

UK economy

Economy expands at 0.4% quarterly rate in February, 0.5% in Q1

- **PMIs point to economic upturn in Q1.**
- **Underlying trend weak as growth in part reflects rebound from December.**

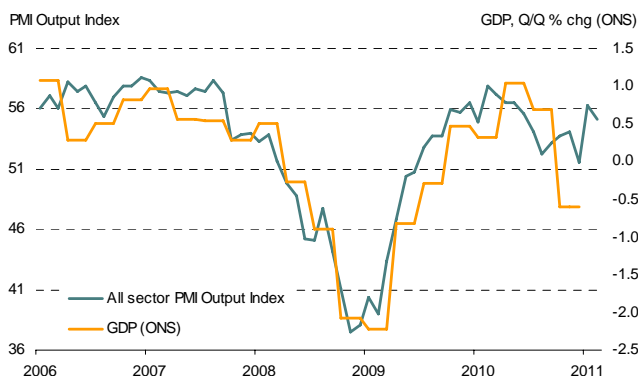
PMI surveys pointed to further robust growth in February, suggesting gross domestic product will have recovered in Q1 from the decline seen in the final quarter of last year. However, the rebound flatters the rate of expansion and the underlying trend is likely to have remained weak as fragile consumer demand offsets manufacturing expansion.

The Markit/CIPS PMIs showed a solid pace of expansion in February, holding up well on the sharp upturn seen in January. The combined index fell from January's eight-month high of 56.2 to 55.2, thereby remaining well above the no change level of 50.0.

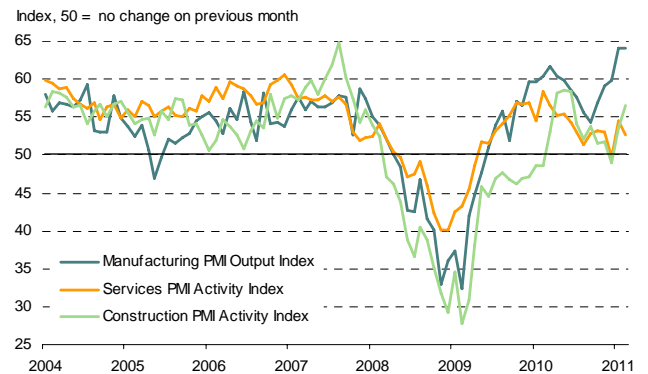
Manufacturing output recorded the strongest growth in the near 20-year history of the survey in January, and the pace slowed only very marginally in February. Construction has meanwhile recovered sharply from the weather-related contraction seen at the end of last year, expanding at the fastest pace for eight months in February. In contrast, the service sector was relatively subdued, continuing to expand in February but at a slower rate than January.

Taken together, the three PMI surveys are consistent with GDP growth of approximately 0.5% in Q1. This represents a substantial improvement on the surprise 0.6% contraction seen in the final quarter of last year.

GDP and the PMI



PMIs – output growth by sector



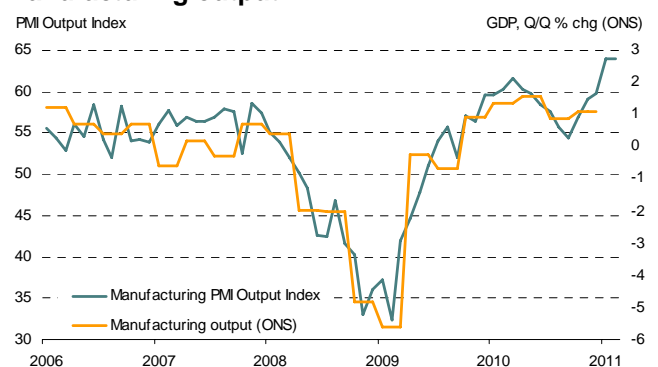
Underlying growth trend closer to 0.2%

However, growth in Q1 is flattered by the recovery from the snow-related disruptions to many businesses in December, notably for construction, travel and transport and other consumer-oriented services. It is evident that the rebound extended into February for some companies. The underlying trend therefore remains weaker than the 0.5% expansion signalled by the PMIs for Q1. Looking over the latest four months (November through to February), the all sector PMI Output Index has averaged 54.3, which is roughly consistent with quarterly GDP growth of 0.2%.

Manufacturing growth surge

Manufacturing continued to lead the upturn in February, and importantly the expansion over the first two months of the year does not reflect a rebound from weather-affected disruptions late last year.

Manufacturing output

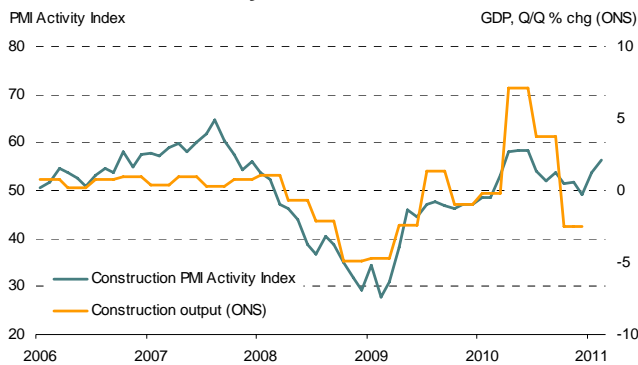


Having risen 1.1% in Q4, the PMI survey suggests that manufacturing growth has accelerated to over 2.5% in Q1 so far. That would be the fastest growth since 1988. However, the impact on GDP is limited as manufacturing accounts for just 13% of the economy.

Construction

Official construction output data have been more volatile than the PMI surveys over the past year, although both series have shown similar trends, with the PMI anticipating turning points in the official data. Construction activity (which accounts for just over 6% of GDP) collapsed by 2.5% in Q4, but a 7.4 point rise in the sector's PMI Activity Index in the past two months suggests a marked upturn in output. However, at 52.7, the average Index reading over the past four months is roughly consistent with a near-flat picture of growth.

Construction activity



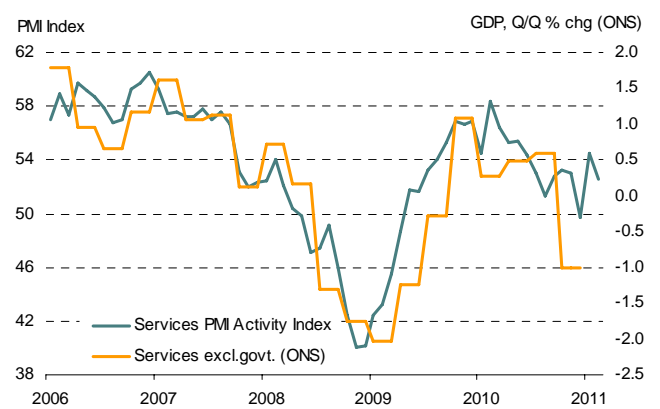
Services

The services PMI survey showed a strong rebound in activity in January following a contraction in December, but fell back in February. At 52.6 (from 54.5 in January), the latest reading suggests that the sector continued to expand in February, albeit at a modest quarterly rate of growth of 0.2-0.3%, putting the sector on course for a 0.3% expansion in Q1.

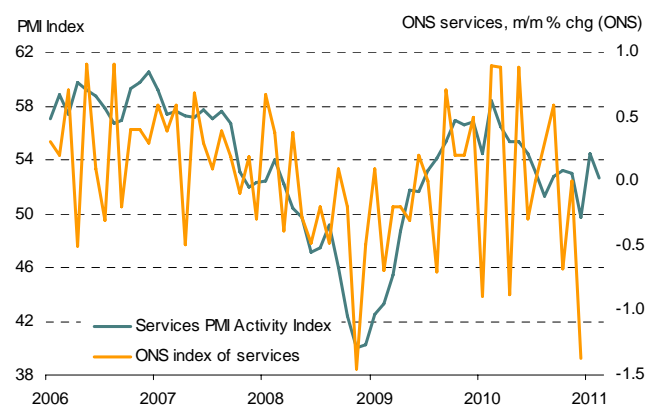
It should be noted that estimation of services growth in Q1 is made difficult by the fact that the services PMI did not indicate as severe a contraction as official GDP data for Q4, with the latter pointing to a 0.7% drop in output compared to the previous quarter (and a 1.0% drop in non-government services). The PMI indicated a broadly flat growth profile for services in Q4. It is therefore highly possible that the GDP data may show a substantially faster services growth rate in Q1 than the PMI indicates due to the stronger rebound from Q4.

We continue to believe that the official data overstate the severity of the downturn at the end of last year, especially the 1.2% drop in business services & finance and the 1.5% collapse in transport, storage & communication output. The drop in the official measure of GDP is also not simply accounted for by the snow in December. The monthly official data on services showed that not only did growth slump in December (a 1.4% monthly decline) but that a sharp contraction (0.7%) was also recorded in October, which is very much at odds with the business survey data.

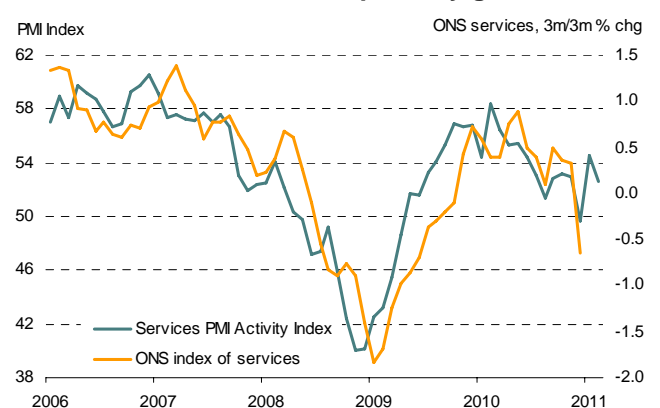
Services (non-government) activity: PMI and GDP



PMI and Index of Services: monthly growth



PMI and Index of Services: quarterly growth

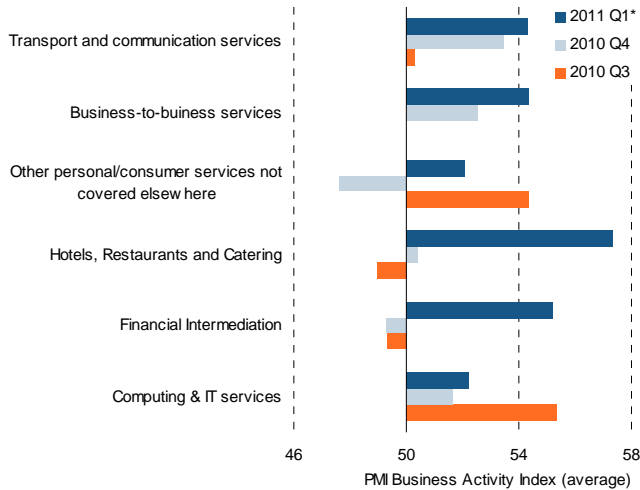


Services sub-sectors

The services economy is far more diverse than the relatively homogeneous manufacturing and construction sectors, and has consequently experienced a mixed growth trend in recent months. Some sub-sectors saw a steep fall in activity due to the harsh weather in December, with a corresponding bounce-back in the early months of 2011. These have included hotels, restaurants & catering and other consumer-based services.

Other sub-sectors of the services economy have seen a more stable trend. These have been the sectors that have had less exposure to weather, notably business-to-business services and computing & IT. These sectors have also shown an upward growth trend in recent months, in part reflecting spill-over gains from the rapid expansion of manufacturing. Thus, while the improving growth profile of these sectors suggest that the recovery has broadened out beyond manufacturing, the trend says little about the underlying situation in consumer-facing services.

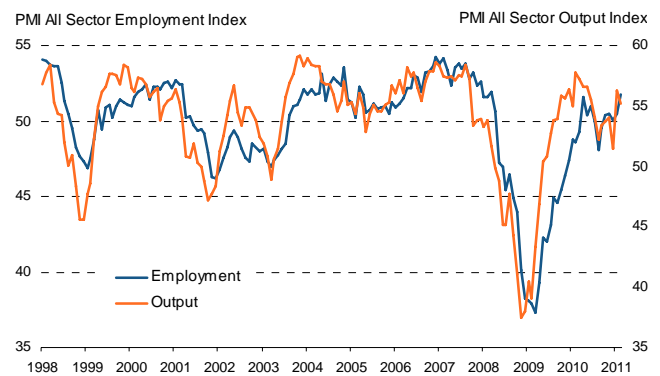
PMI Services Activity Index



Employment holds key to services growth

With the services economy, which accounts for 76% of GDP (52% excluding government), reliant upon domestic demand to a greater extent than manufacturing, the strength of this dominant part of the economy is likely to be driven by consumer spending and therefore the employment situation. The PMIs showed that employment rose in February at the fastest rate since March 2008, but the rate of job creation nevertheless remains too weak to generate strong economic growth (see chart). Until job growth picks up further, economic growth looks set to remain subdued and reliant upon exporting manufacturers.

PMI all-sector employment and output indices



Sources for all charts: Markit, ONS.

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