Economic update
Third quarter 2020

This report has been prepared from information available and forecasts issued by HSBC Global Research as at 25 August 2020

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Key points

- Economic activity is has started to recover in most countries as lockdown restrictions are eased. At a global level, however, the Coronavirus pandemic is still not under control. Getting economies back to a semblance of pre-Covid normality will therefore require a difficult balancing act between keeping a lid on the number of infections without resorting to full national lockdowns.

- Financial markets have remained calm in recent months, although the rise in the price of gold points to ongoing risk-aversion among investors. The oil price has rallied as the supply/demand imbalances have been corrected, while the success of the EU in agreeing a co-ordinated recovery package has propelled the euro higher against the dollar.

- The UK economy is now recovering after a relatively long period of lockdown restrictions. Yet GDP for the whole of 2020 is expected to be more than 10% smaller than in 2019, with the government's budget deficit forecast to balloon to over 17% of GDP.

- The past few weeks have brought a welter of redundancy announcements from the UK's retail, hospitality, and travel sectors. As the Jobs Retention Scheme (JRS) winds down, conditions in the labour market are likely to deteriorate, with the unemployment rate still expected to climb to over 7%. Meanwhile, UK businesses have so far raised around £70 billion of net finance to tide them through the crisis, with the Bounce-Back Loans Scheme (BBLS) being especially important for SMEs.

- The UK's recovery process will be further complicated by the final stage of Brexit. Irrespective of whether a Free Trade Agreement (FTA) can be concluded, businesses which trade with EU countries will likely face increased trade 'frictions', and hence costs, from the start of 2021. The success, or otherwise, of the trade negotiations will also have an impact on sterling.

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The global economy – the tortuous road ahead

The Coronavirus pandemic has pushed the global economy into a deep hole, and the immediate outlook is bleak. Across much of the world, lockdowns have been eased, but the pandemic is still far from being over or even controlled. Any hopes that there may have been in the early days, that the pandemic would be quickly contained, have long since been dispelled, and it's become clear that the virus is not about to be eradicated. So, until treatments and/or vaccines are found and rolled out the world will have to learn to live with Covid-19.

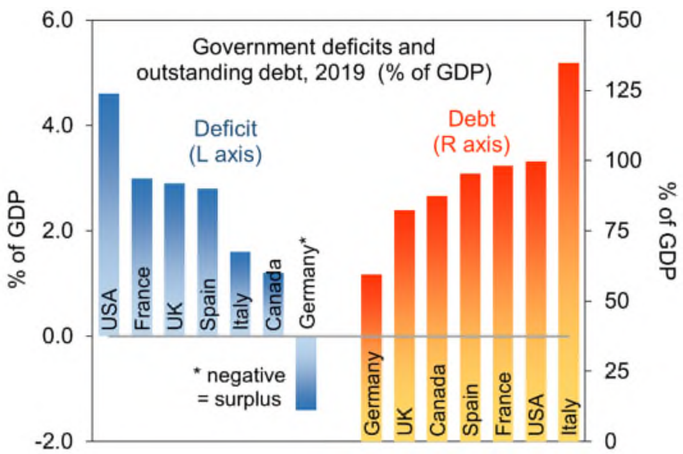
For global economic activity, this means that getting back to a semblance of normal could take a few years – and that's assuming that effective treatments and vaccines arrive. If that doesn't happen, then the risks mount that many of the world's major economies will suffer severe and long-term damage, whether from persistently high unemployment, corporate defaults, rising government debt burdens, or systemic financial instability.

As some countries in Asia and western Europe now worry about second waves, the world as a whole is still dealing with the first wave.   In mid-August, the number of infections was still increasing at around 1.4% a day, that's to say by more than a quarter of a million. Meanwhile, the death toll, which has now passed three quarters of a million, continues to climb by around 6,000 a day. The best that can be said is that things aren't getting any worse, insofar as the global daily death toll is not increasing. Over the past few months each additional 100,000 fatalities has occurred in a period of roughly two weeks.

Equally though, there is scant evidence that things are getting much better.   The epicentres of the pandemic have shifted, from western Europe and the north-eastern United States, to the southern and western United States, Latin America, the Middle East, and south Asia. Three countries – the United States, Brazil, and India – now account for more than a half of global infections, while the rapid increase in cases being seen in the likes of Chile, Peru, and Mexico, is also causing concern. It's also likely that some countries are under-reporting the level of infections and fatalities, whether as a result of bureaucratic overload or deliberate policy.

The extent to which individual economies are able to recover from the shock of the Coronavirus pandemic will obviously hinge on their success, or otherwise, in keeping the number of new infections to a low and manageable level. Beyond that, important considerations will be their fiscal firepower and the extent to which their economies are depend on sectors, such as hospitality and tourism, which are vulnerable to social distancing requirements.

Fiscal firepower: selected countries' fiscal positions before the Covid crisis



Source: HSBC Global Research (*Global Economics, Q3 2020*)

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Doing "whatever it takes"

Until now, the response of most governments, especially among the world's advanced economies, has been to "do whatever it takes". That's fine if, as is currently the case for many countries, their borrowing costs are very low. But that won't always be the case, and a day of reckoning will eventually dawn for those that fail to get their economies back onto their pre-Covid growth tracks and thereby restore their public finances. For those that can't do this – and it won't be easy for any country – higher taxation eventually beckons.

In this respect, the starting fiscal position will have an important bearing on the extent of ongoing support that governments are able to offer. Those countries that went into the crisis with smaller annual budget deficits, and with lower ratios of debt to GDP, will be able to provide more substantial fiscal interventions and will be able to sustain them for longer: Germany, for instance, is much better placed than either the UK or France, who in turn are better placed than Italy where, even before the Covid crisis struck, outstanding government debt already stood at over 130% of GDP.

It hardly needs saying that any economic forecasts made in these extraordinary times are fraught with uncertainty. Our growth forecasts have generally be marked down, compared to our previous update in April: global GDP is now expected to contract by 4.8% this year, as against a previous expectation of -3.3%. That will make this downturn markedly deeper than even that which followed the financial crisis of 2007-09, and means that it will represent the worst economic episode for the global economy since the slump associated with the Wall Street crash in 1929 (albeit that figures from that period aren't as reliable as their modern-day counterparts).

The downgrades, relative to our April forecast, are especially large for some emerging economies, notably India, Brazil, and Russia. For China, by contrast, the outlook has been nudged slightly higher, on the back of an unexpectedly strong rebound in the second quarter, and GDP for 2020 as a whole is expected to be up by 2.4% from 2019. Other than China, South Korea is the only major economy which can expect positive economic growth this year.

As for next year, global growth is expected to revive by 5.1%, which would take the annual level of GDP back to where it was in 2019. But the recovery process will be uneven, and it is anticipated that most advanced economies will not return to pre-crisis levels of output until at least some point in 2022, and in some cases later than that.

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

% change from previous year

		Forecast for 2020		**Forecast for 2021**	
	2019	Latest	(Previous)	Latest	(Previous)
World	2.6	-4.8	(-4.8)	5.1	(5.8)
USA	2.3	-6.4	(-7.0)	3.6	(6.0)
China	6.1	2.4	(1.7)	7.5	(7.5)
Japan	0.7	-4.1	(-4.1)	2.2	(2.8)
India	4.9	-7.2	(-3.0)	6.6	(8.1)
Eurozone	1.2	-8.1	(-8.1)	6.5	(6.5)
UK	1.4	-10.3	(-6.8)	6.0	(6.2)
Russia	1.3	-6.1	(-6.1)	2.1	(2.1)
Brazil	1.1	-7.3	(-7.3)	4.5	(4.5)

Source: HSBC Global Research (*Global Economics*, Q3 2020)

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The Covid impact has varied across countries

The Coronavirus pandemic has made its presence felt in almost every country of the world. Yet the scale of outbreaks and the severity of the movement restrictions that have been put in place have varied enormously. Some countries have experienced less severe outbreaks of Covid-19, while others were simply better prepared. The economic consequences have therefore also varied considerably. In the case of China, the decline in GDP seen in the first quarter was more than made good in the second. At the other end of the spectrum, Spain and the UK suffered falls in their GDP during the first and second quarters, amounting to cumulative declines of more than 20% in both countries. In general, the hardest-hit economies were in western Europe where lockdowns tended to be more severe and lasted for longer.

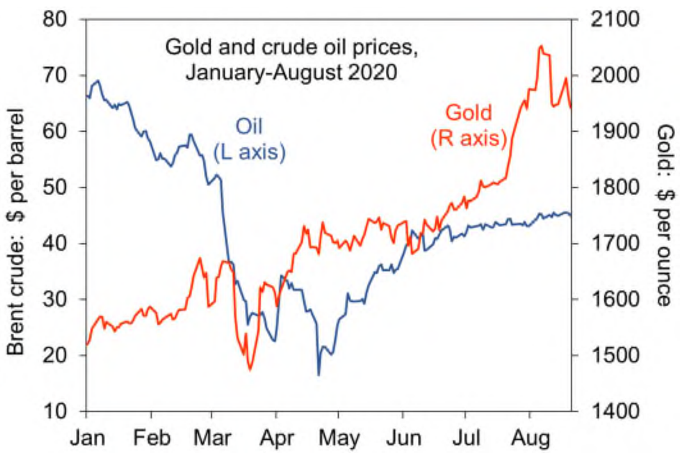
In most countries, the trough came in April, with the scale of the falls in GDP during the second quarter depending much on the timing and speed of the subsequent re-opening. It's therefore possible that those countries which experienced the steepest falls in the second quarter may also enjoy the strongest revivals in the third quarter, as their re-opening process catches up. But many of the countries which quickly re-opened have encountered secondary spikes, which could dent their recoveries if not tackled quickly.

Financial markets: keep calm and carry on

Financial markets have remained relatively calm in recent months, with no repeat of the panic that occurred in March. But the fact that the price of gold went above $2,000 an ounce in early August suggests that the general mood remains one of "risk off". Meanwhile, oil prices have stabilized at over $40 a barrel for Brent crude, and commodity prices in general have revived steadily over recent months.

In the case of oil, demand prospects remain problematic, but the market has now stabilized in the wake of the production cuts, amounting to around 11 million barrels a day, that were agreed by major producers in April and which came into effect at the start of May. Indeed, if the global recovery continues it is likely that inventory levels will start to deplete in the autumn, which will eventually apply renewed upwards pressure on prices. HSBC anticipates that prices will remain pretty much where they are at the moment for the remainder of this year, but that they will then rise during the course of 2021 to finish next year at around $50 a barrel.

Oil prices stabilize; gold rises



Source: Thomson Datastream

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The allure of gold

Across the whole spectrum of commodities, prices in July were a quarter higher than the April trough, but still a seventh down from their pre-Covid level. The price of gold reached an all-time high in early August, breaking through the psychologically-significant barrier of $2,000 an ounce. In real terms (i.e. after adjusting for inflation), however, the price is still some way short of previous peaks reached in 2011 and 1980. To match the 1980 level in real terms, gold prices would need to climb to over $2,600 an ounce. Part of gold's present allure is down to a general lack of risk appetite among investors. But it is also benefiting from the extraordinarily low yields on other 'safe haven' investments, such as US Treasuries. The downside of holding gold is that it doesn't earn a yield, and investors have to pay somebody to look after it (unless they are very brave, and even then they ought to fork out for a decent safe). These disadvantages, however, may seem less of a deterrent at a time when many government bonds are trading at negative yields. Elsewhere, the resumption of manufacturing and construction activity in China has boosted demand, and hence prices, for industrial metals, while a resurgence of building activity in the United States has caused prices for lumber to surge.

A notable development in financial markets in recent months has been the depreciation of the US dollar: its value is down by over 5% on a trade-weighted basis since the start of April, during which time the euro has advanced from around $1.08 to over $1.18. There are several explanations for what's gone on, including fears about secondary Covid spikes and their impact on the US recovery, and the prospect that yields on US Treasuries could remain very low for longer; and, on the other side of the Atlantic, the euro has been boosted by the EU's success (unexpected in some quarters) in reaching agreement on its next seven-year budgetary framework and on a €750 billion Covid Recovery Fund, which will be funded largely by centralized debt issuance.

HSBC's year-end dollar forecasts against both the euro and sterling now look somewhat challenging in this environment. For the time being, however, they have been left intact. The decline in GDP resulting from Coronavirus lockdowns was less steep in the USA than in the Euro Area, which means that it has less distance to travel to recover. This is even more the case in relation to sterling. The US also has more policy firepower available to it, whether that be via fiscal policy or through more unconventional monetary interventions by the Federal Reserve. And although the EU and the Eurozone have exceeded expectations in reaching a collective response to the crisis, there is no getting away from the fact that their debt dynamics are more fragile, which could yet inhibit their ability to recover quickly.

A spell of weakness for the US dollar

Source: Thomson Datastream

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The United States – a secondary spike in the south and west

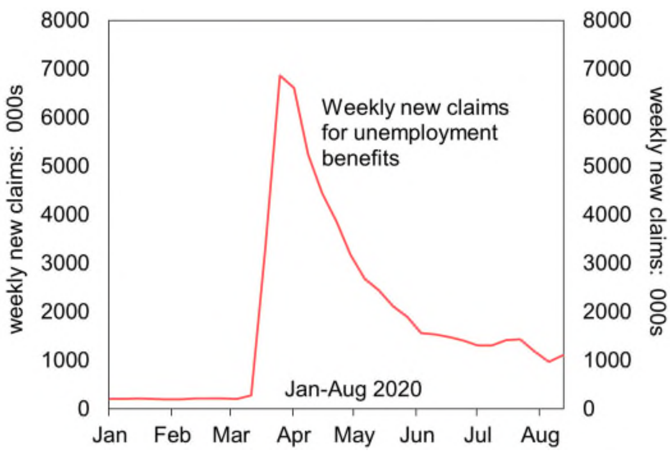
With the USA accounting for around a quarter of global infections, it's perhaps surprising that lockdowns across much of America were relatively short-lived compared with those in Europe. But the rise in infections in southern and western states in recent weeks, especially in California, Texas, and Florida, demonstrates all too clearly the risks of re-opening too quickly. Matters also haven't been helped by strong differences of opinion about the wearing of masks in public places.

Because the US lockdowns were relatively short, and the virus didn't affect every part of the country at the same time, America's GDP fell less steeply compared to some of the major economies of western Europe. With the contraction of 9.5% reported for the second quarter coming on the heels of a fall of not much more than 1% in the first quarter, the cumulative decline since the final quarter of 2019 was 10.6%. Without the sort of furlough schemes that have been deployed in many other advanced economies, the most spectacular aspect of America's Covid experience has been the number of people who have lost their jobs.

That's not to say that there has been no assistance, it's just that the help has come through more generous welfare benefits rather than by paying employers to keep people on their payrolls. Thankfully, the unemployment rate has fallen dramatically since the April peak, albeit that the pace at which workers are being re-hired eased in July. The unemployment rate for July was 10.2%, as against 11.1% in June, with the unemployment count standing at 16.3 million, a reduction of 6.8 million from April's peak. HSBC anticipates that further reductions in unemployment will be gradual, with the rate still at around 9% by the end of the year.

Our forecast trajectory sees GDP expanding by 4% in the third quarter, and by just over 2% in the final three months of this year. But that would still leave it some 5% down from the pre-Covid peak. Indeed, the economy isn't expected to return to that level of output until sometime in 2022. The recent spikes in the number of infections clearly poses a risk to these forecasts. There are already indications that consumers are starting to pull back, with a very clear and unsurprising link between rising numbers of Covid cases and mobility data. Many states have paused their re-opening plans, while others have gone into partial reverse. Another area of uncertainty is the extent of further government support, given the stalemate in Congress in recent weeks. Both Republicans and Democrats agree that more needs to be done; they just can't agree on what.

Unemployment claims surged during the US lockdowns



Source: Thomson Datastream

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The Euro Area – getting its act together

Across the Eurozone as a whole, GDP shrank by 12.1% in the second quarter, making a cumulative decline of 15.3% since the final quarter of 2019. Among the 'big four' economies, Germany's GDP declined by 10.1% during the second quarter, with falls of 13.8% in France, 12.4% in Italy, and 18.5% in Spain. It's no real surprise that Spain's economy contracted so sharply, given the severity of the lockdown that was imposed. But it's a little surprising that Italy got off as lightly as it did, after a lockdown that was every bit as severe as Spain's.

Having driven the number of new infections down to very low levels, most countries in the Eurozone enjoyed a respite during June and July, with special efforts being made to welcome back foreign tourists to Mediterranean holiday destinations. Google's mobility data showed footfall in retail (non-food) and leisure venues returning to between 5% and 10% below the January baseline in France, Germany, and Italy, although it has continued to lag in Spain. In recent weeks, however, the tide has again started to turn, with infection numbers rising, some travel restrictions being re-imposed, and national and local authorities beefing up social distancing requirements. In France, for example, it will become mandatory to wear face coverings in shared office spaces, while they are also required in busy outdoor areas of major cities. For the time being at least, the trends look much less alarming than in the southern and western United States, and governments will hope that wider use of face coverings will prevent a widespread reversal of recent re-opening.

The policy highlight of the past few months was the agreement reached on 21st July, after a marathon EU summit, on the next Multi-Annual Financial Framework (a fancy description for a budget) for the seven years from 2021 to 2027, as well as the €750 billion Next Generation EU plan. While the more 'frugal' members succeeded in scaling back the grants element from €500 billion to €390 billion, the allocation to each country remained much the same, with the hit instead being taken by pan-EU projects. It's also worth noting that no member has a power of veto over the disbursement of grants, as some had sought. It means that until 2026 the EU will become a significant player in the bond markets in its own right, which may well result in foreign reserve managers around the world opting to hold more euros in their portfolios. Meanwhile, the ECB continues to promote lending by commercial banks through its programme of asset purchases and its system of tiered reserves. It looks as if the annual rate of inflation has already troughed, but there is no imminent pressure on the ECB's target, so that an expansion of asset purchases from €20 billion a month to €40 billion is expected before the end of the year.

China – a skewed recovery

After a fall of around a tenth in its GDP in the first quarter, this was more than recovered in the subsequent three months. As a result, China's GDP in the second quarter was up by 3.2% up compared to the same period last year. That said, the Coronavirus pandemic has still delivered a considerable shock to the world's second biggest economy, with domestic consumers wary about returning to pre-Covid spending patterns and export demand disrupted by deep recessions elsewhere.

While investment in infrastructure and property rose strongly in the second quarter, spending by households did not follow suit and was still 6% lower than in the same months of last year; by June the volume of retail spending was still 1.8% down on a year-on-year basis. This isn't particularly surprising, given the shock that the pandemic has wrought on incomes and employment. People have hunkered down, increased precautionary savings, and altered their spending behavior, ditching some of the 'discretionary' elements. It's clear that the authorities are resolved to continue easing monetary conditions, while seeking to boost the incomes and job prospects of households. They are facing criticism for not doing enough to protect the incomes of lower paid workers, who appear to have suffered disproportionately. As household consumption becomes more important in China's economic mix, the traditional approach of the government of focusing on infrastructure investment will no longer suffice to deliver a sustainable recovery.

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The UK economy – bottom of the class

The UK has been badly affected by the Covid-19 pandemic. The number of excess deaths in relation to the size of the population, at nearly 1,000 per million, is higher than for any other country. The situation has, thankfully, improved considerably in the past few months, so that while some localized restrictions are in place in Leicester, Greater Manchester, Lancashire, and West Yorkshire, for the time being the incidence of new Covid infections across the country as a whole is very low, at around seven per 100,000 people. The pilot study of infections undertaken by the Office for National Statistics (ONS), based on a random sample of households, suggests that after an increase from the middle of June, the number of people catching Covid may now have stabilized.

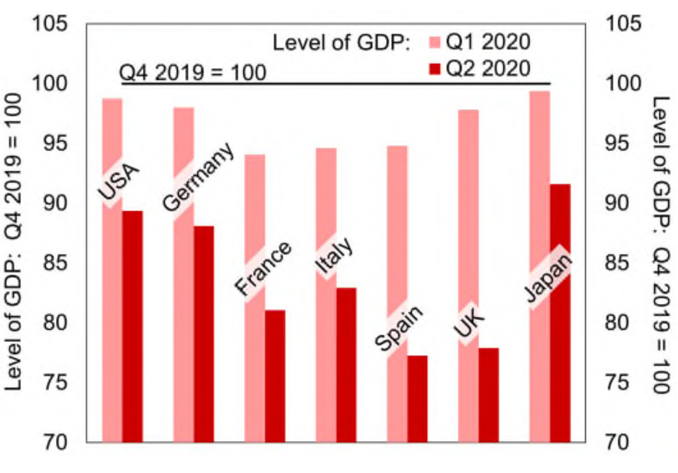
The lockdown effect

The UK's 'lockdown' that was introduced in March was not as severe as in some other European countries but it lasted longer, with non-essential shops not opening in England until 15th June, and English pubs, restaurants, and hairdressers not allowed to open their doors until 4th July. In general, re-opening has been even slower in the devolved nations. The result of these measures was to reduce economic activity by more than a quarter, with the monthly estimates of GDP showing falls of 7% in March and of 20% in April. It is likely that some countries in the Eurozone may have seen steeper falls in economic activity, but these cannot be quantified as they don't report monthly GDP data.

A better way of grasping the impact across different countries is to compare the level of GDP in the second quarter with that in the final three months of 2019. On that basis, the UK has fared relatively badly, with GDP falling by 2% in the first quarter, followed by a drop of 20.4% in the second quarter. The cumulative decline of 22.1% across both quarters is on a par with that experienced in Spain, but deeper than in Italy, France, and Germany, and much more severe than in the United States, Canada, and Japan. With the UK having spent more of the second quarter in full lockdown, it may however have more scope to make up some ground in the third quarter.

With everybody apart from 'key workers' told to stay at home, spending by households plummeted by 30-40% in the weeks after the lockdown was introduced, according to data on debit and credit card transactions. Road traffic was 65% below normal and the volume of retail spending in April was more than a fifth down from February's level. Perhaps the most spectacular statistic to emerge from this period of extreme lockdown was that only 4,321 new cars were registered in April, a fall of over 97% from the previous year.

The UK economy has been hit by a longer lockdown



Source: Thomson Datastream

Viewed from an output perspective, some service sectors saw declines in activity of more than 90%, including hospitality, tourism, airlines, motor vehicle dealerships, and hotels. In the manufacturing sector, transport equipment and textiles were hardest hit, seeing falls in output of around 60%. Some other sectors escaped relatively lightly, including public administration and defence, financial services, information technology, farming, and production of food and beverages. In relation to food, the lockdown saw the population of the UK replace the 25% of meals usually eaten outside of the home with produce sourced from retail outlets. We haven't eaten less, but we have eaten differently: less frothy milk in cappuccinos and lattes; more mince and pasta; less steak and chips. Despite what some of us may think, we have also consumed less alcohol.

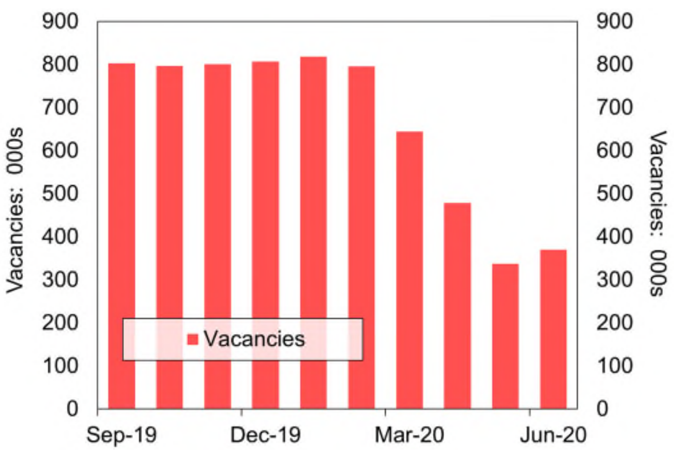
Somewhat bizarrely, the unemployment rate has not risen at all, standing at 3.9% in the three months to June. But this presents a false picture of what's going on in the labour market. The 9.5 million people who've been furloughed don't count as unemployed, while some of the people who've lost their jobs have decided not to look for alternative work for the time being. The Labour Force Survey, which is the source of official employment and unemployment data in the UK, requires people to be in work or actively seeking work (and to be available to start work in four weeks) if they are to be counted as 'economically active'. People who don't meet this requirement are deemed to be 'economically inactive' and are not included in the unemployment count.

The deterioration in the labour market is however very evident from data on PAYE and vacancies. The number of people whose Income Tax is collected through PAYE fell by 730,000 between March and July. In similar vein, the number of vacancies, which is measured on a rolling three-month basis, was nearly 60% lower in the April to June period than it had been in January to March. It's also telling that the number of hours worked during the second quarter was 19.3% down from the same months of last year.

The recovery gathers momentum

The recovery began in May, although the revival in that month's GDP was only a modest 2.4% despite a bounce in retail spending. June then saw a much stronger increase of 8.7%, taking the revival across the two months to 11.3%. June's resurgence was due to a strong pick-up in the construction and manufacturing sectors, while retail sales returned to pre-crisis levels. It should be noted, however, that the composition of sales remained markedly unusual, with spending in physical non-food outlets still down by 15% from February, within which spending in clothing and footwear stores was a third lower.

Falling vacancies are the clearest sign of deteriorating conditions in the labour market



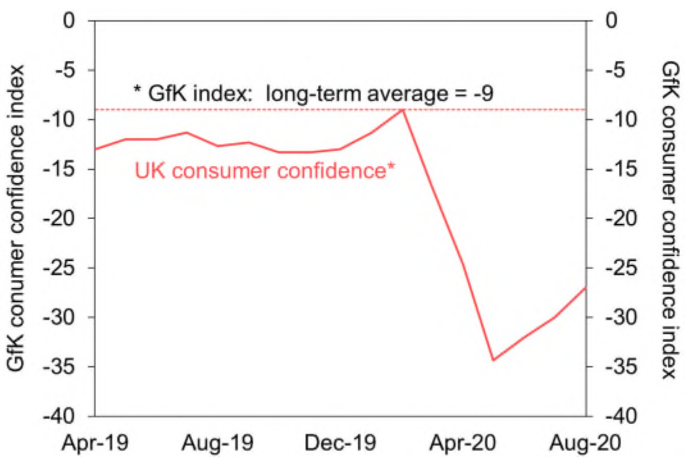
Source: ONS

The upshot was that by June, overall GDP was still 17% down compared to February. Needless to say, the differences across sectors were huge, depending how far they had progressed on their re-opening journeys. Output of the agriculture and fishing industry in June was only some 3% lower than in February, as against a decline of 83% for the accommodation and food service sector. Elsewhere, output of the construction sector was still a quarter shy of its pre-Covid level, while activity of manufacturing industries was a seventh lower. On the expenditure side, where the figures are only available on a quarterly basis, spending by households fell by a dramatic 24% during the second quarter, while business investment was down by 31%, and exports by 12%. An unusual feature of the second quarter is that the decline in exports wasn't anything like as steep as the fall in imports (-23%), with the result that the UK posted a very rare trade surplus. But given that it only arose because of the steep, but temporary, fall in consumer spending, the surplus is unlikely to last.

For households, the fall in spending was considerably greater than the decline in incomes, the latter having been cushioned for many people by the Covid Jobs Retention Scheme (JRS) and the Self-Employed Income Support Scheme, which between them were supporting some 12 million people by June. The household savings rate (the portion of incomes not spent) therefore rose dramatically, perhaps to an unheard-of 25%, as people built up bank deposits at a rapid pace and also paid down debt. In usual times, households add to their bank deposits at a rate of around £5 billion a month. From March to June, the increase averaged £17 billion. While some of this money will be held back as precautionary savings in case of job losses and possible reductions in income, and some will be kept back for purchases that can't be made at the moment (such as long-haul holidays), consumers do not lack the spending power to return to their previous consumption habits. It's not just a matter of economic and financial confidence, but also an issue of health and safety confidence.

After being shut down for two months the housing market is now roaring back to life. The number of loans approved for house purchase revived to 40,000 in June, from under 10,000 in May, and should very soon return to its pre-crisis level of around 70,000. Prices have also held up, with the Halifax House Price Index for July being 1.7% higher than in June and 3.8% up from last year. Estate agents across the country have reported brisk business, with the recent momentum likely to be sustained throughout coming months by the reduction in Stamp Duty Land Tax announced by the Chancellor on 8th July. This means that any property selling for under £500,000 will not incur tax. But as with all the government's support measures there are concerns about what will happen when the tax relief expires, which is currently set to happen at the end of March next year. By then, conditions in the housing market may well be cooling in response to higher unemployment.

Consumer confidence is still well below pre-Covid levels



Source: GfK

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How long before activity recovers?

It is likely that July saw another sizeable increase in GDP on the back of the re-opening of pubs, bars, restaurants, and hairdressers. But evidence from Google's Global Mobility Survey suggests that people haven't exactly rushed back to their pre-Covid lifestyles. By mid-August, footfall in non-food retail and leisure settings across the UK was still 22% below the January baseline (as against declines of about -5% to -10% in France and Germany). August is seeing some improvement, however, with the "Eat out to help out" scheme, announced by the Chancellor on 8th July, proving to be popular and being used more than ten million times in the first week.

If the pandemic remains under control, it's likely that people will gain in confidence about going to the shops and eating out. On the other hand, the onset of cooler weather may deter people from eating and drinking in outdoor spaces, while there are many activities, such as music venues, concert halls, theatres, sporting events, and conference centres, which will struggle to re-start even though restrictions have been eased. The Government's priority is to get children back into education from September, and it has made it clear that it won't hesitate to re-impose restrictions on other activities in order to keep schools open.

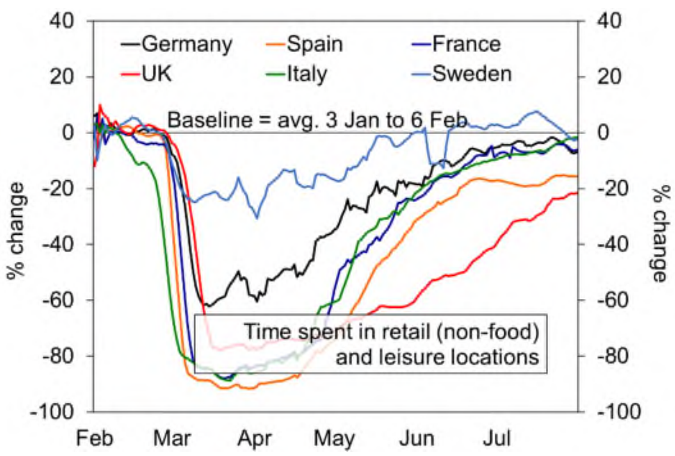
Cutting our UK growth forecast

In the wake of the steeper-than-expected fall in GDP during the second quarter, which was reported by the Office for National Statistics on 12th August, HSBC has slashed its forecasts for the UK. For 2020 as a whole, the economy is now expected to be 10.3% smaller than in 2019, a fractionally worse outcome than in either Spain or France, and weaker than our previous forecast of a contraction of 7.8%. Despite rebounds of 14.7% and 4.0% that we have pencilled in for the third and fourth quarters, the level of GDP in the final quarter of this year will, we estimate, be 7% down on a year earlier.

Looking further ahead, our forecasts envisage that GDP in the final quarter of 2021 will still be 4.5% lower than at the end of 2019, which implies that it will be 2023 before the economy gets back to its pre-Covid level. If an effective vaccine is developed in the near future – a big 'if' – this process could perhaps be accelerated. On the other hand, it's possible that our experience of lockdown may well bring about long-lasting changes in our habits and behaviour, in particular with regard to commuting and office-based working.

UK leisure and retail activity has been slower to recover

Time spent, compared to January, in retail (non-food) and leisure locations



Source: Google Community Mobility Reports

Vulnerable sectors

At a sectoral level, some parts of the economy will return to normal quite quickly. But activities which involve indoor gatherings of people will continue to operate at well below pre-Covid levels so long as social distancing restrictions remain in place. The same is true of what can loosely be described as the 'commuting economy', made up of all the shops, cafes, and sandwich bars which serve people on their way to and from work and during lunch breaks. While most people who work in production and construction settings are now back on site, relatively fewer people are back in offices. The office districts in London and other major towns and cities remain more or less ghost towns, a situation which will not change quickly, despite the exhortations of the government. It is the realization that some parts of the economy will not revive quickly that has led to the high-profile redundancy announcements in recent weeks across retailing, hospitality, travel, and the arts.

One of the biggest impediments to recovery is always the time that it takes to get those people who lose their jobs into new employment. The objective of the employment support measures put in place by the government this time around is to preserve the connections between employees and their employers, in much the same way as was done by the German 'Kurzarbeit' scheme in the wake of the financial crisis. The Jobs Retention Scheme will prove invaluable for those sectors where operating conditions should be more or less back to normal by the autumn. But it won't prevent economic scarring in those sectors, such as retailing, where structural changes were already under way before the crisis struck, or in those sectors, such as hospitality and travel, where it will take years rather than months for things to get back to a semblance of normality. The government therefore faces a difficult dilemma in balancing the need to preserve jobs and to support struggling businesses, without wasting public money to subsidise jobs that are eventually going to be lost whatever happens.

Company finances – filling the coffers

It goes without saying that the collapse of economic activity has had a profound effect on the cashflows and profitability of many companies. An ill wind may bring new opportunities for some firms, such as those involved in courier deliveries, and manufacturers of personal protective equipment, but the majority of companies have experienced falling turnover. The Business Impact from COVID-19 Survey, conducted by the ONS in the second half of June, found that 60% of respondents had seen their turnover fall, with 16% suffering declines of more than a half. To date, the number of insolvencies remains at a historically low level, but the recent stream of announcements about job losses and restructurings means that the number of failures will inevitably climb as the year wears on. It should also be remembered that companies don't always fail during the eye of an economic storm, but are often at greatest peril during the recovery phase as their working capital needs grow.

In an analysis presented in the Financial Stability Report (FSR), published on 6th August, the Bank of England has estimated that those businesses in a negative cashflow position in the 2020/21 financial year will amass a cumulative shortfall of up to £200 billion. Larger firms are expected to account for £135 billion of this total, with SMEs running up a deficit of £40-70 billion. Gauging the position of SMEs is tricky, as many smaller firms file only limited financial information at Companies House. These are also not aggregates for the economy as a whole, as they relate only to those businesses which will be in a deficit position. T his analysis has been modelled from filed accounts and is based on the economic forecasts contained in the August *Monetary Policy Report* (MPR), which are more optimistic than HSBC's expectations.

These shortfalls can be addressed in several ways, including by running down existing cash balances, reducing costs, cutting capital expenditure, and raising finance. During the four months from March to June, non-financial businesses raised net finance (that's to say net of loan repayments, bond redemptions, and equity buybacks) of £69.4 billion, with the Bank of England estimating that larger businesses raised around £50 billion and SMEs around £20 billion. At the start of the crisis in March, larger firms drew heavily on committed credit lines and revolving credit facilities with banks. Gross lending by banks to these firms usually runs at around £15 billion a month, but surged to £45 billion in March. After that, much of this money was repaid as they looked to other sources of finance. Nonetheless, between March and June net lending by banks (inclusive of overdrafts) increased by £44.7 billion.

The capital markets have also remained open and active, so that between March and June non-financial businesses raised net finance of £32.3 billion across the markets for bonds, commercial paper and equities. Within this, an important contribution has come from the Bank of England's Covid Corporate Finance Facility (CCFF), which allows investment-grade firms to issue commercial paper, which the Bank then buys on favourable terms, which means that for large corporates this is the cheapest source of financing available to them.

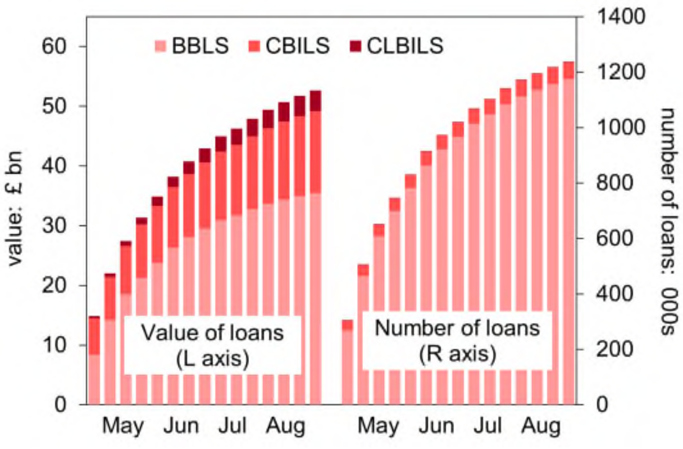
For SMEs, the chief source of new finance has been the Bounce-Back Loan Scheme (BBLS), which was launched by the Government on 4th May. By mid-August, over 1.1 million small businesses had availed themselves of the scheme, with the value of facilities approved reaching £35 billion, equating to an average loan size of just over £30K.

It's fortunate that businesses collectively entered this crisis in rather better shape than was the case at the onset of the financial crisis in 2007. They spent several years after the last recession repairing their balance sheets, and they've also benefited from low borrowing costs, thanks to a prolonged period of historically low interest rates. During the present crisis they have also markedly increased their holdings of bank deposits, which rose by some £120 billion from the end of February to the end of June, as not all the money raised from banks and the capital markets has yet been spent.

With bank deposits now exceeding bank borrowing by some £200 billion it's tempting to think that companies have all the money they need to get through the crisis. This not necessarily the case, however, with bank deposits being very unevenly distributed. The Bank of England's cashflow analysis suggests that firms in a deficit position had around £85 billion of bank deposits to call on, but would be understandably reluctant to run these down too far.

Over £50 billion borrowed by UK firms under Government-backed lending schemes:

- Bounce-Back Loan Scheme (BBLS)
- Coronavirus Business Interruption Loan Scheme (CBILS)
- Coronavirus Large Business Interruption Loan Scheme (CLBILS)



Source: HM Treasury

So, as the recovery continues there will be concerns about cashflows, especially when deferred VAT payments become due, and as the Jobs Retention Scheme comes to an end. Looking further ahead, there are concerns that the increased burden of debt will inhibit the ability of firms to expand and adjust.

A key moment will arrive in the spring of 2021 when the interest-free period on loans granted under the various government schemes will come to an end. Given that the economy will not have recovered fully by that point, it's possible that the Government might extend the interest-free period, perhaps by another year. Large firms will have the option to replace borrowings with equity through the public markets. But these options are not readily available to many SMEs, which is perhaps another issue that may be addressed through government initiatives.

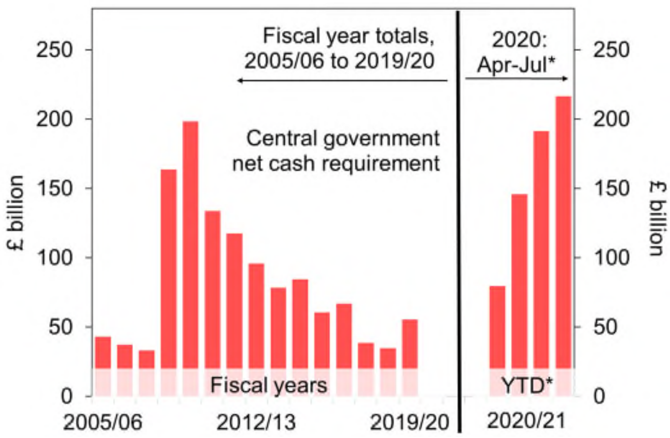
Government finances – the deficit starts to reduce

In recent months, the UK Government, like most others around the world, has run some truly eye-watering deficits. Tax revenues have fallen sharply, while at the same time the various support measures have caused spending to balloon.

In these extraordinary times, the usual headline measure of government borrowing ("net borrowing") is less reliable, and it is better to focus instead on the central government's "net cash requirement". In the first four months of the current fiscal year, this amounted to £216.5 billion, nearly four times the total of £55.4 billion for the whole of the 2019/20 fiscal year. The good news is that the monthly deficits are now coming down as the economy starts to revive, with the cash requirements in June and July being 'only' £46 billion and £25 billion respectively, as against the requirements of around £80 billion and £66 billion in April and May.

The monthly deficits will continue to shrink as the fiscal year progresses, thanks to a revival of tax receipts and to the tapering of the Jobs Retention Scheme (JRS). From 1st August the JRS becomes progressively less generous, with increasing contributions required from employers, and the scheme is due to be withdrawn entirely at the end of October, though some sort of extension for some struggling sectors is possible. Following Rishi Sunak's latest package of fiscal measures, announced on 8th July, the cost of support measures in the present fiscal year will reach £192 billion, with the result that the government deficit is expected to come in at close to £380 billion, equivalent to around 18% of GDP.

The government's cash requirement has ballooned this year



* cumulative total
Source: ONS

Economic update: 3rd quarter 2020

Falling gilt yields have lowered the government's borrowing costs …

So far at least, the government's burgeoning need for funding has been comfortably funded from the bond markets. The issuance of new UK government bonds (often called 'gilts') was around £45 billion in April, rising to £60 billion in May, June, and July. With a further £50 billion due to be financed in August, issuance for the first five months of the fiscal year will amount to £275 billion. This means that the Debt Management Office will be able to dial back the pace of fund-raising for the remainder of the year. That's just as well, as the Bank of England's gilt purchases under its programme of quantitative easing (QE) will also slacken: the latest £100 billion of purchases, announced in June, will be completed by the turn of the year; and HSBC's view is that there will be no more rounds of QE, so that the Bank of England will not be active in the gilts market from the start of 2021.

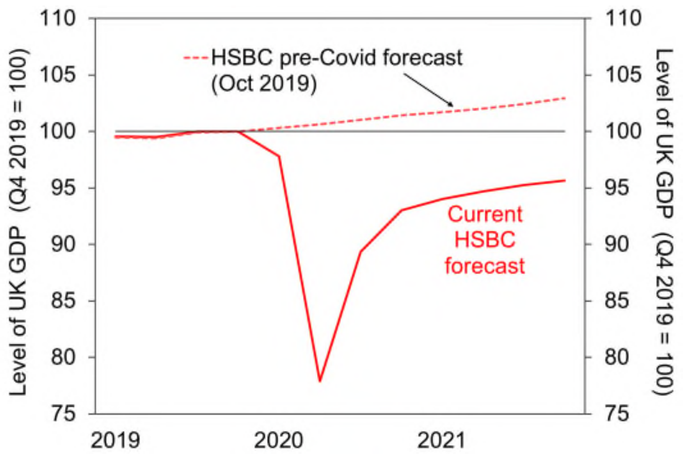
With the Bank of England lending less of a hand to mop up any excess supply of gilts, it's likely that the cost to the government of raising all this money will start to creep up during coming months. In the wake of the Chancellor's latest statement the yields on gilts fell even further, to the point that anything with a maturity of less than eight years has been trading in negative territory, with the yield on benchmark 10-year bonds falling to under 0.1%. The government will therefore fund this year's colossal requirement extraordinarily cheaply, possibly at a lower cost than the £34.5 billion forecast by the Office for Budget Responsibility (OBR) at the Budget in March, even though the deficit will be five times bigger than was then expected.

… but getting the public finances back on an even keel will depend on economic recovery

The big question is how quickly will the economy recover, and hence how long will it be before the government finances are back on an even keel. That won't just be a case of restoring GDP to its pre-Covid level, but will also mean trying to get the economy back onto something akin to its previous growth track. For only then is the rate of unemployment likely to fall back to roughly where it was at the start of this year, and only then will the government's revenues return to where they were. If this can't be achieved, then within a few years' time the government will be looking to plug a hole in its finances. Given that there currently seems little appetite, neither at Westminster nor among the general public, for a return to 'austerity', any revenue-raising would likely have to come predominantly from tax increases.

Can the economy get back onto its pre-Covid growth track?

HSBC's forecasts for the level of GDP relative to its pre-Covid level at the end of 2019



Source: HSBC Global Research

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Monetary policy – anything is possible, but nothing is likely

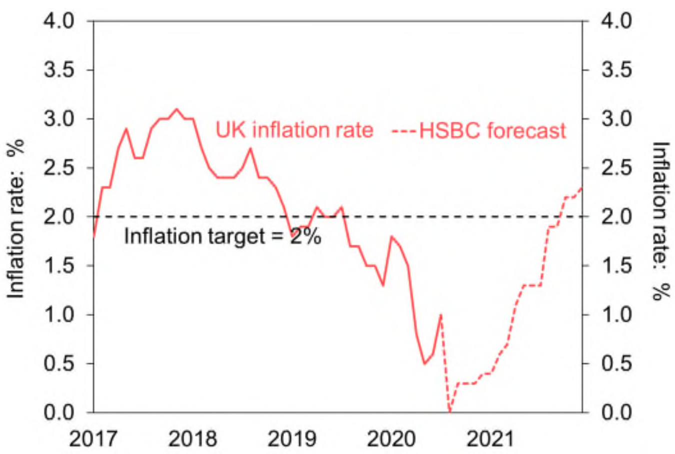
Having decided to boost the stock of asset purchases by a further £100 billion in June, HSBC doesn't anticipate any further monetary policy actions by the Bank of England before the end of 2021. The possibility of cutting interest rates into negative territory remains under active review; and some members of the Monetary Policy Committee have said that more QE could be undertaken if needed. But unless the recovery process takes a decided turn for the worse, these options will probably be kept in reserve.

In an interview with Bloomberg, back in June, the Governor of the Bank of England, Andrew Bailey, discussed the sequencing when the time comes to return monetary policy to something like 'normal'. He indicated that he would prefer to see some reversal of the Bank of England's asset purchases before interest rates are increased. This runs counter to the approach adopted under Mark Carney, which saw interest rates raised a couple of times before any reversal of the earlier QE purchases: with Bank Rate still at only 0.75% when the Covid crisis struck, nothing had been done about running down the QE. It's interesting though that the August *Monetary Policy Report* made no mention of this 'sequencing', which suggests that the Governor's preference is perhaps not yet the Committee's established policy.

As well as interest rates and asset purchases there is another often-overlooked tool which the MPC has deployed, namely the provision of low-cost funding for banks. This takes the form of the Term Funding Scheme with incentives for SMEs (TFSME), which was launched in March. It follows similar schemes which were rolled out in 2012 and 2016. The present scheme has so far disbursed around £18 billion, which is far short of what banks could potentially borrow and also below what was drawn under the 2016 scheme. It may be that with businesses and households building up deposits, banks feel they have less need for such funding.

August's *Monetary Policy Report* meanwhile presented a fairly sanguine view about the trajectory for inflation. On an assumption that UK Bank Rate remains unchanged, the headline measure was forecast to reach the 2% target in early 2023. But this is on the basis that GDP returns to its pre-Covid level at the end of next year, which is rather more optimistic than HSBC's expectation. In the short term, however, the annual rate of inflation will remain low: indeed, with the Chancellor having reduced the rate of VAT to just 5% for the hospitality, holiday, and attractions sectors, the rate could dip briefly into negative territory, and is expected to average around 0.25% for the remainder of this year.

Inflation stays low for the rest of this year



Source: ONS / HSBC Global Research

The Brexit headache

As if businesses don't have enough to contend with at the moment, many firms will also face a major change in the way in which goods and services are traded with the 27 countries of the EU. Even if the Government is able to reach an agreement with the EU on an ongoing trading relationship, there will be new frictions and extra costs. Businesses which already trade goods with non-EU countries will know what they're in for, in terms of the paperwork that will need to be completed. But it may come as an unpleasant surprise for those businesses which have until now traded only with EU countries.

The mood music from the negotiations hasn't always been good, but it appears that both sides now understand and accept each other's 'red lines'. A deal is therefore perfectly possible, if only the lawyers can come up with acceptable wordings and oversight mechanisms, and so long as politicians are prepared to accept some difficult choices. Yet any agreement which emerges is likely to fall short of the "Canada plus" scenario which was often mentioned in Theresa May's time. Instead, it's likely to be more of a "Canada minus" arrangement, with the only question being how big the minus will be. In practice, this could mean no tariffs or quantitative restrictions on trade in goods. But the agreement is unlikely to stray much into areas of services, although it will hopefully address some of the more pressing issues relating to access for road hauliers and airlines. The UK may insist on its sovereign right to make its own rules, free from the jurisdiction of the European Court of Justice, but in exchange it may have to accept that the EU can revoke tariff-free access at short notice, for specific goods, if the EU believes that rules set in Britain undercut the Single Market's 'level playing field'.

The critical juncture will probably arrive in October. It would be no surprise if the current trade talks, like last year's talks over the Withdrawal Agreement, wrap up about mid-October. Success is not guaranteed, which means that there is a significant risk that the UK's Covid recovery process will be disrupted by a sudden shift to trading with the EU on World Trade Organization (WTO) terms. HSBC's view has always been that failure to reach an agreement on an ongoing economic relationship would deliver an adverse shock to the UK economy, and during the negotiations about the Withdrawal Agreement it was forecast that a "no deal" outcome would tip the economy into a mild recession, lasting two or three quarters. The past year has, of course, provided more time to make preparations, in particular the building of Border Inspection Posts in France. But there would still be a clear negative impact, with the value of both exports and imports likely to fall sharply, and with higher prices for food imported from the EU.

Meanwhile the UK has been seeking to replicate the EU's existing Free Trade Agreements (FTAs) with third countries. Of the 'deeper' arrangements, South Korea and Switzerland were taken care of last year, and it's hoped that an agreement will soon be reached with Japan. The proposed deal with Japan would see UK tariffs on imported Japanese cars fall from 10% to zero over the next six years, as against the eight-year timescale in the EU-Japan agreement. Some significant EU FTAs are still outstanding, notably the agreements with Canada and with Vietnam, while the relationship with Norway and Iceland, both of which are members of the European Economic Area (EEA), can't be finalized until the ongoing relationship with the EU is known. Earlier this year, there was much talk about a trade deal with the United States: those discussions are continuing, but it would now be a surprise if any formal agreement was reached this side of the US Presidential election on 3rd November.

Economic update: 3rd quarter 2020

Forecasts

Global economic growth

Annual % change in real GDP	2017	2018	2019	2020(f)	2021(f)
World (nominal GDP weights)	**3.4**	**3.2**	**2.6**	**-4.8**	**-5.1**
Developed economies	2.4	2.2	1.7	-6.7	4.6
Emerging economies	4.9	4.7	3.9	-2.1	5.7
North America					
USA	2.4	2.9	2.3	-6.4	3.6
Canada	3.2	2.0	1.6	-8.3	5.6
Asia/Pacific					
China	6.9	6.7	6.1	2.4	7.5
Japan	2.2	0.3	0.7	-4.1	2.2
India	6.6	6.8	4.9	-7.2	6.6
Australia	2.5	2.8	1.8	-4.3	4.9
South Korea	3.2	2.9	2.0	0.3	2.5
Indonesia	5.1	5.2	5.0	-0.9	5.4
Taiwan	3.3	2.7	2.7	-2.6	3.8
Thailand	4.1	4.2	2.4	-8.2	3.3
Malaysia	5.8	4.8	4.3	-4.6	6.6
Singapore	4.3	3.4	0.7	-6.6	7.6
Hong Kong	3.8	2.9	-1.2	-5.0	4.4
Philippines	6.9	6.3	6.0	-3.9	7.0
New Zealand	3.2	3.2	2.3	-5.1	5.7
Eurozone	**2.7**	**1.9**	**1.2**	**-8.1**	**6.5**
Germany	2.8	1.5	0.6	-7.2	5.2
France	2.4	1.8	1.5	-10.0	8.6
Italy	1.7	0.7	0.3	-9.8	6.2
Spain	2.9	2.4	2.0	-10.2	7.5
Other Western Europe					
UK	1.9	1.3	1.4	-10.3	6.0
Switzerland	1.8	2.8	1.0	-6.7	6.3
Sweden	2.8	2.1	1.2	-5.1	2.9
Norway	2.3	2.5	2.4	-5.0	3.0
Eastern Europe, Middle East & Africa					
Poland	4.9	5.3	4.1	-3.5	4.3
Hungary	4.3	5.1	4.9	-4.3	4.0
Czech Republic	4.5	2.8	2.5	-7.8	5.7
Russia	1.6	2.3	1.3	-6.1	2.1
Turkey	7.4	2.8	0.9	-4.9	3.7
Saudi Arabia	-0.7	2.4	0.3	-5.8	4.3
South Africa	1.4	0.8	0.2	-7.9	2.9
Latin America					
Brazil	1.3	1.3	1.1	-7.3	4.5
Mexico	2.1	2.1	-0.3	-9.0	4.0
Argentina	2.8	-2.6	-2.1	-10.0	4.0
Chile	1.3	4.0	0.9	-7.0	5.0

(f) = forecast

Source: HSBC Global Research

Economic update: 3rd quarter 2020

Forecasts

Policy interest rates

Interest rate (%) at end-period	Aug 2020	Dec 2020 (forecast)	June 2021 (forecast)	Dec 2021 (forecast)
North America				
USA*	0.25	0.25	0.25	0.25
Canada	0.25	0.25	0.25	0.25
Western Europe				
Euro Area (Refi rate)	0.00	0.00	0.00	0.00
Euro Area (deposit rate)	-0.50	-0.50	-0.50	-0.50
UK	0.10	0.10	0.10	0.10
Norway	0.00	0.00	0.00	0.00
Sweden	0.00	0.00	0.00	0.00
Switzerland	-0.75	-0.75	-0.75	-0.75
Emerging Europe				
Poland	0.10	0.10	0.10	0.50
Hungary	0.60	0.50	0.50	0.50
Czech Republic	0.25	0.25	0.25	0.50
Asia/Pacific				
Japan	-0.10	-0.10	-0.10	-0.10
China	3.85	3.65	3.65	3.65
India	4.00	3.50	3.50	3.50
Australia	0.25	0.25	0.25	0.25
New Zealand	0.25	0.25	0.25	0.25

* Upper end of target range
Source: HSBC Global Research (*Policy Interest Rates, 10 August 2020*)

Currency exchange rates

Exchange rate at end-period		2020 Q3 (forecast)	Q4	2021 Q1	Q2	Q3	Q4
Rates against £							
US dollar	USD/GBP	1.22	1.20	1.22	1.25	1.25	1.25
Euro	EUR/GBP	1.11	1.09	1.11	1.14	1.14	1.14
Japanese yen	JPY/GBP	128	126	131	137	137	137
Canadian dollar	CAD/GBP	1.71	1.74	1.77	1.81	1.81	1.81
Australian dollar	AUD/GBP	1.77	1.71	1.69	1.67	1.67	1.67
New Zealand dollar	NZD/GBP	1.97	1.94	1.91	1.89	1.89	1.89
Swedish krona	SEK/GBP	11.65	11.45	11.42	11.36	11.36	11.36
Norwegian kroner	NOK/GBP	11.98	11.78	11.65	11.59	11.59	11.59
Swiss Franc	CHF/GBP	1.16	1.15	1.18	1.23	1.23	1.23
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	6.95	6.95	6.95	6.95	6.95

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

Economic update: 3rd quarter 2020

Forecasts

UK economy: HSBC growth forecast compared with selected other forecasts

		HSBC	Bank of England	Bloomberg consensus	OBR 'main case' scenario
Annual growth 2020	%	-10.3	-9.5	-11.3	-12.0
Annual growth 2021	%	6.0	9.1	5.5	9.0
Level of GDP at Q4 2021, compared to Q4 2019	%	-4.5	0.5	-5.7	-2.4

Source: HSBC Global Research (*"UK GDP Revision",* 19 August 2020)

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