

UK economy

Recovery accelerates from a trot to a sprint

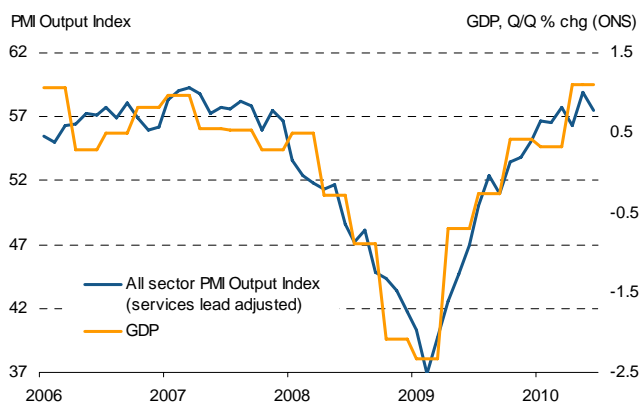
Growth surge in Q2

The UK recovery finally found its legs in the second quarter, moving from a trot to a sprint. The first estimate of gross domestic product smashed expectations by showing the economy expanding at 1.1% – the largest quarterly increase for four years. Analysts were expecting 0.6% on average.

The improvement goes some way to make up for disappointingly sluggish growth in the previous two quarters, which had meant that only Italy, Spain and Greece had shown weaker recoveries than the UK by the end of the first quarter (with Greece in fact still contracting)¹. However, the economy has still only regained approximately one quarter of the output lost in the recession, well below that seen in many other developed countries.

The official data correspond with upbeat survey data during the quarter, which had shown a far stronger recovery than the GDP data until now. Both official data and PMI™ surveys showed strong growth in manufacturing, services and construction during the quarter.

GDP v. PMI



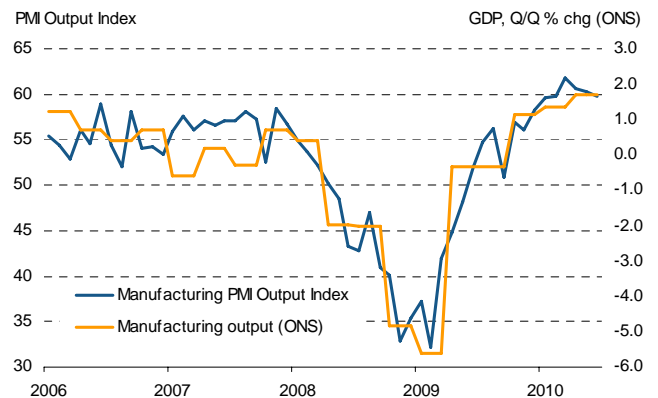
But it's very unlikely that this pace of growth will continue, and a more moderate rate of expansion is on the cards for the second half of the year.

¹ See http://www.markit.com/assets/en/docs/commentary/markit-economics/2010/jul/UK_recession_10_07_12.pdf

Manufacturing growth at 10-year high

Initially weak official manufacturing output data have been revised up to show a more impressive recovery, matching the message of the manufacturing PMI survey. An initial estimate of 0.3% growth in Q1 was recently raised to 1.3%, and a further 1.6% expansion was seen in Q2. That was the fastest growth since late-1999 and fits well with the PMI, which has shown near-record growth for the survey in recent months, although the rate has cooled slightly more recently. With manufacturing having benefited temporarily from the refilling of warehouses with stocks that had been depleted at record rates during the recession, the sector is unlikely to sustain the 1.6% growth seen in Q2.

Manufacturing



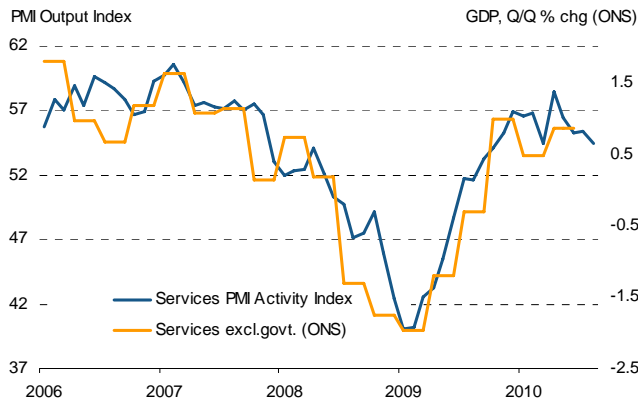
Services growth to weaken in Q3

A 0.9% increase in service sector output, the largest quarterly rise for over three years, is also unlikely to be matched in coming quarters.

PMI data for services have moved in advance of GDP data in recent years by approximately three months, and suggested that non-government service sector growth accelerated in Q2 (GDP data showed a 0.8% increase in Q2, up from 0.5% in Q1). However, the PMI Business Activity Index for the service sector has fallen sharply in recent months, dropping to a 10-month low in June. Given the lead services PMI data

tend to have over actual GDP outcomes, this points to weaker growth in Q3.

Services

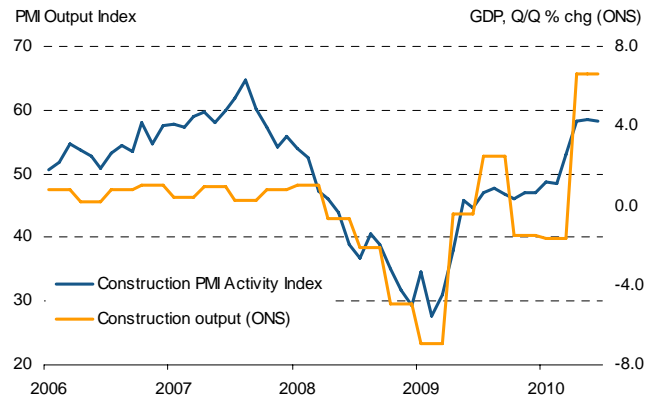


June also saw a record fall in business confidence in the PMI service sector survey, widely linked to the spending cuts announced in the emergency Budget, which will in turn reduce the government’s contribution to the recovery. Households meanwhile grew increasingly worried about their finances in June, according the Markit/YouGov HFI survey.

Construction surges as weather improves

One of the biggest surprises from the initial estimate of Q2 GDP was that construction output surged 6.6% during the three months to June. However, activity was boosted by a return to better weather compared to Q1 (when the sector had seen output fall 1.7%). If these two quarters are taken together, the underlying trend in the GDP numbers therefore tallies with the steady improvement that has been seen in the PMI data for the sector, which showed the strongest growth for almost three years in Q2.

Construction



As good as it gets

The release of initial GDP estimates for Q2 therefore provide reassurance that the strong recovery message from the PMIs has been accurate. But the new numbers do not change our earlier view based on the survey evidence (see our commentary note from 5 July*) that the second quarter represented a peaking in the rate of growth. A more moderate rate of expansion is on the cards for Q3.

Sources for all charts: Markit, ONS

* http://www.markit.com/assets/en/docs/commentary/markit-economics/2010/jul/UK_gdp_10_07_05.pdf

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