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Economic Overview (September 2020)

Though the global economy has experienced a solid bounce following the easing of the initial pandemic lockdowns, it remains weighed down by the effects of COVID. Additionally, the ongoing, recent increases in infections across the economic regions, have seen fresh localised lockdowns that could spread and would, potentially, hold back recovery. The major challenge to all areas will be how the labour markets and businesses react to the cessation of the widespread furlough, job and business support schemes that have, essentially, prevented a total economic collapse. The dark clouds of Sino-US trade tensions and similar Brexit trade concerns are also hanging overhead and the outlook for the global economy, though better than three months ago, remains uncertain and, possibly, fragile. The surge of equity markets belies the state of play and in recent weeks there appears to be a dawning of realisation that the world cannot survive on the success of the technology sector through the pandemic alone.

The UK economy has recovered relatively strongly from its COVID slump, but it faces stiff headwinds in the coming months that will test its resilience. Certain sectors of the economy have fared less well in the post-lockdown bounce, most notably the hospitality sector. The recent surge in COVID infections has required localised social restrictions, which it is feared could become more widespread if control cannot be achieved. The uncertainty of the domestic situation adds to the concerns that a Brexit deal is no nearer to being agreed and that unemployment resultant from the pandemic is set to increase further, and potentially sharply, all of which could put the brakes on the pace of growth recovery.

With some member states reimposing COVID restrictions the EU economic recovery has stalled, while in some individual countries it may have started to decline. While there are signs of Spanish infections growth now starting to slow again the authorities are unlikely to rush to roll back on safety. Fears of a second wave has seen use of recreational and retail centres decline, weighing on the economy. With these local lockdowns across parts of the EU, and their impact on recovery, the ECB will likely need to continue to support, and be required to extend, the asset purchase programme beyond its current life expectation.

The momentum of US economic recovery has slowed but remains relatively strong. This is despite the mass increase of COVID infections through the summer months and the cessation of the Federal enhancement of unemployment benefits. Retail sales grew solidly in August, even though already having surpassed pre-COVID levels. However, the same cannot be said for industrial production,

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which is still markedly below February levels, while housing starts declined. Employment intensive areas, such as many services, remain under the cosh, which is why unemployment has remained high. With winter approaching and activities where social distancing has been achieved (such as outdoor dining in the cold North East) less viable, recovery will face further challenges. However, the Fed's easy monetary policy and hopes of further fiscal relief should enable the economy to sustain growth.

Since April, the Japanese government has issued securities valued at 17% of pre-COVID GDP and will issue about a third as much again in the coming six months. The funds have, largely, been used to fund household transfers and those to firms included in the April and May emergency budgets. A significant proportion of these government funds, however, is sat with the Bank of Japan, indicating that much of this year's planned fiscal spending is still to be undertaken. This indicates that the armoury should be in place to underpin recovery over the next two quarters.

The Chinese economy may be recovering but, for this to be sustained, much now depends on how global demand develops. With the lockdowns having been eased, the ensuing possible threat of a "second wave" may hamper recovery in key export partners. Overarching all of this is the trade dispute with the US, though a Trump defeat at the election could impact on relations between the two super-powers. Domestically, concerns about the economy receding has seen property developers having their borrowing capacity limited due to authorities' concerns about credit risk. Previously they had been surprisingly omitted from policy makers' plans for stimulating the economy, which was a contrast to the stance following the financial crisis.

UK

Taking a view of the UK economy has seen economists raise concerns that recovery could be set back severely if fresh restrictive action taken to contain COVID is coupled with a "no deal" Brexit. The forecast potential is to the downside for GDP, which will force the Bank of England to add to its £745bn of Quantitative Easing (QE) and maintain Bank Rate at current levels for a prolonged period. This scenario would likely ensure no material upside to gilt yields.

The economy has recovered in the main from the disastrous hit to GDP caused by the lockdown and should see strong growth in Q3. However, the surge in infections and actions being taken to combat the spread will likely leave growth flat in Q4, and possibly Q1 2021. In turn, this could delay the return to pre-pandemic levels. Forecasters suggest that if the new restrictions are widened, tightened and last into 2021 in some form - and a narrow EU trade deal is achieved by year end -

then the delay could push into 2022. Early easing of restrictions and availability of a vaccine would tip the balance to the upside, but the downside risks seem greater at present, particularly without any clear indication that a Brexit “deal” is in the offing. It is hoped that the UK and EU will come to a compromise to avoid this, but a modest cooperative deal is still expected to see GDP fall by 1% next year, whereas a hard Brexit could result in a 2.5% hit to growth.

The budget deficit is unlikely to be reduced greatly next year but the cessation of government support schemes will hit households and businesses. The job support schemes have and will dampen job losses to a point. Nevertheless, unemployment is forecast to balloon to around 8% in 2021 and business failures are likely to increase. That potential outlook, and broader uncertainty, is hitting business investment. Equally, inflation was suppressed by schemes such as Eat Out to Help Out and the VAT cut for some sectors, but the ending of these will result in inflation rising steadily, potentially getting towards the Bank of England’s 2% target by the end of next year, before the moderated economic recovery pulls the level down in 2022. Note, however, that a “no deal” Brexit could push inflation higher in 2021 due to a likely negative impact on sterling. Negative interest rates are in the Bank’s armoury but are not likely to be used. However, additional QE looks on the cards, which will, if some commentators are correct, keep Bank Rate at 0.10% until 2025. The added impact of such a scenario would be to dampen the upside potential for gilt yields in coming years.

Having bounced strongly on the release of pent up demand, and a significant build-up of household savings, consumer spending is now heading into a number of headwinds. Withdrawal of government support, rising unemployment and the re-introduction of restrictions will hit both the ability and desire of consumers to spend, causing a contraction, delaying the return to pre-crisis growth levels for some time. After the Q2 disaster, spending burst into life on the release from lockdown, with total retail sales 4% higher in August than back in February, bolstered by strength of online activity and a spending switch from hospitality/leisure to goods. While household goods’ sales may continue to do well, the recovery is moving to the next phase as the initial tsunami of spending has passed. There are already signs that retail and recreational sites are seeing declines in footfall, and not simply due to the increase in localised lockdowns. Looking ahead, incomes and COVID will be the determinants of spending, and rising unemployment and uncertainty will weigh on spending. Labour market slack and weak GDP will impact on nominal earnings growth, which may flatline in coming years. This will hit real household disposable incomes, with the lowest paid sectors hit hardest. With those sectors spending the highest proportion of incomes, consumer spending will inevitably take a hit. Consumer confidence will also be held back if lockdowns return and are widespread. This will filter into a reluctance to spend, while the service sector will be hit hardest by the restrictions placed on consumers.

Two of the strongest areas of GDP growth are likely to remain Government and dwellings' investment, being among the fastest areas to regain pre-COVID levels post-lockdown. Contrasting these, business investment will lag as one of the weakest. The Help to Buy scheme and stamp duty holiday have helped to tap the pent-up demand in the housing market, while the Government has added £7bn to the spending budgets for health capital and infrastructure. In the short-term these have offered a significant boost, but the levels of growth generated are unsustainable. It is highly likely that housing demand has surged as buyers have been encouraged to bring forward activity to benefit from the withdrawal of the tax, as has been the case with the infrastructure projects. Both areas are likely to flatline or contract at some point in 2021. The concern is that business investment will remain subdued because of the uncertainty over Brexit and the duration of COVID. Surveys of investment intentions remain reflective of business plans contracting steeply, and even a delayed Brexit deal would do little to help in the short-term as businesses wait to assess how the terms of any deal will work. Having seen profits hit and debt levels increased, firms are likely to be cagey about capital investment and may prioritise paying down debts. A sticking point for smaller businesses may be access to credit with Business Interruption and Bounce Back loan schemes due to close at the end of November, with repayment of interest and gradual principal reductions to commence next March. At the same time, other firms will just have no need to invest as they are not operating at full capacity - indeed spare capacity is likely to be a drag on the economy for some time. The downturn in commercial property will be a long-term drag on buildings/structures investment. One area that analysts suggest may buck the trend in investment is Information Communication Technology, which has felt less impact from the situation, and has possibly benefited. Q4 could see stockpiling if a "no deal" Brexit looks likely, but with demand concerns and weak cash reserves the impact on GDP may be rather less than that seen ahead of the original Brexit date. Analysts are fearful that total investment will still be lower than pre-virus levels by the end of 2022, with business investment 5% down.

The collapse of trade during the pandemic saw UK trade run at a surplus, but that will not last. Q2 declines in both exports and exports are reversing, which will turn the positive net trade contribution to GDP growth in Q1/2 into a drag in Q3. At the same time, low levels of international travel and the slow recovery here are likely to result in less large deficits for a while. Looking ahead and a "no deal" Brexit would impact with potential disruption of trade flows once more. Recovery in

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Europe appears to be stuttering, but has been stronger in the US and China, thus with our trade partners rebounding strongly that should be supportive of healthy growth in UK exports, helping the trade balance, while the UKs slower recovery should also subdue import demand.

Weakness of business investment will also put downside pressure on import demand, but any shift in consumer spending to goods, from domestic services, is generally supportive of imports. However, the collapse in travel and tourism will likely offset any such switch, as UK travellers tended to outspend the amount foreign visitors spend in the UK. Net trade is expected to add 2% to GDP this year, but could be a 1.5% drag in 2021, as the surplus turns mildly negative.

To date, the labour market has been cushioned from the full impact of the pandemic by the government support packages for businesses and workers. However, as the new year progresses and those schemes are wound down, there is the potential for problems. Most, but not all, of the 5.5 million workers who came off the furlough scheme in August returned to work. Employment only declined by 482,000 in the six months to August, with inactivity up 465,000 and unemployment 158,000. Jobless numbers hit 1.5 million pushing the unemployment rate to 4.5%, though there is a feeling that the job losses may be higher as HMRC paid employee numbers are down 685,000, while those receiving jobless benefits are up by 1.5 million. Notwithstanding this, the outlook is uncertain, with around two million jobs of those still on furlough support at risk, particularly as fresh tightening of restrictions will rein in recovery. Some of the blow will be softened by the reduced Job Support Scheme, but this will just kick the problem to a later date, with economists fearing a 1.5% fall in employment at cessation of the current schemes, which could worsen to a 4% decline in 2021.

The unemployment rate may be held back by a fall in the labour force, while the drop in vacancy levels may deter some from looking for new employment. That will change as the economy picks up, paradoxically pushing the unemployment rate higher. Jobless numbers could rise to 2.6 million, which would equate to a jobless rate of 8% next year, with some services sectors suffering until 2022/23. Average earnings have increased on the basis that those coming off the furlough scheme are receiving 100% of wages, compared to 80%, and that will be sustained as more of these workers return. Indeed, by August earnings had reversed all falls, but rising unemployment and increased labour market slack will dampen earnings growth down the line and is likely to have an ongoing disinflationary impact. Inflation has started to bounce from its 0.2% low in August and is expected to rise slowly and gradually over the next year or so, but while forecast to hit around the 2% target in 2021, it is expected to ease back to around 1.5% in 2022. Longer term risks remain to the upside, and the BoE will be alert to this. The cause of the CPI fall was due to the Eat Out To Help Out scheme pulling consumer prices down, combining with the impact of the sharp fall in crude oil prices earlier in the year and the temporary VAT reduction in the tourism/hospitality sector. However, these will gradually fall out of the inflation equation, and CPI will then head towards 2%. The subsequent dip will be due to weak goods inflation, which has been heightened recently by the lag in production to meet post-lockdown demand. If there is a Brexit deal, Sterling should strengthen to weaken goods inflation, conversely a no deal Brexit could have serious upside implications, as weaker Sterling pushes import prices higher. In addition, there would be import tariffs to factor in, which could see CPI surge to well over 3%. However, that would not be a long-lasting factor. Another indication of weaker CPI is the reluctance of businesses to pass on rising costs, due to social distancing, to customers. Meanwhile, volumes of spare capacity is allowing other costs to be capped though to 2022, with wages the largest outlay for services firms. Once spare capacity is utilised, though, inflation could push through target. Unlike the financial crisis, monetary/fiscal stimulus, this time around, has been focussed on businesses and households who are going to spend in the economy, rather than the shoring up of the banking system. The BoE may welcome rising inflation as it would lower real interest rates to give the economy a boost and erode the government debt burden. However, the BoE is unlikely to take the Fed route to average inflation, and any significant target breach would likely be met with some paring back of stimulus, and the lack of a great change in market inflation expectations would support that view.

Economic concerns will likely force the BoE to increase QE and keep interest rates at record low levels for a prolonged period. However, the Chancellor will struggle to balance his books. Fiscal support is being pared back which will dent the recovery, as will the potential re-imposition of the COVID restrictions. This will offer little opportunity for tax increases and, indeed, could require the Government to extend support measures. With the economy having recovered more strongly than forecast, the OBR borrowing projections have not been met … yet. Looking ahead, deceleration in the recovery will likely require Government borrowing to be scaled up to around the OBR forecast, at around 20% GDP, the highest since World War Two.

The deficit should fall relatively swiftly as activity and tax revenues should bounce more speedily than in the financial crisis. In addition, many of the support scheme have ceased and with GDP improving the debt-to-GDP ratio should stabilise at around 100%. The BoE has cut rates to 0.10% (forecast to stay year for up to five years) and increased QE to £745bn, but rising unemployment may force their hand to do even more. However, negative interest rates will likely be avoided, despite support from some “external” MPC members, due to the impact on the banking sector.

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More likely will be more QE over the coming year, possibly up to £250bn. Weak inflation, low interest rates and QE will severely limit upside to gilt yields, and cheap debt financing means that the Government can continue to underpin the economy rather than pay off the deficit.

The FTSE performance has lagged that in other major centres and is now back at around levels seen in May. It has been dented by the nearing of the Brexit deadline with no deal in sight, coupled with the spectre of a second wave of COVID. The strength of Sterling has certainly been a factor in the index's performance, but that is not the case in September as the currency has weakened over the period, with the reasons much the same as those noted above. The Government's stance on Brexit and COVID will pose a serious downside risk to both equities and the currency if the former does not deliver a deal, or an extension to the transition period, and/or the second wave results in renewed lockdowns in any major form. If the opposite prevails then both should have upside potential.

Monetary Policy

Nothing changes with respect to policy which is being driven by the need to regenerate activity in the global economy in the wake of the COVID 19 pandemic. The gradual and non-standard easing of lockdown has helped to generate recovery, with some economies faring better than others. This sees them all operating at different levels and experiencing slightly different challenges in achieving the target of returning to normality. As previously noted, this will result in a disjointed recovery.

However, an increasing number of economies are experiencing a rise in COVID infections as restrictions have been eased. That, in turn, has seen governments react with the re-imposition, to varying degrees, of some restrictions, which will, in turn, impact on domestic as well as global demand and activity.

Government and central bank schemes have continued to underpin and stabilise economies as best they can, while encouraging people to re-engage with the economy more fully. As those schemes are wound down will come more potential problems, including the risk of rising unemployment as furloughed staff are not re-employed. The political self-interest ahead of the US Presidential elections has, to date, prevented vital, additional stimulus from being pumped into the US economy.

The role of central banks will not change due to the need to maintain the stability and viability of financial markets, and to support economic growth. This includes asset purchasing programmes remaining for a continued, and likely lengthier period, suppressing interest rate pressures.

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Any policy changes are unlikely until 2021 at the earliest. As noted previously, the risk is that in re-opening their economies too early a second wave or resurgence of infections hits, which is currently being seen in a growing number of places.

Interest rates are unlikely to rise soon and current support packages may prove insufficient. As such, analysts expect more money to be pumped into the system, one way or another, to give recovery whatever boost is required.

Source: City Watch June 2020 - Link Asset Services