the forecast implied rates would need to rise at some point so why – and I remember David Smith asking this question at the May press conference – did the MPC not raise rates? For Martin Weale a hike would have been ‘a prudent insurance policy’; for me it risked tipping the economy onto a slower growth trajectory (the one we are now on) that would not have required a rate hike for some considerable period. For me the fact that the forecast then implied rates would need to rise at some point was no argument for an early hike, which the current forecast tells us would have been unnecessary.

The rest of the speech was far more interesting. It returned to a familiar Martin Weale theme: that we as an economy do not save enough. Rebalancing the economy away from debt-financed consumption (both private and public) in favour of investment and exports will at the same time raise the national savings rate, something that we need to do if we are not going to suffer a decline in our living standards over the long term. If we do not rebalance we are effectively living off the future (consuming tomorrow’s resources today) which ultimately will impoverish future generations.

Weale also admitted that ‘despite my very public concerns about inflation, I should be worried if, as a result of the recent market disorder or for any other reason, the UK exchange rate were to rise markedly’. That, I think, characterises the position of the MPC as a whole. The fall in sterling may be behind the current high inflation rate but that does not mean that the MPC wants a stronger pound. The inflationary effects of the fall in sterling have largely run their course and, with wages so far not following prices higher, this has left us with the more competitive exchange rate that rebalancing needs. It may not have done much yet in terms of switching resources into net exports (the MPC routinely describes exports as disappointing and imports as puzzlingly strong) but that is all the more reason to persevere with a weak pound.

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