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Markit Economic Research

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UK economy

Recovery rate slows, with further easing likely

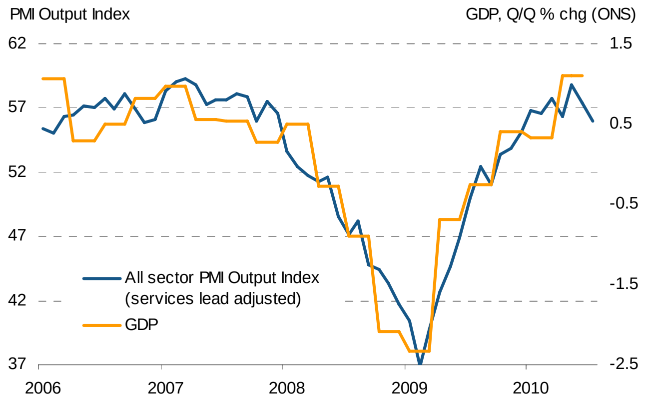
The UK economic recovery moved up a gear in the second quarter, but is already showing signs of being unable to sustain momentum as we move into the second half of the year.

The first estimate of gross domestic product showed the economy expanding 1.1% in 2010 Q2, the largest quarterly increase for four years and a rapid acceleration from the 0.3% increase estimated for Q1. This means that official data now align more closely to the Markit/CIPS PMI™ surveys: the latter had shown a far stronger recovery than the GDP data until now, but both official data and PMI surveys showed strong growth in manufacturing, services and construction during 2010 Q2. However, the PMIs are now showing slower growth, which we expect to feed through to softer GDP numbers in the second half of 2010. The risk of the slowdown being steep has also increased.

July PMI data signal weakest growth since September

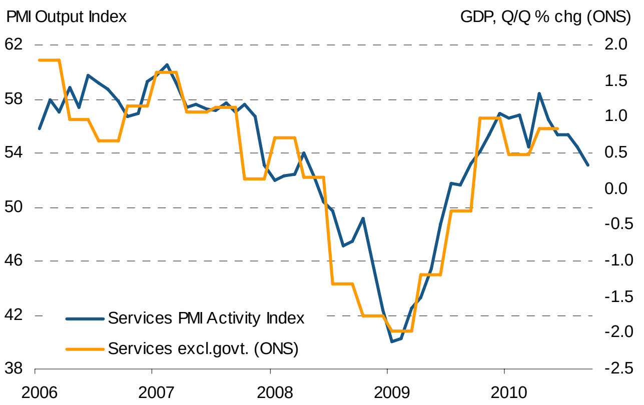
A simple weighted average of the PMI Output Index from the three sector surveys hit a two-and-a-half year high in February, but has since gradually fallen such that the July reading was the weakest since September 2009.

GDP v. PMI



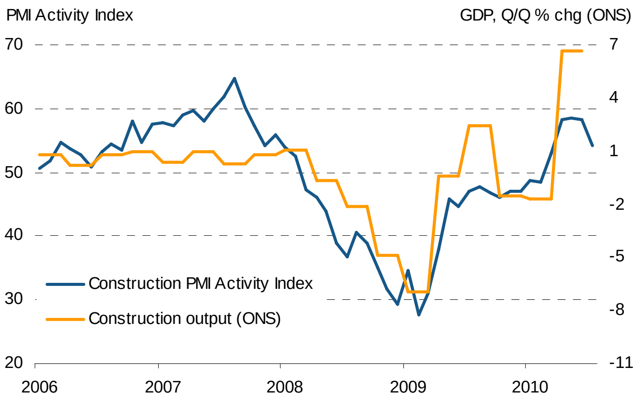
When tracking the PMIs against GDP, we find that the services component acts with a lead on comparable GDP numbers. If we adjust for this lead, then a weighted average of the three sectors in fact peaked in May. This means that the fifth successive monthly fall in the services PMI Business Activity Index, which sat at a 13-month low in July, is consistent with a slowing of services GDP up to the start of 2010 Q4.

Services (PMI shown with 3-month lead)



The construction sector also looks set to disappoint compared to the surprisingly strong 6.6% surge in output signalled by the GDP data in Q2. The PMI data have provided a good indication of the underlying growth trend in the construction sector, and July data showed a steep deceleration in the sector's rate of growth (the survey's Business Activity Index posted its largest monthly fall since February 2009).

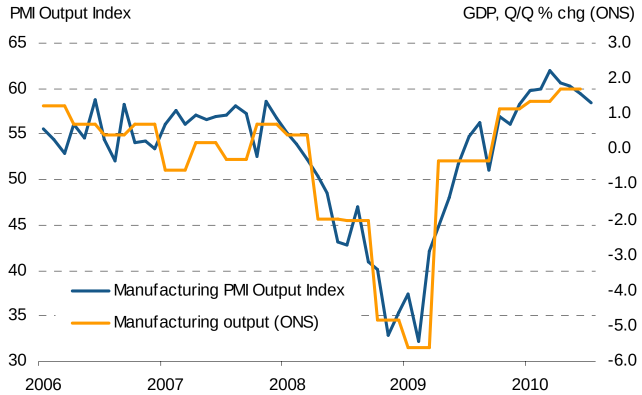
Construction



A further concern for the services and construction sectors relates to business confidence. PMI indices tracking companies' expectations about activity levels in the coming year showed record falls in June, and failed to bounce back in July. The drop in confidence has been linked in many cases to fears that the austerity measures announced in the emergency Budget will have dampened growth prospects (see http://www.markit.com/en/about/news/commentary/markit-economics/markit-economics.page).

Manufacturing consequently remained the only PMI survey which did not display signs of much slower growth in July. The rate of output growth has eased steadily over the past four months to the weakest since December, but nevertheless remained robust. This raises hopes that the sector may maintain a rate of expansion not far off the 1.6% quarterly pace seen in Q2 and thus provide a big support to GDP in Q3.

Manufacturing



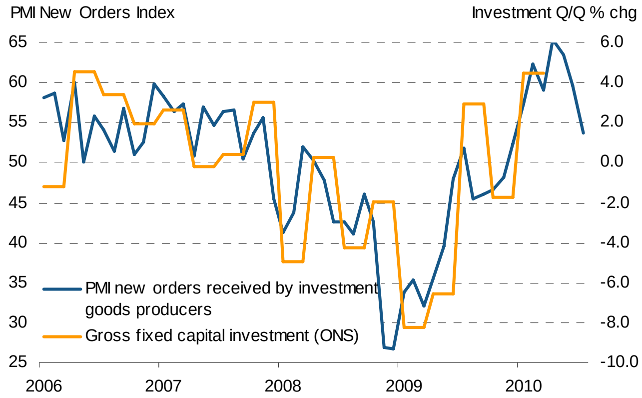
Exports, investment and inventories add to darker outlook

However, the manufacturing survey provided other signals which suggested that GDP growth may weaken.

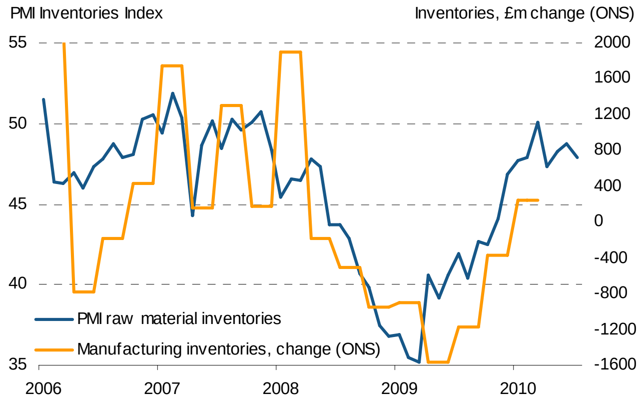
First, the manufacturing New Export Orders Index has collapsed from signalling strong growth in Q2 to near-stagnation in July. Second, growth of new orders received by producers of investment goods (which acts as a useful indicator of business investment) has fallen by almost 12 points over the past three months.

Third, fewer companies are rebuilding inventories, suggesting that the stock-cycle will provide less of a stimulus to growth in the second half of the year.

Business investment



Inventories



If these three factors continue to weaken in coming months, and business and consumer confidence measures fail to revive from current lows, GDP growth could slow particularly sharply from the 1.1% surge seen in Q2.

Sources for all charts: Markit, ONS

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