Economic Research and Analysis

Lloyds TSB | Corporate Markets

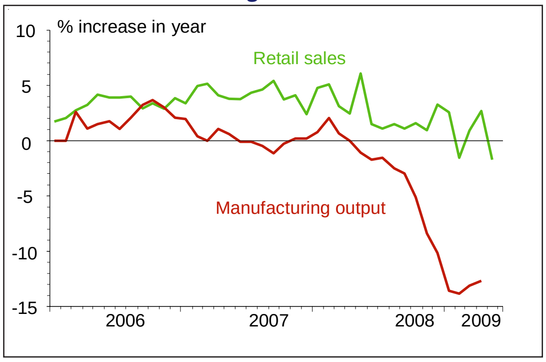
Economics Weekly

29 June 2009

Deja vu – same old inventory-led economic downturn

Many assumptions about economic and financial market performance have been shattered in the 2 years since the global credit market crisis started. Not least amongst these assumptions was the view that 'lean production' methods – including manufacturers keeping stocks to a minimum and producing on demand to customer specification – would reduce the impact of the stock or inventory cycle on economic growth. But this economic downturn has, as always, been led by investment cut backs and falls in manufacturing output, driven by the inventory cycle. Chart a shows how sharp the fall in manufacturing output has been compared with the less pronounced reduction in the growth of volume retail sales, which has only just dropped into negative territory in annual terms.

Chart a: Manufacturing leads downturn



A sharp drop in demand last year led to savage cuts in stock levels...

What appears to have happened is that a sudden, sharp and unexpected drop in demand last year, combined with a rapid rise in costs as energy prices rose to record highs and a tightening of credit conditions, led to a severe squeeze on company cash flows. The result was a savage reduction in stocks. In chart b, we show the percentage falls in the components of gdp since Q2 of last year - when gdp peaked. The biggest contributor to the fall in economic growth has been the change in inventories, which by itself accounted for over half of the 4.1% decline in gdp in this period. Moreover, chart c shows that the change in inventories as a share of gdp has been sharper than in the 1970s, 1980s or 1990s downturns.

...perhaps precisely because of 'lean production' which means firms respond quicker to changes in demand...

Why were the cuts in stock levels so harsh? For all of the talk that companies were carrying a lower level of stocks, the latest CBI industrial trends survey shows differently. The survey includes a question on whether reporting firms felt that present levels of stocks were more than adequate or less than adequate (to meet demand). The balance between these answers last year showed that, generally, manufacturing firms' stock levels were much higher than the average since 1999. If so, then 'lean production' methods would produce a quick and severe response if demand disappointed expectations. To some extent, this is exactly what is shown in chart d: that the change in stocks as a share of gdp has been quicker for this stage of the downturn than in the last three recessions. This response would be sensible, and implies that once demand picks up, stocks could quickly add to economic growth as industrial output picks up as well. Some support for this notion can be found in chart e, which shows just how closely the stock cycle and production move together in the UK. The chart also highlights how severe the reaction to the reduction in demand has been from companies as they cut stocks and production, and the risks to growth if stocks are cut further.

Chart b: The fall in gdp has been led by a reduction in stocks

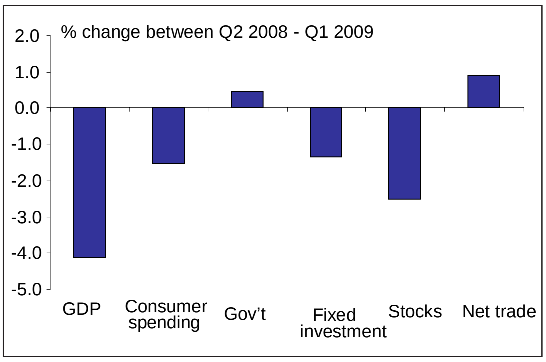
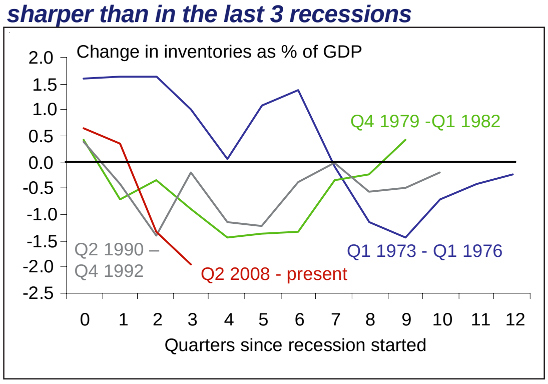


Chart c: The current reduction in inventories is sharper than in the last 3 recessions



Client support

Economic Research Team

Trevor Williams
0207 158 1748
trevor.williams@lloydstsb.co.uk

Nichola James
0207 158 1741
nichola.james@lloydstsb.co.uk

Jeavon Lolay
0207 158 1742
jeavon.lolay@lloydstsb.co.uk

Hann-Ju Ho
0207 158 1745
hann-ju.ho@lloydstsb.co.uk

Kenneth Broux
0207 158 1750
kenneth.broux@lloydstsb.co.uk

Rabia Bhopal
0207 158 1747
rabia.bhopal@lloydstsb.co.uk

Nikesh Sawjani
0207 158 1749
nikesh.sawjani@lloydstsb.co.uk

Paul Rodriguez
0207 158 1744
paul.rodriguez@lloydstsb.co.uk

Customer sales

Andrew Willett
0207 158 1616
andrew.willett@lloydstsb.co.uk

Kathryn Ball
0207 158 1672
kathryn.ball@lloydstsb.co.uk

Credit Distribution

Ton Roeten
0207 050 6047
ton.roeten@lloydstsb.co.uk

2009 calendar of central bank meetings

European ECB (1.00%)
2 July, 6 August, 3 September, 8 October
US FOMC (0-0.25%)
12 August, 23 September, 4 November, 16 December
UK MPC (0.50%)
9 July, 6 August, 10 September, 8 October

Rolling calendar of UK data releases and events

Industrial production (7/7)
NIESR GDP (8/7)
Trade balance (9/7)
Producer prices (10/7)
DCLG house prices (14/7)
Inflation data (14/7)
Labour market stats (15/7)

Rolling calendar of US data releases and events

Consumer credit (8/7)
Trade balance (10/7)
Import prices (10/7)
Uni of Michigan conf. (10/7)
Producer prices (14/7)
Retail sales (14/7)
Business inventories (14/7)

Chart d: Are CBI manufacturing firms stock levels still too high?

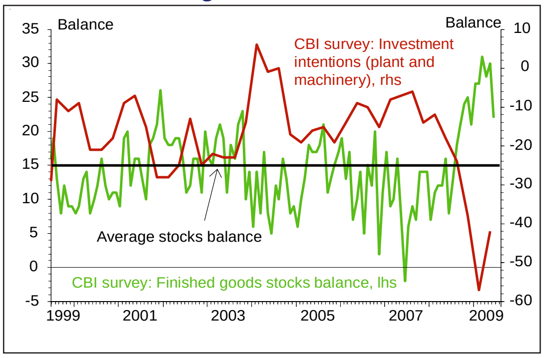
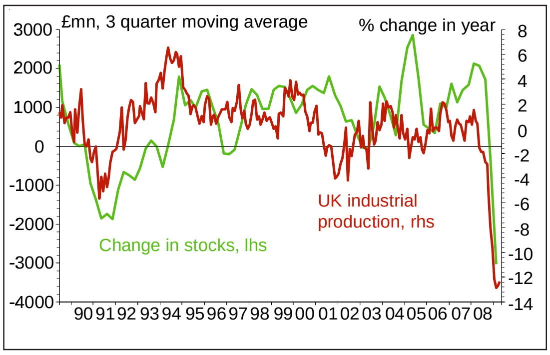


Chart e: UK manufacturers stock cycle and industrial production closely correlated



...but despite recent reductions, stock levels are still high and if demand does not pick up then further cuts in production are possible

Unfortunately, analysis of chart d implies that inventory levels still remain high compared to the average since 1999 and so have the potential of falling further and hitting economic growth. Further, the close link between stocks and investment intentions shows that if stocks are cut further then investment spending could also be cut, see chart e. Such an outcome implies that economic recovery could be long and slow, and output could even fall back from current levels. This is because, as is apparent from the latest data point in chart d, investment intentions have improved but this is perhaps dependent on stock levels stabilising. However, for stock levels to stabilise, there needs to be an increase in final demand. If that does not materialise in the months ahead, possibly because rising unemployment hits consumer spending, there is room for stock levels to fall back and so investment to be cut once again, creating a vicious circle. The next few months will therefore be critical in deciding whether the current halt to the economic downturn, and some hopeful signs of a pick up, can become a sustained economic recovery.

Trevor Williams, Chief Economist, Corporate Markets

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

Weekly economic data preview

29 June 2009

ECB and US non-farm payrolls to set the tone

Markets will be watching this week's economic releases closely for signs that a nascent recovery is taking hold. After last week's relatively light economic calendar, the pace picks up with a number of key releases and events, culminating in the ECB council meeting and the US Employment Report on Thursday. Before then, various forward-looking business surveys are due for release, along with Eurozone inflation and money supply figures, and the US consumer confidence report. Over the past week, testimony by members of the UK Monetary Policy Committee and the statement accompanying the latest US FOMC meeting strongly suggest that US and UK policy makers are in no hurry to change policy course. It's the turn of the ECB to provide guidance this week. We expect the refinancing rate to be left unchanged at 1.0% at Thursday's council meeting, with last week's €442bn 1-year liquidity injection likely to be viewed by the policy-setting council as providing enough new policy stimuli for now. We expect the general tone of this week's US data to be cautiously upbeat although, as always, the payroll out-turn is a wild card. In May, nonfarm payrolls dropped by 345k – the smallest decline since September 2008. While the rate of decline in employment should steadily slow as the downturn in the US economy eases, we believe the persistent high level of jobless claims point to a payroll drop of around 400k in June. The unemployment rate is forecast to rise to 9.6%, putting it on course to hit double figures by the autumn.

- The data calendar in the UK remains relatively light this week, although the UK PMIs and Bank of England Credit Conditions survey are likely to attract interest. Over recent months, the manufacturing and service sector PMIs have steadily improved, suggesting that the UK inventory downturn and the associated drops in output and orders are beginning to ease. We expect a further modest improvement in both surveys in June. Given the recent improvement in credit markets, the pick-up in mortgage approvals and the gradual response to QE, the BoE's Credit Conditions survey is expected to show that access to credit has continued to improve, albeit from still exceptionally tight levels. Also in the UK, focus will be on demand and supply in the gilt market. The DMO is due to auction a record £5.25bn of long-dated gilts, while the BoE will be purchasing a further £6.5bn of gilts, under its Asset Purchase Facility. The BoE is committed to buying £125bn of assets under the APF by the end of July. This week's purchases will take the running total to £102.5bn. Also due this week are the Nationwide house price release, net consumer credit, final GDP and current account data.
- Although the payroll report dominates this week's US releases, the consumer confidence, Chicago PMI and ISM reports also have the capacity to shift market sentiment. Overall, we expect the tone of this week's US consumer and business surveys to be cautiously upbeat. The recent strength in US durable goods orders suggests US capital equipment spending is starting to turn, supported by the weaker dollar and recent government stimulus. Still, with the unemployment rate likely to breach 10% by the end of the summer and the household sector deleveraging rapidly, there remain significant obstacles to a sustainable recovery. We expect the ISM to rise from 42.8 to 43.5 in June, with the orders index moving further above 50 after breaching this level for the first time in seventeen months in May. The employment component of the ISM, by contrast, remains well below 50, remaining at 36 in May. The employment component of the ISM will be watched closely as a leading indicator ahead of Thursday's payroll report.
- With the ECB widely expected to keep rates unchanged at this week's council meeting, focus will be on the tone of President Trichet's comments in the accompanying press conference. Although the Eurozone has lagged the improvement in the US and the UK, there have been signs that the pace of decline across most EU-16 countries is gradually easing. Still, as this week's inflation figures are likely to highlight, the Eurozone has entered deflation (alongside the US). Based on the regional figures, the headline EU-16 CPI inflation rate is forecast to have dropped from zero percent in May to -0.2% in June, driven lower by the fall in energy prices. Moreover, German unemployment and Eurozone business confidence figures due this week are likely to show that conditions remain extremely weak. While Eurozone money supply growth is picking up as a result of the extreme monetary stimulus that has been imparted, it is far too early for President Trichet to rule out the possibility of further easing (either interest rate cuts or QE) in the months ahead.

Adam Chester, Senior UK macroeconomist

Chart 1: UK manufacturing conditions are improving

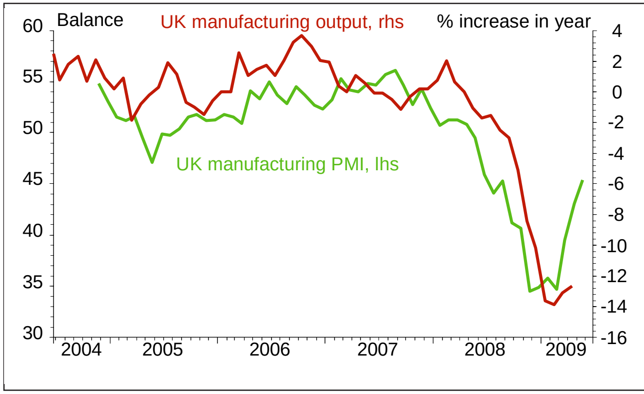
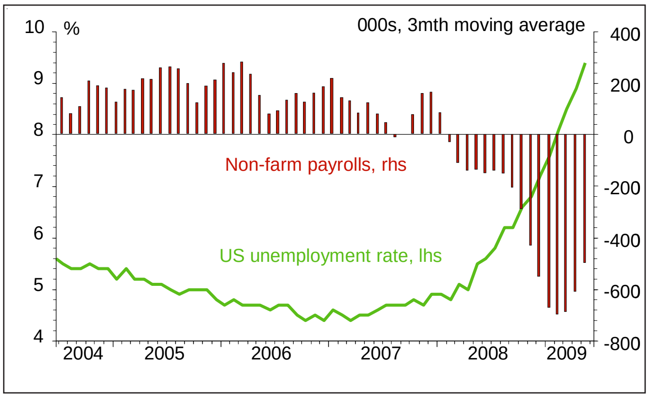


Chart 2: US unemployment rate may breach 10% by autumn



29 June - 6 July 2009

Date	United Kingdom	United States	EU-16
Mon 29	**Money supply, M4 (final, sa)** Apr +0.2% Y-O-Y +17.4% May (final) +0.2% Y-O-Y +16.6% **Consumer credit** Apr +£0.2bn May (act) +£0.3bn *Median +£0.3bn Range +£0.1bn:+£0.5bn* **Net mortgage lending (sa)** Apr +£0.9bn May (act) +£0.3bn *Median +£1.0bn Range +£0.7bn:+£1.3bn* **Mortgage approvals** Apr 43K May (act) 43K *Median 46K Range 45K:49K*		**EU-16 consumer confidence (10:00)** May -28 Jun (act) -31 *Median -30 Range -31:-29* **EU-16 industrial confidence (10:00)** May -33 Jun (act) -32 *Median -32 Range -33:-31*
Tue 30	**Consumer confidence (GfK) (00:01)** May -27 Jun (f'cast) -25 *Median -25 -26:-24* **GDP (final)** Q1 (2nd estimate) -1.9% Y-O-Y -4.1% Q1 (f'cast) -2.2% Y-O-Y -4.4% *Median -2.1% Range -2.2%:-1.9%* **Current account** Q4 -£7.6bn Q1 (f'cast) -£6.7bn *Median -£6.7bn Range -£8.1bn:-£4.1bn* **Business investment (final)** Q1 (prel) -5.5% Y-O-Y -6.8% Q1 (f'cast) -5.5% Y-O-Y -6.8% *Median -5.5% Range -5.8%:-5.5%* **Nationwide house prices (07:00) (Jun) (30/6 - 3/7)** May +1.2% Y-O-Y -11.3%	**House prices (S&P/CaseShiller)(Apr)(14:00)** Mar Y-O-Y -18.7% **Chicago PMI (14:45)** May 34.9 Jun (f'cast) 38.5 *Median 39.0 Range 34.0:44.0* **Consumer confidence (15:00)** May 54.9 Jun (f'cast) 55.2 *Median 55.1 Range 51.7:58.0*	**French producer prices (07:45)** Apr -0.9% Y-O-Y -6.4% May (f'cast) +0.4% Y-O-Y -7.1% *Median -0.2% Range -0.9%:+0.5%* **German retail sales (07:00) (30/6 - 5/7)** Apr +0.5% Y-O-Y -0.8% May (f'cast) -0.3% Y-O-Y -2.6% *Median zero Range -1.0%:+0.5%* **German unemployment (sa) (08.55)** May +1K Rate 8.2% Jun (f'cast) +40K Rate 8.3% *Median +45K Rate +6K:+70K* **EU-16 money supply, M3 (sa) (09:00)** Apr Y-O-Y +4.9% May (f'cast) Y-O-Y +4.5% *Median +4.6% Range +3.9%:+4.8%* **EU-16 CPI (10:00) (flash)** May Y-O-Y zero Jun (f'cast) Y-O-Y -0.2% *Median -0.3% Range -0.3%:zero*
Wed 1 July	**Manufacturing PMI** May 45.4 Jun (f'cast) 46.4 *Median 46.4 Range 45.0:47.5*	**ADP employment change (13:15)** May -532K Jun (f'cast) -425K *Median -374K Range -500K:-315K* **ISM manufacturing index (15:00)** May 42.8 Jun (f'cast) 43.5 *Median 44.0 Range 40.0:47.0*	**French manufacturing PMI (08:50) (final)** Jun (prel) 45.5 Jun (f'cast) 45.5 **German manufacturing PMI (08:55)(final)** Jun (prel) 40.5 Jun (f'cast) 40.5 *Median 40.5 Range 40.5:40.6* **EU-16 manufacturing PMI (09:00) (final)** Jun (prel) 42.4 Jun (f'cast) 42.4 *Median 42.4 Range 42.2:42.5*
Thu 2		**Non-farm payrolls (13:30)** May -345K Jun (f'cast) -400K *Median -365K Range -450K:-225K* **Unemployment rate (13:30)** May 9.4% Jun (f'cast) 9.6% *Median 9.6% Range 9.5%:9.7%* **Average earnings (sa) (13:30)** May +0.1% Y-O-Y +3.1% Jun (f'cast) +0.1% Y-O-Y +2.9% *Median +0.1% Range zero:+0.2%* **Average weekly hours (sa) (13:30) (Jun)** May 33.1 *Median 33.1 Range 33.0:33.3* **Initial claims (w/e 27/6) (13:30)** Previous 627K Forecast 650K **Factory orders (15:00)** Apr +0.7% May (f'cast) +0.3% *Median +0.5% Range -1.0%:+1.5%*	**EU-16 unemployment rate (10:00)** Apr +9.2% May (f'cast) +9.3% *Median +9.4% Range +9.2%:+9.5%* **EU-16 producer prices (10:00)** Apr -1.0% Y-O-Y -4.6% May (f'cast) +0.7% Y-O-Y -5.0% *Median +0.1% Range -0.5%:+0.3%* **ECB interest rate decision (12:45)** Current: 1.00% Forecast: 1.00%
Fri 3	**Services PMI** May 51.7 Jun (f'cast) 51.4 *Median 51.5 Range 49.0:53.0*	**Independence Day- Markets Closed**	**French services PMI (08:50) (final)** Jun (prel) 47.5 Jun (f'cast) 47.5 **German services PMI (09:00) (final)** Jun (prel) 44.3 Jun (f'cast) 44.3 *Median 44.3 Range 44.3:44.5* **EU-16 services PMI (09:00) (final)** Jun (prel) 44.5 Jun (f'cast) 44.5 *Median 44.5 Range 44.5:44.6* **EU-16 retail sales (10:00)** Apr +0.2% Y-O-Y -2.3% May (f'cast) -0.3% Y-O-Y -2.8% *Median -0.1% Range -0.5%:+0.2%*
Mon 6		**ISM Services index (15:00) (Jun)** May 44.0	

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.

29 June - 6 July 2009

Date	Japan	Other Countries	Main events
Mon 29	**Industrial output (00:50) (prel)** Apr Y-O-Y -30.7% May (act) Y-O-Y -29.5% *Median -28.8% Range -31.0%:-25.7%* **Retail sales (prel) (00:50)** Apr Y-O-Y -2.8% May (act) Y-O-Y -2.8% *Median -2.8% Range -4.1%:-0.3%*		***• Bank of England to purchase £3.5bn of gilts at a reverse auction***
Tue 30	**Job-applications ratio (00:30)** Apr 0.46% May (f'cast) 0.45% *Median 0.45% Range 0.40%:0.47%* **Unemployment rate (00:30)** Apr 5.0% May (f'cast) 5.2% *Median 5.2% Range 5.1%:5.3%* **Workers' spending (00:30)** Apr Y-O-Y -1.3% May (f'cast) Y-O-Y -1.6% *Median -1.5% Range -3.0%:+0.3%*	**Canada IPPI (13:30)** Apr -0.5% May (f'cast) -0.5% *Median -0.6% Range -1.8%:+0.5%* **Canada RMPI (13:30)** Apr -0.5% May (f'cast) +2.5% *Median +2.0% Range -0.7%:+5.0%* **Canada GDP, monthly (13:30)** Mar -0.3% Apr (f'cast) -0.1% *Median -0.1% Range -0.4%:+0.1%*	***• ECB member Nowotny speaks in Vienna (10:00)*** ***• Bank of England member Tucker speaks in London (10:30)*** ***• US Fed member Bullard speaks in Philadelphia (17:00)*** ***• US Fed member Hoenig speaks in New York (21:00)***
Wed 1 July	**Tankan manufacturing index (00:50)** Q1 -58 Q2 (f'cast) -42 *Median -43 Range -50:-37* **Tankan services index (00:50)** Q1 -31 Q2 (f'cast) -27 *Median -27 Range -35:-19*	**Australia retail sales (sa) (00:30)** Apr +0.3% May (f'cast) +0.7% *Median +0.5% Range -2.0%:+1.5%*	***• US Fed member Yellen speaks in San Francisco (02:00)*** ***• Germany to sell €6bn of 10yr bunds (10:15)*** ***• UK DMO to auction £5.25bn of 2.25% gilts due 2014 (10:30)*** ***• US Fed member Evans speaks in London (16:15)*** ***• Bank of England to purchase £3bn of gilts at a reverse auction***
Thu 2	**Monetary base (00:50)** May Y-O-Y 7.9% Jun (f'cast) Y-O-Y 8.4%	**Australia trade balance (00:30)** Apr -A$0.1bn May (f'cast) -A$0.1bn *Median -A$0.1bn Range -A$1.0bn:+A$1.0bn*	***• Swedish central bank interest rate decision (interest rates expected to stay on hold at 0.5%) (08:30)*** ***• Bank of England releases its quarterly Credit Conditions Survey (09:30)*** ***• UK Treasury Committee appointment hearing for David Miles (09:30)*** ***• Bank of England member Besley speaks in London (09:30)*** ***• UK DMO to auction £2.5bn of 4.25% gilts due 2039 (10:30)*** ***• ECB interest rate decision (interest rates expected to remain on hold at 1.0%) (12:45), followed by press conference (13:30)***
Fri 3			
Mon 6	**Leading index (prel) (06:00) (May)** Apr 76.2% **Coincident index (prel) (06:00) (May)** Apr 86.0%		***• US Treasury to sell 10yr TIPS (18:00)***