



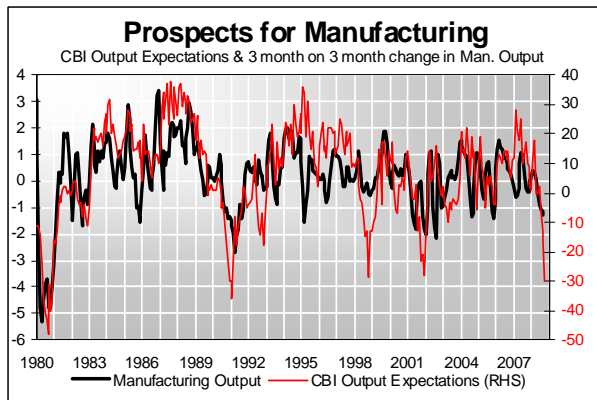
Monday, 3rd November to Friday, 7th November 2008

United Kingdom

5/11 Index of Production (Sep)

Previous month in brackets)	mom %	yoy%
Manufacturing output	-0.8 (-0.6)	-2.2 (-2.0)
Mining & quarrying	7.1 (-0.6)	-0.7 (-8.5)
Utilities	-1.5 (-1.3)	-2.7 (1.2)
Industrial production	-0.2 (-0.7)	-2.2 (-2.3)

Source: ONS



Source: ONS, CBI

Activity in the industrial sector was again weaker than expected in September, with manufacturing output contracting by 0.8%, extending the run of declining output to seven straight months. The only good news within the figures was a huge 7.1% surge in output from the extraction industries, although this was partly offset by a further 1.5% slide in output from the utilities. Consequently, overall industrial production fell by a more modest 0.2% on the month. However, this still meant that the contraction in activity in Q3 of 1.1% was more than had been assumed by the ONS in its preliminary estimate of third quarter GDP growth. Consequently, there is a serious risk that the initially reported 0.5% decline in GDP in Q3 could be revised to -0.6%. Looking ahead, the sudden plunge in the CBI output expectations balance (lowest since March 1991) points, at face value at least, to a major fall in industrial sector activity over the next 3-6 months. However, as the chart above clearly illustrates, the survey has a history of exaggerating the sector's weakness during periods of weakness – note the manufacturing recessions that failed to materialise in both

1998 and 2001. Nevertheless, the industrial sector will be a major drag on overall economic growth for the foreseeable future.

6/11 MPC Interest Rate decision

Although we said in the last issue of *Economic Data Roundup* that the risk to the consensus forecast of a half-point bank rate reduction was that “an even larger cut could be forthcoming”, the Monetary Policy Committee’s decision to slash interest rates by 150 basis points came as a massive shock. As a result, at just 3%, official interest rates are now at their lowest since May 1954. The Committee provided an extremely full explanation for the decision, citing a “substantial downward shift in the prospects for inflation”, a “marked deterioration in the outlook for economic activity at home and abroad” and on top of this a sharp fall in commodity prices. Since mid-September the global banking system had “experienced its most serious disruption for almost a century”. Whilst the measures taken on bank capital, funding and liquidity had begun to ease the situation, the availability of credit to households and businesses was likely to remain restricted, a development that had resulted in a sharp tightening of money and credit conditions. Indeed, immediately prior to the announcement, three-month LIBOR was still 5.84%, almost one-and-a-half percentage points above Bank Rate. As a result, the latest projections from the Bank of England staff, which will be published on Wednesday, showed that the risks to inflation have “shifted decisively to downside”. Thus, whereas as recently as the summer the MPC was worried that an extended period of above target inflation was threatening to drive up inflation expectations, its primary concern now is that inflation will undershoot in the medium term. Consequently, finding itself substantially “behind the curve”, the MPC had little option other than to take an axe to interest rates.

The initial reaction from financial markets to the decision was favourable, with equities in London rallying after having fallen around 3% earlier in the day. Perhaps more surprisingly there was little immediate impact on sterling, which held steady against the dollar and euro at \$1.59 and €1.24 respectively. One explanation for this could be that investors have reasoned that by cutting interest rates so sharply, the MPC has maximised the economy’s growth potential (or minimised the downside risk) in the year ahead. However, in our view, the prognosis over the medium term

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Economic data roundup

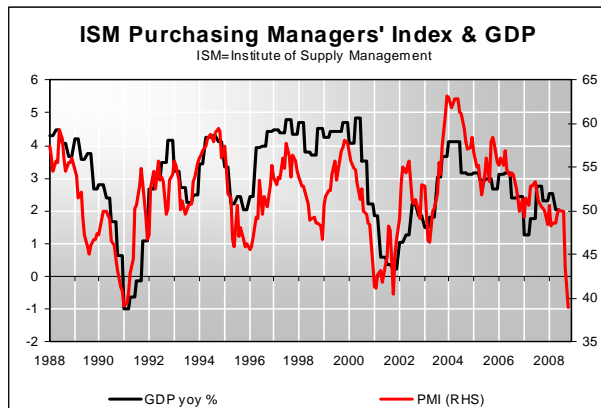
for sterling is not good. Whilst market rates should fall from here – and it does appear that some of the banks at least will be passing on the rate cut in full to variable/tracker mortgage payers – with the recession already in full swing, it is going to take a considerable amount of time to turn the tanker that is the UK economy around. In the interim, inflation is going to fall sharply, with the headline RPI rate almost guaranteed to turn negative next year. Barring a sudden reversal of the recent decline in oil and food prices, the target CPI measure will also plummet, dropping from 5.2% currently to less than 1% by September. This means that interest rates have significantly further to fall, possibly even below 2%, which would be lower than at any time since Bank of England records began in the 17th century. Sterling is therefore likely to come under further downward pressure. That said, this cannot be anything other than excellent news for both gilts (and high quality corporate bonds) and equities. Although the recession will inevitably take its toll on corporate earnings in the short term, as conditions in the credit markets ease, increasingly investors will look ahead to the next cyclical upturn. And with valuations at rock bottom, I wouldn't want to be out of the market at these levels.

United States

3/11 ISM Survey of Manufacturing (Oct)

PMI	38.9	43.5 (Sep)
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Source: Institute for Supply Management



Source: ISM, Bureau of Economic Analysis

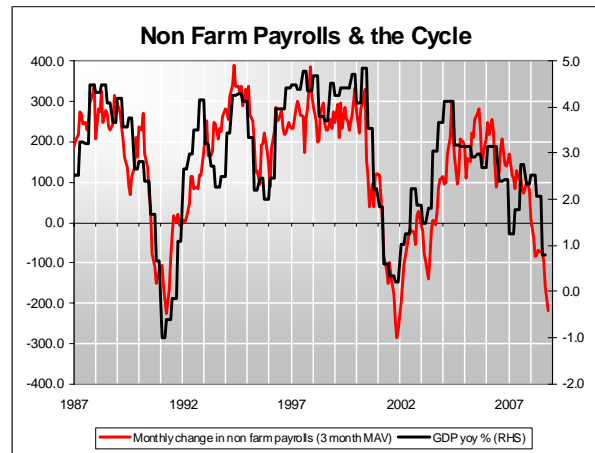
Rather too late given that it is supposed to be a leading indicator, the ISM Purchasing Managers' Index for

manufacturing dived into recession territory in October. Worse than this, at 38.9 it fell to its lowest level since March 1982. Taken at face value, the implication is clear; the annualised rate of growth in GDP will plummet over the next couple of quarters. The only problem we continue to have with this view is that since manufacturing represents less than 15% of US GDP, severe question marks over the usefulness of the survey of the wider US economy must surely remain. Quite clearly we are looking at a major downturn in manufacturing, but it is far from certain that the non-manufacturing sector will be anywhere near as weak.

7/11 Employment Situation Report (Oct)

(Initial estimate in brackets)	Oct	Sep
Non-farm payrolls	-240,000	-284,000 (-159,000)
Household survey employment	-297,000	-220,000
Unemployment	603,000	101,000
Unemployment rate	6.5%	6.1%
Weekly hours (index 2002=100)	105.9	106.2
Avg hourly earnings	0.2% mom, 3.6% yoy	

Source: Bureau of Labor Statistics



Source: Bureau of Labor Statistics, BEA

The October jobs report was substantially worse than expected, with non-farm payrolls declining by a massive 240,000 on the month after a larger than initially reported 284,000 (159,000 previously reported) fall in September. As a result, the average change over the last three months plunged to 214,000, the worst outcome since the economy was last in recession in 2001. Thus, whilst hitherto we have been using this indicator as a measure of the US economy's ability to avoid recession (successfully arguing that the US

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economy would continue to expand through the first half of the year) quite clearly the game is now up. Recession in the second half of the year is now inevitable; the only question is how deep will the recession be? The good news is that within the overall decline of 297,000 in the Household Survey measure of employment, part-time employment *increased* by 320,000, with the number of people working part time for “economic reasons” (i.e. not through choice) surging by 544,000. Thus, the labour market is already adjusting to the changing economic environment. In other words the labour market is much more flexible than in the past, which will help limit the severity of the downturn. However, whilst this might slightly alter the relationship in the chart above, it is difficult to see the US economy escaping with anything less than a couple more quarters of negative growth.

Eurozone

6/11 ECB Interest rate decision

Having dramatically changed tack in early October (don't forget the governing council raised rates by a quarter-point in June) when it cut rates in unison with the MPC and the Federal Reserve et al, the ECB eased policy by a further 50 basis points. This brought the central bank's

repo rate down to 3.25%. The move was in line with market expectations, but was overshadowed by the UK MPC's decision to slash rates by 150 basis points in an attempt to “get ahead of the curve”. To its credit the ECB has recognised that the downside risks to the Eurozone economy have increased. However, why it didn't perceive this several months (as opposed to weeks) ago is anybody's guess. In our view the problem rests with the central bank's long-standing misguided preoccupation with the idea that rising energy prices would feed through to inflation more generally. As we have argued at length, this was never going to happen in an environment in which the economy was operating beneath its productive potential. Now not only has the oil price more than halved, headline inflation has peaked and already started to fall sharply. In fact the decline has been so rapid, that the ECB now reckons inflation will be below its 2% target by the middle of next year. This is a massive change from just a couple of months ago when the central bank judged it would remain above target for the “foreseeable future”. Despite this, the ECB couldn't stop itself from saying that “upside risks to inflation remained”. With growth in Germany and France likely to be negative in Q3 it needs to follow the MPC's lead and kick-start growth.

Monday, 10th November to Friday, 14th November 2008

United Kingdom

10/11 Producer Prices (Oct)

The deceleration in cost and price pressures within the manufacturing sector continued in September. Reflecting the sharp reversal in oil prices in recent weeks, unadjusted input prices fell a further 1.2% on the month to bring the annual rate of change down from 28.8% in August to 24.5%. This is still extremely high by historical standards, but it will plunge over the course of the next few months. Meanwhile, output prices declined 0.3%, after having fallen 0.7% in August. Much of this simply reflected the ongoing decline in oil prices, but even after allowing for this, core output prices fell 0.1%. As this followed a fall of 0.5% in August, it is clear that underlying inflationary pressures within manufacturing are declining sharply. With activity within the sector weakening month by month, ignore what the CBI price expectations indicator has been saying; there is no upward pressure on inflation from the manufacturing sector. The consensus expects input prices to have fallen 2.6% in October, whilst output prices should have fallen by 0.4%.

12/11 Labour Market Report (Oct/Sep)

As a former Department of Employment economist I probably follow developments in the labour market data more closely than most. And like MPC member David Blanchflower I believe the labour market provides a vivid picture of the current state of the UK economy. The rise in the claimant count is largely irrelevant as it only covers people in receipt of benefit. Instead, the key figure is the LFS measure of unemployment, which showed a rise of 164,000 in the three months to August, enough to take the unemployment total to almost 1.8 million. However, one only has to go back as far as 1999 to find when unemployment was last higher, which suggests that the number out of work and looking for employment is going to rise sharply in the year ahead. At the same time, employment, somewhat belatedly, is now falling, with the number of full time jobs declining even more rapidly. Having failed to accelerate during the up-phase of the cycle, average earnings growth, which eased from 3.5% to 3.4% year on year in August, confirms there has been no follow

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through from high food and energy prices into underlying inflation. Taking the report in entirety, the MPC now has free rein to do whatever is necessary to support the UK economy in the year ahead. Financial markets have priced in a 40,000 October increase in the claimant count and a further easing in headline average earnings growth to 3.3%.

12/11 Bank of England Inflation Report

The key interest in the report will be the revised growth and inflation projections. Central here will be how quickly the MPC expects inflation to return to target and how far the undershoot will be through the second half of 2009 and into 2010. We expect the report to leave substantial scope for further monetary easing.

United States

14/11 Retail Sales (Oct)

We have now reached something of a watershed with regard to the US consumer. September's larger than expected 1.2% decline in nominal spending was the third straight monthly fall, an unprecedented event in a series that began back in 1992. Admittedly, part of the weakness can be attributed to ongoing (and profound) softness in new car sales, but even if we exclude this (as well as spending on gasoline) underlying retail sales growth is clearly declining. As a result, the three month on three month annualised rate of change fell to -4.0% in September compared with +3.7% in June. If we further allow for price changes, real retail sales on the same basis declined 10.1% compared with a fall of 1.2% in the June quarter. In part this explained the sharp 3.1% annualised decline in real consumer demand in Q3. These data will provide an important snapshot on the extent to which this weakness has extended into Q4. The consensus is looking for a monthly decline of 1.5%.

Eurozone

13-14/11 Eurozone GDP (Q3)

It is almost impossible to say anything positive about the detailed German second quarter GDP figures. The Federal Statistical Office had already indicated that both consumer demand and fixed investment spending had contracted, whilst the positive contribution to growth from net trade had come primarily as a result of declining import demand. However, the scale of the falls in consumer spending (-0.7%) and in residential fixed investment (-3.5%) was significantly more than the consensus had been looking for. Indeed, within the domestic economy only government consumption managed to post a quarterly gain and that was only 0.3%. As a result, overall domestic demand shrank by a full

1.0%, whilst final domestic sales (domestic demand less the change in inventories) fell 0.8%. Exports also dropped 0.2%, but with imports tumbling 1.3% as a result of the weakness in domestic spending, net trade boosted headline GDP by 0.5%. Considerable uncertainty now surrounds the near-term prospects for the real economy. The improvement in labour market conditions has been enormous over the past 18 months and yet consumer spending has contracted in each of the last three quarters. Future improvements in the labour market will be less spectacular during the remainder of 2008 and 2009, so a pronounced rebound in personal spending looks unlikely. From here, recent developments in the banking system combined with a plunge in leading indicators, suggest that growth will be extremely weak during the second half of 2008. Meanwhile, economic activity in the Eurozone as a whole fell 0.2% in the second quarter, the first outright contraction since the first quarter of 1993. In addition to Germany, activity declined in France and Italy, whilst in the Netherlands GDP stagnated. Meanwhile, Spain eked out a 0.1% advance, whilst Portugal and Austria expanded by 0.4%. Consumer demand and fixed investment both fell during the quarter. Financial markets are anticipating a 0.2% decline in German GDP in Q3, whilst France is expected to record a fall of 0.1%. Overall Eurozone GDP should decline by 0.2%.

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