Economic Research

WEEKLY ANALYSIS

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BOE reassures but will not rule out recession in the UK

Likely recession in H1. BOE lowers rates and increases asset purchases. Swift rebound of long-term rates. New opportunities in real estate and equities.

Key points

- Boris Johnson does a U-turn and gives up on his so-called herd immunity strategy
- U-turn in terms of economic policy: fiscal stimulus package
- BOE announces exceptional measures
- Two consecutive key rate cuts to 0.1%
- Additional 200 billion in asset purchases
- Leading indicators will not help assess the real risks of a recession
- Expected deterioration of household confidence
- Volatility affecting capital market too
- Rise in yields from 0.2% to 1% in only two weeks
- Low probability of recovery for the pound
- Opportunities in real estate and equities after adjustment of values of close to -40%

Boris Johnson does a U-turn and gives up on his so-called herd immunity strategy

After developing a unique strategy in contradiction with those implemented by all governments in the countries affected by the coronavirus, Prime Minister Boris Johnson has ended up siding with the experts.

For a few days, the Prime Minister presented a strategy for the UK that aimed to try out a "herd immunity" theory on the country's population. This worst-case theory could have led to contamination of 80% of the population, with the aim that the majority of British citizens would develop natural immunity in this context.

The logic of this approach was that, once a sufficient number of people had developed antibodies, the epidemic would stop. Scientific experts had estimated at around 250,000 the potential number of deaths if this policy was implemented, as the British healthcare system would likely have been completely overwhelmed. Fortunately for the British, Boris Johnson's policy to address the coronavirus epidemic in the UK did not stand for long against scientific analysis and the criticisms expressed in the last few days against this worst-case theory.

It is probably a report from the Imperial College of London, which was made public this week, highlighting the risk that over 500,000 deaths could occur in the country if a *laisser-faire* strategy was implemented with no measures taken against the spread of the virus, that drove the government to change strategy.

In the end, the United Kingdom joined the club of countries recommending that their population adopt measures in line with the gravity of the situation. For the moment though, no radical measures like those taken in most European countries have been announced, such as closures of schools, restaurants, bars and other public venues.

Considering the relative weakness of the healthcare system in the UK, Boris Johnson's U-turn is certainly welcome. Nevertheless, it is likely that the measures announced ultimately will be insufficient to allow the country to fight efficiently against the ongoing epidemic.

By international comparison, the UK has the lowest patient capacity when measured in terms of number of beds per 1,000 inhabitants. With only two beds available, the British ratio is inferior to that of Italy, Spain (3) and China (4).

It is far below the French (6) and German (8) ratios and six times below that of Japan and South Korea, which have ratios that exceed 12 beds per 1,000 inhabitants. The UK is thus likely to be more heavily affected than other European countries by the current coronavirus epidemic.

In terms of impact on economic growth, the current strategy may initially have more limited effects due to continued activity in most sectors. Services and consumption are thus likely to be only lightly affected, initially at least.

U-turn in terms of economic policy: stimulus package

Boris Johnson's U-turn with regards to managing the epidemic is not the only surprise, since he has also opted for a major change in economic policy in the face of the current crisis. The Prime Minister and his government have indeed turned things upside down by adopting an economic strategy that is contrary to their main budgetary austerity doctrine. The new Chancellor of the Exchequer, Rishi Sunak, who was only appointed a few weeks ago, announced a recovery plan of 30 billion pounds to support economic activity, which was already weak before the coronavirus outbreak.

Approximately 12 billion pounds will be disbursed to meet immediate needs resulting from the health crisis. A further 18 billion will be released to stimulate the economy through utility and infrastructure expenditure. Other measures, including loan guarantees of 330 billion pounds, i.e. 15% of the UK's GDP, and close to 20 billion pounds in tax cuts for companies this year have been announced.

After a decade of growth stimulus measures almost exclusively led by central banks, we are urgently rediscovering, in the face of the Covid-19 crisis, the merits of government fiscal stimulus actions and the necessity of supporting the actions of central banks, which are already very active, by adopting more direct support measures for the real economy.

BOE announces exceptional measures

We were expecting a drop in key rates from the Bank of England at the start of the year in the context of the UK's exit from the European Union, but ultimately, it is the urgency of the global health crisis that will have pushed the British institution to adjust its key rates more quickly, lowering them by 50 basis points, from 0.75% to 0.25%.

This first action by the BOE occurred before the regular meeting of the Monetary Policy Committee in order to support the UK's economy, which was already in sharp decline at the end of 2019 and is now severely threatened by the coronavirus. The BOE thus sought to reassure financial markets by reducing the UK's key rates to new lows.

Moreover, it has announced that it would ease solvency and ratio requirements for banks and create a new mechanism aimed at supporting SMEs. The bank has recognised that the coronavirus will raise significant issues in production and supply chains that will cause a likely slowdown of economic activity.

However, it also considers that these damaging disruptions will probably be temporary. One week later, the BOE has once again lowered its key rates from 0.25% to 0.1% and has announced it would increase its asset purchase programme from 200 billion pounds to 645 billion. These new funds will be used to repurchase government and corporate debt.

These last measures were taken during an extraordinary meeting of the Monetary Policy Committee on 19 March and are obviously aimed at reassuring all stakeholders of the UK economy that the central bank will do everything in its power to limit as much as possible the negative impact of the coronavirus on the UK's economic fabric.

Leading indicators will not help assess the real risks of a recession

The UK's latest GDP figures pointed to a growth rate of +0.1% over three months at the end of January 2020 and +0.6% yoy. The manufacturing sector dropped by -1.2% over three months, raising fears that the brief lull that had followed the election of Boris Johnson would be short-lived.

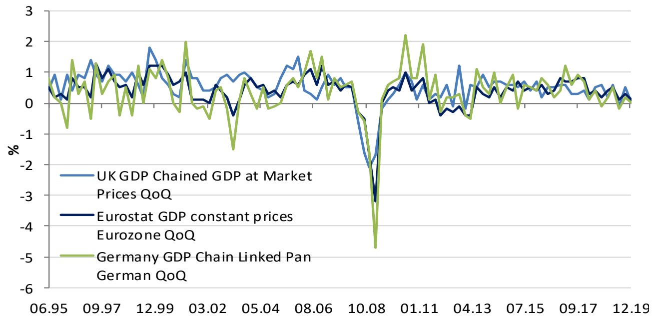
The economy was thus already in sharp decline and close to a recession before the coronavirus outbreak. Industrial production in January was once again negative over one month (-0.1%), posting a -2.9% drop over one year.

Furthermore, the weakness of the UK's economy was already in sharp contrast with the renewed vigour of the rising PMI indices at the end of December.

Indeed, the composite index bounced from 49.3 (December) to 53.3 in January, its highest level of confidence since October 2018, and remained robust (53) in February, despite the uncertainty and rising risks relating to the epidemic.

In the context of the particularly troubled last few weeks in financial terms, we believe that worries relating to developments in the health crisis that will affect the United Kingdom will trigger a sharp decline in leading indicators.

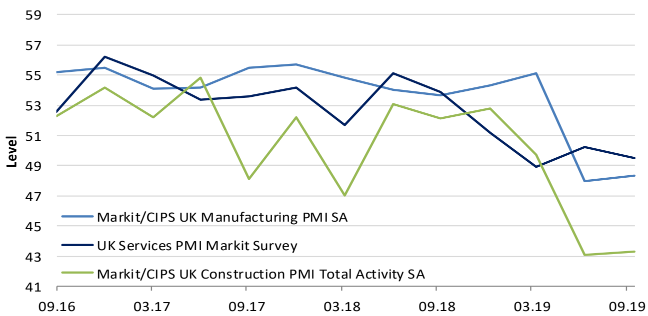
Quarterly GDP growth for the UK



Sources: Bloomberg, BearBull

Despite the support measures mentioned, PMI indices will likely drop below 50 and increase investors' risk perception for several months. We believe that the support measures announced are unlikely to be taken into account quickly in most usual sentiment measures.

Manufacturing, services & construction PMI



Sources: Bloomberg, BearBull

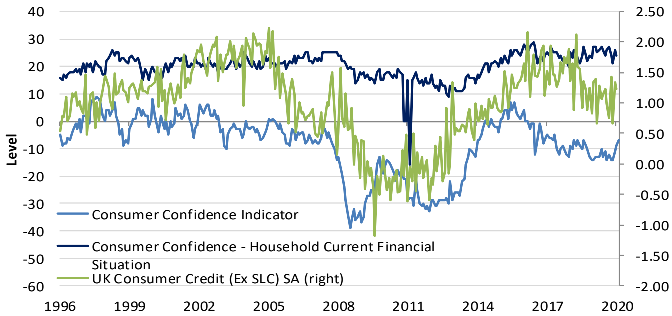
Leading indicators are unlikely to be good guides in seeking to assess the real risks for the British economy. This calls for caution in interpreting future signals, which will nevertheless undoubtedly be analysed by most observers as they were in the past.

Deterioration of household confidence

The confidence indicator, which had already reached a six-year low at the start of 2019, remained weak until November before the legislative elections.

Given a still solid employment market, this lack of confidence was mainly down to uncertainties relating to Brexit, which left observers in a "wait-and-see" situation.

Consumer confidence



Sources: Bloomberg, BearBull

At this time, the health crisis has not really exploded in the United Kingdom, but our expectations as to its evolution are rather pessimistic.

The low degree of preparedness of the healthcare system could exacerbate the crisis, which we believe will develop more deleterious effects on household confidence in the next few weeks.

This environment will not be conducive to consumption, investment and the real estate market. Given the absence of more radical measures such as schools and public spaces closing and confinement measures, the UK's economy may still show a few signs of resilience.

However, a rise in unemployment rates and a reduction in job creation will certainly go hand in hand with a new dip in sentiment.

Private consumption is likely to weaken and will not be mitigated by a rise in corporate expenditure and investment. Public spending is thus likely to be a supporting factor for GDP.

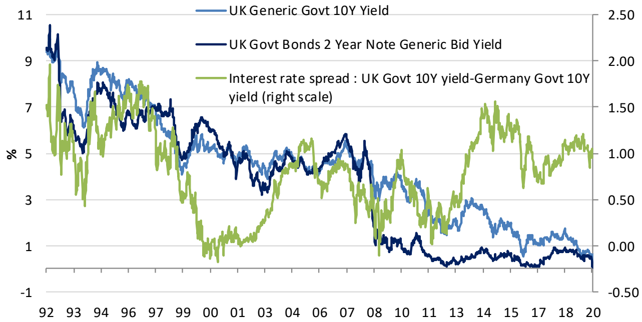
Volatility affecting capital market too

Uncertainties relating to the emergence in Europe of Covid-19 cases drove long-term rates downwards from mid-January before triggering a drastic drop in British Treasury yields of 0.6% on 21 February to 0.075% on 9 March.

The economic support actions announced by the BOE and the British government convinced some investors, while others demanded a higher yield to accommodate for the growing risks and rising government debt.

These realisations triggered one of the sharpest rebound in ten-year yields in pounds, which suddenly climbed in five trading sessions from 0.2% to over 1% on 19 March.

Two- and ten-year UK government rates



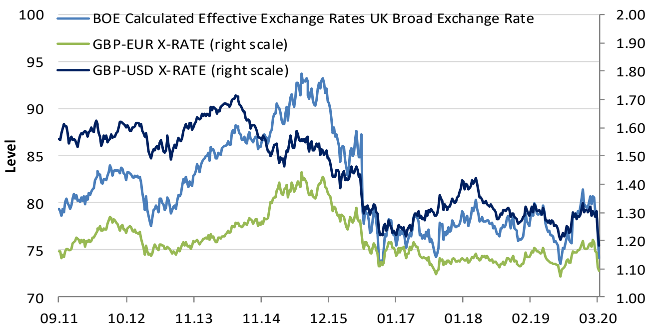
Sources: Bloomberg, BearBull

Nevertheless, the pound-sterling capital market is still rather unappealing to our mind due to yields that are still significantly lower than those of US dollar markets in particular. We believe that risks of holding bonds in pounds are sufficient in this context to avoid positioning in this market. In this uncertain environment, we recommend that international investors avoid any exposure to capital markets in pounds and to position themselves in other bond segments.

Low probability of recovery for the pound

We already mentioned it, but the pound will be influenced for a long time still by the UK's political situation and Brexit's final form. However, its -13% drop in the last two weeks of March rather seems to reflect the relative changes of prospects for the British economy.

Effective and dollar – euro exchange rates



Sources: Bloomberg, BearBull

We do not expect any quick recovery of the exchange rate in this context. However, we do expect the pound to stabilise above 1.10 against the euro.

Opportunities in real estate and equities

For a long time we recommended caution towards British equities and real estate investments due to the high level of uncertainty relating to Brexit, despite reasonable valuations.

In the current context of a probably temporary slowdown of the UK's economic activity, we believe that valuation corrections of more than -40% in real estate and -36% for the FTSE100 index are excessive and do not reflect the real medium-term prospects of these two asset classes.

UK securitised real estate & equities

Sources: Bloomberg, BearBull

We believe that the drops in valuation have clearly reduced positioning risks for long-term investors, and we now recommend a more positive and constructive strategy with regards to both securitised real estate and equities with a 12-month time horizon.

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