

Global economy

Attention shifts from spotting the turning point to mapping the recovery

- **New orders-to-inventory ratios suggest further improvements in output in coming months.**
- **Financial conditions and service sector optimism add to the brightened outlook.**
- **But headwinds are likely to subdue growth.**

Turning points appear

PMI data suggest that the global recession has bottomed out. Chart 1 plots PMI Composite Output Indices (which cover both manufacturing and services) showing an almost universal improvement from the lows seen at the turn of the year. Although the UK was the only country to see the PMI rise above the 50.0 no-change level in May, which indicates an increase in output on the previous month, rates of decline have eased considerably elsewhere, and more quickly than generally expected. Discussion is therefore now turning away from whether a turning point has been reached, towards gauging the sustainability of any recovery.

Several sub-indices from the PMI surveys are supporting hopes for a 'V' shaped upturn, whereby economic growth strengthens throughout the rest of 2009. But many headwinds are present which may subdue the recovery process, raising the risk of a 'double-dip' or 'W' shape to the recovery trend.

Orders-to-inventory ratios suggest further growth can be expected in coming months

One key indicator which suggests that the global manufacturing upturn will gain momentum in the short-term is the PMI new orders-to-inventory ratio. As chart 2 shows, the rate of decline of new orders at manufacturing plants worldwide has eased sharply since hitting a record in December, registering the smallest drop in demand for 12 months in May. At the same time, manufacturers' inventories continued to fall

Chart 1: Worldwide economic growth trends

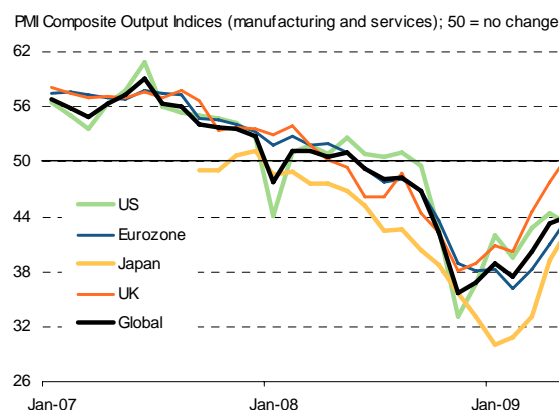


Chart 2: New orders and inventories

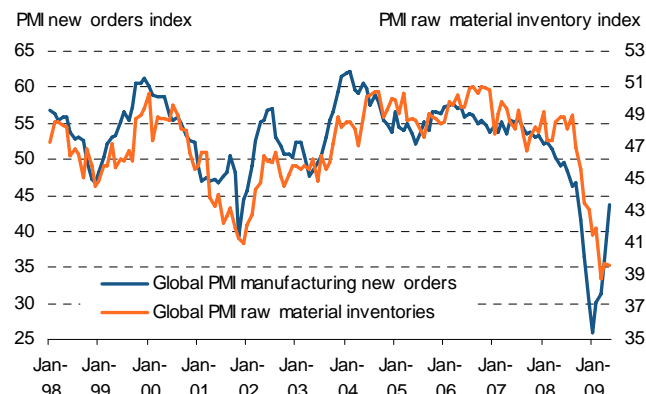
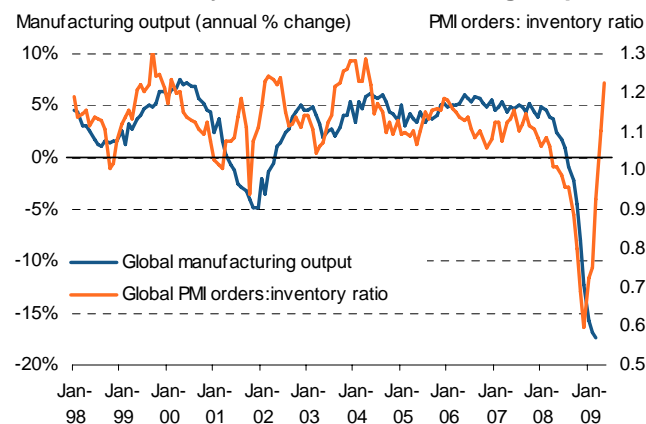


Chart 3: Inventory ratio and manufacturing output



at a near-record pace as firms deliberately reduced stock levels to cut overheads. As a result, the new orders-to-inventories ratio rose from 1.10 in April to a five-year high of 1.23 in May – up sharply from December’s all-time low of 0.60.

Chart 3 demonstrates the relationship between the PMI orders-to-inventory ratio and manufacturing output (derived from an amalgamation of data from national statistics bureaux), with a clear suggestion that output growth should recover quickly in coming months.

Importantly, orders-to-inventory ratios have risen sharply for the main developed and emerging markets alike, suggesting a synchronised, broad-based upturn is possible (see charts 4 and 5).

Chart 4: Orders/inventory ratio: developed nations

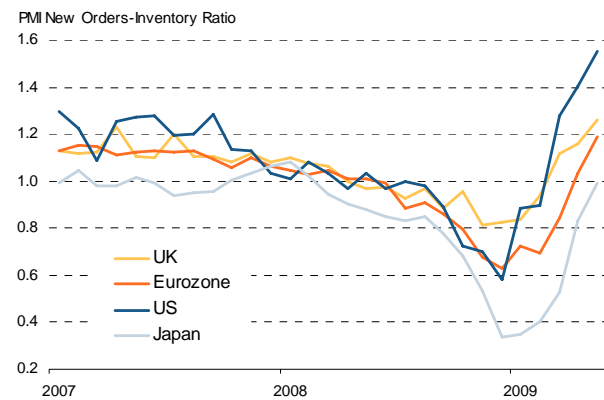
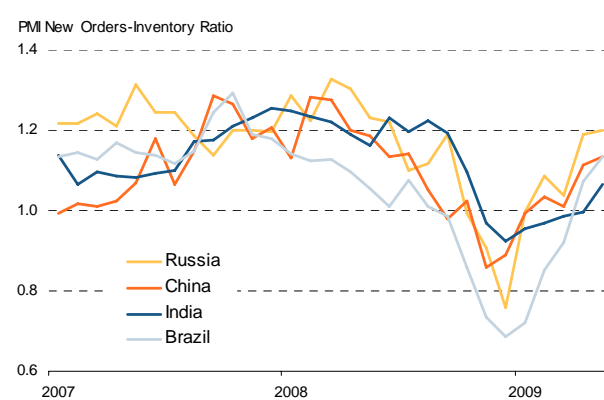


Chart 5: Orders/inventory ratio: emerging markets



Concerns over longevity of inventory-based upturn

A major concern is that, in the absence of any improvement in consumer and corporate ‘final’ demand, growth momentum in the manufacturing sector will subside once inventory levels return to normal. While this is a valid fear in principle, it should be noted that

global inventory levels – both raw materials and finished goods – are *still falling at near-record rates* in many countries (see charts 2, 6 and 7). This suggests that the global re-build of stocks has yet to commence in earnest, so any boost from inventory building could yet have some time to run, allowing final demand to strengthen. A notable exception is China, where the stock cycle appears to be leading the West.

Chart 6: Stocks of raw materials

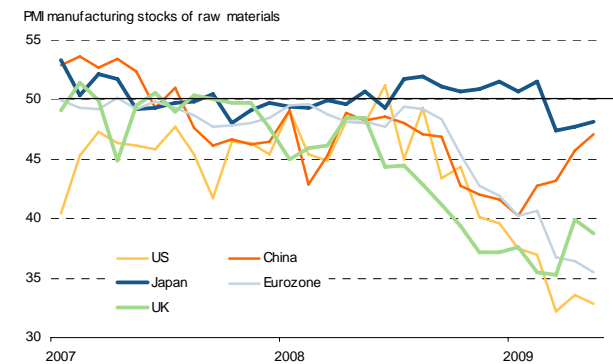
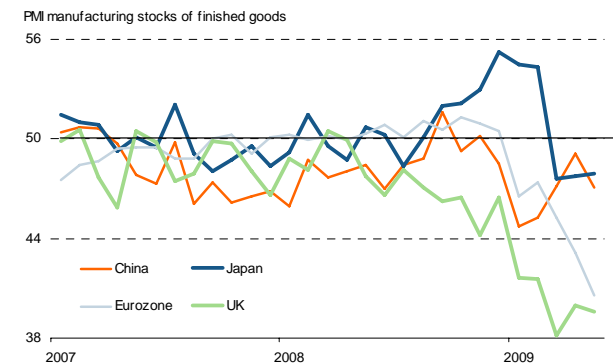


Chart 7: Stocks of finished goods*



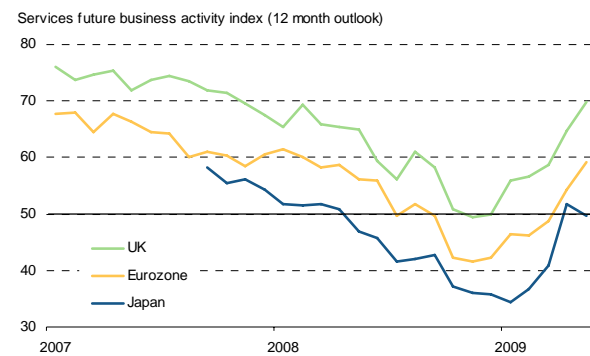
* data not available for the United States.

Service sector also points to improvement in coming year

Another positive indication for the economic outlook is the role of the services economy in the recent improvement. In the UK, for example, business activity levels in the services economy rose in May according to the PMI survey, outperforming manufacturing. As inventories are not a key part of the operations of most service sector companies, this upturn cannot be explained by restocking. Instead, anecdotal evidence from the surveys indicates that business has improved due to a restoration of some confidence in the economy, in part due to a belief that aggressive policy responses to the financial crisis will reap benefits over the coming year.

This return of optimism in the service sector is evident in many key economies. Markit's services PMI surveys include a question asking companies to report on the expected level of business activity at their companies in one year's time (the only subjective question asked in the PMIs). Any index reading above 50 indicates that more companies expect activity to be higher in 12 months' time than expect it to be lower. As chart 8 shows, these expectations indices have risen sharply in the UK, Eurozone and Japan (data are not available for the US or other main economies at present).

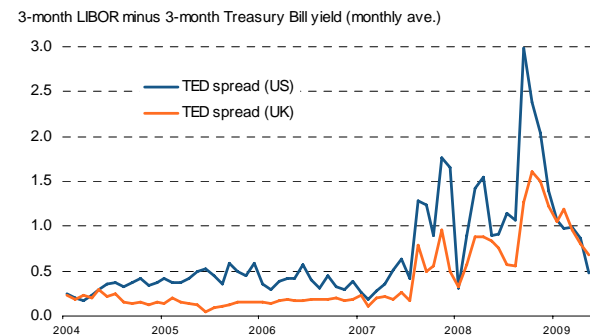
Chart 8: Service sector confidence



Inter-bank lending is showing signs of returning to normal and fears of corporate default have eased

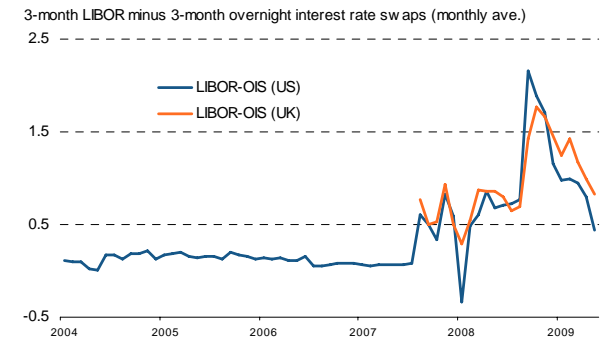
The brighter economic outlook and restoration of business confidence are also suggested by the improved functioning of the financial markets, with LIBOR-OIS and TED spreads both indicating that the interest rates at which banks are prepared to lend funds to each other have fallen dramatically. At the same time, fears of corporate default have eased markedly, as measured by Markit's credit default swap indices such as the European iTraxx index, which has in turn helped improve business confidence.

Chart 9: TED spreads



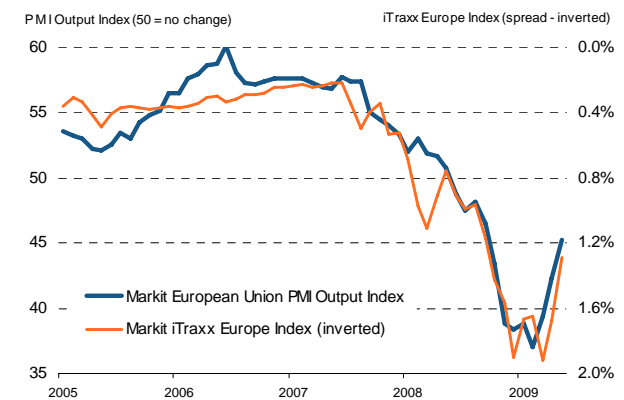
Source: Ecwin.
11/06/2009

Chart 10: LIBOR-OIS spreads



Source: Ecwin.

Chart 11: Credit default fears and the PMI



Source: Markit.

Not out of the woods yet

Despite all of the optimistic looking data, a 'V' shaped recovery throughout the rest of 2009 is by no means a sure thing. Many headwinds face the world's major economies, not least the continued retrenchment of the corporate and household sectors as debt and spending are brought down to manageable levels, which will in turn be exacerbated by an inevitable rise in unemployment for some time to come.

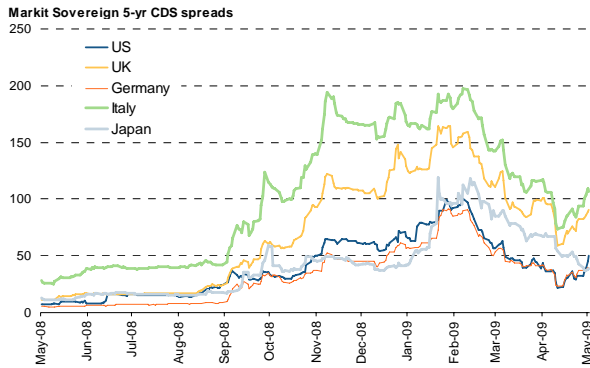
Bank lending to the corporate and household sector is also likely to act as a brake on any recovery: a recent Markit survey showed that one-in-ten companies reported that a lack of credit was constraining their business (although conditions varied markedly by country, with no credit crunch visible in Germany, for example¹).

The ability of governments to fund rising deficits is also being closely watched, and sovereign CDS spreads

¹ see http://www.markit.com/assets/en/docs/commentary/markit_economics/may-updates/Global_credit_conditions_09-05-18.pdf

neatly highlight the return of fear about defaults (see chart 12), although spreads are nowhere near as wide as at the height of the financial crisis.

Chart 12: Sovereign CDS spreads



Some comfort may therefore be drawn from the fact that May saw more signs of definitive turning points in the PMIs, and some indicators even showed that we have moved from a situation of things merely getting less worse to actually getting better. Many PMI indicators have at least moved back into 'normal' bounds, rather than the extreme lows seen in the aftermath of the Lehman's collapse. But the high frequency data will need to be watched carefully for any let-up in recovery momentum, and in this respect two key indicators: the ISM's service sector business activity index for the US and Markit's index for business expectations for the year ahead in the Japanese service sector, showed signs of losing momentum in May. While it is dangerous to read too much into just one month's data, it is also unwise to ignore data altogether just because they don't fit the general trend.

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