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ZURICH®

Double, double toil and trouble

Brexit uncertainty resurfaces just when lockdown measures ease

Like most other regions the British economy has been hit hard by COVID-19 and the ensuing lockdown. Monetary and fiscal measures are helping to bridge the gap until the economy reopens, supporting both households and firms. However, just as we emerge from the worst of the crisis, the UK economy must now cope with further Brexit uncertainty as trade negotiations with the EU falter, while the end of the transition period is looming.

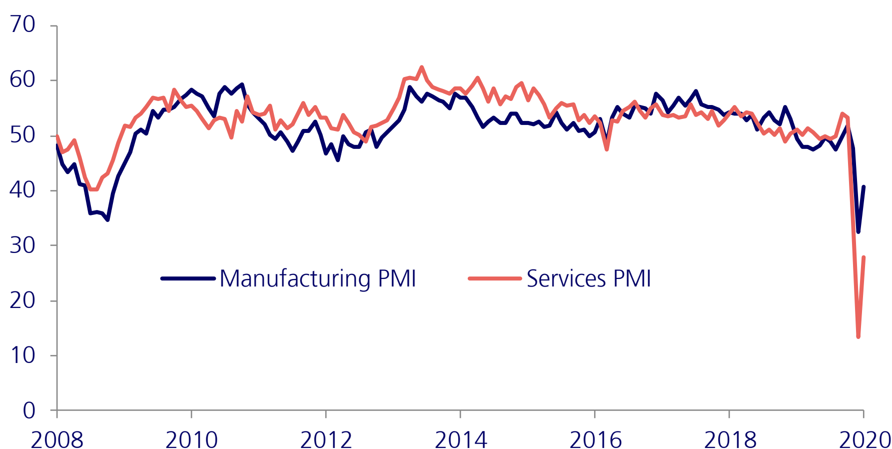
Source: iStock

Growth is likely to rebound in the second half of the year, but a self inflicted wound could undermine its stength

The global economy is facing the worst downturn in decades as COVID-19 and the ensuing lockdown have paralyzed countries all over the world. The UK government and the Bank of England (BoE) are acting decisively to mitigate the impact, though more will be needed.

We expect the economy to rebound in the second half of the year as lockdown measures ease, helped by fiscal and monetary stimulus and a recovery of the global economy. However, as the stringency of the coronavirus measures begins to recede risks around a no-deal Brexit are reappearing on the horizon. With the end of the transition period moving closer, the UK government seems unwilling to ask the EU for an extension. Just when improving business and consumer confidence are most needed to reignite growth the expected recovery could be more subdued than necessary due to the ongoing political jousting and the uncertainty this creates.

The economy is on a steep downward trajectory



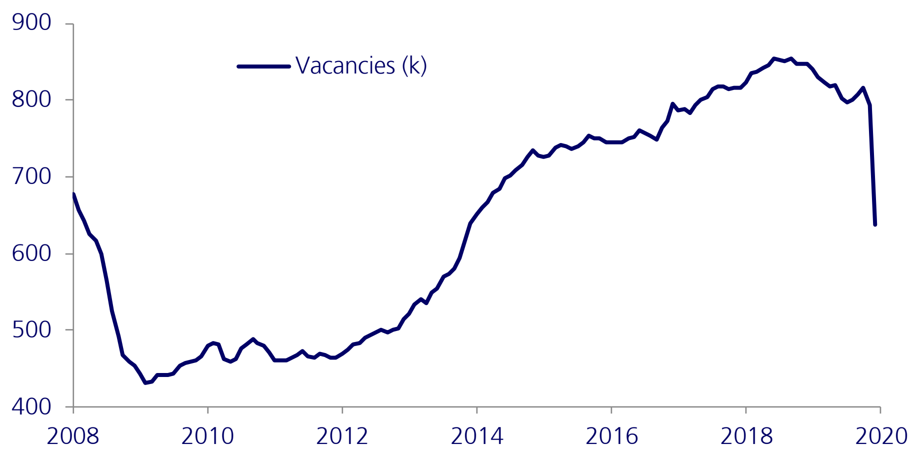
Source: Bloomberg

The UK has fallen into a severe recession as lockdown measures close down the economy

GDP contracted by 2% QoQ in the first quarter of 2020. That's the worst drop since the financial crisis. However, given that the UK was relatively late in imposing the lockdown, the direct impact on Q1 growth was only felt at the end of the quarter. This becomes obvious when we look at the monthly numbers with growth rates of 0.1% and -0.2% in January and February. Economic activity then came to a sudden stop in March with GDP tumbling by 5.8% MoM.

With the lockdown in place in April followed by a timid reopening in May the economy is expected to suffer a double-digit contraction in the second quarter, which would be the worst post-war quarter by far. Based on payments data used by the Bank of England the level of consumption is likely to have fallen by around 30% at the beginning of the current quarter. Household purchases of durable goods have been particularly hard hit. Vehicle sales have been close to zero recently, for example, as car vendors were closed during the lockdown. Unlike spending on services such as restaurants and cinemas, we expect spending on durable goods to rebound

Vacancies fall as firms are reluctant to hire



Source: Bloomberg

quickly once the social-distancing measures ease.

While the lockdown affects the whole economy, the service sector has been particularly hard hit. April's PMI survey revealed that around 79% of the respondents saw business activity plunging with the activity index falling to a mere 13.4. This is by far the lowest reading since the beginning of the series in 1996. Even in the depth of the financial crisis the survey never fell below 40. A silver lining came from business expectations, which ticked up slightly from March's record low indicating that the economic drawdown has passed its nadir. Manufacturing has fared slightly better than services, benefitting from rising production levels in food, pharmaceuticals and healthcare-related sectors. The decline in business activity slowed in May but the economy remains on a steep downward trajectory. Employment numbers continued to fall rapidly, particularly in the service sector. The pace of job shedding has eased only slightly since April and remains much more severe than during the Global Financial Crisis.

Significant falls in vacancies and hours worked point to a severe deterioration of the employment situation

The impact of COVID-19 and the lockdown on the economy in general and the labour market in particular will be massive. The BoE expects the unemployment rate to rise to around 9% in the second quarter. The latest data from the Office for National Statistics (ONS) give an early indication of how severe the drawdown will be. Despite the economic contraction in the first quarter, the unemployment rate actually ticked down to 3.9% in March. However, more timely data give further clues of what is to come. The average number of hours worked fell substantially in the last two weeks of March. Total weekly hours worked for the whole of Q1 showed the largest annual decrease in a decade. Vacancies saw the largest quarterly decrease between February and April 2020 since the time series started in 2001, falling by 21%. Estimates by the Institute for Employment Studies (IES) show that the overall vacancy level decreased by 59% between the second week of March and the week ending May 3, 2020.

Not all sectors have been affected to the same degree, of course. Not surprisingly, the accommodation and food services sector recorded the largest quarterly decrease in vacancies and the largest proportion of the workforce being furloughed (73%). The sector's output declined by 9.5% in the three months to March 2020, based on first quarterly estimates for GDP in Q1.

Given the severe deterioration of the employment situation it is no surprise that consumer confidence has tumbled in May, matching the post-recession low reached in 2011 when Europe was caught in the stranglehold of the Eurozone crisis that eventually led to the ECB adopting its QE policy.

The budget deficit soars as the government provides much needed support to businesses and households

In an effort to avoid a severe recession turning into a depression the government has stepped up its measures to support the economy. This is particularly necessary as monetary measures are limited due to the fact that yields are already at record low levels. Steps to loosen fiscal restraints were already taken before the lockdown hit the economy and are likely to increase further going forward. Tax cuts and grants to support small businesses have been complemented by significant government lending guarantees, amounting to GBP 330bn or roughly 15% of GDP.

The fiscal impact of the support measures will be huge. The latest data show that tax payments received in April were down 42% compared to the same month last year. At the same time central government spending jumped 52%. As a result, the budget deficit soared to GBP 62bn in April alone, the largest in any single month and greater than the Office for Budget Responsibility's earlier budget forecast for the full year. The fiscal deficit is likely to rise to 15% of GDP this year as government spending increases further and GDP falls. Net debt rose by 17.4% of GDP on a year earlier to 97.7%.

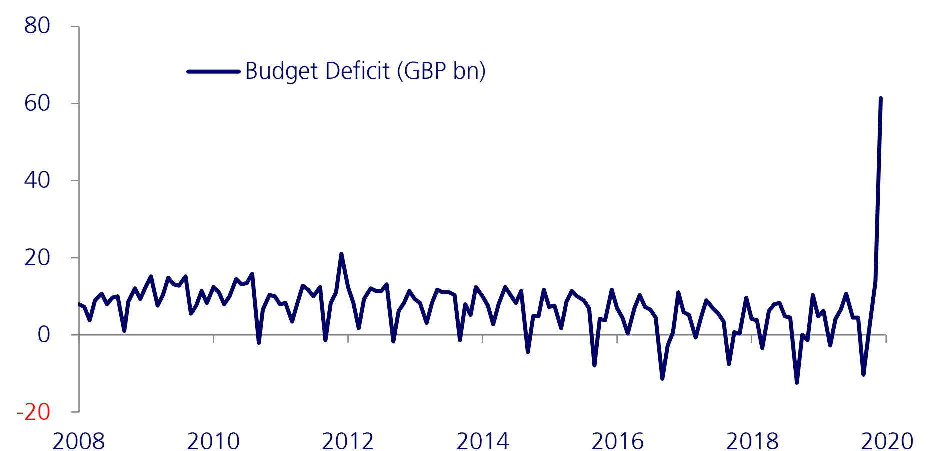
The job retention scheme helps to bridge the gap until the economy begins to recover from the lockdown

A major pillar of the government's policy to support the economy is its job retention scheme, which pays furloughed workers up to 80% of their monthly wages up to GBP 2'500. The program, which costs about GBP 14bn a month, has recently been extended to last until the end of October. The extension is crucial to bridge the fragile period of slowly reopening the economy and helps to remove some near-term uncertainty for affected workers.

Unemployment numbers would be much worse had the government not imposed its job retention scheme. There has been substantial take-up of the program, reflecting the need for government support to mitigate the crisis' impact on the labour market. Across all industries, more than a quarter of the workforce had been furloughed under the terms of the Coronavirus Job Retention Scheme at the beginning of May.

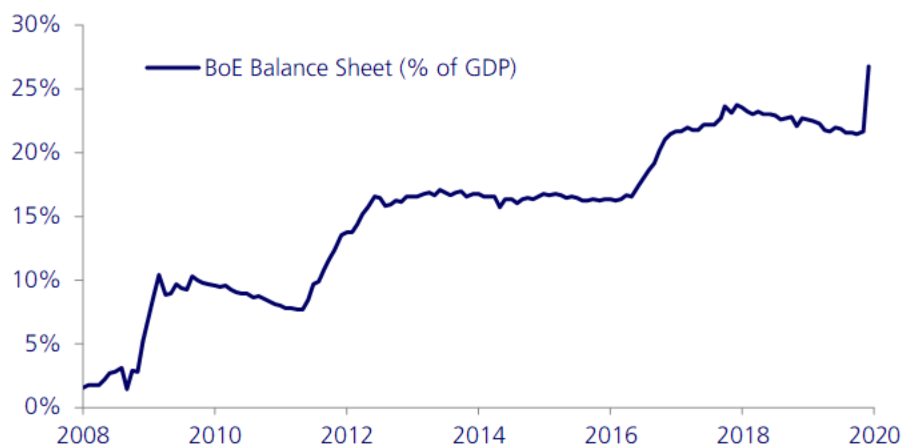
According to the ONS Business Impact of Coronavirus Survey 75% of firms that were still trading had furloughed around 20% of their workforce, while the remaining 25% that were not trading had furloughed around 80% of their workforce. The British Chambers of Commerce (BCC) reported that roughly three quarters of firms had furloughed at least part of their workforce, with 14% of firms furloughing their entire workforce. Early data showed that applications for furlough had been received from 800,000 companies covering over six million jobs.

The budget deficit soars as the government increases spending



Source: Bloomberg

The BoE boosts its balance sheet to keep yields in check



Source: Bloomberg

The Bank of England cuts rates to the lowest ever and reignites its asset purchases to keep yields in check

In order to mitigate the impact of COVID-19 and the lockdown, the Bank of England took a number of actions to support both the economy and financial markets. It cut the Bank Rate to 0.1%, the lowest level ever and announced a GBP 200bn increase in its UK government bond and sterling non-financial investment-grade corporate bond purchases to a total of GBP 645bn. At the current pace of purchases this target will be reached by the beginning of July. Two of the nine members of the BoE's Monetary Policy Committee (MPC) wanted to increase the purchases by another GBP 100bn at a recent meeting. While the proposal did not find a majority in May it is likely that the purchases will be further expanded at one of the upcoming MPC meetings, particularly if the economic slump drags on even after some of the restrictions related to COVID-19 are lifted. Finally, the BoE also introduced a Term Funding Scheme with a particular focus on small and medium-sized enterprises.

As shown above, the government support measures are costly but will go a long way to bridge the expected income gap due to the lockdown while the BoE's liquidity injection will help to keep a lid on yields despite the soaring fiscal deficit. This should mitigate the uncertainty weighing on households and firms, providing incentives to spend and invest once the worst of the COVID-19 crisis is over. However, just when we expect the global economy to recover, new headwinds will slow the potential rebound in the UK.

Brexit risks loom on the horizon as trade talks fail to make significant progress

There has been little progress in Brexit negotiations despite several rounds of talks. One of the main obstacles to an agreement are the EU's demand for a level playing field. The EU worries that without such a guarantee British firms would gain an unfair advantage when competing against EU firms. It therefore wants the UK to apply EU rules in areas like taxation, state subsidies, workers' rights and environmental standards. However, given that one of the Brexiteers' key arguments for leaving the EU was that the UK be able to define its own rules, it will be difficult to find a compromise that suits both sides.

Other key issues include the UK financial services firms' access to the EU market as well as EU access to UK fishing grounds. There is one more scheduled round of talks before a first wrap-up in June. By the end of June, the UK would have to ask for an extension of the transition period, which currently runs until the end of this year. Given that PM Johnson has repeatedly ruled out such an extension it is unlikely that this deadline will be met.

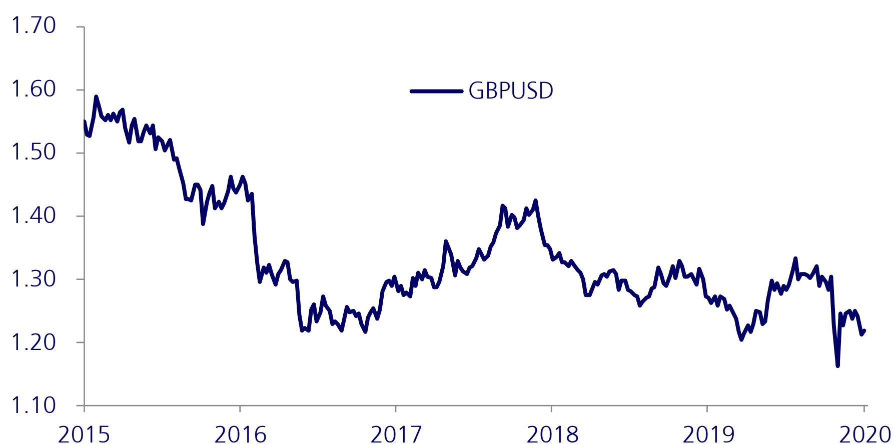
We still see the possibility of a narrow trade agreement by the end of the year, but a significant risk of a no-deal Brexit remains, particularly given that the government's focus currently lies on dealing with the fallout from the COVID-19 crisis and lockdown. Sterling has fallen back to levels seen in the aftermath of the Brexit referendum as the economy struggles with several headwinds and we suspect that weakness will persist for some time.

Conclusion

COVID-19 and the ensuing lockdown have hit the UK economy with full force. The Bank of England and the government have acted swiftly to mitigate the economic impact of the crisis. The BoE's liquidity provision helped stabilising financial markets and kept yields under control despite the massive increase in government borrowing that is expected. The government's job retention scheme is costly, but helps to keep workers tied to the labour market and bridge the income gap until the worst of the crisis is over.

However, just when confidence among households and businesses is about to recover and would be most needed to support the economic rebound, uncertainty around the UK's future relationship with its biggest trading partner has resurfaced. The current deadlock in trade negotiations with the EU weighs on the outlook and will hamper investment and spending. The fact that an extension of the transition period has been categorically ruled out by the UK government exacerbates the situation. More compromises on both sides would be needed as no one gains from a rise in trade frictions and unpredictability.

Sterling under pressure as Brexit risks resurface



Source: Bloomberg

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