

UK economy

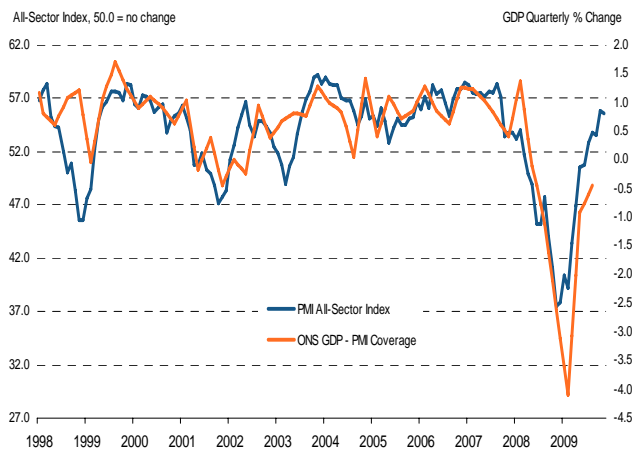
UK ends 2009 on a strong note

- Economy strengthened in Q4
- Labour market shows resilience
- Productivity growth surges
- Short-term inflation spike evident

Output

The UK economy ended 2009 on a positive footing. December's 'All-Sector' PMI (covering manufacturing, services and construction) maintained the general upward trend seen in the second-half of the year, reaching a 27-month peak. The marked shift upwards in the PMI in Q4 signals a robust expansion of private sector output.

All-Sector PMI and Private Sector Output¹

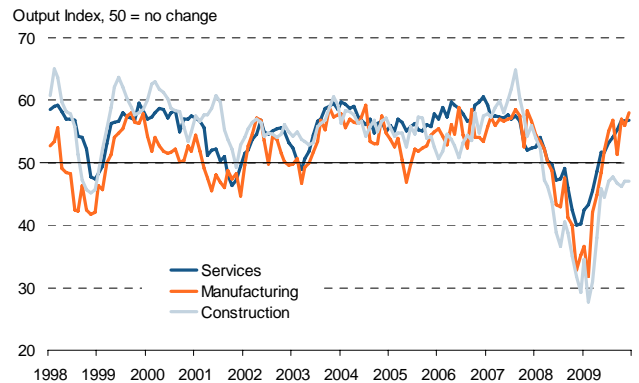


Sources: Markit, ONS

The PMI data therefore raise the possibility of an expansion of gross domestic product (GDP) in the final quarter of the year, and that Q3 may not have been as poor as official data continue to suggest. GDP data for Q3 have been revised up from an initial quarter-on-quarter reading of -0.4% to -0.2%, and the PMI suggests that future estimates by the Office for National Statistics may eventually show modest growth.

¹ Private sector output refers to those industries covered by the UK PMIs. Coverage is around 58% of the UK economy.

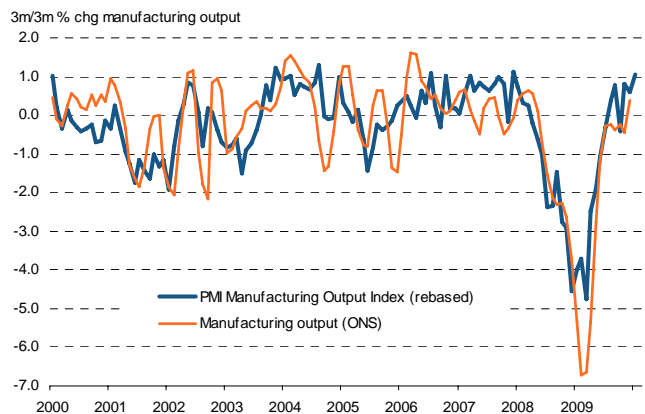
PMI Output by Sector



Sources: Markit

The PMI data have indicated that expansion in recent months has been led by improvements in both manufacturing and services, with the hard-hit construction sector remaining a laggard.

Manufacturing output*

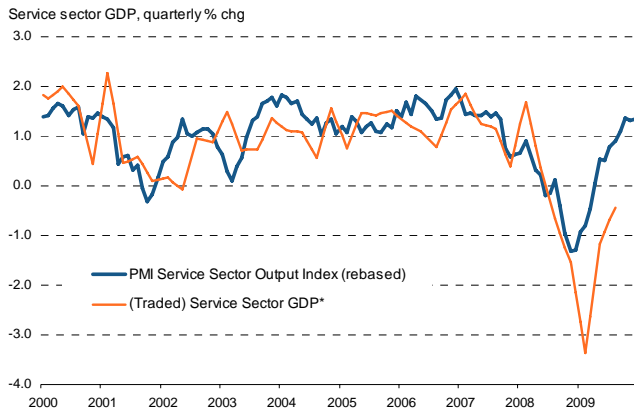


*chart uses a linear regression to rebase PMI data to a comparable level with official data.

Sources: Markit, ONS.

The Output Index from the manufacturing PMI survey hit a 25-month high in December, pushing the average index reading for Q4 to 57.0 – well above the average of 54.4 seen in Q3. Official data on manufacturing appear to be lagging behind the PMI, but are catching up: the latest data showed output rising 0.4% in the three months to November; the best performance since March 2008.

Services (traded) GDP*

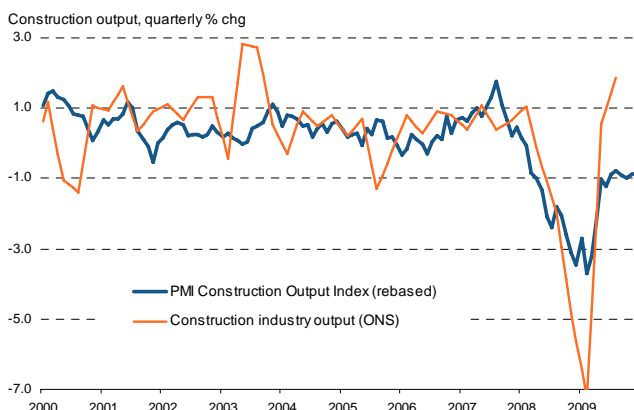


*chart uses a linear regression to rebase PMI data to a comparable level with official data.

Sources: Markit, ONS.

The service sector appears to be the area where PMI and official data have diverged to the greatest extent in recent months, and is likely to be the key to the weaker official GDP data in Q3 relative to the PMIs. The PMI Services Business Activity Index has risen to levels consistent with robust growth, up from an average of 54.2 in Q3 to 56.8 in Q4 (by comparison, the average reading in the two years prior to the financial crisis was 57.8). Official data for this part of the economy (which excludes retail, wholesale and government services) showed a further contraction in Q3, although the rate of decline eased sharply.

Construction output*



*chart uses a linear regression to rebase PMI data to a comparable level with official data.

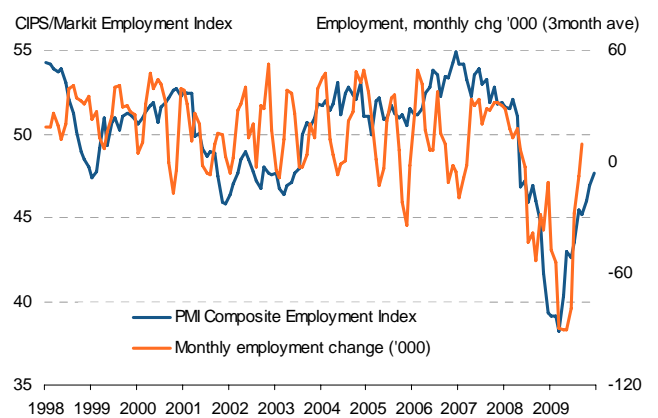
Sources: Markit, ONS.

PMI data have also diverged with official construction data. Having indicated a deeper recession, official data have (not surprisingly) signalled a stronger rebound than PMI data in Q3. The PMI data indicate that the sector continued to contract in Q4.

Employment

One of the surprising features of the past 18 months has been the UK labour market's resilience, which has so far confounded early predictions from many experts of an increase in unemployment to at least three million (the number currently stands at 2.49 million). Official data even showed a surprise increase in employment in Q3 and the PMI surveys have meanwhile indicated a sharp easing in the rate of private sector job losses during the second half of last year.

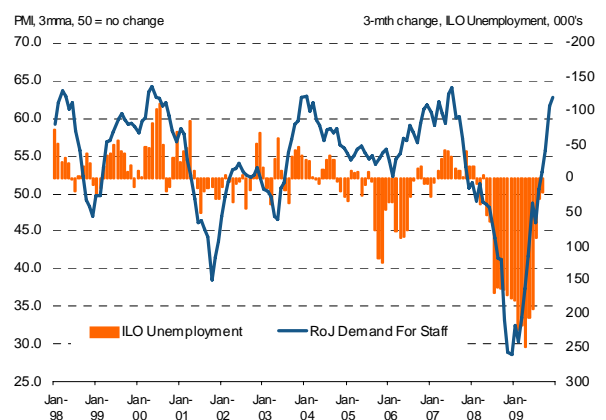
UK Employment



Sources: Markit, ONS

Evidence from the KPMG/REC survey of recruitment consultancies also indicate that companies, encouraged by the turnaround in business sentiment, sales and output, have begun to hire again. Growth of both permanent staff appointments and vacancies in December reached the strongest since July 2007.

Report on Jobs demand for staff



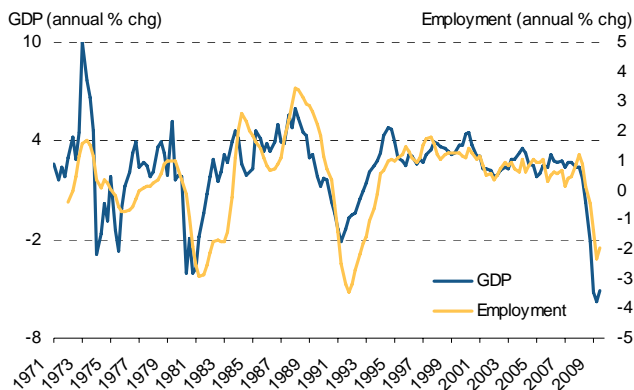
Sources: Markit, ONS

Productivity

The resilience of the UK labour market is particularly interesting (and puzzling) when compared with the situation in the United States. It is evident that UK employment has fallen to a much lesser extent relative to the decline in GDP than has been the case in the United States, according to official data. This has meant that US productivity soared late last year but slumped in the UK. This is surprising, as companies usually take advantage of downturns to raise output per head.

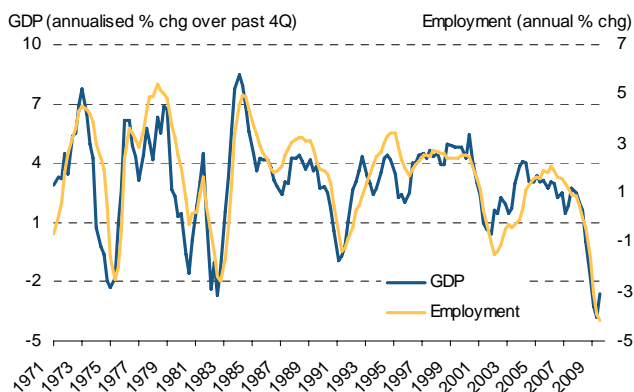
However, PMI data paint a very different picture of productivity, largely because the survey data have indicated a shallower drop in output than official statistics. A simple comparison of output and employment growth from the PMI surveys suggests that productivity has risen sharply in both the US and UK in recent months. This of course has important implications for corporate profitability.

United Kingdom



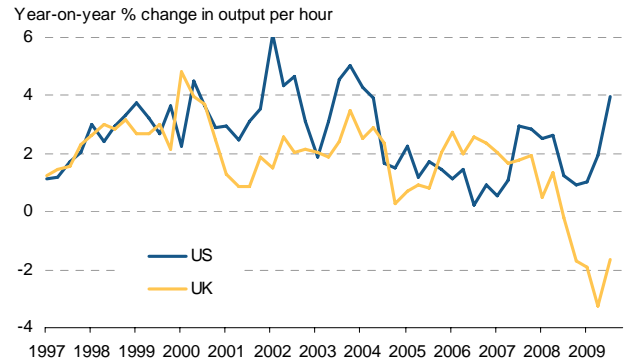
Source: Ecwin.

United States



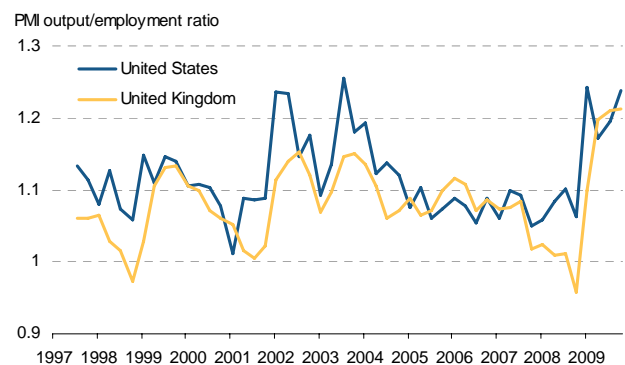
Source: Ecwin.

Productivity – official data



Source: Ecwin.

Productivity – PMI data



Sources: Markit, ISM.

Inflation

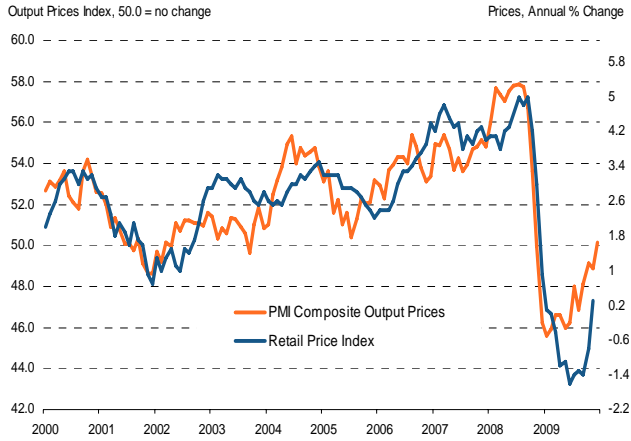
Rising fuel costs, the weak pound and increasing commodity prices have caused input price inflation in manufacturing to hit a 15-month peak in December. There are also signs of increased price pressures in services, and the *Report on Jobs* and services PMI surveys have picked up some upward wage pressures, although rates of increase remain muted. The composite (all-sector) PMI index of input prices signalled the fastest rate of increase for 14 months in December, while output prices showed the first (albeit marginal) increase for 14 months. The latter correlates well with retail price inflation, and suggests headline inflation will pick up in early 2010.

Households have signalled growing concern over the inflation outlook, according to the YouGov/Markit Household Finances Index (HFI) survey.

At present, such a short term spike in consumer price inflation is widely expected, and this expectation has been communicated clearly by policy-makers, but in the longer term price pressures are anticipated to

remain subdued. However, much may depend on global factors, such as oil and other commodity prices.

UK PMI Output Prices and Retail Prices Index



Sources: Markit, ONS

Following the run-down of inventories, vendors are struggling to meet the sharp rises in global manufacturing purchasing activity, as highlighted by a marked lengthening of supplier delivery times. The performance of suppliers to UK companies worsened for a sixth month in a row during December, while lead times at the global level deteriorated at the strongest pace for nearly three-and-a-half years. If this imbalance of supply and demand persists, there is a danger that price pressures could be stickier than currently anticipated.

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