Market Perspective

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Recovery Stumbling in the United Kingdom

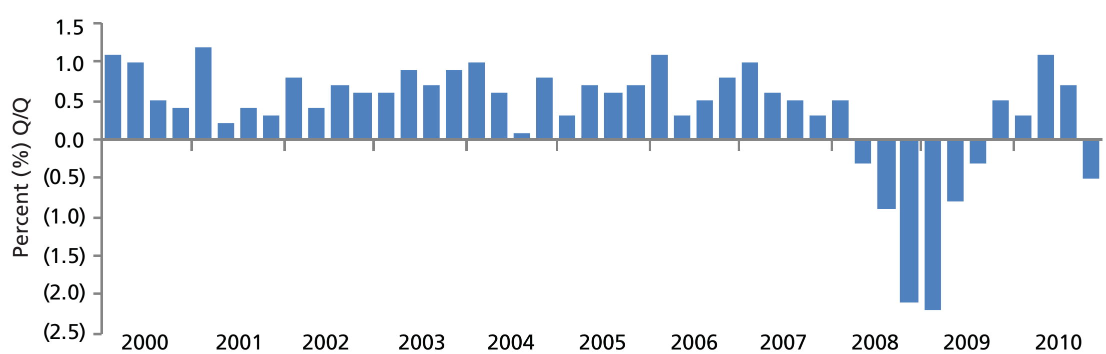
The British economy, suffering from both slow growth and elevated inflation, will struggle in 2011. The fault lies partly with the austerity policies that the British authorities have enacted in an effort to reduce the ballooning fiscal deficit; higher taxes and the reduction of public spending will take a toll on the British economy. Meanwhile, inflation will remain stubbornly high this year and well above the mandate of the Bank of England (BoE), though it is expected to begin to gradually decline next year. Despite the high inflation, policymakers will remain accommodative. While investors are currently pricing in the expectation of a 75 basis point hike in the overnight rate before the end of the year, we believe the BoE will unwind its accommodative policy more gradually.

With the onset of the global financial crisis, the British economy fell into a severe recession. Although the British economy started growing again in late 2009, the pace of growth has been slow, as you can see in the chart below. While the fourth quarter decline in real GDP was attributed to severe weather conditions, the Office of National Statistics indicates that, even had the climate been more typical, real GDP would have been flat at best.

The U.K.'s real GDP is still below its first quarter 2008 peak, and most economic indicators point to a tardy pace of recovery going forward. Industrial production has been rising, but at a fairly moderate rate. Housing, business investment and international trade fell sharply during the recession, while government spending on goods and services rose. Consumer spending fell during the recession, but less markedly than other components of GDP. The subsequent recovery has witnessed a considerable build-up of inventories, a pickup in international trade and improvements in business investment and consumer spending, but most types of expenditures are still below their peaks.

During the recession, household consumption fell; the decline would have been worse had it not been for automatic stabilizers and transfers, a limited increase in the unemployment rate and a two-year decrease in value-added tax (VAT) rates beginning in January 2008. However, the VAT rate returned to 17.5% in January 2010 and was increased to 20.0% at the beginning of this year. Though public sector spending remains quite large and the deficit is still sizable, the successive increases in VAT rates do not bode well either for

The British Economy Is Out of Recession, but the Recovery Has Stumbled



Source: Reuters EcoWin

consumption or households' purchasing power in the near term. Retail sales have weakened after rising for several months during the middle of last year; while the latest retail sales data (for January) did show strength, it is possibly due to the strong sales momentum that often occurs after severe weather conditions. Retailers remain surprisingly upbeat, according to a Confederation of British Industry (CBI) survey, but consumer sentiment is still weak. Consumer spending is likely to be restrained, as prospects for real disposable income growth are circumscribed. Moreover, a continued decline in house prices could inhibit the mending of household balance sheets; the effort to do so has driven up the U.K. savings rate in the last 12 months, and has led to a slowdown in mortgage lending and credit card spending. Households in the U.K. are more leveraged than their counterparts in the U.S., but their housing wealth was less hard hit than U.S. homeowners.

Domestic orders for the coming months are weak, even though business intentions to invest in plant and equipment have improved somewhat, according to surveys conducted by the CBI and the British Chambers of Commerce. The Bank of England also reports improvement in investment intentions.

The U.K. runs deficits on its trade and current account balances. Growth in both exports and imports have improved since late 2009; however, import growth has exceeded export growth, resulting in a drag from net exports. Given that the U.K.'s main trading partners are members of the European Union, the expected tepid growth in EU shall restrain the U.K.'s export growth.

The fiscal situation in the U.K. is not much different from that in the U.S., but British policymakers have taken a different tack, enacting a variety of austerity measures to combat their growing deficit. Tax receipts have started to improve following the increase in the VAT rate, and public expenditure is projected to decline. However, such policies are likely to have adverse effect on employment and real income growth. Moreover, these measures are likely to be a drag on recovery in the coming years and could even prevent it unless domestic private sector consumption and investment spending pick up.

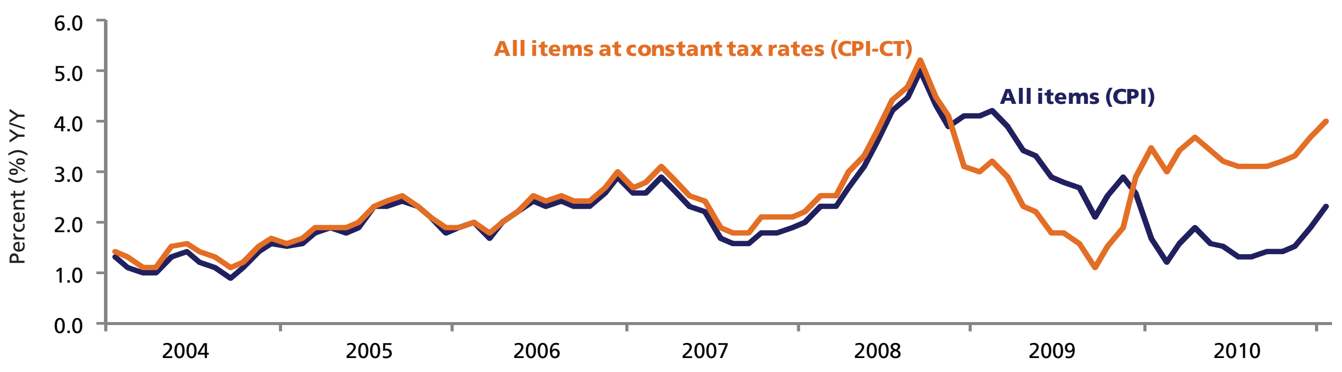
Adjustments in the housing and residential construction sectors are likely to be another source of annoyance for the British economy. House prices in the U.K. rose spectacularly between mid-2002 to mid-2007, even more so than those in the U.S. The adjustment in the U.K. housing market so far has been mild compared to the U.S. experience. However, declines have begun to pick up in the past few months, and a survey from the Royal Institute of Chartered Surveyors implies that further weakening is possible. This would have a significant impact on already-lax consumer spending.

The U.K. is in a difficult predicament of weak aggregate demand and elevated inflation. Headline inflation has been high since the beginning of last year; the latest year-over-year reading of 4.0% is two full percentage points above the Bank of England's target inflation rate. Several factors have contributed to the persistence of inflation. Among the most notable is the increases in the VAT rate that began last year, as you can see in the chart below. With this year's hike in the VAT rate to 20.0%, headline inflation is likely to remain elevated; the BoE estimates that the new rate will contribute a bit more than one percentage point to the headline CPI inflation rate in 2011.

In addition, the depreciation of the pound sterling in conjunction with higher commodity and energy prices and a rise in the foreign currency price of imports has exerted upward pressure on inflation. The nominal effective exchange rate has declined by nearly 20% since late 2007. As a result, the prices of imported goods have been rising; while most of this has already been passed through to consumers, further increases are possible in the coming months.

Finally, high unit labor costs have also caused inflationary concerns, particularly in labor-intensive sectors. Although the unemployment rate in the U.K. rose during the financial crisis, employers did not engage in the same degree of restructuring as their American counterparts; the British unemployment rate increased from below 6% in 2007 to close to 8% in 2010. As a result, U.K. unit labor costs have only recently begun to ease. In the meantime, household expectations for inflation have increased. According to YouGov/Citigroup survey, households' long-term inflation expectations for the next five

VAT Rate Increases Have Been an Important Inflation Driver



Source: UK Office for National Statistics; Reuters EcoWin to ten years have risen to over 3.5% as of late 2010; in mid-2009, expectations for the same period were less than 3.0%.

Headline inflation, measured on a year-ago basis, should decline gradually, particularly as the effects of the recent hike in VAT rates and higher commodity prices level off. But the rise in household inflationary expectations could be troublesome, particularly if it creates upward pressures on wages. The considerable slack in the British economy is likely to stifle pay drifts and an increase in average earnings. Corporate earnings growth is poised to be fairly moderate.

Slower economic growth in the U.K. has entailed job losses, and the labor market continues to be weak, as indicated by the declining number of job vacancies and persistently high rate of unemployment claims. Future cuts in public expenditure will likely exacerbate the situation. While employment in the financial services industries, including banking and insurance, constitutes over 22% of total employment in the U.K., the chances of robust hiring in this industry are quite remote.

The financial markets response to the situation in the U.K. — a stumbling economic recovery accompanied by nearly normal financial conditions — has been intriguing. Like the equity indices for most major advanced countries, the FTSE 100 Index has climbed in the past few months. Along with the global "back-up" in interest rates, gilts have sold off since late 2010 and the slope of the gilt yield curve has flattened since mid-2010. Corporate bond spreads have narrowed since early 2009 and are now close to pre-crisis levels.

We think the back-up in U.K. rates is somewhat overdone. It's based on investor expectations of inflation-driven tightening by the BoE in the neighborhood of 75 basis points or more; while the BoE may raise its policy rate later this year, it is likely to proceed cautiously. The rate of inflation should gradually decline sometime in 2012 as the effects of higher VAT rate and other factors wane. In the meantime, contracting fiscal policy — consisting of spending cuts and higher taxes —will restrain aggregate demand growth. Private sector demand may not be strong enough to substantially offset the drag from contracting fiscal policy, which should cause the BoE to be prudent and accommodative. The odds of further asset purchases by the central bank are now very low, but so too are the chances of rapid and sizable rate hikes. Austerity measures, including higher taxes, means that the U.K. faces the unenviable prospect of slow growth and elevated inflation for the foreseeable future. ■