Investment Performance – Quarter Ending December 2011
Appendix A

Economic background:

Activity indicators suggested that the economic recovery ground to a complete halt in the third quarter and output may even have contracted. The weighted output balance of the CIPS/Markit surveys in October fell to a level that has been consistent in the past with a contraction in GDP. The output balance then broadly held at that level in November.

The CIPS surveys exclude the retail sector and the latest news from the high street has been poor, reflecting the pressures on households' finances. According to the official figures, retail sales volumes (ex. petrol) rose by 0.9% m/m in October but then fell by 0.7% in November, despite deep discounts offered by retailers. Timelier survey and anecdotal evidence suggests that, by and large, spending was weaker than usual in December.

Conditions in the labour market have also continued to deteriorate, albeit at a slower pace than in previous months. The Labour Force Survey measure of employment fell by 63,000 in the three months to October, a slower pace of deterioration than seen in the second quarter. The number of employees plummeted by 252,000 – but this was partly offset by a 166,000 rise in self-employment. Rises in the timelier claimant count measure of unemployment also became more modest – it increased by 'just' 2,500 on the previous month in October and 3,000 in November. Despite this moderating trend, employment surveys have continued to point to further job losses ahead.

The housing market has continued to recover, albeit slowly. The number of mortgage approvals for new house purchase rose from 51,200 in September to 52,900 in November. And according to the Nationwide, house prices were 0.6% higher in December than they were in September. Nonetheless, banks began the process of passing on the rise in their wholesale funding costs, reflecting the adverse effects of the euro-zone debt crisis, to consumers during the quarter.

The latest trade data tentatively suggested that net trade was on course to make a positive contribution to GDP growth in the third quarter. The trade in goods and services deficit narrowed from £4.3bn in September to £1.6bn in October (although the monthly deficit figures have been volatile recently). Some survey measures have also pointed to a recent pick-up in demand for exports as the new export orders balance of the CIPS manufacturing survey rose from 49.0 in November to 53.5 in December. At that level, it points to a quarterly rise in the volume of manufactured goods exports of around 2%.

Despite much weaker than expected GDP growth, the latest public finance figures showed that borrowing is coming in comfortably below last year's totals. Spending growth has slowed, while growth in tax receipts is still holding up reasonably well. And if the trend so far this fiscal year is sustained, borrowing will total about £122bn in 2011/12, equal to what the Office for Budget Responsibility (OBR) was forecasting until it revised its forecast to £127bn in its Economic and Fiscal Outlook that accompanied the Chancellor's Autumn Statement. The OBR also revised up its forecasts for borrowing in future years to reflect its much weaker expectations for GDP growth.

Inflation fell in the third quarter with CPI inflation falling from its recent peak of 5.2% in September to 5.0% in October and 4.8% in November. It probably fell further in

December as past rises in energy prices a year ago dropped out of the annual comparison. Inflation remained on track to fall further in the coming months. Oil prices, for example, remained largely range-bound between $105pb and $115pb, while petrol prices began to fall. Meanwhile, the continued weakness of indicators of money supply growth and firms' pricing intentions, as well as the still large degree of spare capacity in the economy, suggested that underlying inflationary pressures are still very weak.

Granted, measures of inflation expectations remained quite high – the Bank of England's measure of households' inflation expectations for the year ahead only edged down from 4.2% to 4.1% in Q3. But considerable slack in the labour market should continue to prevent the translation of these expectations into stronger earnings growth. Indeed, the annual rate of average earnings growth including bonuses rose was just 2% in October (a slight rise from 1.9% in September). Real pay growth has therefore remained negative.

The MPC restarted quantitative easing (QE) in October and announced £75bn of additional gilt purchases would be completed by February. The MPC also looked primed to sanction further purchases in Q4. The November Inflation Report forecast projected CPI inflation to be well below the 2% target in two years' time, while speeches by certain members of the Committee (such as Martin Weale and Paul Fisher) suggested that they thought there was a strong case for more purchases.

Largely reflecting this dovish stance, markets expectations for official interest rates continued to fall during Q3, helping government bond yields to drop to new record lows (the 10-year gilt yield fell from 2.43% to 2% at the end of the year). The drop may also have reflected growing demand for safe-havens – while bond markets thought that default risk on UK government bonds had grown during the quarter, they viewed that risk to be lower than in many other major economies, including Germany.

In contrast to the UK, the economic data improved in the US in Q3. The manufacturing ISM strengthened in November and December to a level consistent in the past with annual GDP growth of 2.5% to 3.0%. Non-farm payrolls also increased by 112,000 in October and 100,000 in November.

In the euro-zone, policymakers made little progress to deal with the region's debt crisis. The economic data in the euro-zone also continued to weaken – while the composite PMI rose in November in December, it remained below the theoretical "no-change" level of 50 and on past form was consistent with quarterly falls in GDP of almost 1%. A deep recession in the euro-zone remains a key risk to the outlook for the UK economy