

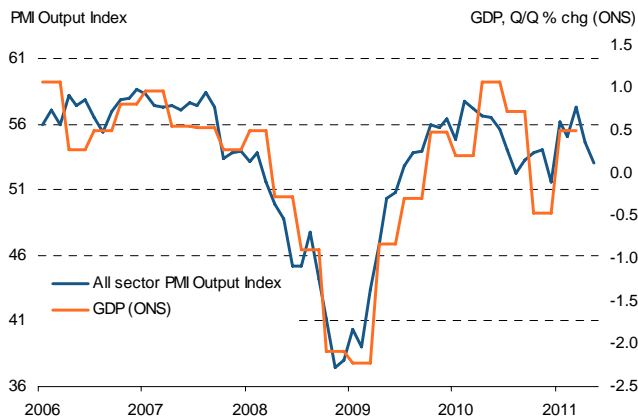
UK Economy

PMI™ surveys point to weaker growth and falling price pressures

- All-sector PMI™ consistent with quarterly GDP growth of just 0.1% in May. Second quarter growth unlikely to exceed 0.3%.
- PMI™ no longer consistent with rate hike.
- Weaker input cost pressures and sluggish labour market point to waning inflation outlook.

The three Markit/CIPS UK PMI™ surveys collectively signalled a slowing in the rate of economic growth for the second month running in May, taking the rate of expansion down to the weakest since heavy snowfall caused a near-stagnation of growth in December. The data suggest the economy could struggle to expand by more than 0.3% in the second quarter.

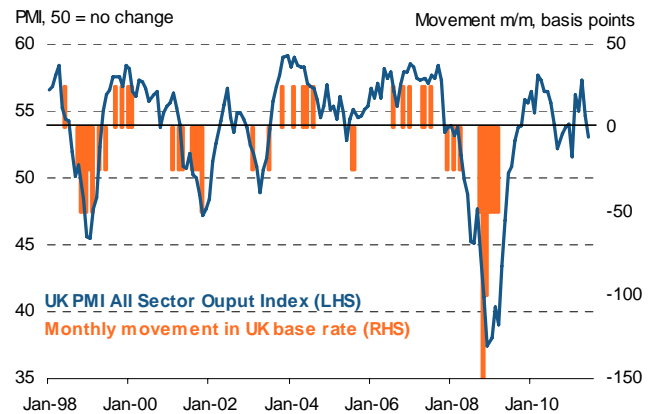
All sector PMI™ and GDP



Policy signal shifts towards need for stimulus

The all-sector Output Index fell from 54.6 in April to 53.1. This pushed the average for the second quarter down markedly to 53.8, from an average of 56.1 in the first quarter. Based on the relationship between rate setting and PMI™ data before the introduction of quantitative easing, the current level of the all-sector PMI™ Output Index is no longer consistent with a rise in interest rates by the Bank of England, contrasting with a strong rate hike signal in the first quarter.

PMI™ and Bank of England rate setting



Economic growth rate weakens

Gross domestic product rose 0.5% in the first three months of the year, which merely reversed a 0.5% fall in the final quarter of last year and means that the economy stagnated over the two quarters. While the average PMI™ reading for the second quarter so far is consistent with GDP rising by approximately 0.25%, the reading for May alone is consistent with a quarterly growth run rate of only 0.1%. The outlook for GDP growth in Q2 as a whole therefore very much depends on what will happen in June. A fall in the index to 50 would be consistent with GDP stagnating in Q2. However, even a full rebound in the all-sector index in June back to April's level would only imply GDP growth of approximately 0.3% for Q2 as a whole.

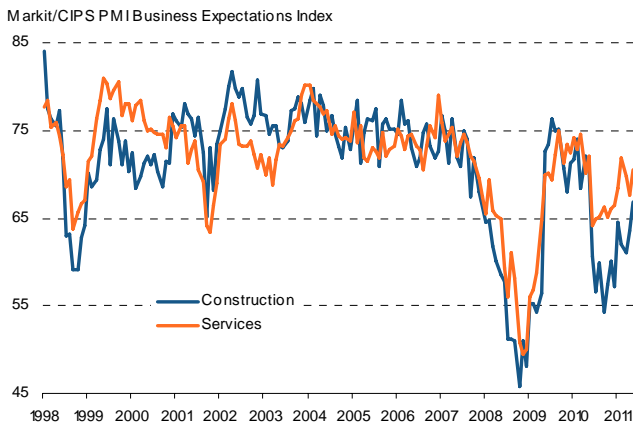
The latter scenario, where growth rebounds - at least to some extent - looks the most likely scenario for June, based on the fact that many companies contributing to the PMI™ surveys (especially manufacturers) reported that temporary factors, such as extra public holidays and supply chain disruptions emanating out of Japan, had adversely affected activity levels.

Drags on growth

Where data are available (services and construction), businesses grew more confident about their activity levels in 12 months' time in June, which also suggests that the slump in the Output Index in May possibly

overstates the underlying slowdown. However, optimism remained well below levels seen in the growth years prior to the financial crisis. This relatively weak optimism was reflected in payroll growth. The all-sector PMI™ Employment Index signalled only modest growth of staffing levels in May, with the increase confined to the manufacturing sector as hiring stagnated in both services and construction.

Business optimism



Weak hiring and low confidence suggest that, even if the PMIs rebound in June, growth will remain modest at best as we move into the second half of the year, as a number of factors act as drags on economic growth.

First, the consumer sector fell back into recession in the first quarter, and surveys of household confidence suggest the situation has not changed in recent months amid falling real incomes and widespread job insecurity (see our [household finance survey](#) for May).

Second, global economic growth and worldwide trade flows have weakened since the start of the year for a variety of reasons, including policy tightening in China and sluggish consumer spending in developed countries such as the US. Worries in the Eurozone periphery have also hampered growth of UK exports.

Third, manufacturers reported a steep easing in demand for intermediate goods – components supplied to other companies – both at home and abroad in May, suggesting that a widely-anticipated period of inventory reduction has commenced.

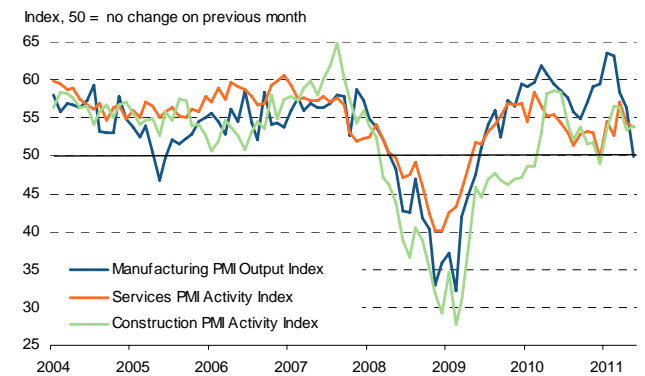
Fourth, PMI™ survey respondents have reported that deficit-fighting government spending cuts have reduced workloads, notably in the service sector. These cuts have yet to show up in official data, with government spending acting as a driver of GDP growth in the first quarter and a record spend reported in April.

It is unlikely that this stimulus will persist as we move through the year.

Growth slows in all three PMI™ surveys

Output indicators fell in both manufacturing and services in May, with only construction – which represents just 6% of the economy – recording an improvement in the pace of expansion.

PMI™ Output Indices



Manufacturing growth slumps

Manufacturing saw the steepest deterioration, recording a drop in output - albeit only very marginal - for the first time since May 2009. The manufacturing Output Index has dropped sharply since hitting a record high at the start of the year and is consistent with the official measure of manufacturing output falling at a quarterly rate in excess of 1% in May. The sector could therefore act as a drag on GDP growth in Q2, contrasting with the 1.1% increase seen in Q1.

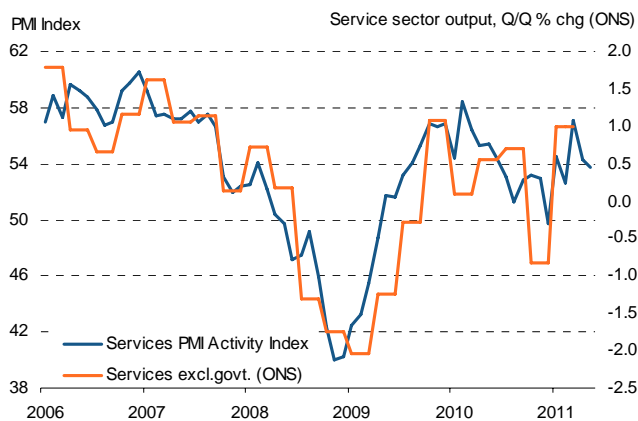
Manufacturing output



Service sector slowdown

In services, the PMI™ data suggest that the quarterly rate of growth has slowed from just under 1% in Q1 to around 0.5% in May. This points to a markedly weaker contribution to GDP growth from the sector in Q2.

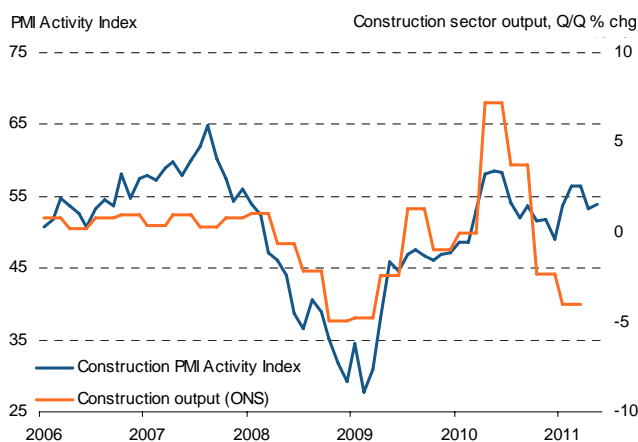
Service sector output



Construction uncertainty persists

The wild-card in the recent GDP numbers has been construction. Although accounting for a small part of the economy, official data have shown huge volatility, which has in turn had a big impact on the overall GDP picture. Official estimates show that construction output rose 7.3% in Q2 of last year and 3.7% in Q3, but then fell by 2.3% in Q4 2010 and by 4.0% in Q1 2011. The Q1 data in particular contrast with a rebound that was signalled by the PMI™, and the survey suggests that construction activity continued to rise in Q2.

Construction output



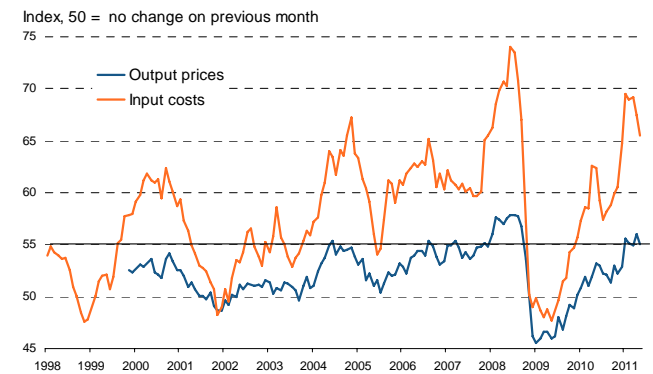
Inflationary pressures ease

The latest PMI™ data therefore add to uncertainty regarding the underlying health of the UK economy,

and suggest that there is an increased risk that growth in 2011 will fall below the 1.8% expansion forecast in the latest Bank of England projections.

At the same time, inflationary pressures appear to have moderated, which may feed through to lower consumer price inflation in coming months. Most importantly, manufacturers reported that their input cost inflation, although still strong, has slowed sharply as commodity prices have fallen. Oil in particular is approximately 10% below its recent peak. Average prices charged by goods and service providers again rose at a strong pace, but the rate of increase slowed slightly in May and is likely to ease further if input cost pressures continue to moderate in coming months.

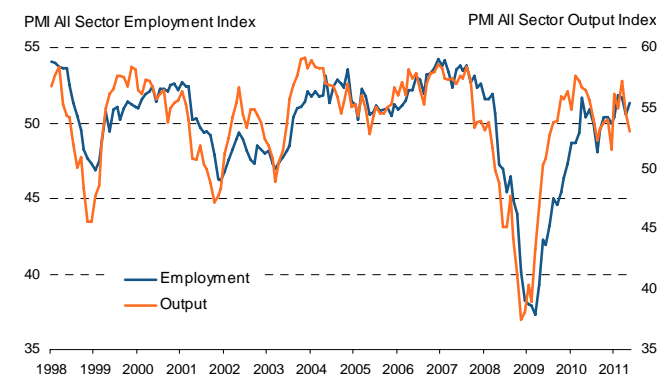
PMI™ Prices Indices (all sectors*)



* Output prices exclude construction.

The combination of easing price pressures, the weak labour market (which should help prevent the build up of second-round inflationary pressures via a wage-price spiral) and growth falling below that anticipated by the Bank of England in its latest projection, will add to calls for the Bank to hold off on hiking interest rates until a clearer picture emerges of a robust and sustainable economic recovery.

Employment



Sources for charts: Markit, ONS, Ecwin, Bank of England.

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