

Novus Capital Markets Research

The Voice of Reason

4 August 2011

Thank you to all those who responded to last week's blog. I particularly liked being described as the Voice of Reason – which I have adopted for my title this week.

Hot town, summer in the city: this week's surveys were a mixed bag. The manufacturing PMI repeated the downbeat message from the CBI. Manufacturing is off the boil and may now be heading back into negative territory. Confidence and, with it, investment and employment intentions are falling. The only bright spot is exports where orders are still advancing. It is a different story in the service sector where activity and new orders improved sharply in July. That suggests that the special factors that held back the sector in Q2 were genuine one-offs and that the most important sector of the economy is on track to make a significant positive contribution to Q3 GDP. As with manufacturing, it is the export-oriented sectors that are growing and the domestic-oriented sectors that are contracting.

Waiting for Godot: last week I argued that there is very little that policy-makers can or should do to boost demand in the short term. The other side of that coin is that, uncomfortable as it is for the Government, we have to be patient about the supply-side response, which is the *sine qua non* for the rebalancing of demand that is vital and necessary to the health of the economy in the medium term. The conditions are in place for a strong supply-side response – a competitive exchange rate, low interest rates, falling corporate tax rates, a cash-rich corporate sector – so why is the response not forthcoming? There are encouraging signs on the export front but precious little follow-through so far on investment. But that does not mean it won't happen, only that it will happen slowly. Unlike Godot who failed to turn up, the supply side usually does – eventually.

Novus Capital Markets Ltd, 29/30 Cornhill, London EC3V 3NF

www.novus-cap.com

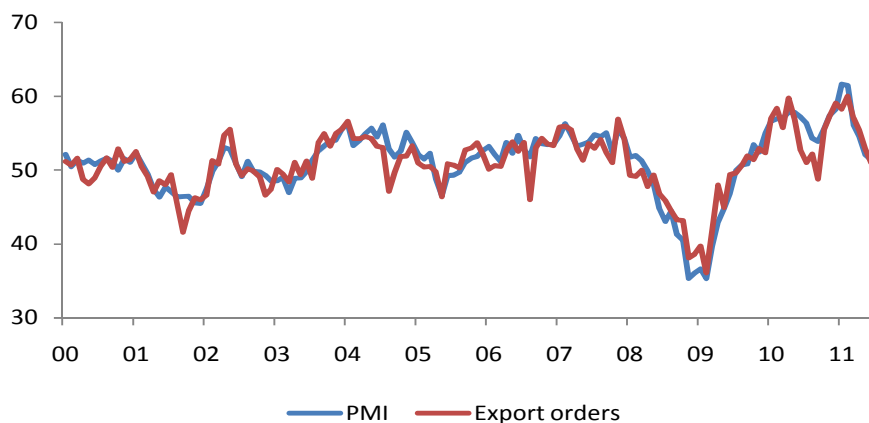
Economist: Geoffrey Dicks (+44 (0) 20 7107 1878); **Institutional Sales:** Peter Bartlett, Neill Flack (+44 (0) 20 7107 1888)

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Hot town, summer in the city

The temperature may have hit 30 degrees in London this week but the July surveys point to a cooling in manufacturing. The manufacturing PMI unexpectedly fell from 51.4 in June to 49.1 in July, below the 50% expansion line for the first time in two years. Within the aggregate measure there was a sharp fall in total order books (47.6 from 50.0) but the weakness was almost entirely in domestic orders since export orders rose from 51.0 to 53.7 (Chart 1).

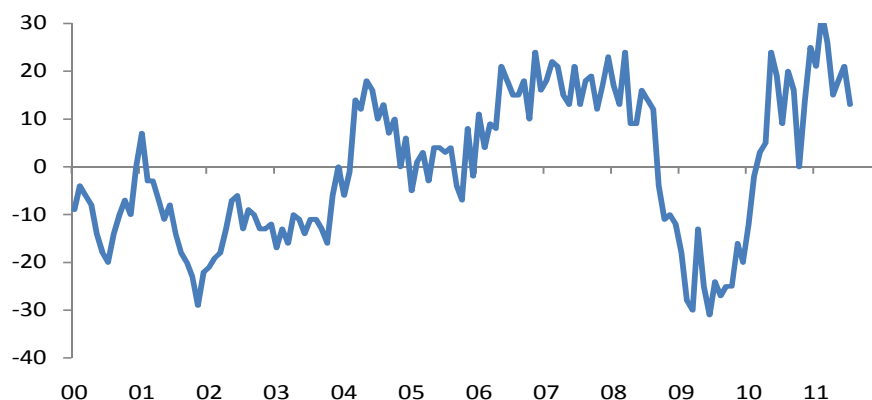
Chart 1: Manufacturing PMI



Source: Markit

Similarly the CBI survey reported a drop in total order books from +1 in June to -10 and a fall in export orders from 0 to -8. Where the PMI asks a simple direct expansion/contraction question, the CBI survey has always asked where order books stand relative to 'normal'. That begs the question as to what is normal and it is hardly a surprise to find that over the history of the CBI survey order books are consistently reported to be below normal (the long-run average for both total and export order books is around -20). If we correct for this by plotting the series relative to the long-run average, the position looks rather better. Order books still fell in July but at +10 for total orders and +13 for exports (Chart 2), they are still relatively healthy.

Chart 2: CBI export order books (relative to long-term average)



Source: CBI

It is also noticeable that the quarterly CBI surveys, which have a larger coverage than the monthly surveys, tend to produce a significantly weaker response than the months either side (Table 1, where the quarterly surveys are in bold). Total orders in July, though weaker than June, were stronger than both the previous quarterly surveys (though export orders were still weaker). On this basis we might expect total orders to rebound in August to a small negative number.

Table 1: CBI survey

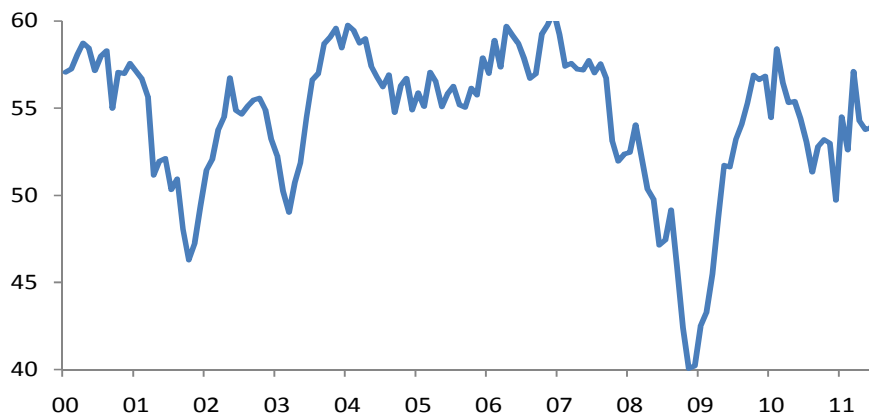
	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec
Total order books	-10	1	-2	-11	5	-8	-16	-3
Export order books	-8	0	-3	-6	5	11	0	4

Source: CBI

Overall the quarterly survey was disappointing. Manufacturers reported that they were less optimistic about the coming three months (-16) for the first time since the depths of the recession in 2009. As a result investment intentions are being scaled back with manufacturers planning to cut investment in plant & machinery over the next 12 months (-17). Employment, which has been on a rising trend, is also expected to fall in the months ahead.

The weakness of the July manufacturing PMI was not replicated in the construction survey, which was essentially unchanged in July (53.5 from 53.6 in June), or in services which unexpectedly rose from 53.9 to 55.4. March apart, this was strongest rate of growth in over a year (Chart 3). Within the total the largest gains were reported by the more export-oriented business services and IT & computing sectors. There were falls in the more domestic orientated hotels, catering & restaurants and personal services sectors. Financial intermediation was also down.

Chart 3: Services PMI



Source: Markit

The robustness of the July services survey is potentially important for Q3 GDP. I noted last week that the ONS estimate for service sector output in Q2 implied that output fell 0.2% in June. That might have been a return to trend since May was boosted by the recovery from April's shortfall or, as appears to be the case with manufacturing, it might have been a genuine weakness. The July services survey suggests that Q3 has started strongly for the predominant sector of the economy and that some of the 'special' factors which took 0.5pp off Q2 growth were genuine one-off events. If so, GDP growth in Q3 should be considerably stronger than Q2's 0.2%.

Waiting for Godot

Last week I argued that there is very little that policy-makers can or should do to boost demand in the short term. The other side of that coin is that we have to be patient about the supply-side response. As every economist knows, though it is often lost on the layman, the output of an economy is determined by a combination of demand and supply conditions. Over the long term, the ability of the economy to supply goods and services at a competitive price and quality is what counts. Over the short term, ups and downs in demand may be more important in determining the path of output. Hence the response to output data is always in terms of what is happening to demand and, as I described it last week, when output is weak there are always calls for demand to be boosted.

On the supply side the fundamentals are improving. The exchange rate, which fell by around 25% in reaction to the financial crisis, gave us a competitive advantage which, with earnings growth at very low levels, is not being eroded. Official interest rates are at record low levels and, in sharp contrast to countries in the euro area periphery, the UK Government can borrow 10-year money at less than 3%. Commercial borrowing rates are higher as the banks rebuild their balance sheets but, against an inflation rate of 5%, they are still low in real terms. The company sector is cash-rich (Bob Diamond reported that Barclays' small business deposits have risen 41%) and corporate tax rates are falling.

Put this all together and it is hard not to conclude that the UK is a profitable place to do business in or from and that while it may not be happening yet, or not yet fast enough, the conditions are in place for the strong supply-side response which is the *sine qua non* for the rebalancing of demand that is necessary and vital for the health of the economy over the medium term.

Why then, given that the conditions are in place for a favourable supply response, is it not forthcoming? Why are UK businesses not taking advantage of a competitive exchange rate to increase their share of markets overseas (by boosting exports) and at home (by displacing imports)? Why – and this is particularly depressing – are UK manufacturers telling the CBI that they are scaling back their investment intentions? The worry is that, like Godot, the supply side just doesn't turn up or, more realistically, doesn't turn up on the timescale that is needed (or that suits the politicians).

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Novus Capital Markets Limited, 29-30 Cornhill, London. EC3V 3NF.

Tel: +44 (020) 7107 1850 Fax: +44 (020) 7107 1851. Website: www.novus-cap.com