



Economics Weekly

8 June 2009

UK outlook: too soon to be sure of recovery?

The release of the Bank England's Inflation Report in May showed that it expected the economic downturn to be steeper and to last longer than it projected in the February report. This view was echoed in the latest consensus forecasts for the UK, also released in May. The expectation in that report was for the UK economy to contract by 3.8% this year and to expand by just 0.3% in 2010, see table 1. But recent monthly economic dataflow, from PMI surveys to housing statistics, are showing that the economic outlook for the UK is improving and may not be as grim as expected. We comment on some of the evidence in this Weekly.

Table 1: Consensus expects big drop in gdp

UK consensus projections – May 2009 survey		
% Increase in year	2009e	2010f
GDP growth	-3.8	0.3
Consumer spending	-2.7	-0.4
Investment spending	-10.2	-3.6
Manufacturing output	-10.0	0.7
CPI inflation	1.6	1.7
3mth interbank rates	1.3%*	1.5%**
£/\$	1.458*	1.522**

* End Aug 09

** End May 10

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Are expectations for the contraction in the UK economy too pessimistic?

Chart a shows that the Bank of England central view is that quarterly annual gdp contracts by close to 5% this year at its worse point (it was down 4.1% in Q1) before gradually becoming less negative and returning to positive growth in 2010. The Bank's inflation forecast, based on this economic profile, shows that the consumer price index (CPI) remains below the 2% target throughout the next two years, falling close to zero this year before gradually rising back to above 1% in the second half of 2010, see chart b. This is also consistent with consensus forecasts made in May, with CPI expected to average 1.6% this year and 1.7% in 2010. The expectation is that this weak inflation environment will allow interest rates to stay low, with the three month interbank rate in the table at 1.3% at end-August this year and only a modest rise from this level to 1.5% at end May 2010. Not surprisingly, with that interest rate profile, the UK exchange rate versus the US dollar also stays weak.

What gdp components lead to the weak growth outcome?

The Bank of England does not provide details of the components that make up its gdp forecasts but the details of the consensus gdp projection can be seen in table 1. This shows that, from the perspective of expenditure, it is a fall in consumer spending of 2.7% this year and a further 0.4% contraction next year that drive down economic growth. As a result of weak consumer expenditure, which accounts for some 67% of the economy, business investment spending falls, by 10.2% this year and by an additional 3.6% in 2010. Associated with the latter is a drop in manufacturing output of 10% this year with only a modest rise of 0.7% expected in 2010.

There are signs that the economic outlook is improving...

The consensus forecast of a 3.8% contraction in gdp this year suggests that there is a further fall of 1.9% expected, given the 1.9% fall in Q1. But will the economy contract by as much as this, given the signs that

Chart a: Bank of England expects severe economic contraction...

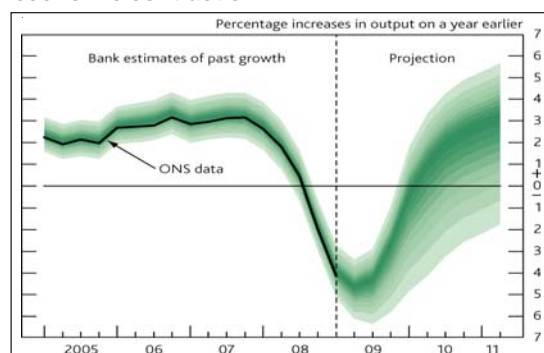
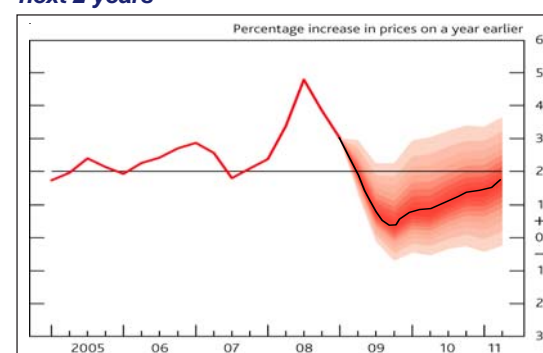


Chart b: ...leading to below 2% inflation over the next 2 years



2009 calendar of central bank meetings

European ECB (1.00%)
2 July, 6 August, 3 September, 8 October
US FOMC (0-0.25%)
24 June, 12 August, 23 September, 4 November
UK MPC (0.50%)
9 July, 6 August, 10 September, 8 October

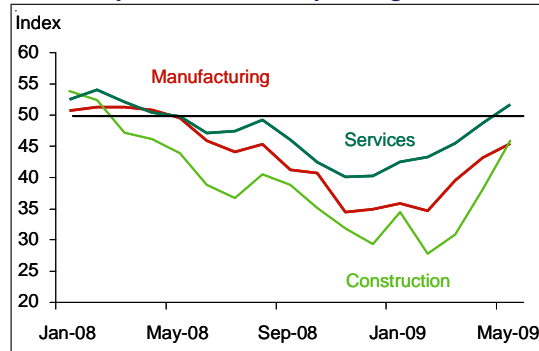
Rolling calendar of UK data releases and events

Inflation data (16/6)
BoE MPC minutes (17/6)
Labour market stats (17/6)
Retail sales (18/6)
Public finances (18/6)
M4 money supply (18/6)
Consumer credit (29/6)

Rolling calendar of US data releases and events

Empire manufacturing (15/6)
Treasury capital flows (15/6)
Producer prices (16/6)
Housing starts (16/6)
Building permits (16/6)
Industrial output (16/6)
CPI inflation (17/6)

Chart c: PMI surveys of business activity show output trends are improving



the intensity of the economic downturn is already lessening? Chart c shows that the service sector PMI is now above 50, at 51.7%, the highest it has been since March 2008. But the chart also shows that the PMIs for construction and manufacturing, although recovering sharply from their lows, are still well in negative territory. Taking a composite of all these indices shows that overall output in the economy was flat in May at 50.4.

It is therefore very possible, that if the rise in the services PMI is sustained, and the improvement in manufacturing and construction continues, overall UK economic growth could turn positive by the end of the year, most likely in Q4. But we are still a long way from that point. Chart d shows that although the rate of contraction of mortgage approvals is much smaller, and that the RICS survey shows that buyer interest has increased rapidly, the level of approvals is still extremely low, and inconsistent with a strong recovery in either housing activity or house prices. Although consumer and business confidence is improving, they still remain at very low levels compared to their highs and are not supportive of economic recovery at this time.

...but it is too soon to be sure as rising unemployment could hit consumer and business spending

One of the key factors that could help determine whether the so called 'green shoots' of economic recovery become entrenched is the path of unemployment, which is still rising rapidly, see chart f. With unemployment already at 2.2m, the highest since 1996, the risk is that consumer confidence gets undermined by the reality of rising unemployment and this then hits business confidence. Such an outcome could result in business investment remaining weak and stall any recovery in production, even though company stock levels are also low. It is still too soon to be sure - it is possible that economic recovery could occur earlier than many expect, even the consensus - but it is also equally (or more than equally) possible that the UK economic downturn will persist into 2010. The jury is out.

Chart e: UK business and consumer confidence has improved but still very weak

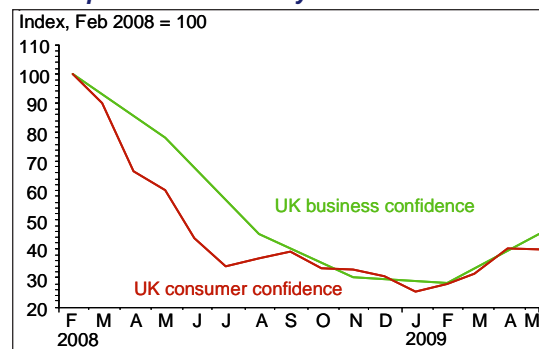


Chart d: UK housing market off its lows, but still extremely weak

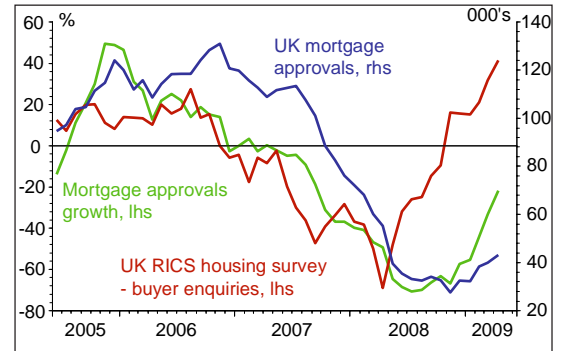
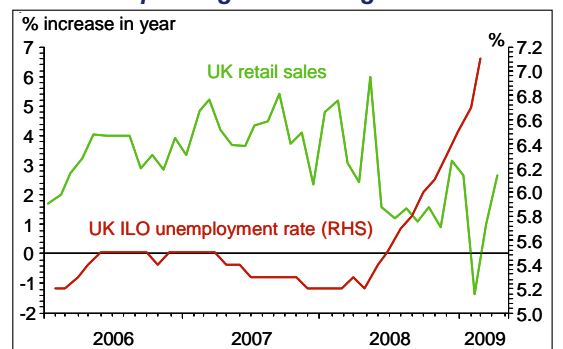


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Chart f: Rising UK unemployment rate could hit consumer spending and hence growth



Trevor Williams, Chief Economist, Corporate Markets

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research and Datastream

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Weekly economic data preview

8 June 2009

BoE inflation attitudes survey, US retail sales in focus

Market participants will keep a close eye on this week's economic data releases and government bond auctions to establish whether confidence in the prospects for recovery and the sharp rise in government bond yields is sustained. Considering the still fragile economic backdrop, characterised by rising unemployment and weak lending growth, concerns may intensify that a further rise in market yields could cause business and household optimism to lose recent gains. The NIESR will release its UK gdp estimate for the three months to May and the BoE will publish the results its latest inflation attitudes survey. Retail sales and the Fed Beige Book are due in the US.

- Growing optimism about the UK economy and political volatility were credited for the sharp swings in sterling and a marked rise in swap rates last week. Confidence that the economy has bottomed is likely to receive further support this week from the NIESR. The National Institute of Social and Economic Research already reported a smaller rate of contraction in gdp in the three months to April (-1.5% vs -1.9% in the 3-month period to March). It is expected to report a 2nd successive improvement on Thursday when the 3-month gdp data to May will be published. The surprise increase in the services PMI in May to 51.7 indicates that the sector returned to growth for the first time in thirteen months. Questions are now asked whether the next few months will see a further normalisation in activity or whether demand will peter out. The situation for manufacturing is more downbeat and confidence, whilst having recovered somewhat from the lows, will not be aided by the surge in oil prices and the strengthening in sterling. The manufacturing PMI last week pointed to a tentative improvement in output but the question is to what extent the rise in optimism is led by expectations that business will accelerate rather than an actual increase in demand. Restocking will ultimately help output levels to stabilise but with export orders still extremely weak lending to the sector still falling at an annual rate of 7.4% in May, we are doubtful that the sector is poised for an imminent return to growth. Manufacturing output data are due on Wednesday, and we expect a modest rise. Gilt auctions attracted strong demand last week and the DMO will be hoping to attract similar participation levels this week when it sells £5bn of 2014 gilts on Tuesday and £725mn of 2047 index-linked bonds on Thursday. The BoE will purchase £6.5bn of gilts this week, bringing the total so far purchased to just over £80bn, leaving roughly £45bn to do under the £125bn APF programme. In a statement the BoE last week said that programme will take another two months to complete and that the scale of the purchases will be kept under review. Other data releases this week include the RICS May house price survey on Tuesday and the monthly foreign trade statistics on Wednesday. The BoE will publish its quarterly Inflation Attitudes survey for May on Thursday. Inflation expectations for the next 12 months have fallen considerably since hitting a peak of 4.4% in Q2 2008, falling to a 4-year low of 2.1% in February. A decline to below 2% is possible.
- The Fed will publish a round-up of the latest economic developments in the Beige Book on Wednesday. A majority of regional Fed Districts have observed a slight improvement in output growth in early Q2 leading the Fed to adopt a less downbeat assessment of the economy. However, last Friday's employment report for May underlined the still very weak labour market situation. The unemployment rate now stands at 9.4%, the highest since 1983. With mortgage rates up about 50bp in May and weekly claims having stabilised around 620,000, considerable uncertainty remains over the path to economic recovery. Retail sales data for May are due on Thursday and are forecast to show a rebound from a disappointing fall in April. Despite the distribution of tax credits and the resulting rise in personal income in early Q2, early evidence points to a preference among households to save rather than spend. Foreign trade data are due on Wednesday and may show a slight widening of the deficit in April due to higher oil prices. Consumer confidence will be published on Friday and may show a stabilisation in sentiment in June following three consecutive months of improvement. The Treasury will sell \$65bn of notes in 3y, 10y and 30y maturities. Mixed demand for US paper and mortgage related selling could push 10y yields further above 3.80%.
- The ECB last week kept interest rates on hold at 1% but revised down its growth estimates for the economy this and next year. The Bank made no comment on the possibility of further asset purchases beyond the 60bn euros already committed. Data this week may show a less negative trend in manufacturing output in Germany and France following increases in the manufacturing PMI's since Q1.

Kenneth Broux, Economist

Chart 1: The Q2 BoE inflation survey may show a fall in inflation expectations to below 2%

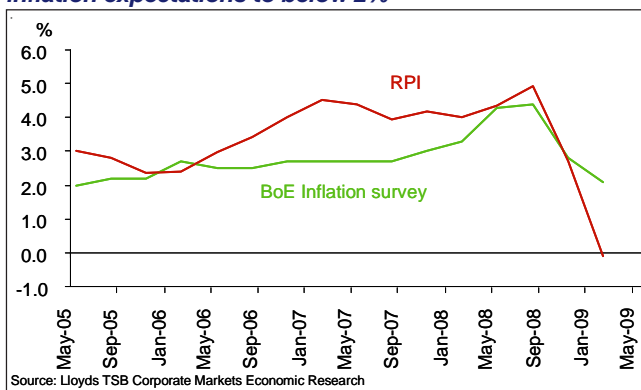
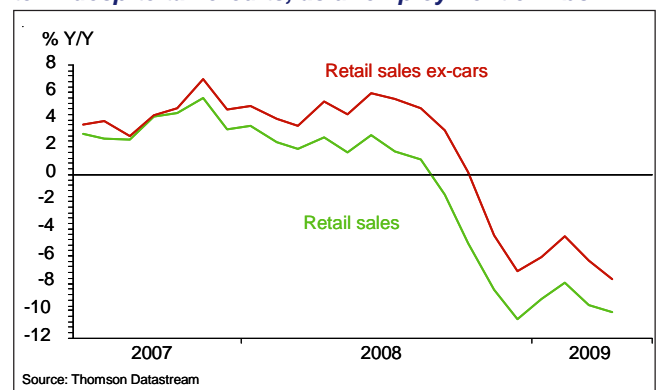


Chart 2: US retail spending is likely to stay weak near term despite tax credits, as unemployment climbs



Date	United Kingdom	United States	EU-16
Mon 8			
Tue 9	BRC Retail sales monitor (00:01) (May) RICS house price survey (00:01) Apr -59.9 May (f'cast) -58.0 Median -52.0 Range -58.0:-40.0 Official house prices (DCLG) Mar Y-O-Y -13.6% Apr (f'cast) Y-O-Y -13.3% Median -13.3% Range -15.0%:-13.0%	Wholesale inventories (15:00) Mar -1.6% Apr (f'cast) -1.2% Median -1.1% Range -1.6%:+0.5%	German trade balance (07:00) (Apr) Mar +€11.3bn Median +€9.3bn Range +€6.8bn:+€13.0bn German current account (07:00) (Apr) Mar +€10.2bn Median +€10.0bn Range +€6.2bn:+€11.0bn French trade balance (07:45) (Apr) Mar -€4.9bn Median -€4.5bn Range -€5.1bn:-€4.0bn German industrial output (11:00) Mar zero Y-O-Y -20.4% Apr (f'cast) +0.3% Y-O-Y -20.0% Median +0.3% Range -1.5%:+3.5%
Wed 10	Global visible trade balance (sa) Mar -€6.6bn Apr (f'cast) -€6.4bn Median -€6.4bn Range -€6.7bn:-€6.1bn Non-EU trade balance (sa) Mar -€3.3bn Apr (f'cast) -€3.5bn Median -€3.5bn Range -€3.6bn:-€3.0bn Industrial production (sa) Mar -0.6% Y-O-Y -12.4% Apr (f'cast) -0.2% Y-O-Y -12.5% Median -0.1% Range -0.8%:+0.6% Manufacturing output (sa) Mar -0.1% Y-O-Y -12.9% Apr (f'cast) +0.1% Y-O-Y -12.6% Median +0.1% Range -0.6%:+0.5%	Trade balance (sa) (13:30) Mar -\$27.6bn Apr (f'cast) -\$28.5bn Median -\$28.7bn Range -\$31.0bn:-\$26.1bn Treasury statement (sa) (19:00) Apr -\$165.9bn May (f'cast) -\$175.0bn Median -\$175.0bn Range -\$238bn:-\$25bn	German CPI (07:00) (final) Apr +0.1% Y-O-Y +0.8% May (f'cast) -0.2% Y-O-Y -0.1% Median -0.2% Range -0.3%:-0.1% French industrial production (07:45) Mar -1.4% Y-O-Y -16.1% Apr (f'cast) +0.2% Y-O-Y -16.5% Median +0.1% Range -0.8%:+0.5%
Thu 11	NIESR GDP estimate (00:01) (May) Apr -1.5%	Retail sales (advance) (13:30) Apr -0.4% Y-O-Y -9.4% May (f'cast) +0.1% Y-O-Y -10.1% Median +0.4% Range -0.4%:+0.9% Retail sales, ex-autos (13:30) Apr -0.5% Y-O-Y -6.6% May (f'cast) +0.2% Y-O-Y -7.8% Median +0.2% Range -0.3%:+1.5% Initial claims (w/e 11/6) (13:30) Previous 621k Forecast 610k Business inventories (15:00) Mar -1.0% Apr (f'cast) -0.8% Median -1.0% Range -1.4%:+0.4%	
Fri 12		Import prices (13:30) Apr +1.6% Y-O-Y -16.3% May (f'cast) +1.2% Y-O-Y -17.6% Median +1.1% Range +0.5%:+3.2% Uni. of Michigan confidence (prel) (15:00) May 68.7 Jun (f'cast) 68.8 Median 69.2 Range 68.0:72.8	French consumer prices (07:45) Apr +0.1% Y-O-Y +0.1% May (f'cast) +0.2% Y-O-Y -0.2% Median +0.2% Range +0.1%:+0.3% EU-16 industrial production (sa) (10:00) Mar -2.0% Y-O-Y -20.2% Apr (f'cast) -0.3% Y-O-Y -19.8% Median -0.4% Range -1.8%:+0.6%
Mon 15		Empire manu. survey (13:30) May -4.55% Treasury Internat. Capital Data (14:00) Mar +\$55.8bn	EU-16 employment (10:00) Q4 -0.3% Y-O-Y 8.2%

NB: UK data released at 9.30 a.m., unless otherwise stated. Market medians are as of preceding Friday. Release times of US data are stated in brackets after the description of the indicator. Events are listed in the events column on the next page.

Date	Japan	Other Countries	Main events
Mon 8	Current account (total) (00:50) Mar +Y1485.6bn Apr (act) +Y630.5bn Median +Y850.0bn Range +Y427bn:+Y1027bn Trade balance (BoP) (00:50) Mar +Y132.9bn Apr (act) +Y184.3bn Median +Y184.6bn Range +Y102bn:+Y816bn	Canada housing starts (13:15) Apr 117.6k May (f'cast) 135.0k Median 130.3k Range 120.0k:135.0k	<ul style="list-style-type: none"> • US Treasury to purchase notes (amount tbc) (16:00) • Euro-Area finance ministers hold meeting in Brussels (16:00) • US Fed member Tarullo speaks in Washington (17:30) • ECB member Stark speaks in Austria (18:35)
Tue 9	Leading index (prel) (06:00) Mar 76.3% Apr (f'cast) 77.4% Median 77.2% Range 76.0%:77.4% Coincident index (prel) (06:00) Mar 85.1% Apr (f'cast) 86.1% Median 86.0% Range 85.8%:86.3%		<ul style="list-style-type: none"> • ECB member Liikanen speaks in Finland (09:00) • EU finance ministers hold meeting in Brussels (09:30) • UK DMO to auction £5bn of 5% gilts due 2014 (10:30) • US Treasury to sell \$35bn of 3yr notes (18:00)
Wed 10	Machinery orders (00:50) Mar -1.3% Y-O-Y -22.2% Apr (f'cast) +0.8% Y-O-Y -28.3% Median -0.7% Range -5.4%:+9.9% Domestic CGPI (00:50) Apr -0.4% Y-O-Y -3.8% May (f'cast) -0.3% Y-O-Y -5.2% Median -0.3% Range -0.5%:+0.2%	Canada int'l merchandise trade (13:30) Mar +C\$1.1bn Apr (f'cast) +C\$0.9bn Median +C\$0.8bn Range +C\$0.5bn:+C\$1.3bn Canada new housing index (13:30) Mar -0.5% Apr (f'cast) -0.3% Median -0.5% Range -0.5%:-0.2%	<ul style="list-style-type: none"> • Germany to sell additional €6bn of 5yr bonds due 2014 (10:15) • ECB member Gonzalez-Paramo speaks in Madrid (12:00) • US Fed member Lacker speaks in North Carolina (15:00) • US Fed to purchase notes (amount tbc) (16:00) • US Fed member Duke speaks in Cleveland (17:15) • ECB member Stark speaks in Germany (17:30) • US Treasury to sell \$19bn of 10yr notes (18:00) • US Fed releases Beige Book economic report (19:00) • New Zealand interest rate decision (interest rate expected to stay on hold at 2.50%) (22:00)
Thu 11	Real GDP (23:50) (final) Q1 (prel) -4.0% Annualised -15.2% Q1 (f'cast) -4.0% Annualised -15.2% Median -4.0% Range -4.4%:-3.6% GDP deflator (23:50) (final) Q1 (prel) +1.1% Q1 (f'cast) +1.1% Median +1.1% Range +0.3%:+1.4%	Australia unemployment rate (02:30) Apr 5.4% May (f'cast) 5.7% Median 5.7% Range 5.5%:6.0%	<ul style="list-style-type: none"> • ECB publishes its monthly economic report (09:00) • Bank of England releases its quarterly Inflation Attitudes survey (09:30) • UK DMO to auction £725m of 0.75% index linked bonds due 2047 (10:30) • US Treasury to auction \$11bn of 30yr bonds (18:00) • US Fed member Lockhart speaks in Atlanta (18:05)
Fri 12	Industrial output (05:30) (final) Mar (prel) +1.6% Y-O-Y -34.2% Mar (f'cast) +1.6% Y-O-Y -34.2%		<ul style="list-style-type: none"> • ECB President Trichet speaks in Sofia (12:30) • G8 finance ministers hold meeting in Italy (to 13th June)
Mon 15		Canada manu. shipments (13:30) (Apr) Mar -2.7%	<ul style="list-style-type: none"> • US Fed member Evans speaks in Chicago (14:30) • ECB members Tumpel-Gugerell and Nowotny in Vienna (18:00)