

# Down and not out (of recession)

26<sup>th</sup> October 2009

**Despite the increasingly optimistic tone of data releases in recent months, the UK economy remained mired in recession in Q3.**

**Last week, the UK economy confounded expectations, contracting for a sixth consecutive quarter.** Economic output in the three months to September fell 0.4% compared to the previous quarter, making the current recession the longest in the country's post-war history. The cumulative contraction in output now stands at 6%, on a par with the decline seen in the early 1980s.

**The value of the pound fell sharply on the news,** as most investors had expected a return to growth, and contraction raises the probability of more quantitative easing. Growth expectations were based on business survey data, which had been resoundingly positive in recent months. The September purchasing managers survey (PMI) recorded a respectable reading of 55 for the service sector, which makes up almost 80% of the economy, well above the 50 level that signals expansion. Concern that the link between survey evidence and economic performance has shifted has gained credence.

**No sector has escaped the downturn** and differences between sectors have become smaller. Services contributed -0.2 percentage points to the overall decline, with production and construction accounting for an additional -0.1 percentage points each. Distribution, hotels and catering made the largest contribution to the decline while construction and manufacturing continue to posit the largest year-on-year falls. Government services were the only part of the economy not to contract.

**The minutes of the UK Monetary Policy Committee's (MPC) October meeting showed unanimity in their decision to continue with the stated program of asset purchases.** The November meeting will be much more important, as the asset purchases agreed in August will have been completed and the Bank will publish its quarterly assessment of the inflation outlook – the key input into deciding the appropriate policy stance. In the wake of the poor GDP numbers, the MPC will be thinking hard about whether more monetary stimulus is needed. However, they may elect to pause for breath to let the effects of previous measures feed through to the economy. After all, the Bank will already have spent \$175 billion (12% of GDP) on assets, as well as slashing rates to 0.5% to support the economy.

**Lending in the UK mortgage market ticked up in September according to the British Bankers'**

**Association.** The number of approvals for house purchase returned to levels last seen at the end of 2007 despite a shortage of properties on the market. Remortgaging, however, continues to be weak as households stick to low standard variable rates rather than move on to new deals. This is increasing the interest rate sensitivity of the household sector, something the Bank of England will have to bear in mind when it eventually starts to raise rates. Aside from property decisions, consumers are reducing unsecured borrowing and increasing personal deposits.

**Sales of existing US homes climbed in September to the highest level for more than two years,** helped by supply and demand side developments. Purchases jumped 9.2% y/y to a 5.6m annual rate as lower mortgage rates and house prices have increased affordability. The \$8K tax credit for first-time buyers has added a temporary boost to sales, but is due to expire at the end of November. The number of previously owned homes on the market fell 7.5%, reducing the stock of properties for sale. At the current pace, it would take 7.8 months to sell all homes on the market, close to the six months that indicates a market in balance.

**In the euro area, PMI surveys for October showed a further improvement in economic conditions.** The composite index hit 53.0, the highest since December 2007, as manufacturing moved into positive territory for the first time in 17 months and service industry output continued to improve. The link between survey evidence and output appears stronger in Europe where the recession ended in Q2 for France and Germany. The euro area as a whole could have emerged from the downturn in Q3. But, continued recession in the UK (the euro zone's largest trading partner), and the strength of the euro will act as headwinds to the recovery on the continent.

**Oil prices marked a fresh record for the year,** touching \$82 per barrel. This has little to do with fundamentals. Stocks remain plentiful and there is additional floating storage of around 125m barrels of crude oil and petroleum products. The rally has been driven by confidence that the global economy is on its way to recovery, which would boost demand, but also by concern about the US dollar. For some, fears that the dollar has further to fall makes investing in commodities an attractive hedging strategy.

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