Economic Research

WEEKLY ANALYSIS

Alain Freymond
Partner & CIO

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Did the UK see the worst of it in January ?

UK GDP contracted by -2.9% in January. Exports to the EU plunged by -40.7%. Economic recovery postponed to Q2. Rising long-term interest rates and the prospect of an end to the lockdown support the pound.

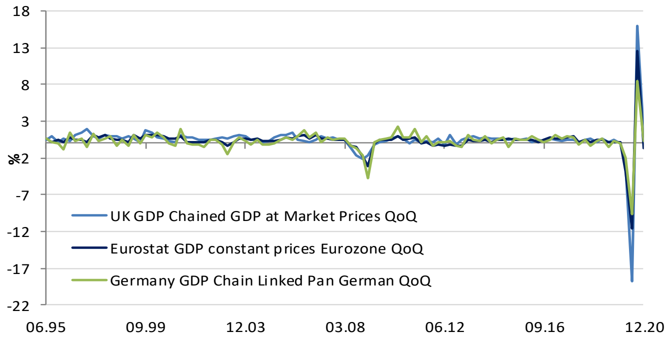
Key points

- UK GDP shrinks by -2.9% in January
- Historic fall in British exports
- Border controls and breach of protocol
- Consumption will soon benefit from the end of the lockdown
- Trend reversal in interest rate markets
- BOE likely to maintain a stable monetary policy
- Sterling reacts to the end of the lockdown
- UK equities benefit from a 20% risk premium

UK GDP shrinks by -2.9% in January

The UK's first post-Brexit GDP figures in January 2021 showed a contraction of -2.9% and a three-month decline of -1.7%. Compared to December's economic performance (+1.2%), the UK economy has kicked off the post-Brexit era with clearly negative though not unexpected results. The UK's economy stumbled in January as a result of the introduction of health measures, which had a negative impact on the consumption of goods and services, and of the sharp drop in activity in the manufacturing sector (-2.3%) and the collapse of exports. The UK ended 2020 with the worst economic performance of any European country or G7 member and started the year with a worryingly negative performance. However, the outlook for the year as a whole remains rather positive at the start of 2021. Although GDP will probably fall by -3.5% in Q1, growth estimates for the full year are of +4.7% on average. The economy is thus expected to start recovering already in Q2, which could potentially see an upturn of +4.8%. In January, the construction sector recovered somewhat (+0.9%) after a decline in December, due in particular to a +3.1% increase in infrastructure spending.

Quarterly GDP growth – UK



Sources: Bloomberg, BearBull

Historic fall in British exports

UK exports to the euro area fell by -40.7% in January 2021 over one month and by more than -60% for food exports, and for fish in particular (-83%). Total exports plunged by -19.3% overall, costing UK exporters over €6 billion in value. The expected shock resulting from leaving the EU has not been long in coming, as Brexit is already affecting Britain's foreign trade significantly, even in times of lockdown and economic contraction. The UK's GDP contracted by -2.9% in January after rising by +1.2% in December 2020. This historic fall in exports was accompanied by a notable -21.6% fall in imports, linked unsurprisingly to the health situation prevailing in the country in January. This collapse is also historical and probably induced by the complexity of the administrative rules to be followed as well as by added costs and taxes weighing on trade. The comparison with the evolution of trade in Q4 is brutal. British exports were still stable (-0.1%), while imports grew by +8.9%, supported by the precautionary demand of British households and businesses.These initial post-Brexit findings are unlikely to be temporary despite the forthcoming end of the lockdown, whose effects on foreign trade are likely to remain limited.

Border controls and breach of protocol

However, the UK has shown its willingness to support its businesses by unilaterally postponing for six months the implementation of new customs measures and procedures for certain imports. Border controls will therefore certainly be carried out in very different ways on either side of the Channel, as the European authorities have decided to implement customs controls at the borders immediately. British importers will therefore have more time to adapt to the consequences of Brexit. However, while this decision seemed indispensable for British importers, it will not be without consequences for political relations with the EU. Boris Johnson's government has already incurred the wrath of the EU by extending the grace period for controls on trade in goods with Northern Ireland. The EU is once again losing confidence in the good faith of the British government and is not hesitating to initiate proceedings against the UK, which clearly seems to be taking the political risk of not respecting an essential point in the withdrawal agreement negotiated with Brussels. A new page is thus being written in the UK's tumultuous relations with the EU, which accuses London of not respecting the rules of the treaty. The latter provided for the establishment of customs controls in Northern Ireland in order to protect the European single market. A letter of formal notice has therefore been sent to the British government, which is unlikely to pay much attention to the EU's reminders and will certainly remain firm in its position – a position which, in its view, is aimed solely and simply at temporarily managing the consequences of Brexit as well as possible. Barely two months after the UK's exit from the EU, the situation is already getting heated between the parties, who are unhesitatingly heading down the path of an almost inevitable and foretold legal dispute. The worst is never certain, so let's hope that the EU and the UK will be able to be creative and resolve their differences, similarly to the agreement reached with Norway today on fisheries.

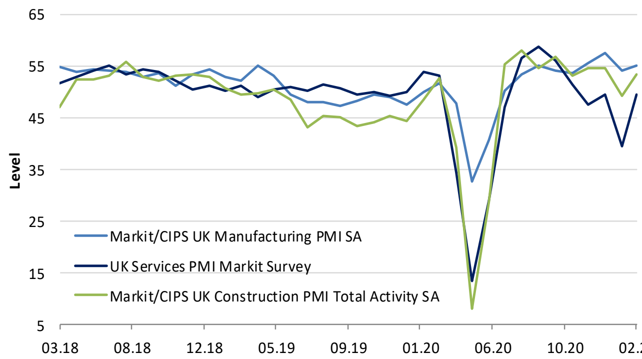
The end of the lockdown is on the horizon

In 2020, the UK had one of the worst records of any Western country involved in the fight against the pandemic before launching a massive and rapid vaccination campaign that now places it among the best performers. Having already injected at least a first dose into 24.8 million people, or just under 40% of its population, the UK is one of the most active and effective countries in implementing its vaccination policy. Even though less than 2 million people have received their second dose to date, Johnson's government seems to be delivering on its commitments in contrast to the organisational and logistical difficulties encountered in other European countries. The success of the vaccination campaign will certainly enable the UK to proceed more quickly with a gradual end to the lockdown, which is essential for the economic recovery that is anticipated more than ever following the initial post-Brexit GDP contraction shock in January 2021.

Leading indicators still relatively mixed

The services PMI already reflected the uncertainty caused by Brexit by slipping below the theoretical growth threshold of 50 at the end of the year, while the manufacturing PMI was still benefiting from a better outlook supported by a weaker pound. The latest PMI releases for February are still broadly below the growth threshold, with the composite index showing a slight drop from 49.8 to 49.6. The services PMI also slipped during the lockdown from 49.7 to 49.5. Only the manufacturing PMI seems to be showing increasing optimism by strengthening from 54.9 to 55.1. Levels in the construction sector remain comfortable thanks to a further significant rise from 49.2 to 53.3. Sentiment in this segment is supported by strong monthly figures showing a +0.9% rise in construction. House prices regained positive momentum in January (+0.7%) after declining for several months, which pushed price growth to +6.9% year-on-year. The value of UK real estate assets thus appears to be holding up well and may offer some prospects in the current environment of economic adjustment to this new post-Brexit era.

PMI indicators (manufacturing, services, construction)

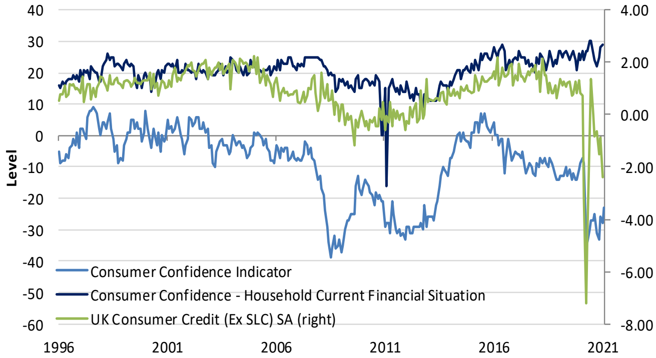


Sources: Bloomberg, BearBull

Consumption will soon benefit from the end of the lockdown

Household consumption is still largely held back by health measures and thus showed a rather massive decline in retail sales of -8.2% in January over one month and -5.9% over one year. The gradual end of the lockdown is expected to restore momentum to this sector, whose confidence measure improved again in February while still remaining clearly pessimistic. Private consumption, which declined by -0.2% in Q4, is likely to pick up in March and gradually strengthen as the economy opens up. However, the very significant rise in the unemployment rate during the pandemic shows no sign of reversing. The unemployment rate is now back above 5%.

Household confidence



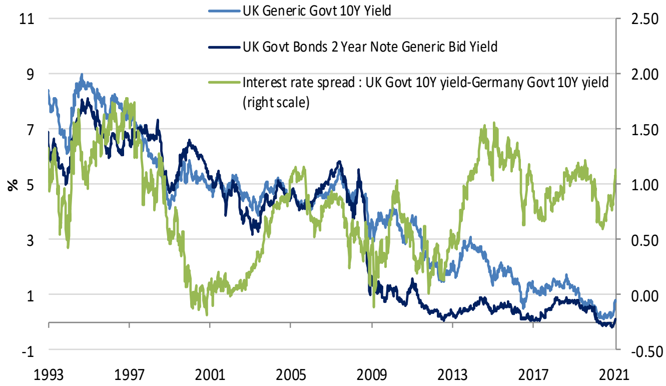
Sources: Bloomberg, BearBull

Trend reversal in interest rate markets

Long-term sterling rates have also risen in recent months in a general trend that has affected most international bond markets. In the UK, hopes of an imminent economic recovery also supported a very significant adjustment in bond yields. Indeed, they adjusted very quickly back to the level they were at before the health crisis broke out. Ten-year UK government yields jumped from 0.2% to 0.8%, while inflation was negative in January (-0.2%) and remained under 1% yoy at the beginning of the year. Despite the likely weakness in Q1 GDP, expectations are now focusing on the year as a whole, while the favourable economic outlook also supports revised inflation expectations. We had expected a reversal in the early months of the year that would mark the likely turning point for UK rates, and the recent shift confirms this. The increase in positive sterling bond yields places the UK bond market among those offering attractive relative returns compared to the European, Japanese and Swiss markets.

The reconstitution of the risk premium is a favourable factor, but the attractiveness of holding sterling bonds still seems insufficient to us.

Government rates (2yr-10yr)



Sources: Bloomberg, BearBull

BOE likely to maintain a stable monetary policy

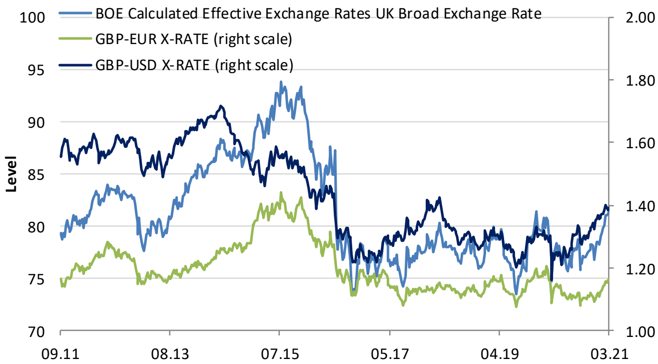
The UK central bank does not have much leeway in setting monetary policy in the current environment. Key rates are currently still 0.1%, and despite speculation regarding a possible drop below zero, the BOE does not seem ready to adopt such a policy. Negative rates will therefore not be an option at least until the summer, and the BOE's ability to manage the yield curve will thus be limited for a few more month to the sole implementation of its asset purchase programme. The British central bank is likely to maintain its action without necessarily reinforcing or accelerating it, contrary to the change of strategy adopted by the ECB. The current view of the BOE governors is more optimistic and is based on the fact that the current rise in bond yields is more suggestive of a strengthening economic outlook than a threat to growth. Inflationary pressures in the UK also appear to be sufficient to justify maintaining the status quo on monetary policy. The BOE is therefore not expected to change its asset purchases and will continue its programme at the current rate of GBP 4.4 billion per week.

Sterling reacts to the end of the lockdown

Boosted by hopes that the lockdown in the UK will be lifted more quickly than in the Eurozone in particular, the pound has appreciated quite significantly against the euro and the dollar in recent weeks. The economic outlook has certainly appeared more favourable to investors in the recent context of a clear divergence in the management of the health crisis between the UK and Eurozone countries.

The new lockdown in Italy and the likelihood of a new lockdown in the Ile de France region, for example, are pushing back the prospect of a Eurozone recovery and allowing the exchange rate to approach the level of 0.85 pound to the euro, a support level that has been tested several times over the last five years. However, Brexit will pose significant challenges to the UK's economy that are unlikely to be easily overcome in the coming months and will not simply be eclipsed by a recovery that is likely to come sooner in the UK than in the EU.

Pound effective exchange rates



Sources: Bloomberg, BearBull

The rise in ten-year UK government yields, which we had estimated as likely in Q1 2021 in our previous analyses, essentially manifested itself at the beginning of the year with an increase from 0.2% on 31 December 2020 to 0.8% in mid-March. This rise in 10-year sterling yields has caused spreads over European yields to widen sharply due to the more modest rise of around 0.2% in German Bund yields in euros. The increase in the risk premium from +0.4% to +1.2% was therefore logically a factor supporting investor interest in pound investments offering such a positive yield differential. On the other hand, the likelihood of an end to the lockdown may also push back the threat of a decision by the BOE to adopt negative policy rates. In this context, the pound sterling is still likely to remain within the 0.85-0.925 band established since the June 2016 vote.

The potential for appreciation is therefore limited, also taking into account the fact that the British currency would be a likely adjustment variable in the event of a sustained post-Brexit economic shock in line with the GDP figures already published for January (-2.9%).

UK equities enjoy a 20% risk premium

The UK equity market has still not benefitted from positive momentum and continues to lag most other European markets in 2021 as it did throughout 2020. The FTSE 100 index's rise of around +5% in local currency in the first few weeks is well below that of European equities (+8%) in euros. UK stocks are still suffering from Brexit-related uncertainty. The FTSE 100 index is still trading at just over 14x expected earnings for 2021 and thus benefits from a favourable risk premium of around 20% compared to the Eurostoxx 50 (18x). This valuation gap is likely to be favourable, but the composition of the UK stock market likely still acts as a brake to the adjustment of UK stock prices and valuations.

UK equities and securitised real estate

Sources: Bloomberg, BearBull

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BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae