BearBull
Global Investments Group

17 June 2020

In April, UK sees sharpest drop in GDP (-20.4%) since 1703

Brutal economic shock in April. BOE must boost its action. Stability of the pound. Negative UK Treasury yields. FTSE100 benefits from favourable relative valuations.

Key points

- The UK's economy is headed for the worst economic recession in Europe
- Intense shock in April, the worst is probably over
- Exceptional governmental measures for a unique situation
- The BOE must go further to support the UK's economy
- Likely injections of an additional 100 billion
- Nothing to expect from leading indicators?
- First issuance of negative-yielding government bonds
- Stabilisation of the pound sterling
- Fundamentals are still in favour of British equities and real estate

The UK's economy is headed for the worst economic recession in Europe

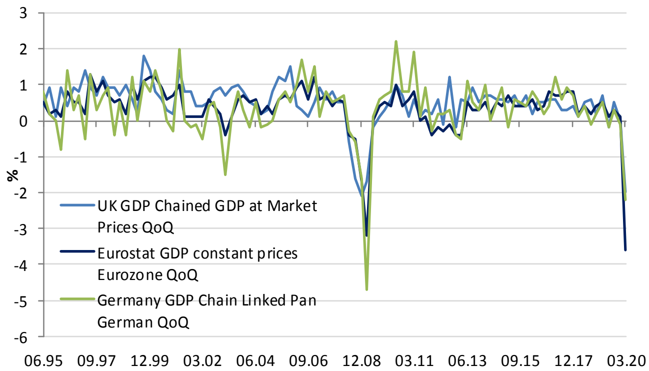
The UK's economy contracted by -20.4% in April, wiping out close to 20 years of GDP growth in a few weeks. The collapse is greater than estimated by the consensus (-18.7%). April was indeed the first month of confinement in the country, following Prime Minister Boris Johnson's decision to finally adopt measures to protect the UK population that were adapted to the health situation, after several weeks of damaging political procrastination.

These results are not surprising. Indeed, we mentioned in previous analyses that the UK could well be the most affected country in Europe due to its weaker intake and reaction capacity in the face of a deteriorating health situation in the country.

The UK has indeed been the hardest hit in Europe, recording the highest death rate (42,000). From an economic point of view, this result may well have a longer-lasting effect on consumer mindset and behaviour. Demand may indeed be affected and dampened for a longer period of time.

In this context, the OECD believes that the UK's economy may well be the most severely affected among the economies of industrialised countries, with a recession of -11% in 2020, which would be the sharpest economic contraction recorded in the country since 1709, i.e. more than 300 years ago.

Quarterly growth of UK GDP



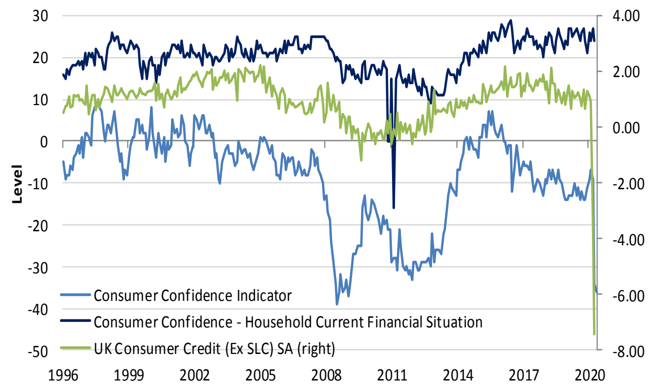
Sources: BearBull Global Investments Group Limited

The UK has thus been hit by one of the most severe health crises in Europe and one of the sharpest economic recessions in its history. In the current context, the issue of Brexit has been pushed into the background, although it is far from resolved. The likelihood of a no-deal Brexit before the end of the transition period in December has thus increased significantly. Discussions between Brussels and London are at a standstill due to the current crisis, and it is increasingly difficult to expect any quick and significant progress in this context. The UK's economy will have a hard time withstanding both a recession in 2020 and the shock of a brutal exit from the EU in 2021. The current situation thus poses a significant challenge for the Prime Minister as well as for the BOE, which is likely to further boost its action to support the economy.

Intense shock in April, the worst is probably over

The contraction in April (-20.4%) was caused by massive reductions in activity in most economic sectors. The food and hotel sectors posted the sharpest drop (-88.1%), followed by the construction sector, which also collapsed by -40.1%, a plunge barely superior to that of the leisure (-39.7%) and education (-33.6%) sectors. Industrial production logically collapsed by -20.3% over a month in this context and by -24.3% over a year. The situation is similar for manufacturing output, down by -24.3% and -28.5%. The situation is even more dramatic in the construction industry, which suffered a -40.1% correction over a month after a -5.9% drop in March and -44% versus last year. Retail sales logically also suffered, dropping by -18.1% in April, hand in hand with the confidence of consumers, who are increasingly worried about losing their jobs when the support measures eventually end.

Consumer confidence



Sources: BearBull Global Investments Group Limited

The situation in the employment market in April had positively surprised observers with a surprise rise in employment over three months that contradicted projected job losses of 110,000 jobs. These figures were surprising and have since been corrected with the loss of 429,000 jobs in April and the announcement in June of a very sharp increase in unemployment benefit claims (+1,500,000) during the confinement period, with total claims now in excess of 3,000,000. This probably masks a situation that is undoubtedly worse, as will no doubt become clear in the next few months. The unemployment rate, which was expected to rise by 4.7%, finally remained stable at 3.9%. Moreover, wage growth in the private sector was negative in April.

Exceptional governmental measures for a unique situation

Boris Johnson's government finally also adopted economic support measures, which were implemented in the last quarter as the seriousness of the health and economic situation became clear. A first stimulus package of GBP 30 billion aiming to support economic activity, already weakened before the outbreak of the Covid-19 crisis, was accompanied by other measures, including loan guarantees in the amount of GBP 330 billion, i.e. 15% of the UK's GDP; in addition, close to GBP 20 billion in corporate tax cuts were announced so far this year. In the UK as in most countries, after a decade of measures to support growth almost exclusively carried out by central banks, the merits of fiscal stimulus measures in the face of the Covid-19 crisis and the necessity of supporting the efforts of the already very active central banks by adopting more direct support measures for the real economy were suddenly made clear.

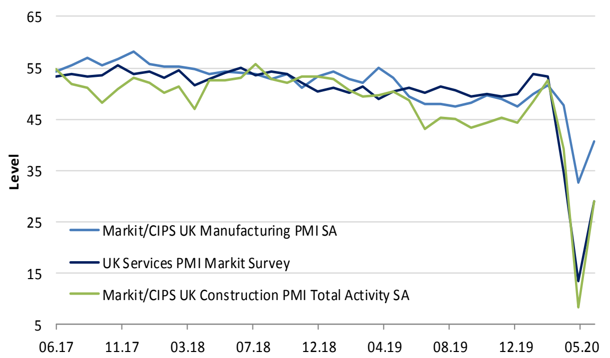
The BOE must go further to support the UK's economy

We expected the BOE to cut rates at the start of the year in the context of Brexit, but it is the urgency of the global health crisis that drove the British institution to adjust its key rates more quickly, lowering them by 50 base points, from 0.75% to 0.25%, and then to 0.1%. The BOE now has little room for manoeuvre and will likely wait before lowering its key rates to zero. Nevertheless, it could announce a increase in its asset purchase programme more quickly to act across the whole yield curve. The BOE is thus likely to announce a new, additional bond-buying programme that could amount to GBP 100 billion, which would bring its government bond and corporate debt purchase programme to 745 billion.

Nothing to expect from leading indicators?

PMI leading indicators rebounded sharply in May from their April lows, probably suggesting that April was the worst month in terms of GDP growth in 2020. The manufacturing PMI index reached a low point of 32.6 and improved significantly in May (40.7), much like other indicators, e.g. the services PMI (13.4 to 29), the construction PMI (8.2 to 29.4) and consequently, the composite PMI (13.8 to 30). The worst of the recession is very likely over, although these indicators' respective levels do not point to a future recovery.

Manufacturing, services & construction PMIs



Sources: BearBull Global Investments Group Limited

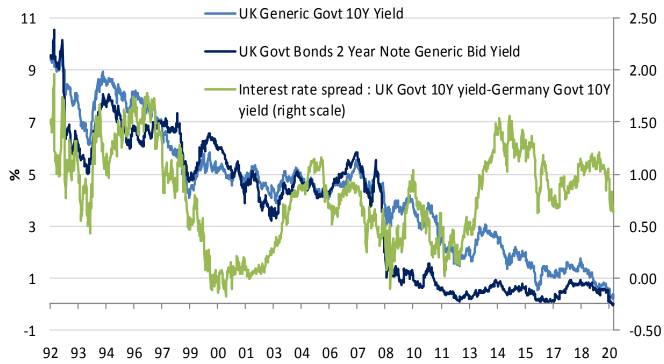
The exceptional support measures put in place by the government and the central bank have not yet developed any major effects on the confidence of economic agents. The lockdown has gradually started to ease, but a few months or even a few quarters will be needed before the situation truly returns to normal. GDP growth in Q2 will remain negative, and no recovery is expected before the third quarter.

First issuance of negative-yielding government bonds

UK inflation dropped to its lowest level in four years in May. The consumer price index for the month of May posted its weakest 12-month progression (+0.5). The drop in energy prices was a determining factor. This element, which occurred in the context of a sharp contraction of GDP, will certainly give the BOE a little more leeway. In this economic environment, the British government was able to issue its first negative-yielding bond in May. At the height of the pandemic, the government issued GBP 3.8 billion in short-term bonds (2023) at a yield of -0.003%. The UK thus joins the closed circle of countries that can issue negative-yielding debt, this despite the high degree of uncertainty regarding the country's political and economic future. Given the magnitude of the budget deficit following government interventions in the fight against the devastating economic effects of Covid-19, the government is forced to borrow to finance its rising deficits.

The UK government's ten-year yields have remained relatively stable and close to zero for three months, except for a short stressful period in March, which was marked by some very high volatility on sterling yields, temporarily bouncing from 0.2% to 0.8% before stabilising once again at 0.2% in June.

UK government 10-yr & 2-yr rates



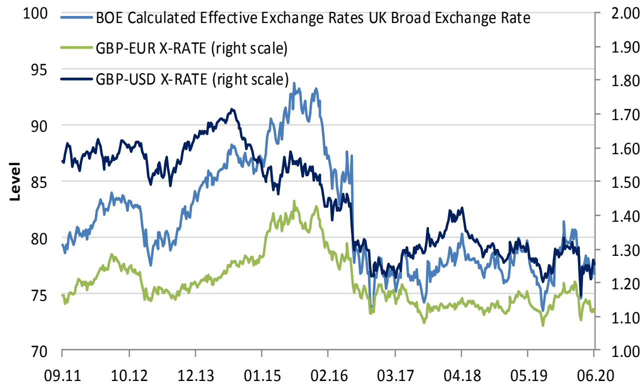
Sources: BearBull Global Investments Group Limited

At these levels, we believe capital markets in British pounds are still rather unattractive. The risks of holding GBP bonds seem sufficiently significant in this context to avoid taking positions in this market. In this uncertain context, we recommend international investors avoid any exposure to capital markets in GBP and position themselves in other bond segments.

Stabilisation of the pound sterling

The GBP to USD exchange rate has not seemed particularly penalised by the above-mentioned drop in yields. In the last four weeks, the pound has even appreciated temporarily by +5% against the US dollar, remaining stable against the euro and the Swiss franc. The UK's economy has nevertheless been heavily hit by the current crisis, and prospects of a recovery are no better than in other countries. The British pound is not backed by a favourable economic environment and is thus likely to be affected by the ongoing risks of a no-deal Brexit.

Effective, dollar, and euro exchange rates



Sources: BearBull Global Investments Group Limited

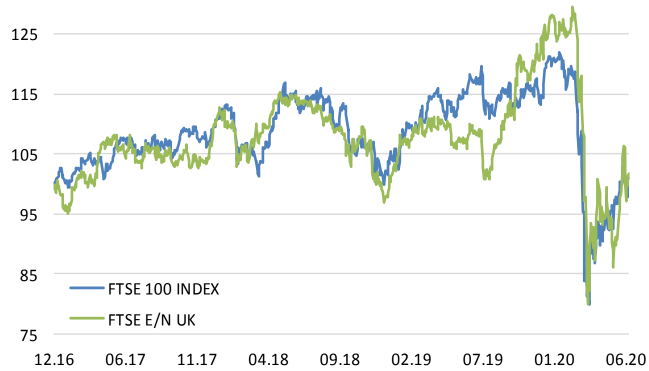
We do not expect any significant or quick recovery in the exchange rate in this context and anticipate a stabilisation of the pound above 1.10 against the euro and 1.20 against the Swiss franc.

Fundamentals still in favour of British equities and real estate

Since our last recommendation at the end of March to once again acquire positions in the British real estate market and purchase FTSE100 stocks, as they were too heavily penalised by the stock market panic relating to Covid-19, a price recovery of approximately +30% occurred in these two asset classes. From a relative point of view, these price recoveries were a little less significant than in other regions. The two asset classes thus still have some room for growth.

The FTSE100 index is now being traded at a little over 13x expected 2021 earnings and 19x 2020 earnings. In Europe, equity market valuations are a little more generous, which is likely to favour a positive relative performance of British stocks. The dividend yield of 4.45% is also significantly higher than in other European markets, where dividends lie a little under 3%. In this context, we believe that British equities may still garner investor interest for stocks with higher yields and more reasonable valuations.

UK securitised real estate and equities



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