Economic update
First quarter 2020

This report has been prepared from information available as at 30 January 2020.
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Key points

- Prior to the coronavirus outbreak (which poses some downside risks to the forecasts set out here) there were signs of stabilisation in the global economy. Confidence has been buoyed by the signing of a preliminary trade agreement between the USA and China, and by the clear-cut result of the UK's general election in December, while the global manufacturing sector appears to have bottomed out.

- But pulling the global economy out of its malaise will take time, with GDP growth expected to be very similar next year to this year. Central banks have limited monetary firepower left, and some of the adverse consequences of negative interest rates are receiving more attention. Some governments will help with modest fiscal stimulus programmes, but these are unlikely to make a material difference.

- In the UK, the orderly exit from the EU heralds an 11-month transition period during which the future relationship with the EU will be negotiated. The most likely outcome is that a basic trade agreement will be concluded during the course of this year, though there is still a risk that no agreement is reached, which would mean that UK trade with the EU would shift to World Trade Organization terms from the start of next year.

- Confidence has revived, among both businesses and households, since the General election. This will eventually be reflected in 'hard' economic data, with particular scope for a strengthening of consumer expenditure. But GDP growth this year is only expected to amount to an anaemic 1.1%, with the running down of inventories and tougher conditions for exporters acting as drags.

- With the annual rate of inflation set to remain below 2% for the next two years, the Bank of England is expected to cut UK Bank Rate by 25 basis points in May. Before then, the Budget on 11th March will flesh out the Government's new fiscal framework and set in motion an increase in infrastructure spending aimed at a regional 'levelling up' in the north of England and the midlands.

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The global economy: the bottom of the cycle

The outbreak of coronavirus (formally named 2019-hCoV) in China means that the forecasts presented in this update are subject to downside risks. It is too soon to know how widely it will spread or how long it will take to get the outbreak under control. We do know, however, that it is highly infectious, with each person who catches it passing it on to between two and four others. This compares with a spread rate of about 1.4 for winter flu.

The initial outbreak has occurred in China, but even if it is largely confined within that country there will still be negative effects for other economies, especially in the luxury goods, tourism, and airlines sectors. It is estimated, for instance, that Chinese buyers now account for around a third of the world's purchases of luxury goods, with much of the retailing taking place outside of China. As a rough rule of thumb, a one percentage point slowing in China's growth rate would be expected to shave 0.1 percentage points off growth in the Euro Area, with similar figures for other advanced economies. Should the virus take root in other countries, then the prognosis for the global economy will, clearly, be more serious.

Stuck in a rut

The closing weeks of 2019 brought some good news for the global economy. The various Purchasing Managers' Index (PMI) surveys for November and December suggest that the painful downswing in the manufacturing sector has finally hit bottom. And on 14th December the USA and China announced that the two countries had reached agreement on a so-called 'Phase One' trade deal.

It's important not to get carried away, though. Reaching the trough of the present economic downswing is good news, but it doesn't automatically follow that the coming upswing will be either long or strong. Indeed, if trade and other tensions between the world's largest economies are not contained, it could become derailed. But these positive developments, together with a resolution of the Brexit crisis in the UK, meant that financial markets and economic policymakers ended 2019 in more sanguine moods than they had started the year. The skies may not have cleared, but some of the storm clouds have lifted.

The upshot is that there have been few revisions to our growth forecasts since our previous Update, which was released last November. But at least the process of creeping downgrades from one quarter to the next has now run its course. Across the globe, GDP is expected to expand by an anaemic 2.5% in 2020, and by 2.6% in the following year. This means that the global growth rate will be almost identical during the three years from 2019 to 2021.

HSBC global growth forecasts for 2020 and 2021 (compared to our previous forecast)

	2019 forecast		**2020 forecast**		**2021 forecast**	
	Latest	(Previous)	Latest	(Previous)	Latest	(Previous)
World	2.6	(2.6)	2.5	(2.5)	2.6	(2.6)
USA	2.3	(2.3)	1.7	(1.7)	1.6	(1.6)
China	6.2	(6.2)	5.8	(5.8)	5.8	(5.8)
Japan	0.9	(0.9)	0.3	(-0.1)	0.8	(0.7)
India	4.9	(5.9)	5.9	(6.5)	6.3	(6.5)
Eurozone	1.2	(1.0)	0.7	(0.7)	1.0	(1.0)
UK	1.2	(1.1)	1.1	(1.0)	1.4	(1.4)
Russia	1.0	(1.0)	1.7	(1.7)	2.1	(2.1)
Brazil	1.0	(1.0)	2.1	(2.1)	2.3	(2.3)

Source: HSBC Global Research (*Global Economics*, Q1 2020)

This is thin gruel, representing a slowdown of around one percentage point from the best year (in 2017) of the previous upswing. But no major economy is expected to fall into recession during the next two years, though there are several, including Japan, Italy, and Germany, where growth is not forecast to exceed 1% in either year. The only major revision, and hardly a surprising one, is the big downgrade to the prospects for Hong Kong. With the territory's GDP having contracted by nearly 2% during 2019 as street protests raged, growth is expected to come in at a distinctly sub-par 0.7% this year.

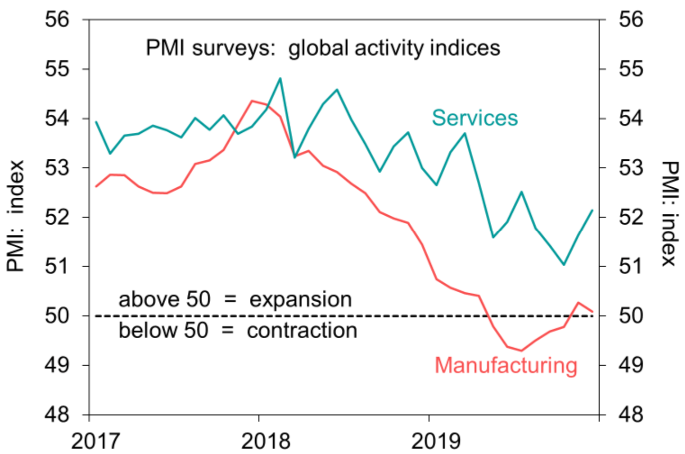
Among the key points to note is the continued slowing in the USA, where growth is expected to be less than 2% both this year and next. In the Eurozone meanwhile, 2021 is projected to bring the third year of sub-1% GDP growth. A milestone has been reached in China, with the economy forecast to expand by less than 6% in both 2020 and 2021 (and that's before taking any account of the outbreak of coronavirus). The 'Phase 1' trade agreement with the USA should ensure that no further tariffs are slapped on China's exports, but it only partially reverses the additional tariffs that have been imposed in the past 18 months. This means that some $370 billion of China's exports to the US, representing around two-thirds of the total are still subject to higher tariffs than was the case before the 'trade war' began.

Resilience in service industries

The latest clutch of Purchasing Managers' Index (PMI) surveys suggest that the global economic downswing has finally hit bottom. The composite measure, combining the results from surveys of manufacturers and service sector businesses, improved very slightly to 51.7 in December, compared with 51.4 in November. But the manufacturing index fell again, thanks especially to ongoing weakness in advanced economies. The good news is there is no evidence that the weak state of manufacturing is spilling over into other aspects of economic activity. In particular, consumers in advanced economies are continuing to provide the mainstay for economic growth on the back of rising real incomes.

Nonetheless, the outlook for manufacturing industries around the world, and hence for trade in goods remains pretty bleak. In almost all major economies, manufacturing production is lower, compared to a year ago, and even in China it is expanding at a much slower rate than is usually the case. Indeed, it is some of the long-established manufacturing powerhouses which are suffering the most. In October, for example, the output of manufactured goods was down by more than 6% compared with a year earlier in both Germany and Japan, and was lower by more than 3% in Sweden and South Korea. The figures from Germany showed a slight improvement in November,

The global manufacturing downturn may have bottomed out



Source: IHS Markit

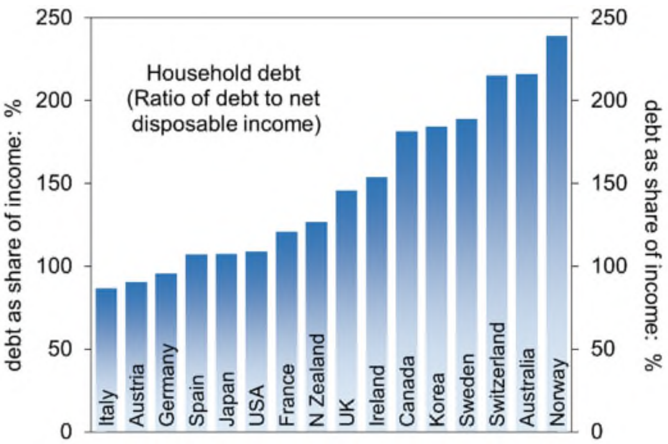
but it will take a sharp revival in December to avoid a sixth successive quarterly decline in manufacturing output. The countries which have suffered most during the present downswing are those which specialize in high value-added industrial equipment, demand for which has faltered as large corporates await a resolution to the trade conflict between the USA and China. While they will be relieved at the Phase 1 agreement, which was signed on 15th January, the coming year is likely to see stabilization of capital spending rather than a meaningful revival.

Against this background of falling capital spending and manufacturing production, cross-border goods trade has been stuck firmly in the doldrums. According to the CPB bureau, the volume of goods traded around the world was down by 0.4% in the first nine months of 2019 compared with the same months of 2018. Moreover, the trend deteriorated as the year wore on, with trade volumes in the third quarter being 1.1% lower than a year earlier. This means that 2019 was by some margin the worst year for goods trade since the dark days of 2009. As for the main protagonists, the tit-for-tat measures taken by the USA and China have severely dented the flows of goods across the Pacific. According to the US Department of Commerce, America's exports to China in 2018 were worth $120 billion, while $540 billion came in the opposite direction. The figures up to October suggest that both exports and imports were set to decline by around a seventh during 2019 as a whole. So, while the dispute has had a bigger negative impact on China's overall economic growth rate than it has on America's, President Trump's ambition of reducing the trade gap has not been achieved.

With manufacturing and export activity still providing little impetus to global economic growth, it will be left to households, and to a lesser extent to governments, to keep the shows on the road. With inflation rates at a very low ebb those countries with tight labour markets, such as the USA, the UK, and Germany, have seen meaningful increases in disposable incomes in the past few years. It's also helpful that consumers in some major economies, notably the UK and the USA, have also paid down some debt since the financial crisis. But elsewhere the ability of consumers to increase spending is restricted by high levels of indebtedness. This is especially the case in some countries which escaped the worst effects of the global financial crisis, such as Sweden, Norway, Denmark, Australia, and Canada. Economic growth will therefore receive a boost from household spending during 2020 in the United States, the Euro Area, especially in Germany, and China. But even here the impact will be modest: enough to make anaemic growth rates a little more respectable.

In any event, the positive spillovers from stronger consumer spending to increased demand for goods, whether produced domestically or imported, is limited by the changing composition of household spending in advanced economies. Once upon a time, a surge in spending by consumers would be evident in strengthening demand for

Levels of household debt are still high in some major economies



Source: OECD

cars, consumer electronics, and white goods. These days, with many people having satiated their demand for such goods (and the goods themselves in some cases being longer-lasting), the focus of spending is shifting more towards 'experiences', whether that be meals out, weekends away, holidays, sporting and music events, children's play, and pets. This is great for businesses catering for such activities (music venues, doggy daycare, "glamping" sites, etc) but it does little for the manufacturing sector.

Governments remain reluctant to lend a hand. Some are still constrained by the size of their budget deficits, especially in the Euro Area, where Brussels continues to obsess about fiscal discipline. Countries like Spain, France, and Italy, push the rules as hard as they dare, but the net effect is that the Eurozone economy – which is barely growing – will receive a meagre fiscal boost of just 0.4% of GDP this year. Germany, which has plenty of fiscal room for manoeuvre, continues to be wedded to its 'black zero' policy. In the past few months, however, Japan's government has announced a substantal fiscal boost, which could in theory amount to some 5% of GDP. This is designed to help the economy deal with the aftermath of last year's hike in the rate of sales tax from 8% to 10% and also to smooth things out in the months after the Olympic Games, which will be held in Tokyo this summer. The government in the UK will also deliver a modest fiscal stimulus to deliver on promises made before December's General Election. But at a global level efforts at fiscal stimulus remain piecemeal and muted. In particular, there is no appetite on the part of the Chinese government to deliver the sort of massive stimulus which did so much to help the global economy through the aftermath of the financial crisis. With corporate and household debt now at uncomfortably high levels, the authorities in Beijing are above all else keen not to re-ignite another property boom, with the associated run-up of leverage.

No drama for commodities

As the global economy struggles to get out of first gear it's hardly surprising that commodity prices have been more stable. The days of the so-called 'super cycle' are long gone, and even the stronger demand for battery commodities, such as lithium and cobalt, is not stretching current supply capacity. As a result, global commodity prices ended 2019 much where they had started the year, with an increase of around 3%. And much of that was accounted for by oil, which started last year at $54 a barrel for Brent crude, and ended at $65 a barrel. Geopolitical tensions in the Middle East have played a role in recent price movements, but so too have the decisions by OPEC to restrict production.

Despite the overall stability in prices and reduction in volatility there were still some big movements, both upwards and downwards, for individual commodity prices. Natural gas prices fell by more than 40% during 2019 in the face of strong supplies, while cobalt prices were down by 39%. At first sight, this appears to be a strange outcome, given the ramping-up of electric vehicle production. But supplies are adequate to meet present demand, and it appears that battery producers, especially in China, may have over-stocked in 2018. In contrast, Palladium and palm oil prices both increased by around 50%. Palladium is used mostly in catalytic converters for petrol engines, and so has benefited from the shift away from diesel, so that at more than $2,000 an ounce the metal is now more valuable than gold. But the most spectacular price increase has been for Chinese pork, where prices more than doubled during the course of 2019 as the pig herd was culled to eradicate the epidemic of African Swine Fever. The surge in pork prices ran counter to the general trend in soft commodities, which fell by around 8% last year.

The coming year is likely to bring another muted spell for commodity prices, albeit with the usual *caveat* about geopolitical events and their potential impact on oil markets. Indeed, with the global economy likely to be mis-firing for at least the next two years, most commodity prices are expected to continue to trade in relatively narrow ranges. In the longer term there is clearly scope for battery commodities to increase in price as electric vehicle production steps up, though last year's experience suggests that suppliers may have gotten a little ahead of themselves.

Economic update: 1st quarter 2020

The weird world of negative interest rates

As central banks around the world have struggled over the past decade to come to terms with weak demand and stubbornly low rates of inflation, some of them have been induced to enter the mysterious world of negative interest rates, sometimes in conjunction with quantitative easing. But there is growing disquiet about the potential harm of such an approach, and in particular its negative impact on middle-class savers. The issue was highlighted in stark terms by the cartoon (shown below) which appeared in the German tabloid *Bild* on 13th September. This portrayed Mario Draghi, the President of the ECB's Governing Council as 'Count Draghila' sucking the life-blood out of honest German savers through the Bank's negative interest rates policy.

Bild's cartoon was published following the most acrimonious meeting held by the ECB Governing Council in the euro's 20-year history. The Council agreed to re-start quantitative easing, to cut the ECB's deposit rate by a further 10 basis points (from -0.40% to -0.50%), and to introduce a tiered system of reserves to encourage commercial banks to lend to the private sector. But there was a lack of unanimity on all aspects of the package, with some members of the Council, unusually, airing their dissenting views in the media.

The idea behind negative interest rates is to encourage investors to move out of cash and bonds and into longer-term and riskier investments, so that long-term rates will be pushed lower. This approach may work in some countries, but not in Germany, where savers are notoriously cautious. A survey of commercial banks undertaken by the Bundesbank shortly after the ECB's latest rate cut found that 58% of them were charging corporates to park their cash, with 23% also charging individual depositors. Admittedly, it's not yet reached that stage where ordinary folk are being charged to keep cash in their current accounts, but private banking clients are likely to have to stump up for the privilege. Despite this, a survey by DZ Bank found that Germans increased their holdings of cash and deposits by 8.5% during 2019, with the household savings rate standing at around 11% (about twice the level for other western European countries). With negative rates also impacting on the profitability of an already-anaemic banking sector, it's no wonder that serious questions are being asked about the policy.

September's package of measures was Mr Draghi's swansong at the ECB, with his term of office then ending on 30th October. This leaves his successor, Christine Lagarde, with the unenviable task of trying to unite the Council, to which end she has announced a review into the way in which monetary policy is conducted in the Eurozone. The mere fact that this review is taking place will be enough to ensure that there is no pressure for further action during 2020, even though the annual rate of inflation is not expected to get anywhere close to the current target of "close to, but not above, 2%".

"Sucking our savings dry": what German savers think about the ECB's interest-rate policies

Elsewhere, the US Federal Reserve cut its policy rate three times during 2019, but now appears content to await further developments, while also undertaking a review into the operation of monetary policy. There has also been a flurry of rate cuts from other central banks, as they attempted to mitigate the effects of the global economic slowdown. Some of those that have so far managed to steer clear of zero rates now find themselves perilously close to this Rubicon, with the Reserve Banks in Australia and New Zealand both implementing three cuts during the past year. With both expected to make some further cuts this year, their policy rates are expected to bottom out at just 0.50%. Although the bulk of the rate-cutting activity is now behind us, further trimming is also expected during 2019 in China, India, the UK, Canada, Russia, and Indonesia.

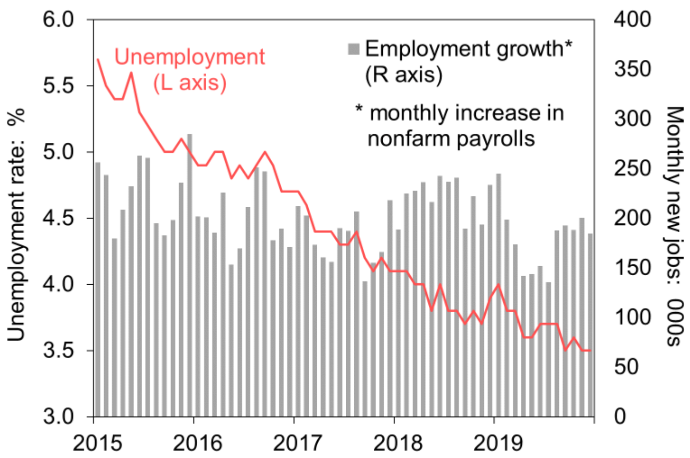
The growing disquiet about negative interest rates was highlighted on 19th December, when Sweden's Riksbank raised its repo rate from -0.25% to zero. This decision came despite slowing domestic economic growth and an inflation rate which remains below the central point of the 1-3% target range. But there have been concerns in Sweden for some time about the impact of negative interest rates, with around a half of corporates reporting that they are paying to keep their money in the bank, and a continuing rise in the level of household indebtedness. The Riksbank is also planning to launch a digital currency, the e-krona, and if this is a non-interest-bearing currency, then it will in effect set a lower bound on the policy rate of zero. It's unlikely that the four other central banks which have gone down the negative rates path will switch tack in response to the move by the Riksbank, but Sweden's experience may yet serve as a cautionary tale for others thinking of following suit.

The United States: full employment sustains consumer spending

During the summer of 2019 the US Federal Reserve cut its policy interest rate three times at successive meetings of the FOMC, so that the target for the Fed funds' rate is now at 1.50-1.75%. In December the Fed indicated that it believed it had done enough, and HSBC now expects that it will sit on its hands throughout 2020 and 2021. In the meantime, the pace of economic growth continues to ease down gently, with GDP expected to expand by a little under 2% both this year and next. Given that the unemployment rate is now down at just 3.5%, some way beyond what many would once have considered to be the level of full employment, such growth is reckoned by most analysts to be a little below the 'trend' rate, but follows a period of above-trend expansion.

Activity has been sustained mostly by household spending in recent months, a pattern which is expected to persist for some time. The leg-down in Treasury yields during the past year has made it cheaper for Americans to fund mortgages, and so has led to a revival in the housing market after a soft patch in 2018 and during most

Unemployment in the USA is at a 50-year low



Source: US Bureau of Labor Statistics (BLS) of 2019. In recent months the level of new housing starts and the number of building permits issued have both increased, suggesting that residential investment will make a positive contribution to GDP growth during 2020. As for retail spending, while the annual growth rate is less buoyant than it was in the early months of 2019 the trajectory remains fairly solid, buoyed by rising disposable incomes and ongoing job creation. But the trend may soften from here on as the level of employment rises more slowly. With the unemployment rate at such a low level, it's hard to see how the closely-watched non-farm payrolls measure of employment can continue to keep increasing at its recent pace.

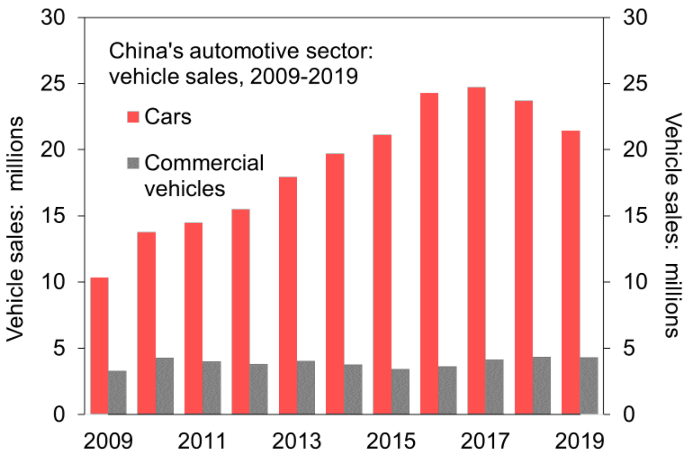
Other sectors of the economy are having a tougher time. With the Trump Administration taking a tough stance on trade and technology policies, many businesses have become nervous about capital spending. The Phase 1 trade agreement with China implies a marked increase in China's purchases of American farm, industrial, and energy products, but many remain doubtful that these targets are realistic. In the meantime, exports have stalled, not increasing at all in real terms last year. Fixed investment and exports are likely to remain the laggards of the US economy until such time as there is more certainty about trading relationships, especially with China.

China: the trade war takes its toll

The recent outbreak of coronavirus in the central Chinese city of Wuhan could present downside risks to HSBC's growth forecasts in the short-term, if the outbreak cannot be contained quickly. Back in 2003, the SARS outbreak took around five months to bring under control, and in the meantime had a marked impact on consumer spending. This sector of the economy is, of course, considerably more important today than was the case back then.

China's economy expanded by 6.1% during 2019 as a whole, down from 6.6% in the previous year. Indeed, this was the slowest pace of growth reported since the early 1990s, but conveniently still fell within the government's official target range of 6.0-6.5%. The annual pace of growth slowed to 6.0% in both the third and fourth quarters, and prior to the coronavirus outbreak it was thought that the trough of the downturn was close. HSBC's current forecast, which takes no account of the coronavirus outbreak, anticipates that annual growth will ease a touch further, coming in at 5.8% both this year and next. The Phase 1 trade deal with the United States, signed in Washington on 15th January, is unlikely to be enough to persuade businesses to step up investment, while consumers remain cautious, as evidenced by an ongoing decline in car sales, which fell by around 8% in 2019.

Chinese car sales have fallen for a second consecutive year



Source: China Association of Automobile Manufacturers (CAAM)

Yet the authorities do not appear to be overly concerned by the recent slowdown. They have not launched an infrastructure spending blitz, as they did at the time of the global financial crisis, nor have they embarked on aggressive monetary policy easing. With the burden of debt held by households, corporates, and local governments having climbed dramatically over the past two decades, they are above all else keen that no further property and debt bubbles should be unleashed. There will be further gradual easing of monetary conditions, especially if the coronavirus outbreak begins to have a material dampening impact on economic activity. There will also be some stepping-up of spending on infrastructure projects. But across the economy as a whole fixed investment is expected to expand, in real terms, by less than 3%. This is a far cry from the surge of 14.3% seen ten years ago, and is just one indicator of how much China's economy has changed in that time. Its days as a low-cost assembler of manufactured goods have gone, and will not return.

With the signing of the Phase 1 trade agreement with the USA, the question arises of what comes next. After all, most goods exported from China to America are still being charged an additional tariff on arrival, compared with early 2018. Meanwhile, the Phase 1 deal contains some ambitious (challenging, some might say) targets for China to import more goods from America. This raises the risk that the deal under-delivers, which could then impede progress towards a Phase 2 agreement.

There have been some hopeful signs of late, including a decision by the two sides to resurrect the semi-annual dialogue on structural reforms and dispute resolution, and the announcement by the US Treasury on 13th January that China is no longer deemed to be a 'currency manipulator. The focus of America's pressure is shifting from trade and towards issues around technology transfer and intellectual property (IP) protection. Some of the reforms demanded by the USA are not totally anathema to the Chinese, who continue to make progress (albeit sometimes at a glacial pace) on improving IP protections and easing access for foreign investors. A Phase 2 agreement is unlikely until after November's US Presidential election. In the meantime, on the hopeful assumption that the coronavirus outbreak is contained quickly, business confidence will be influenced by how the Phase 1 deal is implemented and whether the two sides are able to pursue meaningful negotiations.

The Euro Area – Germany is the new laggard

The Eurozone economy continued to grow during 2019, albeit at a subdued pace. For the year as a whole, GDP is expected to have expanded by 1.2%, compared with rates ranging from 1.7% to 2.0% in the preceding four years. With growth slowing, the unemployment rate has stabilized at around 7.6%, a level which is just a few percentage points above the pre-crisis trough.

Unusually, the main culprit for the slowdown has been Germany. Germany's economy has avoided recession, but its industrial sector has been in a deep decline since the third quarter of 2018, while GDP grew by a measly 0.6% in 2019 as a whole. Europe's largest economy has been hit hard by the global trade tensions, with net trade knocking 0.4 percentage points off GDP growth in 2019. Elsewhere, with Italy remaining stuck fast in the twilight zone between meaningful growth and recession, it's been left to France and Spain to carry the growth baton, with their economies expanding last year by 1.3% and 2.0% respectively.

It's anticipated that the Eurozone economy will continue to expand at a sluggish rate of roughly 0.2% a quarter during 2020, much as it did in 2019. This means that the annual growth rate will slow further, to just 0.7% this year. The draft budgets submitted to the EU Commission suggest that across the Eurozone there will be a modest fiscal stimulus of 0.4 percentage points of GDP, similar to the situation that applied in 2019. But Germany continues to run a budget surplus of around 1.5% of GDP and is still not inclined to loosen the fiscal taps to boost growth. With the international trading situation remaining difficult, it will be left to households to do most of the heavy lifting, thanks to further modest expansion of real incomes.

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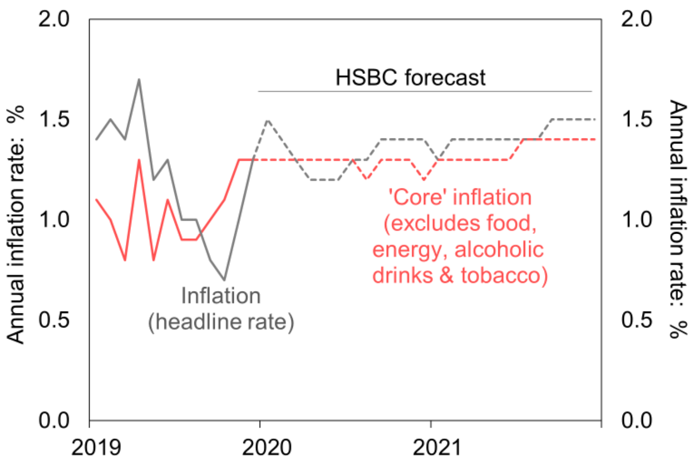
Although earnings growth is running at a modest pace of only around 2%, this remains well above the muted increase in consumer prices. For all the monetary gymnastics performed by the ECB in recent years, inflation remains well below target, with both the headline and 'core' rates coming in at 1.3% in December 2019. The core rate has edged higher in recent months, but some of this was down to measurement changes, and in such a sluggish growth environment there is little reason to expect it to move meaningfully higher.

On the political front, negotiations will get under way with the UK in February on a post-Brexit trade agreement. The EU appears convinced that a full agreement cannot be done during this year, and has yet to accept that the UK will not seek an extension, and certainly not a lengthy one. Meanwhile, a tortuous wrangle is in prospect on the EU's next Multiannual Financial Framework (in other words, its budget) for the period from 2021 to 2027. It is at this point that the UK's departure will be felt in the pocket, meaning that either some countries will have to make higher net contributions (including perhaps some that previously have been net beneficiaries) or the EU will have to cut its cloth according to its reduced means.

The tide of far-right populism has been held in check for the time being, but has not been rolled back in any meaningful way. Traditional political parties, especially of the centre-left are struggling in many European countries, including France, Germany, and Italy. A novel development has been the coming together of centre-right and green parties to form coalition governments. In the past, they would not have been considered natural political bedfellows, but are now in government in Austria and in the German state of Baden-Wuerttemberg, with the prospect that they might even form a government for the whole of Germany after the next parliamentary elections in 2021.

Low Eurozone inflation may trouble the ECB, but will support consumer spending



Source: Eurostat, HSBC Global Research

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The UK: Brexit done, a 'quick & dirty' trade deal to come

With the General Election held on 12th December having resulted in a resounding victory for the Conservative Party, all the difficulties which once lay in the path of the Government's vision of Brexit have suddenly disappeared. Rancorous debates and knife-edge votes have changed to mere formalities. The European Union Withdrawal and Implementation Bill became law on 23rd January, with the treaty between the UK and the EU being formally signed the following day. The way is now clear for the UK's formal exit to take place at 11pm on Friday 31st January.

Talking trade

But the UK will still not be entirely out of the Brexit woods. The formal departure on 31st January ushers in an Implementation Period (IP) during which the UK will negotiate its ongoing relationship with the EU. Under the terms of the Withdrawal Agreement, the IP runs until the end of this year. It can be extended once, for either one or two years, with the UK needing to notify its intentions by 1st July 2020. The Government has pledged not to ask for an extension, which increases the risk that the IP will come to an end without a new relationship having been agreed. In that case, the UK's trade with the EU would revert to the rules of the World Trade Organization (WTO).

A sudden shift to WTO rules was the most feared element of the "no deal" departure, which so many politicians and businesses were keen to avoid during the political dramas of 2019. The risks from a 'cliff-edge' transition to WTO rules may not be quite of the same magnitude as the threatened 'no-deal' departure, but they will be real enough, with the potential for considerable disruption to the flow of goods. In practice, if agreement is close, then both sides are likely to accept a short extension, perhaps lasting for a few months. Nonetheless, the risks arising from a sudden shift to WTO terms, either at the end of 2020 or shortly thereafter, will continue to haunt the UK's economic outlook in the year ahead. In particular, it could undermine the confidence of businesses about undertaking capital expenditure, and might hamper the ability of British firms to win new business in EU markets.

The most likely outcome is therefore that a 'quick and dirty' basic trade agreement will be concluded during the course of this year. Ideally, the outlines of such a deal will be agreed in time for the EU's June Summit, with negotiators then filling in the details during the autumn. Since the UK government is not seeking either a customs union arrangement or access to the EU's Single Market, the model will be the recent free trade agreements (FTAs) that the EU has concluded with Canada, with South Korea, and with Japan. But given the short timescale available, it is realistic to expect that what is agreed will be a 'Canada-minus' rather than the 'Canada-plus' arrangement suggested earlier in the Brexit process by Theresa May's Government.

Businesses will hope that the ongoing trading relationship with the EU will be on the basis of there being no import tariffs or quantitative restrictions (quotas) on the flow of goods between the UK and the EU. But that will still leave them with the requirement to fill in customs declarations and other paperwork every time goods are shipped across the border, and also to demonstrate compliance with the other side's regulatory standards. With these 'non tariff barriers' (NTBs) often being more onerous than the import tariffs, which are almost always below 10% on anything other than agricultural produce, greater frictions in the UK's trade with the EU will become a fact of life from the beginning of 2021.

At the same time as negotiations take place with the EU, the UK government will be keen to open discussions with other trading partners who have a history of striking FTAs. The government has trumpeted the merits of such deals since the EU referendum, and will now be keen to deliver on its commitment to equip the UK with a suite of comprehensive agreements. The USA will obviously be the starting point for this process, given that it has for many years been the UK's largest national export market by a considerable margin. But the relationship with the

Trump Administration is going through a distinctly frosty patch at present, with differences of opinion on how to handle Iran, the role of Huawei in providing hardware and software for the UK's 5G networks, and the tax on profits of digital service companies (which is due to be introduced from April). Even if these issues can be put to one side, trade negotiations could be hampered by the reticence of British consumers to accept some American agricultural practices, and the political hot potato of whether markets in procurement for the NHS should be opened further to foreign suppliers. Meanwhile, discussions will also get underway with the likes of Australia, Canada, New Zealand, Japan, and South Korea, countries which have a strong record of concluding FTAs. Needless to say, operating on many fronts simultaneously may prove challenging, and as with the EU trade deal, what emerges may well be provisional 'Phase 1' agreements rather than fully-fledged final-form FTAs.

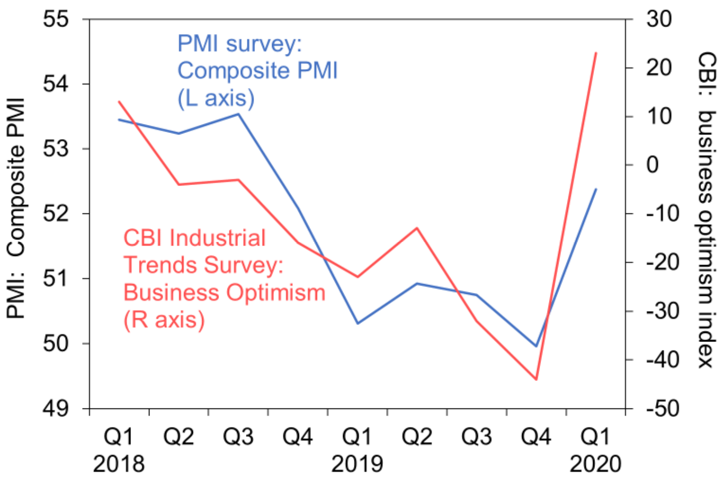
A sense of relief

There has been a palpable sigh of relief since the clear-cut result of the General Election. Whatever people's views on Brexit, many are just glad that the political and constitutional dramas of last year have come to an end. Surveys of businesses in particular have shown a marked revival of confidence and optimism, as instanced by the latest quarterly survey of manufacturers by the Confederation of British Industry (CBI), and the preliminary ('flash') reports of the monthly IHS Purchasing Managers' Index (PMI) surveys.

The CBI has conducted its quarterly Industrial Trends Survey of manufacturing businesses since 1958. Back in October the mood among respondents was grim, with a balance of -44% reporting that they expected business conditions to deteriorate over the next four months. By January the mood was transformed, with a balance of 23% of respondents anticipating that conditions would improve. Not only was this the most positive that manufacturers have been since 2014, but it was the largest swing in sentiment between consecutive surveys ever recorded. Meanwhile, the preliminary results of the PMI surveys for January showed a surge of more than three points in the composite index. This combines the results from the manufacturing and services surveys, and so is a reasonable proxy for the private sector. At 52.4 the index for January was higher than at any point since September 2018, having been in negative territory (a reading of below 50) in three of the final four months of last year.

There is less evidence to hand about the response of households to the result of the General Election. The main source of information is the GfK survey, which is undertaken on behalf of the EU each month. Sentiment fell back in the months after the EU referendum, and has languished at a low ebb ever since. The past year or so has seen

Business surveys suggest a post-election rebound



Source: CBI, IHS Markit

a marked improvement in the financial position of households. Earnings growth is now running well above the rate of inflation, rather than well below it, as was the case during most of 2017 and 2018. The latest reading for the annual rate of consumer price inflation was 1.3%, as against an increase of 3.2% in average total pay.

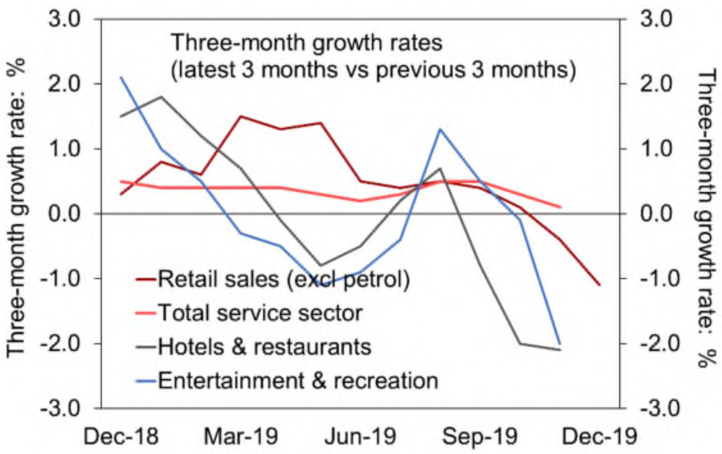
But concerns about Brexit meant that this improvement in household finances was not translated into a revival of sentiment, or at least not until December. The survey for that month showed an increase of three points in the overall measure of confidence compared with November, from -14 to -11. The survey work, in which responses were collected from around 2,000 households, was undertaken between 2nd and 11th December, which means that it was completed before the General Election. The results of January's GfK survey will be released on 31st January, and will therefore provide the first meaningful insight into the post-election mood of households.

Downbeat hard data

If the recent revival of survey data presages an imminent improvement in the hard data, it can hardly come soon enough. The economy has barely grown in the past six months, and many sectors have experienced declining activity. In the three months to November (the latest figures available) GDP expanded by a marginal 0.1% compared with the preceding three months, with a decline of 0.3% in the month of November. Compared with the previous three months, the output of the manufacturing sector fell by 0.8% while activity in the services sector nudged up by just 0.1%. Within this part of the economy, which accounts for getting on for 80% of GDP, there were steep falls of 2% or more in activity in hotels & restaurants, and also in the arts, entertainment, and recreation sectors, suggesting that the reticence of consumers to spend extended from 'big ticket' purchases into the appetite for buying experiences. A relatively bright spot was the increase of 0.6% in the construction industry, although the output of this sector continues to be highly volatile and prone to large statistical revisions.

It's also worth noting that the certainty delivered by the General Election in mid-December did not trigger a rush to the shops in the run-up to Christmas. Indeed, the figures for retail spending were pretty bleak, with the volume of sales (excluding fuel) falling by 0.8% between November and December. Moreover, this wasn't just a flash in the pan caused by weather effects, with the volume of sales declining by 1.1% in the final quarter of last year. Given the underlying improvement in household finances, it's not unreasonable to hope that the lack of enthusiasm for retail purchasing was a response to Brexit uncertainties and that consumers will return to the shops during the coming months.

Slower growth in the UK service sector at the end of 2019



Source: Office for National Statistics

Economic update: 1st quarter 2020

One of the few areas of cheer in recent months has been the housing market. Given the general reluctance of people to part with their cash, the modest upturn in both prices and the number of transactions appears somewhat counterintuitive. But, having drifted gently lower over the past three years the annual rate of house price inflation perked up in November to 2.2% (based on Land Registry data) having stood at 1.3% in October. Compared with November 2018 average prices were higher in all regions, apart from the East of England. There was a notable turn-around in London, where annual house price inflation had been in negative territory for more than a year, but returned to positive growth of 0.2% in the year to November.

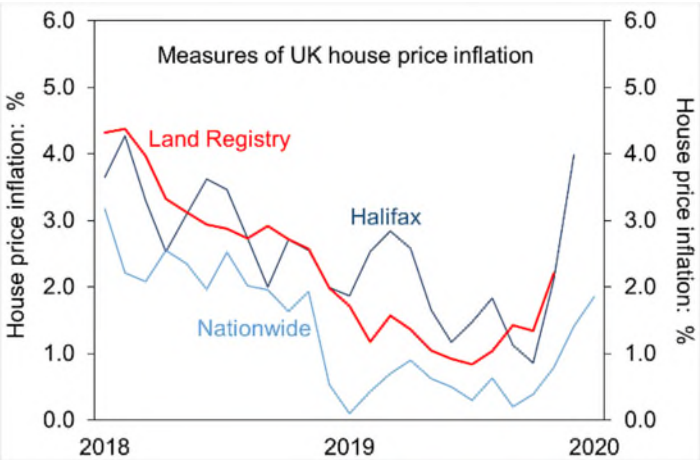
It seems likely that December brought a further firming of the market. Not only did the figures from Nationwide and Halifax show an acceleration of price growth, but HMRC also reported a sharp increase in the number of property transactions. Although the figures are still provisional at this stage, HMRC estimates that the number of residential transactions in December was 6.8% higher than a year earlier, and that they increased on a seasonally-adjusted basis by 6.2% from November.

Further disappointment to come

Yet even if households do eventually start to spend more freely, the positive impact on economic growth will be offset by other factors. 2020 is set to be a year when most people and businesses feel better, but without any meaningful change in the pace of overall economic growth. Many businesses involved in moving goods between the EU and the UK spent 2019 making plans for a 'no-deal' Brexit and stuffing their warehouses with as much inventory as possible. While caution may dictate that stock levels are not yet run right down to normal levels, it's probably won't be practical to sit on inventory for the best part of another year. A fair amount of stock unwinding is therefore inevitable, and while that process lasts firms will not need to place orders with suppliers. Where this has an adverse knock-on effect on domestic manufacturers, it will act as a drag on GDP growth.

On top of the de-stocking process which will be especially evident in the early months of this year, 2020 is shaping up to be a tough year for exporters. Not only may firms find it harder to win and retain business in EU countries ahead of the introduction of barriers to the free movement of goods, but the appreciation of sterling will make British goods and services less competitive in overseas markets, while making foreign goods and services more competitive to UK buyers. On the plus side, the government will make a bigger contribution, but the promised increase in capital spending will take time to bear fruit, so that its impact in 2020 will be minimal.

Tentative signs of a housing market recovery at the end of 2019



Source: Land Registry, Halifax, Nationwide

Economic update: 1st quarter 2020

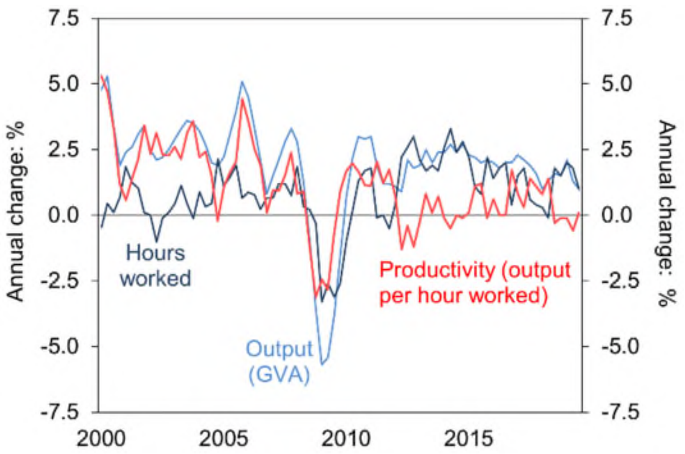
The evidence available so far from the closing months of 2019 suggests that the economy may not have expanded at all in the final quarter and might even have contracted. This would leave GDP growth for the whole of 2019 at an anaemic 1.2%, making it the third successive year of sub-par growth. For 2020, HSBC is anticipating that GDP will expand by just 1.1%, with some upside potential if the outlines of a deal with the EU are fleshed out quickly, but some downside risk if it becomes clear later in the year that a deal cannot be reached. Assuming that some sort of agreement can be struck and that the UK disentangles itself from the EU altogether at the end of this year, then tentative forecasts for 2021 point to a modest acceleration of GDP growth to 1.4%.

This doesn't sound spectacular, but with productivity growth having stalled and with net migration expected to slow, the economy's 'trend' rate of growth – it's natural speed limit – has slowed to 1.25-1.5%. This is about a percentage point slower than it was in the 1990s and early 2000s. Increasing that speed limit will require either that the Government backtracks on its approach to immigration, or that policies can be put in place which have a dramatic effect on productivity growth. Given the history of such attempts and it might be unwise to count on a marked improvement in the near future. The Chancellor of the Exchequer, Sajid Javid, has expressed a desire to boost the pace of economic growth to around 2.75%. With the economy having posted growth in excess of 2.5% only once in the past decade, this looks like a tall order.

One consequence of another year of anaemic growth is that the unemployment rate is expected to edge higher. It's only fair to note that economists have been constantly mystified by the evolution of the labour market in the UK since the financial crisis. A period of often-sluggish economic expansion has nonetheless been accompanied by sustained growth of employment. But with earnings growth now running at more than 3%, with the National Living Wage set to increase by more than 6% in April, and with ongoing difficulties in the retail sector, the pace of economic growth will prove insufficient to prevent a modest rise in the number of people without work. The unemployment rate, which currently stands at 3.7%, is expected to rise to 4.2% by the end of this year, increasing further during 2021 to end the year at 4.5%.

It's always possible that the labour market will continue to confound, but if it does, then it will mean that the economy's productivity performance has worsened still further. It's already pretty grim, with the Royal Statistical Society declaring it to be their UK "statistic of the decade". Output per hour worked increased at a dismal rate of just 0.3% a year between 2009 and 2019, compared with an average of around 2% a year in the decade before the financial crisis. The latest figures from ONS show that productivity growth in the year to the third quarter of 2019 was even worse, at just 0.1%; and that coming after four quarters in which the annual change had been negative.

Slow growth + high employment = poor productivity



Source: ONS

Economic update: 1st quarter 2020

Itchy fingers at the Bank of England

The recent run of weak economic data has led to mounting speculation that the Bank of England will decide that a cut in Bank Rate is necessary to provide a modicum of support. HSBC's view is that the most likely timing for a cut is the policy meeting in early May, although at times during the past few weeks the financial markets have been pricing a more than 50% probability that action would be taken sooner than that. But the robust labour market data from the end of last year and the business confidence surveys for January may well cause the Monetary Policy Committee to stay its hand.

At a time when the economy was barely growing, it appears that firms were still willing to take on new employees, with the number of people in employment rising by a buoyant 208,000 in the three months to November compared with the previous quarter. Moreover, this wasn't down to an explosion of 'zero hours contracts' or in part-time working, with full-time employment increasing by 197,000. As a result, the proportion of the working-age population in employment has reached an all-time high of 76.3%. This sits oddly both with the GDP figures and with the sentiment expressed by businesses at the time in the various surveys.

Yet while these developments may cause the MPC to hold fire for the time being, there will need to be a marked improvement in the hard data to prevent a rate cut in May. At the end of the day, the Bank of England's job is to deliver the government's inflation target, which remains set at 2% on the Consumer Prices Index (CPI) measure. The rate of inflation currently stands at just 1.3%, and is unlikely to reach the 2% target before 2022. It's always possible that the government (now that Brexit is done) might want to re-visit the target, or that the Bank of England's new Governor, Andrew Bailey, might want to institute a review of the conduct of monetary policy, as is being done in the United States and the Euro Area. But with inflation so far below target, the Bank of England must eventually either do something about it, or provide a good reason why it thinks that even lower interest rates would be inappropriate.

A bigger role for the state

Once January's Brexit formalities have been completed, the Government will quickly turn its attention to delivering on its domestic agenda. The Chancellor of the Exchequer, Sajid Javid, will finally get to deliver his first Budget statement, though not until 11th March, which will set out a new framework for the public finances, and put some flesh on the bones of the promises made in the Conservative Party's election manifesto. While that document was fairly short on "big ticket" spending pledges, it did foreshadow a sharp increase in capital expenditure by the government, with a view to increasing the amount spent each year by around "£20 billion. This is equivalent to roughly 1% of GDP, but won't happen overnight, with spending likely to accelerate towards this rate during the course of the present Parliament.

The lengthy period of soggy growth has had a surprisingly small impact on the public finances. Indeed, the biggest negative shock came from the ruling by the Sector Classification Committee (SCC) which means that a portion of student loans have to be treated as public spending. During the first nine months of the present financial year (from April to December) the government borrowed a total of £54.6 billion, just £4 billion more than in the previous year. The government usually runs surpluses at the start of the year, helped by the receipt of self-assessment income tax payments in late January, so that the total for the year could yet come in as low as £41 billion. This compares with a forecast made by the Office for Budget Responsibility (OBR) at the time of the Autumn Statement of £47 billion. And it means that the starting-point for the Chancellor's spending plans will be a deficit of about 2% of GDP, with this expected to reach 3% by 2023/24.

Economic update: 1st quarter 2020

It's hard to over-play the importance of the swing from Labour to the Conservatives which took place in the north and midlands of England in December's General Election. In the past, these areas have voted solidly for labour and so have not featured as political battlegrounds. It's also significant that almost all of the gains made by the Conservatives were in towns, rather than large conurbations. They took just one seat from Labour in Birmingham, and none at all in Liverpool, Manchester, Sheffield, Leeds, Bradford, Newcastle, and Hull. Outside those cities however, the seismic shift in the UK's electoral geography is bound to influence the course of economic policy in the next few years.

The focus on left-behind towns in the north and the midlands isn't new. George Osborne launched the Northern Powerhouse initiative in 2014, while Theresa May talked much about the JAMs – those families who were "just about managing". Yet after more than nine years during which they have been in power, this is the first occasion when the Conservatives have enjoyed a comfortable parliamentary majority, unencumbered by coalitions or "supply and confidence" partners or by rebellious backbenchers. Even when David Cameron won an outright majority in 2015, Budget measures were liable to be derailed by modest backbench revolts.

The upshot is that Boris Johnson's government will unveil a suite of initiatives which will aim to improve the economic performance of northern regions. The phrase in vogue at the moment is 'levelling up'. In addition to high-profile infrastructure projects, such as Northern Powerhouse Rail, significant sums of money are likely to be disbursed to help towns through small infrastructure schemes and ploughing money into long-starved Further Education colleges. There will be more efforts to move national institutions and parts of the civil service out of London, albeit that the history of such moves (for example the relocation of the Office for National Statistics to Newport in South Wales) hasn't always been happy.

A further push towards local devolution is also on the cards, with the Prime Minister recently describing himself as a "Brexity Hezza" (a reference to Lord Heseltine, who for many years championed the cause of shifting power out of Whitehall to regions and cities). The Treasury is also expected to amend the way in which it assesses capital projects, which is widely thought to have favoured London and the South-East over many years.

The challenge of 'levelling up' is a daunting one, to say the least. Previous governments have tried, especially the Labour governments from 1997 to 2010. But so far none have been able to stem the inexorable advance of London and the south-eastern quadrant of the country. There is evidence of a more mixed picture in recent years, with the city regions of Manchester and Liverpool appearing to benefit from the creation of Combined Authorities with elected Mayors. The latest official figures also showed that both the West Midlands and Wales exceeded the UK's overall growth rate in the year to the first quarter of 2019, albeit that London's growth rate was still by some way the fastest. At the other end of the spectrum, Yorkshire and the Humber was the only region to report negative growth in this period, perhaps reflecting the slower progress made towards local devolution east of the Pennines.

Economic update: 1st quarter 2020

Forecasts

Global economic growth

Annual % change in real GDP	2017	2018	2019(f)	2020(f)	2021(f)
World (nominal GDP weights)	**3.4**	**3.2**	**2.6**	**2.5**	**2.6**
Developed economies	2.4	2.2	1.7	1.2	1.3
Emerging economies	4.9	4.7	4.0	4.2	4.4
North America					
USA	2.4	2.9	2.3	1.7	1.6
Canada	3.2	2.0	1.7	1.5	1.5
Asia/Pacific					
China	6.8	6.6	6.2	5.8	5.8
Japan	2.2	0.3	0.9	0.3	0.8
India	7.2	6.8	4.9	5.9	6.3
Australia	2.5	2.7	1.9	2.3	2.7
South Korea	3.2	2.7	2.0	2.2	2.2
Indonesia	5.1	5.2	5.0	5.0	5.2
Taiwan	3.3	2.7	2.4	2.1	2.2
Thailand	4.0	4.1	2.5	2.7	3.0
Malaysia	5.7	4.7	4.5	4.3	4.4
Singapore	3.7	3.1	0.8	1.5	1.8
Hong Kong	3.8	3.0	-1.9	-0.7	2.8
Philippines	6.7	6.2	5.8	6.4	6.5
New Zealand	3.1	2.9	2.2	2.4	2.3
Eurozone	**2.7**	**1.9**	**1.2**	**0.7**	**1.0**
Germany	2.8	1.5	0.6	0.5	0.9
France	2.4	1.7	1.3	1.1	1.2
Italy	1.8	0.7	0.2	0.4	0.5
Spain	2.9	2.4	2.0	1.6	1.3
Other Western Europe					
UK	1.9	1.4	1.2	1.1	1.4
Switzerland	1.8	2.8	0.8	1.2	1.0
Sweden	2.7	2.3	1.2	1.2	1.5
Norway	2.4	2.5	2.5	1.7	1.4
Eastern Europe, Middle East & Africa					
Poland	4.9	5.1	4.2	3.8	3.4
Hungary	4.3	5.1	5.0	3.2	3.0
Czech Republic	4.5	2.9	2.5	2.1	2.4
Russia	1.6	2.3	1.0	1.7	2.1
Turkey	7.4	2.8	0.2	1.6	2.1
Saudi Arabia	-0.7	2.2	0.7	1.9	2.4
South Africa	1.4	0.8	0.3	0.7	1.0
Latin America					
Brazil	1.3	1.3	1.0	2.1	2.3
Mexico	2.1	2.0	0.1	1.2	2.1
Argentina	2.7	-2.5	-3.0	-2.0	1.5
Chile	1.3	4.0	1.5	1.3	2.5

(f) = forecast

Source: HSBC Global Research (*Global Economics*, Q1 2020; *European Economics*, Q1 2020)

Economic update: 1st quarter 2020

Forecasts

Policy interest rates

Interest rate (%) at end-period		forecast			
	31 Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021
North America					
USA*	1.75	1.75	1.75	1.75	1.75
Canada	1.75	1.50	1.50	1.50	1.50
Western Europe					
Euro Area (Refi rate)	0.00	0.00	0.00	0.00	0.00
Euro Area (deposit rate)	-0.50	-0.50	-0.50	-0.50	-0.50
UK	0.75	0.50	0.50	0.50	0.50
Norway	1.50	1.50	1.50	1.50	1.50
Sweden	0.00	0.00	0.00	0.00	0.00
Switzerland*	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging Europe					
Poland	1.50	1.50	1.50	1.50	1.50
Hungary	0.90	0.90	0.90	0.90	0.90
Czech Republic	2.00	2.00	2.00	2.00	2.00
Romania	2.50	2.50	2.50	2.50	2.50
Asia/Pacific					
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
China	4.15	3.90	3.85	3.85	3.85
India	5.15	4.90	4.90	4.90	4.90
Australia	0.75	0.50	0.50	0.50	0.50
New Zealand	1.00	0.75	0.75	0.75	0.75

* Upper end of target range
Source: HSBC Global Research: *Global Policy Rates*, 27 January 2020

Currency exchange rates

Exchange rate at end-period		forecast					
		2020 Q1	Q2	Q3	Q4	2021 Q1	Q2
Rates against £							
US dollar	USD/GBP	1.39	1.42	1.45	1.45	1.45	1.45
Euro	EUR/GBP	1.26	1.29	1.32	1.32	1.32	1.32
Japanese yen	JPY/GBP	146	149	152	152	152	152
Canadian dollar	CAD/GBP	1.95	1.99	2.03	2.03	2.03	2.03
Australian dollar	AUD/GBP	2.04	2.09	2.13	2.13	2.13	2.13
New Zealand dollar	NZD/GBP	2.24	2.29	2.34	2.34	2.34	2.34
Swedish krona	SEK/GBP	14.28	14.59	14.90	14.90	14.90	14.90
Norwegian kroner	NOK/GBP	13.02	13.30	13.58	13.58	13.58	13.58
Swiss Franc	CHF/GBP	1.36	1.39	1.42	1.42	1.42	1.42
Other rates							
US dollar / euro	USD/EUR	1.10	1.10	1.10	1.10	1.10	1.10
Chinese yuan / USD	CNY/USD	7.00	7.05	7.10	7.15	7.15	7.15

Source: HSBC Global Research (*Currency Outlook*, January 2020)

Economic update: 1st quarter 2020

Forecasts

UK economy

annual % change, adjusted for inflation (except where otherwise stated)

	forecast		
	2019 (f)	**2020 (f)**	**2021 (f)**
GDP	1.2	1.1	1.4
Consumer spending	1.2	1.1	1.0
Government spending	3.3	2.2	3.1
Investment	0.1	2.2	2.6
Stockbuilding (% of GDP)	-0.3	-1.0	-1.0
Domestic demand	1.7	0.2	1.7
Exports	0.4	1.6	1.0
Imports	2.8	-1.4	1.9
Manufacturing output	-0.8	-0.5	1.5
Unemployment rate (%)	3.8	4.2	4.5
Average earnings	3.5	3.3	3.2
Inflation - CPI	1.8	1.3	1.6
Current account (US$ bn)	-128	-107	-107
Current account (% of GDP)	-4.4	-3.6	-3.6
PSNB (% of GDP)	2.1	2.4	2.8
Exchange rate[1] US$ / £	1.33	1.45	--
Exchange rate[1] € / £	1.18	1.32	--
UK Bank Rate[1] (%)	0.75	0.50	0.50

1 at end-period.
Forecast as at 29 January 2020; data and forecasts are subject to revision
Source: HSBC Global Research (*European Economics*, Q1 2020)

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