

Novus Capital Markets Research

The poor old consumer

30 March 2011

Squeeze: real household disposable income (RHDI) fell 0.8% in 2010, the first fall since 1981. The trend has been down since mid-2009 and over the last six quarters sums to 2.4%. In the near term there is no respite as earnings growth of 2¼% is swamped by price inflation of 4½-5½%. The OBR forecast is for RHDI to fall another 0.4% in 2011, a two-year decline of 1.1%. This is a significant downgrade from November when they forecast a two-year rise of 0.7%. Against that background the consumer is struggling. Spending fell 0.3% in 10q4 (the weather may have been partly at fault) but still managed a 0.8% rise in 2010 as a whole. For that the saving ratio had to fall from around 7½% in mid-2009 to 5½% at end-2010. The OBR forecast is a further fall to 3½% on the back of which consumption rises a pretty puny 0.6% (revised down from 1.3%) this year. Even that could be too high since we are still to feel the full effects of the fiscal consolidation. All of which casts a long shadow over monetary policy. At what stage will the MPC feel confident that the recovery is so firmly entrenched that they can inflict more pain on the consumer? If, as it appears to me, the MPC will do nothing that risks another downturn in the real economy, the first rate hike could still be some months away, especially if ...

Q1 GDP: today's data show the service sector more than making up for December's losses in January. Together with the industrial production data, they put us on course for a rise in Q1 GDP of around 1%. On ONS unadjusted data, construction output fell again in January. Eurostat data, which are seasonally adjusted, put the January fall at nearly 10%. Unless the data are revised or Feb-Mar show a huge bounce, falling construction could wipe out gains elsewhere. Has the market noticed? I shall be away when the data are released on 27 April but for now I shall put down an early marker: once again the construction tail could wag the GDP dog and Q1 could be disappointingly weak, possibly even flat on Q4.

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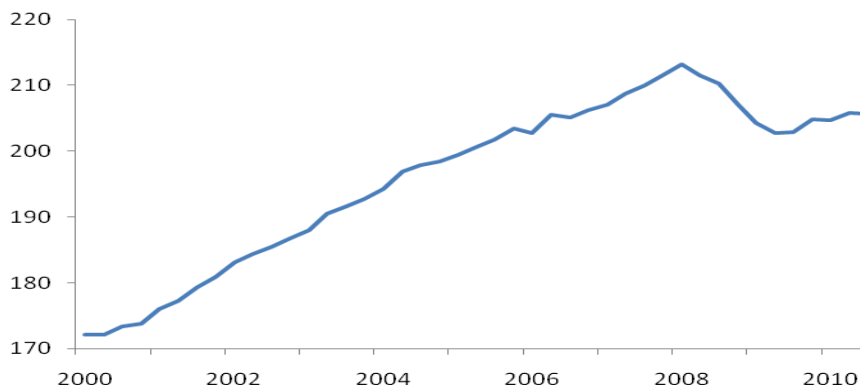
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Squeeze

Yesterday's national accounts data show consumer spending falling 0.3% in 10q4 (revised down from -0.1%). The cash spend rose 0.6% but this was cancelled out by a 0.9% rise in prices (as measured by the consumer expenditure deflator). The equivalent annual (q4/q4) figures were a 0.2% rise in volumes, the product of a 4.6% increase in the cash spend and inflation of 4.4%. In 2010 as a whole consumer spending rose 0.8% in real terms but at the end of the year was still 3.8% below the 08q1 peak and no higher than the levels reached in mid-2006 (Chart 1).

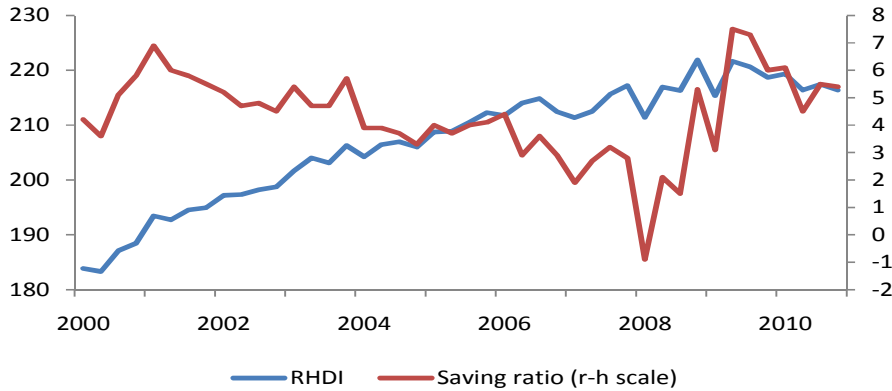
Chart 1: Consumer spending (£bn 2006 prices)



Source: ONS

The data on household incomes were even more depressed. Wages and salaries rose 0.6% in the quarter and 1.9% y/y, well below the rise in prices. This translated into a 0.5% q/q fall in real household disposable income and a 0.8% decline in 2010 as a whole, the first annual decline since 1981. While it is just about possible to argue that the trend in consumption remains upwards (and that the weather might have been behind the Q4 drop), the same is not true of RHD1 which has been trending lower since the middle of 2009, a cumulative fall of 2.4%. All the growth in consumption over this period (a modest 1.1%) has come from a 2pp fall in the saving ratio. At the end of 2010 a still-falling saving ratio was needed to prevent an even weaker outturn for real consumption (Chart 2).

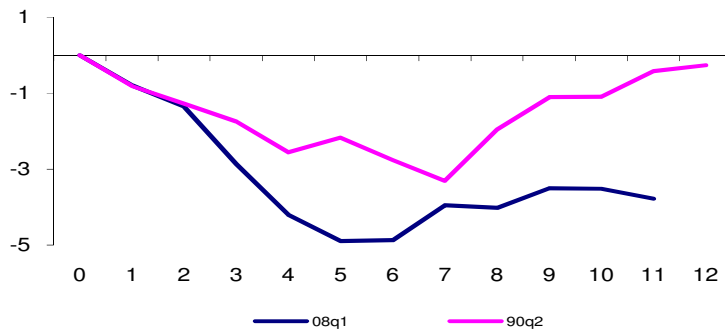
Chart 2: RHDl (£bn 2006 prices) and the saving ratio (% disposable income)



Source ONS

The course of consumer spending and RHDl in the current recession and recovery compares poorly with what happened in the 1990s. In that period the peak-trough fall in consumption was 3.3% and by this stage, nearly three years on from the trough, consumption was almost back at previous peak levels. This time round the fall was nearly 5% and we are still some 4% off the peak (Chart 3).

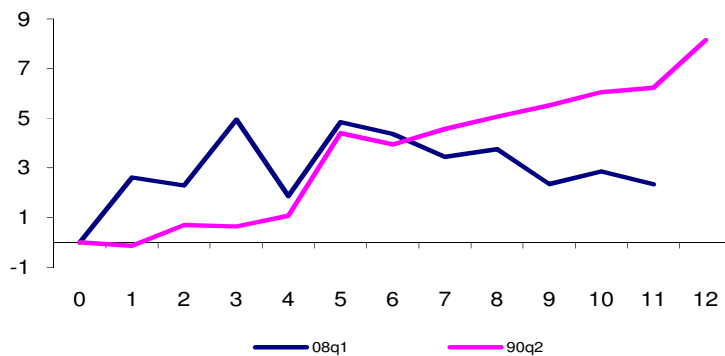
Chart 3: Consumption in the recession and recovery (quarters from peak)



Source: ONS

It is a subtly different story on RHDl. In the 1990s RHDl struggled for the first, most difficult, year of the recession but then picked up quite strongly; by this stage it was around 8% up from the recession trough. This time round RHDl held up well in the first year of recession as falling interest rates boosted the income of many heavily-indebted households but subsequently, as I have already noted, it has gone downhill (Chart 4). Remarkably for a period of recovery (rising GDP), RHDl has gone backwards as rising inflation has outstripped wages and salaries.

Chart 4: RHDl in the recession and recovery (quarters from peak)

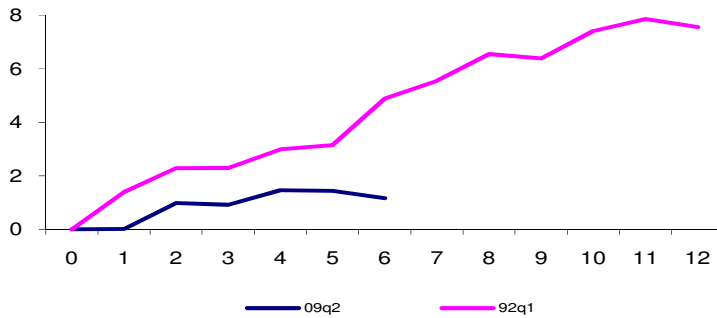


Source: ONS

This information is captured in the following two charts which use the same data as Charts 3 and 4 but are plotted from the start of the recovery in consumer spending (from 92q1 and 09q2 onwards). In the current period (six quarters) consumer spending has risen 1.2% compared with 4.9% in the 1990s while RHDl has fallen 2.4% against a 4.7% rise (Charts 5 and 6).

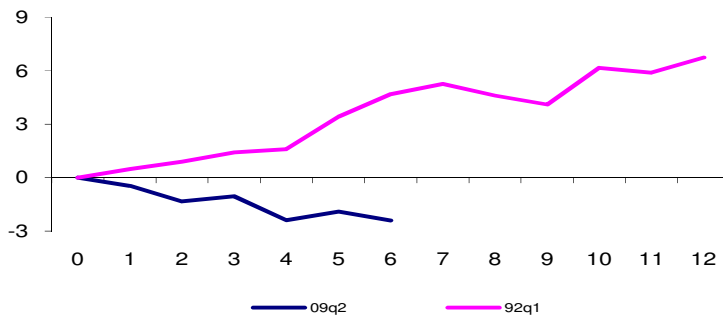
Those trends are unlikely to change in the near term. Real incomes are being squeezed by inflation of 4½-5½% despite which retail sales volumes in Jan-Feb were up about ½% on Q4. I'm still worried about car sales (my 11-reg count has got up to a still-pathetic six) so overall consumption could easily be down again in Q1.

Chart 5: Consumption in the recovery (quarters from trough)



Source: ONS

Chart 6: RHDl in the recovery (quarters from trough)

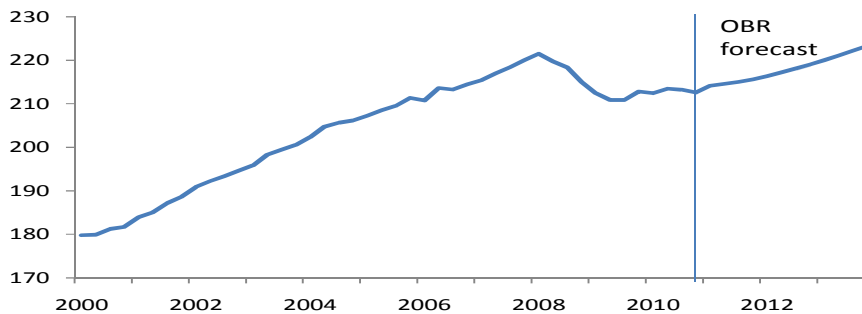


Source: ONS

Over the next few years the picture of weak/falling real income and modest growth in consumer spending supported by a falling saving ratio is not going to alter very much. The OBR Budget forecast has consumer spending (on the wider definition which includes consumption by non-profit institutions serving households) rising 0.6% in 2011 (more than halved from 1.3% in its autumn forecast) followed by 1.3% in 2012 and an average of 2% over the next three years. To obtain even this modest growth the savings ratio falls another 2pp to around 3½% since RHDl is forecast to fall another 0.4% this year and to

rise at a 1½-2% rate thereafter. On the OBR forecast it is only at the end of 2013 that consumption returns to its previous peak (Chart 7).

Chart 7: Consumer spending (including NPISH, £bn 2006 prices)



Source: ONS, OBR

The immediate cause of the weak consumption outlook is a much gloomier forecast for RHD. In November the OBR estimated that RHD would fall 0.1% in 2010 – this week’s ONS data show a fall of 0.8%. It then forecast growth of 0.8% in 2011 where it is now looking for a 0.4% fall. For the two years combined to go from +0.7% to -1.1%, a near-2pp shift, is a huge turnaround. From 2012 onwards the forecast (in % change terms) is little different. For the six years 2010-2015 in total the OBR Budget forecast is for RHD to rise by 6% (1% a year) compared with 8.4% (1.4% a year) in its November forecast (Table 1). That is a significant downgrade.

Table 1: RHD forecasts compared

	2010	2011	2012	2013	2014	2015	Total
OBR (Budget)	-0.7	-0.4	1.4	1.6	1.9	2.1	6.0
OBR (November)	-0.1	0.8	1.2	2.0	2.1	2.1	8.4
Change	-0.6	-1.2	0.2	-0.4	-0.2	0.0	-2.3

Source: OBR

By the standards of recent history, whether in the recovery of the 1990s or the long upward march of the 15 years leading up to the financial crisis, this is a miserable prospect. But, as the Governor observed in January in his speech in Newcastle, ‘the squeeze in living standards is the inevitable price to pay for the financial crisis and subsequent rebalancing of the world and UK economies’.¹ That may be true but it is scant consolation to the poor old UK consumer.

Q1 GDP

Today’s data show the service sector more than making up December’s losses in January. The Index of Services (IS) rose 1.3% after a fall of 1.1% (revised from -1.4%) in December. The level of output in January was 0.6% above the Q4 average which points to an increase of around 0.8% in Q1, which again would more than reverse the Q4 decline (-0.6%).

That relatively good news is tempered by the breakdown of the IS. Business services and finance, which is by some way the largest sector (40.9% of the IS) rose 1.5% after a 1% fall in December. Government and other services (the next largest at 30.9%) also more than made up for December, rising 0.8% after a 0.1% fall. But the rebound in the other three main sectors was not enough to cancel out the December fall. Distribution rose 1.4% (after -1.8%), hotels & restaurants were up 4.3% (-6%) and transport, storage & communication rose 1.7% (-2%).

Industrial production (IP), which rose 0.6% in December as a huge boost to energy demand outweighed weakness in manufacturing and the extraction industries, rose a further 0.6% in January as manufacturing jumped by 1.1%. As a result output in January was 1.1% above the Q4 average which puts IP on course for a rise of as much as 1.5% in Q1. Together IP and services put us on course for a Q1 GDP increase of 1%.

That leaves construction (which is 6.3% of GDP). According to ONS data released on 11 March, output in the construction sector, having fallen more than 16% in December, dropped another 8% in January. The

¹ <http://www.bankofengland.co.uk/publications/speeches/2011/speech471.pdf>

data are seasonally unadjusted so January's decline may just be a normal winter effect – though after December's very sharp fall some sort of bounce might have been expected in January even on unadjusted data. Possibly for that reason the eurostat data published on 17 March, which are (supposed to be) seasonally adjusted, show UK construction output down 9.4% between December and January and nearly 20% lower in January compared with the Q4 average.

If January really was that weak, then construction appears to be set for a large fall in Q1. Although construction is only 6.3% of GDP a large fall in construction in Q1 could cancel out the growth in services and industrial production and give us a very weak GDP number – something like a 13% fall, which is perfectly possible on the basis of the January data, would give no growth in GDP at all. Of course the January data could be revised and Feb-Mar could bounce back strongly. But as of now I doubt that the markets have even noticed the January construction number, let alone taken it on board. Where, City economists, are your GDP trackers when we need them? I shall be away when the Q1 GDP data are released on 27 April but for now I shall put down an early marker: once again the construction tail could wag the GDP dog and Q1 could be disappointingly weak, possibly even flat on Q4.

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