

Novus Capital Markets Research

A tale of two economies

3 March 2011

PMI – perky manufacturing industry: manufacturing industry in most parts of the global economy is prospering. In the UK output is rising at about a 5% rate and, although cost pressures are strong, demand is sufficiently robust for manufacturers to be able to pass on these costs and maintain their profit margins. A strong manufacturing / export performance is essential to the rebalancing of the economy that is needed over the coming years. Even so, if manufacturing were more than just one eighth of the UK economy, the case for a significant rise in interest rates, and a stronger exchange rate to spare manufacturers some of the rise in global commodity prices, would be incontrovertible.

How does the MPC respond? I take it as given that the six MPC members who voted against a rate hike in the context of the February forecast have effectively stayed their hands until the next forecast in May. If that, is correct next week's meeting is a formality. The question is what it will take to get a hike in May. The answer may be not very much. The MPC's bias is to raise rates, to begin the normalisation of monetary policy and to move away from the record low interest rates of the last two years. But the MPC will need to be confident that any hike in rates does not send the economy back into recession. Q1 GDP growth anywhere near 1% will be enough for rates to go up in May; ½% or less and they won't.

And another thing: I was pleased to read of the latest piece of research from UBS, which found that UK food prices are rising far more rapidly than in other comparable economies. I found exactly the same result when I looked at food prices in the UK and Europe in 2007. As a child of the 1960s, I do not often find myself in agreement with the IEA but their latest piece on the positive discrimination of pensioners (free bus passes, winter fuel allowance etc) is another subject close to my heart (and wallet).

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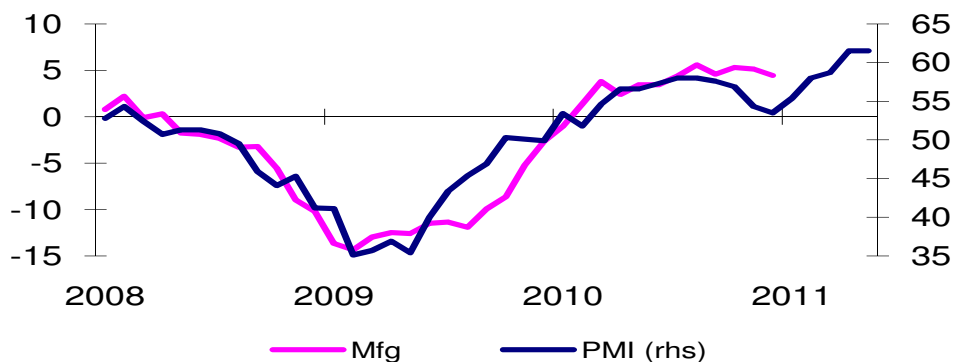
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PMI – perky manufacturing industry

We are starting to get the indicators for February and March which will determine whether interest rates go up in May – I assume that the six MPC members who were against a rate hike in February (in the context of a forecast update) will not be swayed in March or April.

The manufacturing PMI held at 61.5 in February, equalling January’s record reading (which was revised down from 62.0). Within the total, employment also rose at a record rate (61.7, up from 59.0 in January) while export orders strengthened for the fifth successive month. The official data for manufacturing output lag the PMI but, on the basis of the PMI, should be rising at a 5%+ annual rate over the next few months (Chart 1).

Chart 1: Manufacturing PMI (+3m) and ONS manufacturing (% y/y)



Source: ONS, Markit

The February PMI reinforced the findings of the CBI survey. The CBI reported in January that output and orders had strengthened over the previous three months and were expected to grow at a similar pace over the coming three months. In each case the driver was exports with domestic orders and output relatively subdued. The February survey showed the export orders (above-normal) balance at +11, the strongest since 1995.

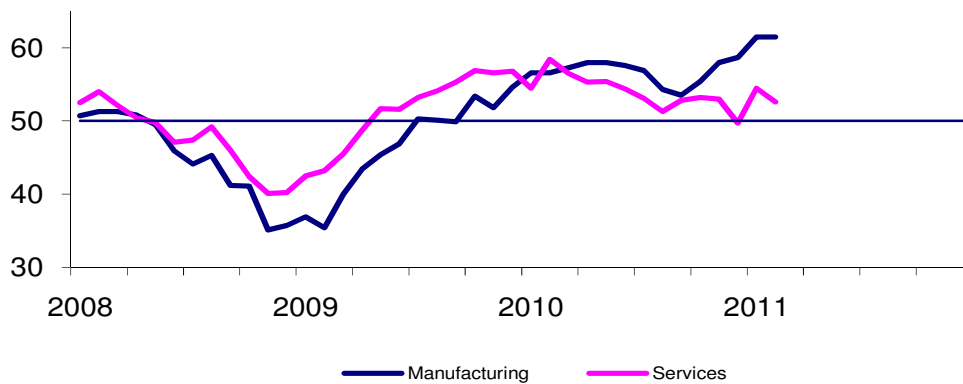
The strength of manufacturing reflects buoyant conditions in the global economy (the US manufacturing survey reported the fastest growth since 1983), and upward pressure on global prices is increasingly apparent. Official input prices rose 13.4% in the year to January and output prices were up 4.8%. The February PMI showed both input and output cost inflation at near-record highs. The CBI reported that manufacturers are under *intense pressure* to pass on rising costs (which I think means that costs are rising rapidly and that, as it always does, manufacturing industry is simply passing these costs straight through to its customers).

In these circumstances I would not trust manufacturers to hold the line on pay, especially if they are threatened with any form of industrial action. For most of last year underlying earnings in manufacturing were rising at a 3-4% rate and could rise even more rapidly in 2011. If manufacturing were the whole economy, rather than just one eighth of it, the case for a significant rise in rates and a stronger exchange rate (to spare manufacturers from some of the upward pressure in global prices) would be incontrovertible.

The construction sector is only 6% of GDP but it has accounted for most of the volatility in recent quarters. This was evident in 10q4 when construction fell 2.5% in the quarter (most of which occurred in December) but it was even more in evidence in 10q2 when construction rose 7.1% and also to a lesser extent in 10q3 when it rose 3.7%. The construction PMI bounced in January as the weather improved and was expected by City economists to revert to a slower pace of growth in February. Instead the PMI rose from 53.7 in January to 56.5 in February, the strongest reading in eight months. It is only a small part of the economy but it too seems to have started 2011 in good shape.

It is a different story in the service sector and on the UK High Street. The service sector PMI fell below the 50% expansion-contraction line in December's snow (49.7) and duly bounced back to 54.5 in January. It fell back to 52.6 in February, just ahead of Dec-Jan combined but in line with the average of the last six months. Given that parts of the service sector are benefiting from buoyant overseas demand, the parts that are focused on the domestic economy are relatively weak. Where over the first year of recovery the manufacturing and service sectors moved more or less in tandem, over the last six months they have gone their separate ways (Chart 2).

Chart 2: Manufacturing and service sector PMIs



Source: Markit

On the High Street too, as I noted last week, life is more difficult – as it can't but be when prices are rising at a 4-5% rate, double the pace of earnings.

How does the MPC respond?

If – and there is no reason to suppose that it won't be – the present combination of a buoyant manufacturing / export sector, sluggish domestic demand and strong upward pressure on prices is sustained over the next two months, will that be enough for the MPC to raise rates in May? My guess is that the MPC as a whole wishes to begin the process of monetary normalisation and to bring an end to two years of abnormally low interest rates. But – and this explains why the process has not already started – they do not want to risk aborting the recovery and sending the economy back into recession. They have to be confident that the strength of the manufacturing and export-oriented service sectors will be enough to outweigh any weakness in private demand. It is a finely balanced decision but a Q1 increase in GDP anywhere near 1% would probably be enough for rates to go up in May; ½% or less and they won't.

Plus ca change

I was pleased to read of the latest piece of research from Paul Donovan and Larry Hatheway at UBS on food price inflation in UK supermarkets. They found that food prices are rising more rapidly here than in other economies and suggest that retailers are boosting higher costs with some expansion of profit margins. They reckon that commodity price inflation and a weaker exchange rate would justify processed food price inflation of 3-3.5% but that prices have risen at about double that rate.

In reply to this research press articles cite a spokesman for the BRC saying *food prices have not risen at anything like the same rate as commodity prices*. As if that were any defence – nor are petrol pump prices rising at the same rate as the price of crude. The selling price includes labour and other costs (and, in the case of petrol, taxes) which are not rising at anything like the rate of commodity prices.

I looked at exactly the same subject and reached very similar conclusions in 2007. Then I observed that UK food prices were rising at three times the rate of those in the rest of the EU. I argued that it may be the case that the supermarkets *are increasingly able to exploit their monopoly position and raise prices, even when consumer spending is not especially robust*.

Bus passes and all that

As a child of the 1960s, I don't often find myself in agreement with the IEA but the recent piece from Philip Booth and Corin Taylor makes a lot of sense.¹ When David Cameron, defending his Government's deficit-reduction process, argued that we are all in it together, he should have acknowledged that, in this case, *all* excludes a significant part of the population. Pensioners, particularly the relatively well-off pensioner in receipt of a private final-salary pension, are *in it* a lot less than the rest of the population.

In his emergency Budget last June and the Spending Review in October, Chancellor George Osborne announced spending cuts and tax increases designed to reduce the budget deficit by an additional

¹ <http://www.iea.org.uk/sites/default/files/publications/files/Sharing%20the%20burden%20-%20how%20the%20older%20generation%20should%20suffer%20its%20share%20of%20the%20cuts.pdf>

£40bn by 2014-15. To achieve this, the net had to be cast widely with higher taxes, cuts in departmental budgets and significant cuts in welfare spending. The one exception to the all-round pain was pensioners who *will also be protected by our new triple lock which will guarantee each and every year a rise in the basic state pension in line with earnings, prices or a 2.5 per cent increase – whichever is the greater*. For April 2011 the strongest arm of the triple is prices, so it has already been announced that the basic state pension will rise in April in line with RPI inflation last September (4.6%). By contrast most working-age benefits were increased in line with the CPI (3.1%)².

The triple lock on state pensions comes on top of a whole range of benefits which discriminate in favour of the pensioner. I am very aware of shooting myself in the foot but I can see no justification for my getting a bus pass or a winter fuel allowance. Why should a council-tax payer from East Devon be able to travel free on London buses, even in the rush hour? Where before I walked almost everywhere, now I hop on the bus – the benign effects on my wallet are offset by a negative effect on my lifestyle. The same is true of the winter fuel allowance which is £250 for a couple tax free – it would be simple enough to tax it for higher-rate tax payers via the self-assessment system. Booth and Taylor reckon that abolishing the free bus pass would save around £1.3bn by 2015-16; the winter fuel allowance would recoup £2.1bn with another £725m from abolishing free television licences, a total of more than £4bn.

Booth and Taylor go on to include a number of more radical proposals building up to a comprehensive reform of the pension system. But the basic point is simple. Discriminating in favour of pensioners is difficult to justify, especially when all pensioners benefit equally (unless the aim is to provide a subsidy to the Bank of Mum and Dad which then gets transferred back to the next generation) and it will become increasingly costly as the population ages. It is true that the Government is taking some offsetting measures by aligning the male and female retirement age and then by raising both. But that will only raise the starting point at which the measures kick in. In the meantime, we know that pensioners tend to vote so taking away their goody bags (most of which were dreamed up by Gordon Brown) will never be popular.

² In future years pensions will be linked to the CPI (though the triple lock will remain in force).

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