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UK economy

Robust growth signalled for Q2, but that may be as good as it gets

Robust GDP growth in Q2

The latest available estimate of UK gross domestic product (GDP) published by the Office for National Statistics showed an ongoing but lacklustre recovery. Having risen by 0.4% in 2009 Q4, a further 0.3% expansion was seen in Q1.

The PMI surveys have tended to be more buoyant than the GDP data in the recent recovery, although we are seeing that initial weak GDP estimates are being subsequently revised up to levels more in line with the PMIs. For example, 2009 Q4 GDP was revised up from an initial estimate of 0.1% to 0.4%, and 2010 Q1 growth has been revised up from 0.2% to 0.3%. History tells us that further upward revisions cannot be ruled out.

A statistical analysis of the PMI against historical GDP data suggests that the PMI signalled a 0.6% increase in GDP in 2009 Q4, with growth rising to 0.8% in Q1. That was far greater than the official estimate of 0.3%, and certainly not consistent with the *slowing* in growth between 2009 Q4 and 2010 Q1 signalled by the official GDP numbers.

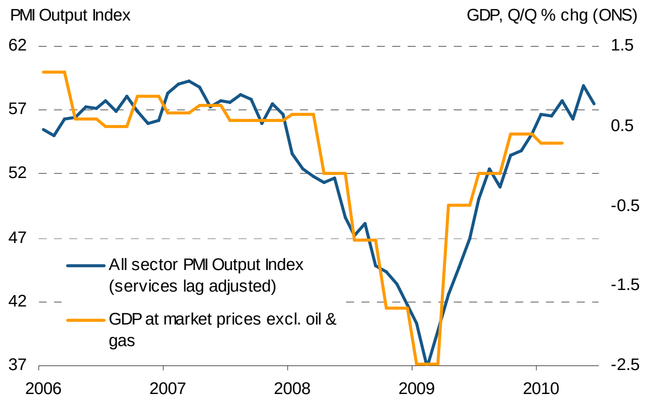
Encouragingly, the PMIs indicated that the manufacturing-led upturn (manufacturing output growth hit a 15-year high in March) has spilled over in to services (where growth hit a three-year high in February) and more recently even the much-suffering construction sector (where growth hit a 32-month peak in May).

Slower growth ahead?

However, the Output Index from the combined PMI surveys of manufacturing, services and construction reached a peak in February, and has since assumed a downward trend. Historically, the level of the PMI is still consistent with GDP growth of 0.7%-0.8% in Q2, but because the PMI excludes some sectors which we expect to be weak contributors to GDP in Q2, notably retail and government, growth is perhaps more likely to be 0.5%-0.6%.

Furthermore, evidence suggest that the services component of the PMI moves in advance of the official estimates of service sector growth, meaning that the PMIs are most likely indicating that growth peaked in Q2 and will slow in Q3.

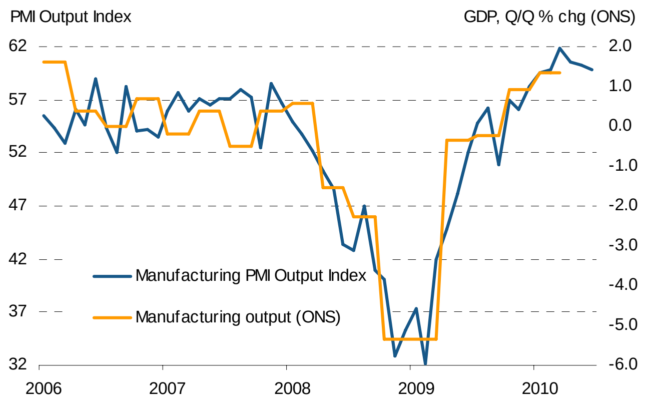
GDP



Manufacturing data converge

A major divergence between the PMI surveys and the initial estimate for GDP in Q1 was evident for manufacturing. However, official manufacturing output data have since been revised up from a paltry initial estimate of 0.3% growth to a far more impressive 1.3% – in line with the PMI. PMI data are signalling a further 1%+ robust expansion of manufacturing output in Q2.

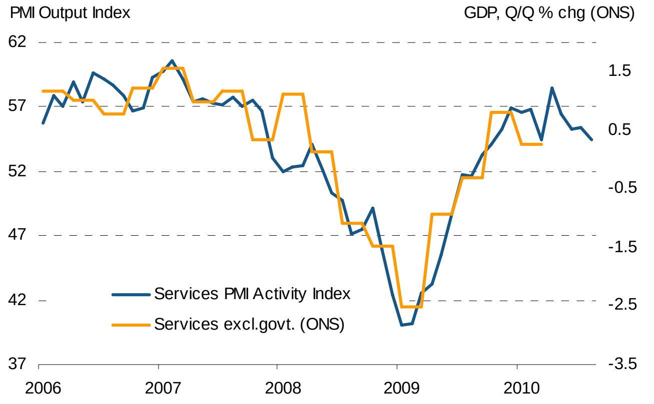
Manufacturing



Services show diminishing boost to GDP

A further divergence between PMI and GDP in the recent recovery has been apparent for the service sector. However, it is evident that the PMI data for services have moved in advance of GDP data in recent years by approximately three months[1]. By taking this lag into account, much of the divergence disappears.

Services



The services PMI therefore suggests that non-government service sector growth is likely have been sustained in Q1 at the 0.8% range seen in Q4 (i.e. the easing in GDP growth in Q1 may be revised up to eventually show stronger growth). However, growth is likely to have slowed in Q2 to perhaps 0.5%.

Investment and inventories boost growth

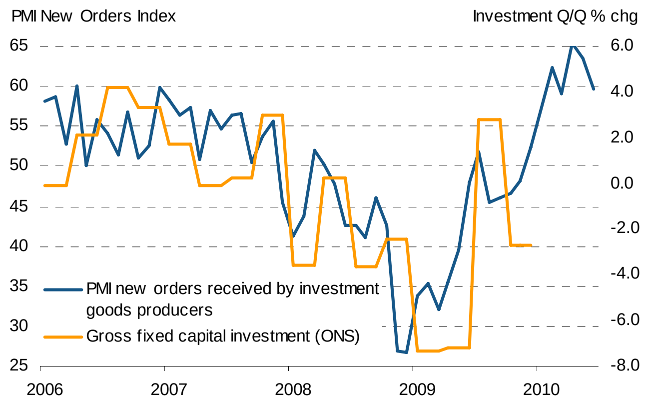
Finally, two other PMI sub-indices add to the robust growth picture portrayed by the survey's main indices for Q2.

First, the manufacturing survey's index relating to new orders placed for investment goods correlates well with official data on fixed capital investment. The PMI series rose to its highest level since mid-1994 earlier this year and, although down from that peak in recent months, remains at a level rarely matched in the past 15 years. This suggests much stronger business investment than portrayed by recent official data.

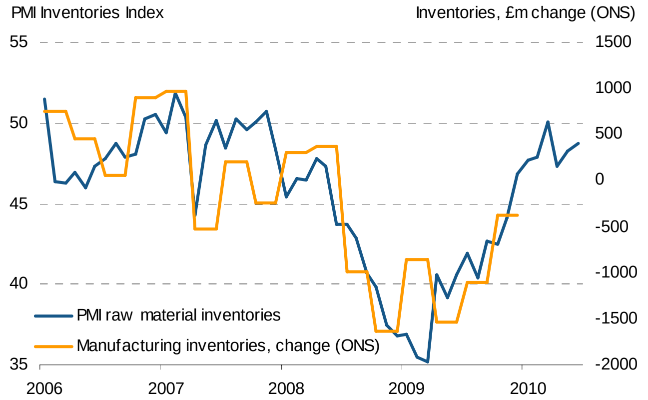
Second, falling inventories acted as a drag on growth during the recession, but PMI data on stocks of raw materials (which anticipate official data accurately) are now signalling a positive contribution to growth.

[1] We are not sure what could explain this, but it could possibly relate to the delay in service sector companies responding to the ONS or differences in definitions of 'output' (with the PMI perhaps tending to measure more timely measures of output).

Investment



Inventories



Sources for all charts: Markit, ONS.

As good as it gets?

With news that a "potential error" has forced the Office for National Statistics (ONS) to delay the publication of the latest update to GDP figures for 2010 Q1 until 12 July, we have grown increasingly sceptical of the accuracy of the GDP in tracking actual economic growth in the recent recovery. The PMIs have painted a more upbeat picture than the initial GDP numbers. However, just as revisions to the GDP data seem to be bringing the GDP numbers more into line with the PMIs, the PMIs have begun to turn down again. With signals from the PMIs of slower growth of private sector activity combining with public sector spending cuts, it is realistic to believe that 2010 Q2 will represent a peaking of the recovery growth cycle.

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