

UK Economy

PMI™ surveys point to economic stagnation in Q3

- All-sector PMI™ signals risk of GDP stagnating in Q3
- Steep slowdown in services exacerbates contraction in manufacturing
- PMI data consistent with looser policy

The PMI surveys collectively pointed to a near-stagnation of economic growth in August, signalling an increased risk that GDP growth in the third quarter could be even weaker than the 0.2% rise seen in the three months to June. Forward-looking indicators also suggest that the economy could weaken further at the end of the quarter, raising the prospect of a slide back into contraction in Q4 – if not in Q3 – and will provide ammunition for those seeking a further injection of stimulus into the economy by the Bank of England. The all-sector PMI is at a level which has always triggered interest rate cuts in the past.

The data also suggest that the Office for Budget Responsibility's forecast of 1.7% GDP growth this year is looking wholly unrealistic, and that growth will instead be unlikely to exceed 1.0%.

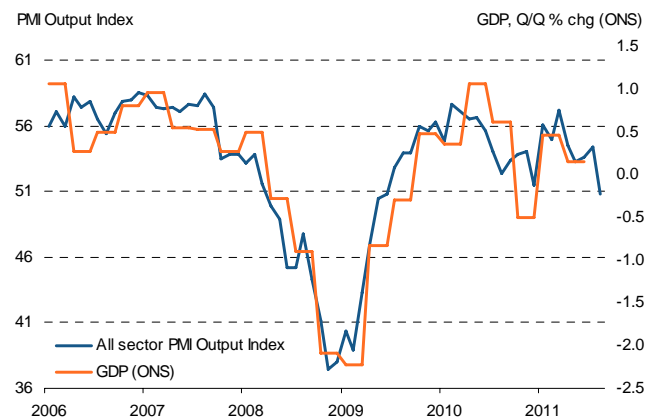
Near-stagnation signalled in Q3

The three Markit/CIPS PMI™ surveys, covering manufacturing, services and construction, collectively signalled a near-stagnation of output in the UK private sector in August. The all-sector index fell sharply from 54.3 in July to 50.9 in August, its lowest reading since June 2009. The 3.4-point fall in the index was the fifth-largest in the 13-year history of the series, exceeded only by the falls of 4.0 points in October 2007 (after the collapse of Northern Rock), 3.7 points in June 2008, and 3.5 and 3.7 points in September and November 2008 respectively (during and after the collapse of Lehman Brothers).

The August survey data are consistent with gross domestic product (GDP) falling at a quarterly rate of approximately 0.2%. The average reading for the third quarter so far (52.6, down from 53.8 in the second quarter) is broadly indicative of GDP stagnating in Q3

compared to a 0.2% rise in Q2. The data for September could therefore tip the balance between a growth or contraction signal from the surveys for Q3.

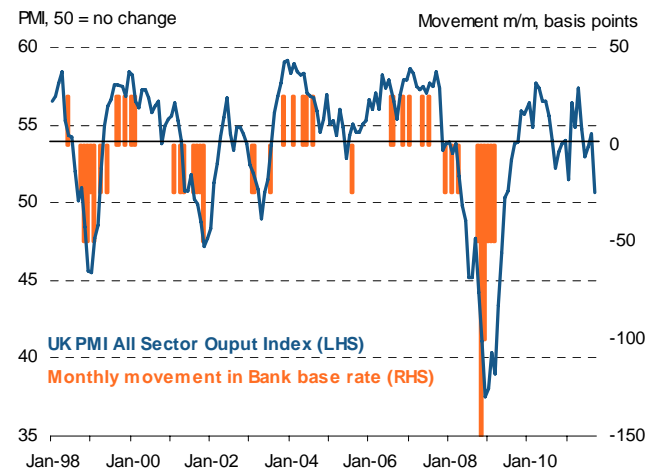
All sector PMI and GDP



In need of a pick-me-up?

The sharp drop in the all-sector PMI in August takes the index to a level which is historically consistent with a loosening of policy by the Bank of England. In the past, every time that the PMI has fallen into this territory, it has triggered rate cuts. The data will therefore add weight to calls for the Bank of England's Monetary Policy Committee to inject more stimulus into the economy through more asset purchases or quantitative easing.

PMI and Bank of England rate setting



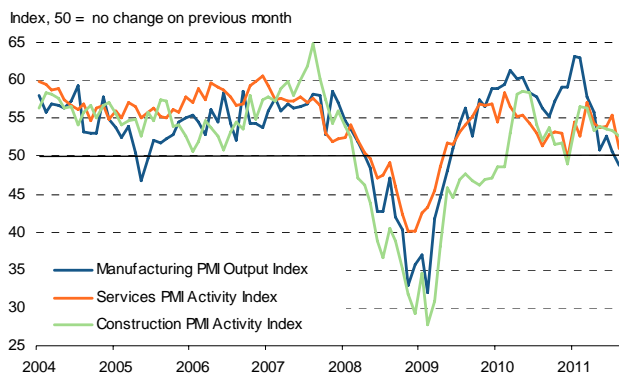
Price pressures ease

Meanwhile, policymakers worried about inflationary pressures may take some comfort from the August PMI data. Prices charged by manufacturers and service providers showed the smallest increase for 11 months, with the rate of inflation driven down in part by slower growth of input costs and running well below the pace seen earlier in the year.

Services index shows near-record fall

Looking further into the detail of the PMI surveys, the largest downshift in growth in August was seen in the service sector, where the index fell 4.3 points – almost equalling the record 4.5-point fall seen in April 2001 – to indicate that the previously robust pace of growth seen in July had been largely lost in August. The resulting increase in services activity was the weakest since the sector’s recovery began in May 2009 (excluding last December when services were disrupted by heavy snowfall).

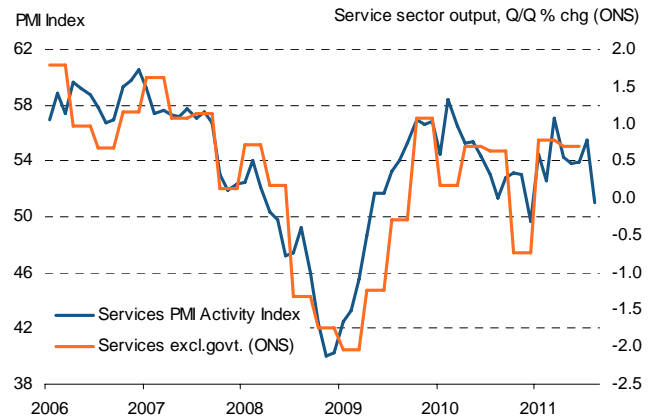
PMI Output Indices



It is likely that the weak growth in August in part reflected disruptions to business caused by the riots – meaning some rebound may be evident in September – but services companies also attributed a weakening trend to a general downturn in household and business confidence.

The near-stagnation signalled by the services PMI in August sits in stark contrast to the reasonably healthy 0.7% expansion signalled by the GDP data for services (excluding government) in Q2. However, the average reading for Q3 so far is down only slightly from Q2, due to the robust PMI figure in July (an average of 53.3 compared to 54.0 in Q2), suggesting that the sector may continue to contribute to economic recovery in Q3 unless the survey turns down sharply again in September.

Service sector output

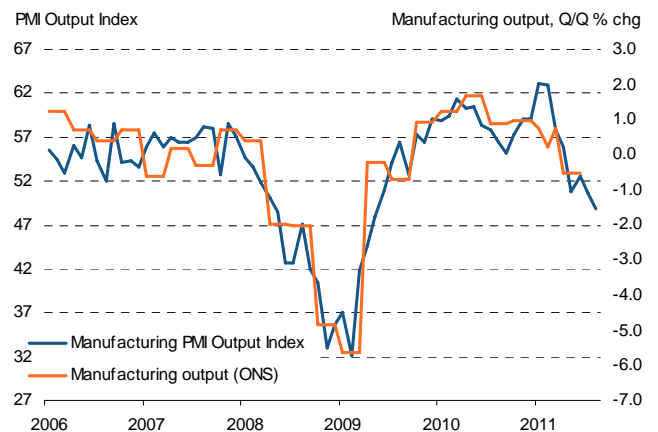


Manufacturing recession?

Manufacturing was less affected by the riots, but the PMI Output index nevertheless signalled contraction for the first time since May 2009, with new orders dropping for the fourth successive month. Overseas sales fell especially sharply, with the New Export Orders Index posting one of the steepest monthly falls on record.

These downbeat survey results translate into even worse news when compared with official data. Comparisons suggest that the manufacturing sector may have contracted at a faster rate than the 0.5% signalled by official data in Q2, with the average Output Index reading of 49.8 in Q3 so far (versus a Q2 average of 53.1) roughly consistent with output falling at a quarterly rate of 1.0%.

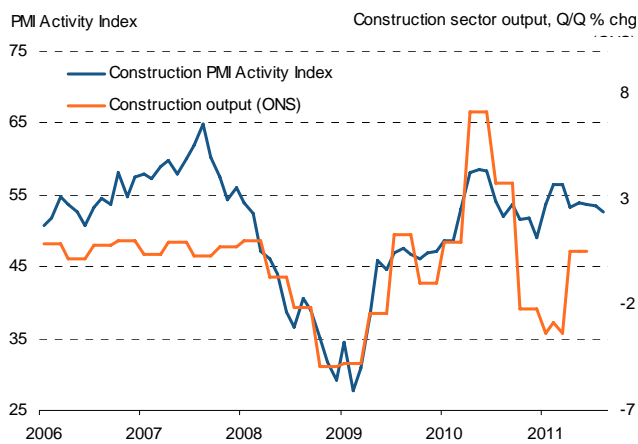
Manufacturing output



Construction 'recovery' sustained in Q2

Growth also slowed in construction in August, easing to the weakest in 2011 so far. Comparisons with official data are difficult, however, with the PMI having signalled stronger growth than the surprisingly weak official data so far this year. The Activity Index from the Construction PMI fell from 53.5 in July to 52.6 in August.

Construction activity



2011 growth target at risk

Given the weak growth of the economy in the first half of the year (0.5% in Q1 and 0.2% in Q2), growth of 1.0% would be needed in each of Q3 and Q4 to achieve the Office for Budget Responsibility's forecast of 1.7% expansion for the year as a whole. If zero GDP growth were to be seen in Q3, which the PMIs suggest is a real possibility, followed by a recovery of 0.5% in Q4, the British economy would have grown only 1.0% in 2011. While zero growth in Q3 may appear pessimistic, a 0.5% expansion in Q4 looks optimistic, given the downbeat forward-looking indicators from the surveys. Consequently, we expect the UK economy to struggle to expand by more than 1.0% in 2011.

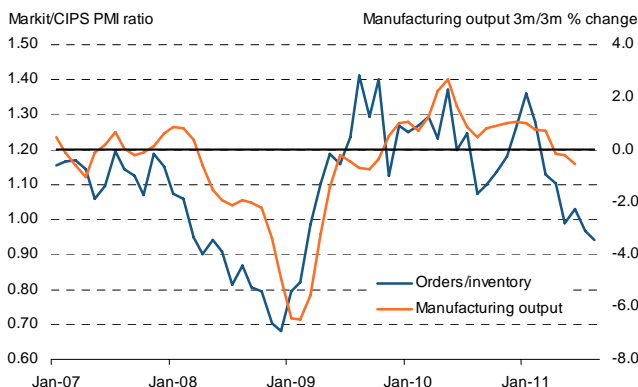
Sources for charts: Markit, ONS, Ecowin, Bank of England.

Leading indicators turn down

Downturns in forward-looking indicators from the PMI surveys, meanwhile, point to a further weakening trend in coming months.

First, the ratio of manufacturing orders to inventories, a leading indicator of production trends, fell to a 30-month low in August.

Manufacturing orders-to-inventory ratio



Second, business optimism about the year ahead fell to a one-year low in the service sector. Third, confidence in the construction sector was at its lowest in 2011 so far.

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