Appendix

Economic Overview (May 2020)

Overview

This report reflects data and surveys released through May, but it appears that the full extent of the impact of the pandemic has still to be fully reflected. Indeed, the longer-term effects could be quite significant if the “V” shaped recovery, that markets have been hoping for, turns out to be rather slower. It is quite clear that in the short-term there has been a severe global downturn, with mass job losses and declines in output etc. The enormous amounts of central bank and government support has eased some of the strife through this time but is not a cure all and will not prevent some businesses going to the wall or permanent job losses. There will be a slow, fragmented global recovery, as the different economies and different sectors emerge from the bunkers of this crisis at different times. This will almost certainly ensure that a “V” shape recovery does not occur.

The worst of lockdown appears to now be over in the UK, with the enforced closure of businesses and social distancing measures being gradually eased. The ONS published its “Business Impact of Coronavirus Survey” which reported that the number of firms ceasing trading has slowed from 25% in early April to 18% in the first half of May. The expectation is that GDP will only make moderate progress in repairing the damage done in April, while despite the Government’s worthy efforts, there are still businesses and individuals that did not meet the criteria of its schemes. The furlough scheme will be pared back in August, which will then put businesses into a position as to whether to retain staff or release them, with decisions clearly having implications for unemployment. Analysts suggest that recovery will not meet with the current levels of optimism. This could force the BoE to loosen policy further in order to generate demand and push inflation in the direction of the 2% target.

Recent EZ data has indicated a modest pick up in economic activity, but tourism/hospitality are struggling to get re-started. At the household level, while some will have been able to accumulate savings and have a desire to spend, there will, equally, be those that lost income streams and jobs and not have the ability to participate in the recovery. Meanwhile, policymakers are, belatedly, putting their

heads together and are taking strides towards a joint fiscal policy approach via the EU budget. Elsewhere, the ECB has upped its policy support with a €600bn addition to the asset purchase programme.

The COVID-related downturn in the US is far sharper than that of the financial crisis, and over a shorter period, with April activity 20% down on just two months earlier. Recovery has, though, begun now that there has been some easing of lockdowns but, to date, the bounce appears to have been relatively modest. As infection numbers fall and restrictions are eased further, this should see the pace of recovery improve, generating a partial reversal of fortunes in the second half of the year. However, some sectors such as travel and leisure, are likely to suffer longer term effects than other areas of the economy. This suggests that the economy will operate at below trend, potentially, for some years.

Pandemic restrictions pared back economic activity in Japan, particularly the retail sector which suffered from the loss of a boost from the busy Golden Week holiday. However, the low point appears to have passed, with the spread of the virus under control, which should permit activity to begin its bounce. The state of emergency has gradually been lifted enabling businesses and the economy to start to rebuild, with economists suggesting a 7% q/q growth pick up in Q3.

The Chinese government's annual report indicated that acceleration in credit growth is a target, while aggregate financing will "grow at a notably higher rate than last year", when it increased by 10.7%. Analysts suggest that even with the huge support, GDP growth is unlikely to rise much in 2020. The debt to GDP ratio increased by 14% in Q1, the biggest quarterly increase ever. It is expected to rise to a 40% y/y increase by year end, which would exceed that seen in 2009. While not raising a threat to financial stability, due to the support of the banking system and the regional banks, it will be more difficult for this support to be withdrawn in an orderly fashion going forward.

UK

The easing of the lockdown on May 13th has generated only modest recovery in activity. Data shows that GDP declined by 5.8% m/m in March, even though

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lockdown was only in place for nine days. Worst hit sectors were those where social distancing was a fundamental problem such as hotels/restaurants, education and transport/leisure. A full month of lockdown in April saw an even larger decline in GDP, as some sectors will have generated no activity at all. Around 20% of all firms stopped trading for the month. For example, only 197 cars were produced in April, a 99.7% y/y decline. April should, though, be the low point for the economy, with lockdown easing now under way and workers being encouraged to return. That optimism is reflected by the improved May composite PMI but there is a suggestion that the index has not factored in the full extent of the drop in economic activity.

Consumer spending will be helped by the lifting of restrictions, but it will take time to recover. Retail sales dropped by a record 18.1% m/m in April, pulling sales to 2005 levels. Online sales benefited but clothing and petrol sales were badly hit, both falling by more than 50% m/m, and even food and drink spending suffered, but to a far lesser degree. With hotels/restaurants/car sales falling outside of retail sales, overall consumption contraction will be even sharper over Q2, possibly up to 25%. On the plus side, with nothing to spend on, household debt was reduced by record a £7.4bn. The mid-May commencement of easing of restrictions does not appear to have resulted in anything other than a patchy improvement, with car sales still massively down. Consumers remain pessimistic about their financial position, indicating that a return to normality remains a way off, even though shops are starting to open.

Trade will only recover very gradually, with global economies re-opening at a different pace. The March trade figures underlined the impact of the epidemic, with the trade deficit surging to a one year high £6.7bn. However, the volatile non-monetary gold component was the key driver of change, with a £3bn contribution. Ignoring this, export volumes dived by 14.5% m/m, and imports by 8.1%, which exceeded those seen ahead of the initial Brexit deadline. Both exports and imports look to have fallen again in April, while tourism will have been all but non-existent, and will barely improve through Q2. The lockdown has undermined demand, which will be the main driver of trade, rather than disruptions to supplies. The UK will only benefit marginally by improved conditions in China as it is not a major trading partner, in the way that Europe and the US are. Exports are forecast to drop by

around 15% in Q2, but imports will be hit far harder, up to 40% down, as the economy remained largely closed and will only re-open gradually.

The Coronavirus Job Retention Scheme should ensure that the rate of unemployment has not run away during the pandemic. However, there are concerns that once “furlough” starts to wind down a pickup in job losses could occur. Prior to COVID 19, employment was healthy and rose by 210,000 in Q1, but PAYE numbers crashed by 500,000 in April, indicating that some firms were laying off employees, rather than furlough them. The claimant count unemployment rate increased to 5.8%, but with Universal Credit claims having fallen back, the rate of joblessness might peak at around 9%, which would be lower than had been initially feared. Average earnings growth fell to 2.4% in March but was set to fall further in April.

Consumer price inflation has fallen and will remain subdued as it will likely take demand some time to fully recover. April saw CPI ease to 0.8%, after the largest monthly decline since December 2008. The Governor of the Bank of England is set to be having regular correspondence with the Chancellor on why the rate has fallen outside of the 1% band of tolerance from the 2% target. This is hardly a great concern as much of this is down to lower energy prices caused by the slump in crude oil price and Ofgem’s reduced utility price cap. Fuel prices should not fall too much further as oil prices have stabilised. However, underlying core inflation has also dipped, while output price inflation is in negative territory for the first time in nearly four years. With demand having collapsed, core deflation will deepen, particularly in the hardest hit industries. Analysts do not see CPI inflation getting too close to the 2% target in the next 18 months.

Equity markets have continued to reverse losses and are expected to gradually climb over the coming years. At the end of May, the FTSE 100 had recovered 25% from the March crash. The UK pick up has been broader based than in the US, where large tech companies have been to the fore. There has also been a pickup in the value of Sterling, but this was more reflective of Dollar weakness. The exchange rate against the €uro was little changed but with Brexit talks ongoing that is not such a surprise. Analysts believe that an agreement will be cobbled together to avoid a dramatic relationship change at year end, which should help currency stability.

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LIBOR spreads continued to fall as financial market pressures eased, while Government bond yields are also drifting lower, on expectations of increased QE, which some commentators predict will be ramped up significantly in 2021.

Monetary Policy

Nothing has really changed or is likely to in the short term. The coronavirus pandemic and its economic impact has been the sole focus of governments and central banks. Policy has been defined by their need and desire to underpin their economies and financial markets. They have gone an extra mile or more, in adding support of the workforce whose income streams have been wiped out by the lockdown, which would thus have compromised their ability to meet financial commitments.

As a result, governments have increased levels of debt to unprecedented levels, which will likely take some time after the pandemic clears to bring down to more manageable levels.

Central banks are maintaining stability and viability of their financial markets with massive asset purchasing programmes. These also help to suppress upside rate pressures, having followed interest rate policies that have seen all major central banks slash interest rates to, or almost zero percent.

Policies are unlikely to change before the pandemic has died down and is in retreat, and economic activity and confidence level have started to normalise. Such a combination is unlikely until 2021 at the earliest. The risk to that scenario could be the evident urgency that some governments seem to be putting on re-opening their economies as early as possible. The risk they run is moving too swiftly, resulting in a second wave of infections, something that appears to be a growing concern in China and the US (as this report is being written).

Support packages from central banks and governments may prove insufficient to get national and global economies out of the deep recession that is likely to hit most areas. As such, analysts expect more money to be pumped into the system, one way or another, to give recoveries whatever boost is required.

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The long and short of the current situation is that interest rates are unlikely to rise in the immediate future, but more stimulus seems inevitable.

Source: City Watch June 2020 - Link Asset Services