BearBull
Global Investments Group

Economic Research
WEEKLY ANALYSIS

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A difficult autumn for the United Kingdom with no deal Brexit in sight

Disappointing GDP growth. Greater economic risks in Q4. The BoE is considering applying negative rates. Long rates are close to zero. Negative prospects for the pound and equities.

Key Points

- A no deal Brexit is on the horizon, the worst-case scenario is becoming increasingly likely
- 1 trillion euros' worth of trade will be subject to new duties
- Disappointing growth in the 3rd quarter
- 4th quarter GDP looks to be shakier than it seems
- Confidence is yet to return
- Leading indicators are misleadingly optimistic
- The BoE is preparing to cut its key rates
- Long rates remain close to zero
- Negative prospects for sterling
- British equities are paying the price of chaotic politics

A no deal Brexit is on the horizon, with the worst-case scenario becoming increasingly likely

The next few weeks will be crucial in hoping for the United Kingdom and the European Union to reach a last-minute deal. Although Prime Minister Boris Johnson set himself a 15th October deadline to complete negotiations with the EU, the European Council has still left the door open to discussions continuing for a few extra weeks until mid-November.

The United Kingdom left the EU on 31st January 2020, with EU rules applying until 31st December 2020.

The aim of this transition period was to enable both parties to negotiate the terms of a trade agreement which would set out the rules for their future relations. A few weeks shy of the deadline, the EU is clearly exasperated by the UK's strategy, although despite everything, they very likely want to achieve a positive outcome to the current clash.

On 1st October, the EU initiated legal proceedings against the United Kingdom, after Westminster cast doubt on the EU-UK Withdrawal Agreement. They consider that the British Internal Market Bill passed by Members of Parliament knowingly violated the terms of the Brexit agreements in force, and in doing so violated international law.

The leaders of the 27 member states of the EU will certainly want to take a firm line and should soon announce that the progress made in discussions with the United Kingdom is insufficient to reach a deal. As such, we could soon be facing no deal at a time when the economic situation is already very tricky. Without an agreement, customs duties will be brought back and will apply to all trade between the two parties, valued at 1 trillion euros a year. The EU will wait and see how the British position develops on the three key issues: governance issues, guarantees of fair rules on competition, and fisheries rights.

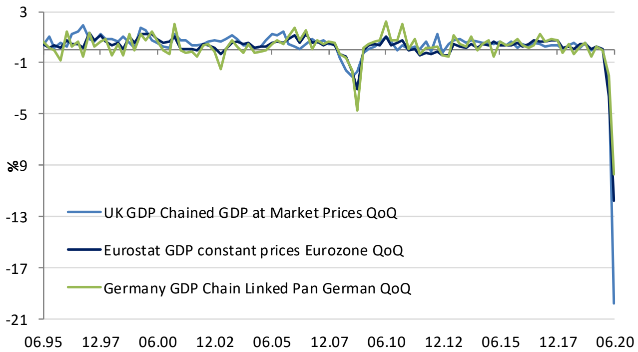
Disappointing growth in the 3rd quarter

The United Kingdom posted the worst economic contraction in its history in the 2nd quarter, with a -20% drop in GDP.

However, hopes of a 3rd quarter recovery were propped up by more optimistic leading indicators in June and July. Although July gave forecasters some cause for comfort, with +6.4% monthly GDP growth, August quickly dampened forecasts of a robust recovery in the 3rd quarter. Indeed, the expected economic recovery tailed off sharply in August, with just +2.1% growth over the month- barely half what forecasters had predicted.

The slowdown came just as the government and the central bank were undertaking an economic support process, which was supposed to enable a more robust recovery.

UK Quarterly GDP Growth



Sources: BearBull Global Investments Group Limited

The situation seen in August is worrying and shows that monetary policy support and the substantial cuts to VAT have given the hotel, bar, and restaurant sectors little help in returning to growth, right when the health crisis was at its lowest ebb since the start of the pandemic. The manufacturing and construction sectors showed stability more than any real growth.

4th quarter GDP looks to be shakier than it seems

Recent statistics seem to once again point to the slowdown continuing in September. Industrial production trod water again in August after having bounced back considerably in May and June. The construction sector is on the same track, and is losing steam, with just +3% growth over the period. With the current resurgence of Covid-19 cases and new restrictions placed on these sectors, it is likely that economic growth will be hobbled even further over the coming weeks. Equally, the British government recently indicated that it had not ruled out the possibility of another national lockdown, with cases having crossed the 500,000 mark and curfew measures in place in certain areas.

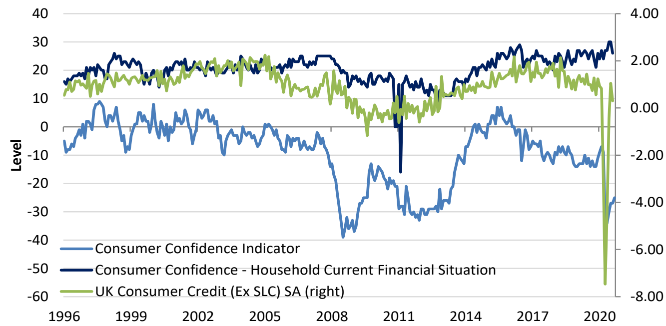
In this specific context, the power struggle surrounding Brexit raises new questions on the impact of no deal on the British economy. The prospect of a no deal Brexit before the end of the transition period in December is significantly increasing the risk of the recovery collapsing again at the end of 2020 and in 2021. However, although this scenario is becoming more likely, it is still not investors' main scenario.

Consensus growth forecasts still stand at +2.7% for the 4th quarter and -10% for the whole of 2020. They could be cut back significantly if no improvement is seen on Brexit and the pandemic.

Confidence is yet to return

Consumer confidence seems to be recovering gradually, but remains extremely low, well under the average for the last five years. Households are still more worried about losing their jobs once emergency support measures are no longer in place, and naturally are concerned by the 4.5% increase in unemployment in August. There were more dismissals in August, with 153,000 job losses, which is five times the consensus estimate. Nearly 500,000 jobs have been lost since February.

Consumer Confidence



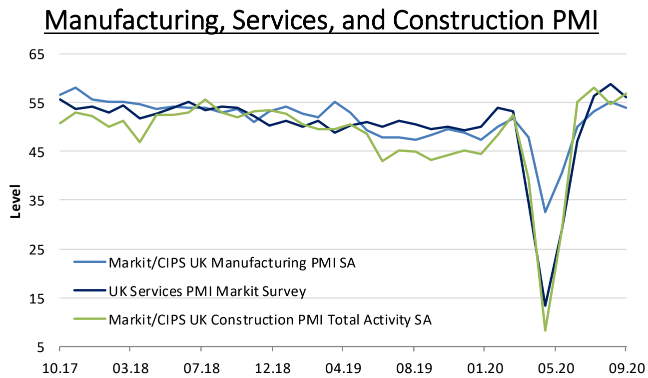
Sources: BearBull Global Investments Group Limited

At the end of October, the government will certainly change the criteria for accessing help and will likely provide more targeted support. The jobs market will then see significant adjustments which could clearly be exacerbated by a no deal Brexit. For a few weeks, pressure has been growing for new economic support measures to be adopted.

The BoE will also certainly have to act to support the economy, as well as preparing for potentially more assertive action if no deal Brexit becomes the main scenario in the 4th quarter.

Leading indicators are misleadingly optimistic

Leading PMI indicators have bounced back considerably from their lowest points in April, suggesting that April was the worst month for GDP in 2020. The manufacturing PMI index hit a low point of 32.6, but was back well above 50 in September (54.1) at its highest point for the last few years. The same is true of the services PMI. It is showing solid optimism and bounced back from 13.4 to 56.1, whereas the construction PMI took off from 8.2 to 56.8. These impressive leaps would suggest a rather robust economic recovery in normal times. However, we doubt that in the current context they point to a real recovery. We therefore do not think that the theoretical optimism shown by these indicators is reliable.



Sources: BearBull Global Investments Group Limited

The economic and political situation in the United Kingdom is still extremely uncertain as it currently stands, even if the EU and the United Kingdom reach a deal. If, however, a no deal Brexit happens, it is highly likely the economy will collapse again in the first quarter 2021.

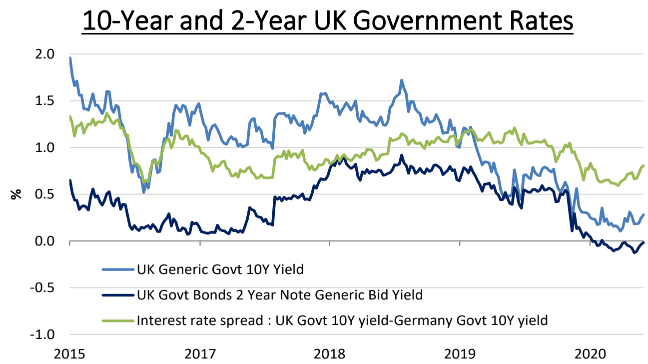
The BoE is preparing to cut its key rates

In light of the exceptional difficulties the British economy is facing and the risk of a no deal Brexit, the Bank of England is wondering about and preparing to cut key rates and apply negative rates. It had reduced its rates from 0.25% to 0.1% during the coronavirus crisis in March and since then has only had limited room for manoeuvre. Although this measure is considered a last resort, the BoE now seems to be seriously considering it, particularly if there is a no deal Brexit.

The Bank might announce that it is stepping up its asset purchase programme earlier in order to intervene across the whole of the interest rate curve. As such, the BoE should announce an additional bond purchase programme, which could amount to 100 billion GBP.

Long rates remain close to zero

Since May, the British government has been able to borrow on a short-term basis due to negative yield. The yield on three-year sovereign bonds has remained negative since then, standing at between -0.05% and -0.1%. Ten-year British government yields have remained relatively stable, at close to zero, for the last three months, with the exception of a short period of stress in March. It saw very high volatility on yields in pounds sterling, which temporarily leapt from 0.2% to 0.8%, before stabilising at 0.2% again in June.



Sources: BearBull Global Investments Group Limited

At these levels, the capital market in sterling still does not seem very attractive. We believe that the risks associated with holding bonds in pounds sterling are high enough in the current context to avoiding this market.

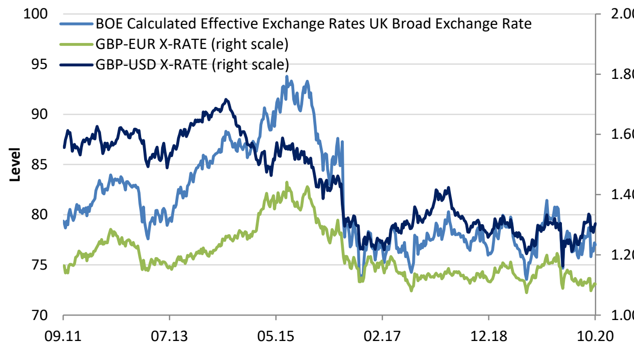
In this very uncertain context, we recommend international investors avoid any exposure to the capital market in GBP and invest in other bond segments.

Negative prospects for sterling

The USD/GBP exchange rate stabilised somewhat over the last quarter. Overall, it has been stable since the start of the year, after significant fluctuations when the coronavirus crisis broke out. Since then, the fall in yields discussed above has only slightly affected the USD/GBP exchange rate. Sterling is not being propped up by a favourable economic environment. On the contrary, it should be further punished by the risk of a no deal Brexit. However, it has remained relatively stable against the Euro and the Swiss franc since the end of June.

The introduction of negative key rates, a more severe dip in the British economy, and the prospect of a no deal Brexit should, however, put pressure on the pound over the coming months.

Effective Exchange Rate USD-Euro



Sources: BearBull Global Investments Group Limited

British equities are paying the price of chaotic politics

Financial markets are wary of the effects of a second potential lockdown in the United Kingdom. It could put a question mark over the fragile economic recovery that was taking shape after GDP's historic nosedive in the 2nd quarter.

Since our last recommendation at the end of March to reinvest in the equity market, which had been punished too severely by the stock market panic linked to Covid-19, there had been a +30% recovery in prices.

Since then, prices have regularly crumbled away, and British equities have posted one of the worst performances of the year among developed markets; they are still down nearly -27% as it currently stands.

In this environment, the FTSE 100 Index is currently trading at just over 13 x expected profits for 2021, and at 19 x 2020 profits, which is considerably lower than the valuation levels of other European markets.

However, bearing in mind the higher risk of the economy shrinking and sterling falling, these differentials are not great enough to justify overweighted exposure to British assets, which are still under pressure from the prospect of a no deal Brexit. We recommend relatively low allocation levels currently.

British Equities

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