Economic update
Fourth quarter 2019

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The global economy: trade tensions still clouding the outlook

Since we issued our previous 'Update' in the summer, global economic growth has continued to slow, and the world economy is ending 2019 with a picture that is rather more subdued than at the start of the year. That's not to say that it's been an unmitigated catalogue of doom and gloom, and one particular source of concern, namely the possibility that the UK might leave the EU without a negotiated exit deal, has diminished: an orderly Brexit now looks more likely than the so-called 'cliff-edge' Brexit. The UK economic outlook, and the various possible Brexit scenarios, are considered in more detail in the UK commentary which follows.

Meanwhile the global economy still faces headwinds, in particular of course the trade dispute between the USA and China, which has seen a further escalation of tariffs on imports into America of Chinese-manufactured goods. The good news is that both sides are still engaged in talks aimed at resolving their differences, and the prospect of progress in the talks has contributed to an improvement in market sentiment over recent weeks. That said, there is still some uncertainty over the short–term outlook: there has been speculation that the conclusion of the first phase of the talks could slip into next year, raising the question of whether the USA will implement the next round of tariffs if the December 15 deadline is missed; and while the prospect of a further escalation has perhaps receded, it's not clear to what extent America will be prepared to roll back the tariffs that have already been implemented. Muddying the waters further, the USA has passed legislation, known as the Human Rights and Democracy Act, which requires an annual review of Hong Kong's special status with the USA and is regarded as lending US support for the protest movements in Hong Kong.

The more assertive US stance on trade issues has also extended to the relationship with the EU, with the WTO's decision that the EU had given improper support to Airbus opening the way for the US for the US to impose tariffs affecting up to $7.5 billion of US imports from the EU. Meanwhile the EU is pursuing a counterclaim against the USA's support for Boeing, though a decision from the WTO on this case is not expected until the first quarter of next year.

In this more challenging climate for global trade, business sentiment and investment has suffered, with the most obvious signs being a sustained slowdown in global manufacturing activity. There are tentative signs that maybe the worst of the downturn has passed, with the global manufacturing PMI having edged higher for the past three months, though it's still in negative territory. Offsetting the slightly better news from the manufacturing surveys, however, there are also signs that the weakness may be spreading to the service sector, the global services PMI falling to 51.0 in October, its lowest since 2012.

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Our latest global forecasts incorporate some negative impact from the tariffs that have already been implemented, and assume that there is neither a complete resolution of outstanding differences nor a marked escalation in the ‘trade wars’. On this basis, we continue to expect a further slowing in 2020, affecting most of the world’s major economies. Our first stab at a projection for 2021 is for a very modest uptick in growth, though this would still leave Eurozone growth at 1.0% or less for a third consecutive year, while US economic growth would again be below 2%.

HSBC growth forecasts for 2019-21 (with our previous forecast for comparison)

	2019 forecast		**2020 forecast**		**2021**
	Latest	(Previous)	Latest	(Previous)	(new forecast)
World	2.6	(2.7)	2.5	(2.7)	2.6
USA	2.3	(2.4)	1.7	(1.7)	1.6
Eurozone	1.0	(1.0)	0.7	(1.1)	1.0
China	6.2	(6.5)	5.8	(6.3)	5.8

Source: HSBC Global Research (*Global Economics*, Q4 2019)

The UK: two visions of Brexit

The UK is heading for its third General Election in less than four and a half years. It will be the first December poll since 1923, and the first winter election since 1974.

General Elections are never easy to predict. Three weeks before polling day in the 2017 campaign, few people would have thought that a hung Parliament was a likely outcome. While many pundits and insiders have since claimed to have known all along that Theresa May’s campaign was going off the rails, it still came as an enormous shock to everybody, including them, when the results of the exit poll were flashed up at 10pm on election night.

All that can be said at this stage, with three weeks of campaigning left, is that the opinion polls are showing the Conservatives holding a strong lead over Labour, and that unless there is a major shift Boris Johnson seems on track to win a comfortable outright majority in the House of Commons. As an illustration of how recent opinion polls might translate into the make-up of the next House of Commons, the Electoral Calculus website published a prediction on 18th November showing an overall majority for the Conservatives of 74. In any event, a much smaller majority will suffice, now that those who oppose the Government’s approach to Brexit have been ousted, or have chosen to leave. To achieve an overall majority, the Conservatives need just nine more seats than the 317 that they won in the 2017 election.

Should the Conservatives gain a clear majority, there will be a dash for Brexit, with plans having been laid for the fourth so-called ‘meaningful vote’ to take place on 23rd December. But should it all unravel for them in the next few weeks, then it is still possible that Jeremy Corbyn could become the next Prime Minister. Given that the polls show Labour so far behind the Conservatives, it seems unlikely that Labour could win enough seats to govern alone. A more plausible scenario is that it finishes a strong second behind the Conservatives, opening up the possibility of an alliance with other parties (the Lib Dems, the SNP, Plaid Cymru, the Greens), to deliver an alternative Brexit process. This would involve crafting a new Withdrawal Agreement under which the UK would enter into a customs union with the EU and agree to abide by many of the rules of the Single Market. This would then be put to the public in a referendum, presumably in the summer or autumn of next year, with ‘remain in the EU’ as the alternative option. The UK would then either leave the EU, perhaps at the end of 2020, or the Brexit process would be stopped in its tracks.

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A different approach?

The approach to Brexit that would be pursued by a Labour-led alliance government would bring the disadvantage of prolonging the uncertainty for businesses and individuals. It would, however, remove altogether the prospect of a 'no-deal' departure from the EU. Over the past few years, those who have opposed the Government's approach to Brexit have often struggled to agree on any alternative, but they have all sought to avoid a 'cliff-edge' exit. By contrast, Boris Johnson's approach, with an exit agreement already in the bag (or "oven-ready"), would see the UK formally leave the EU in a matter of weeks after the election: but it leaves open the question of what will happen at the end of the implementation period.

This is a standstill transition phase, during which the UK takes no part in any of the EU's institutions, but during which little would actually change, especially as regards the movement of goods and people. The idea is that this time will be used to negotiate and ratify a follow-on free trade agreement (FTA) along the lines of that concluded between the EU and Canada. The implementation period runs until the end of next year, although it can be extended by either one or two years, with this decision having to be made halfway through 2020. Mr Johnson has signalled that he will not seek any extension, which means that there is still a risk of a sudden transition to World Trade Organization (WTO) trading terms from the start of 2021. Such an outcome would result in many of the issues associated with a 'no-deal' Brexit, and would represent a negative shock for the economy, as well as for sterling's exchange rate.

An issue of confidence

Despite two periods of extreme political drama, which at times verged on chaos, during 2019, the economy has continued to expand, albeit at a muted pace. The waters have been muddied by the build-up and run-down of inventories as potential Brexit dates have loomed and then passed. Economic activity, as measured by GDP, therefore expanded at a brisk pace in the first quarter, but then contracted in the second. The first estimate of growth for the third quarter, which was released on 11th November, then showed a modest expansion of 0.3%.

Although the annual growth rate in the third quarter was just 1.0%, which is the slowest it's been since 2010, a similar expansion in the final three months of the year will mean that growth for the year as a whole will come in at 1.3%, only fractionally slower than in 2018. Given all that's gone on with Brexit and all that's happening in the global economy, this would arguably be a fairly respectable result. By way of example, both Germany and Japan managed GDP growth of just 0.1% in the third quarter, and their annual growth rates for 2019 will be slower than the UK's.

The pattern of growth has changed little in the last year, with the economy expanding at a sub-par rate on account of an absence of confidence on the part of both businesses and households. Capital expenditure by businesses has continued to decline, while consumers remain wary about spending, and especially about committing themselves to 'big ticket' purchases.

It's clear that getting on for three years of soggy growth is taking its toll. The past few months have seen several high-profile liquidations and administrations of large corporates in the retail and travel sectors, while the housing market remains stuck fast in the doldrums. And the past couple of months have brought signs that the labour market, previously one of the stronger features of the economy, is starting to turn. Although the unemployment rate remains low, coming in at 3.8% in the three months from July to September, this masked a drop in the number of people in employment, while the number of vacancies has been declining since the start of the year. The pace of earnings growth has also started to ease: having reached 3.9% in the summer, it's now eased back to 3.6%, suggesting that the market is not quite as tight as it was.

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But now that the risk of a 'cliff-edge' departure from the EU has diminished, there are grounds for cautious optimism, and for all the uncertainty inherent in the run-up to a General Election, it's likely that sentiment will start to perk up in the closing weeks of the year. In particular, the fundamentals of consumer finances are in much better shape than was the case a few years ago. Although the pace of earnings growth has slackened in the past few months, so too has inflation, where the annual rate for October came in at just 1.5%, the lowest since early in 2016. This means that real incomes (pay growth less inflation) and spending power are expanding at their strongest pace since before the financial crisis. Recent research from the Resolution Foundation has also confirmed that, in real terms, weekly earnings have finally recovered to their pre-crisis level. Consumers therefore have the ability to spend: the only issue is their willingness to do so – in short, confidence. The index of sentiment produced on a monthly basis by GfK fell in the months after the EU referendum, and has languished at relatively subdued levels since the closing months of 2016.

A bigger role for the state

Whoever emerges victorious from the election on 12th December, one thing is for sure: the government will be spending more, and making a bigger contribution to economic growth than it has done since before the financial crisis. Any notion of 'balancing the books', let alone running a surplus, has been discarded. The argument between the two main political parties is now merely about how big a deficit can still be described as 'prudent'.

The starting point for these arguments is a budget deficit for the 2018/19 financial year of £33.6 billion, which equated to 1.9% of GDP. With the economy expanding at only a sluggish pace, and with Philip Hammond having already signalled an end to the years of austerity, it's inevitable that the shortfall for the current financial year will be somewhat larger, and that the deficit will climb further in the years ahead. The new Chancellor, Sajid Javid, has outlined his intentions as part of the Conservative Party's pre-election pledge process, but a new fiscal framework will not be formalised until the next Government presents a Budget, probably in January.

At this stage, it's hard to be specific about the fiscal consequences of the programmes put forward by the various parties. But as a rough guide, the Conservatives appear to envisage the deficit rising to around 3% of GDP, with capital spending being increased by around £20 billion a year. Labour's plans would seem to imply running a deficit of closer to 5% of GDP, with capital spending being boosted by around £55 billion a year.

The average member of the British public may well be somewhat mystified by the fact that deficits are no longer a dirty word in politics. Just a few years ago, a shortfall of between 3% and 5% of GDP would have been viewed as undesirable, and something to be reduced by further swingeing cuts in departmental budgets. But now it's apparently all quite okay. This change of heart, especially from the Conservatives, may take some explaining. It's true that the cost of borrowing through the gilts market has fallen, so that the government is currently able to raise ten-year money at around 0.5%. But it has been cheap by historical standards to raise money for several years, so the change of tack by the Government, which started under Philip Hammond's stewardship of the public purse, also owes something to political necessity: the obvious strains on public services, and the plain fact that the patience of the electorate has been tested to its limit.

Lowering inflation forecasts

With so much uncertainty around, it shouldn't come as too much of a surprise that HSBC has nudged down its forecast for UK GDP growth in 2020. In part, this reflects the expectation of only very sluggish growth in the Euro Area, where our forecast for growth has been cut by 0.4 percentage points, and also of a drag to growth from a run-down of inventories now that a 'cliff-edge' Brexit seems less likely. We therefore expect GDP growth in the UK of just 1.0% next year, compared with the 1.1% anticipated in the last Update. Assuming that a disorderly end to the implementation period can be avoided, then the pace of economic growth is expected to revive to 1.4% in 2021.

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More substantive cuts have been made to our forecasts for inflation in the UK. The recent fall to 1.5% for the headline consumer price inflation (CPI) measure was in part a reflection of the effect of the Energy Price Cap introduced by the government. The ongoing impact of this action, together anticipated rise in sterling's exchange rate now that the risk of a 'no-deal' Brexit has receded, means that we now forecast that the annual rate of CPI inflation will remain some way below the 2.0% target until at least the end of 2021. This inevitably increases the risk that the Bank of England will decide to trim Bank Rate, although our 'main-case' forecast remains for there to be no change. With two members of the rate-setting committee voting for an immediate reduction of 25 basis points at the latest policy meeting, members are clearly beginning to fret about downside economic risks, even if a disorderly Brexit is avoided.

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Forecasts

Global economic growth

Annual % change in real GDP	2017	2018	2019(f)	2020(f)	2021(f)
World (nominal GDP weights)	**3.4**	**3.3**	**2.6**	**2.5**	**2.6**
Developed economies	2.4	2.3	1.6	1.2	1.4
Developing economies	4.9	4.7	4.0	4.3	4.3
North America					
USA	2.4	2.9	2.3	1.7	1.6
Canada	3.0	1.9	1.5	1.4	1.5
Asia/Pacific					
China	6.8	6.6	6.2	5.8	5.8
Japan	1.9	0.8	0.9	-0.1	0.7
India	7.2	6.8	5.9	6.5	6.5
Australia	2.4	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	3.1	2.6	2.1	1.9	2.0
Thailand	4.0	4.1	3.1	2.8	2.9
Malaysia	5.7	4.7	4.5	4.1	4.3
Singapore	3.7	3.1	0.4	0.9	1.6
Hong Kong	3.8	3.0	0.3	1.5	1.4
Philippines	6.7	6.2	5.7	6.3	6.3
New Zealand	3.1	2.9	2.1	2.4	2.3
Eurozone	**2.7**	**1.9**	**1.0**	**0.7**	**1.0**
Germany	2.8	1.5	0.4	0.3	0.9
France	2.4	1.7	1.3	1.0	1.2
Italy	1.8	0.7	0.1	0.4	0.6
Spain	3.0	2.6	2.2	1.8	1.6
Other Western Europe					
UK	1.8	1.4	1.1	1.0	1.4
Switzerland	1.8	2.8	0.9	1.1	1.0
Sweden	2.7	2.4	1.2	1.3	1.5
Norway	2.3	2.6	2.1	1.3	1.4
Central & eastern Europe					
Hungary	4.1	4.9	4.6	2.8	2.9
Poland	4.9	5.1	4.2	4.0	3.4
Romania	7.0	4.1	4.0	3.5	2.4
Czech Republic	4.5	2.9	2.5	2.1	2.4
Turkey	7.4	2.8	-1.1	1.0	2.1
Russia	1.6	2.3	1.0	1.7	2.1
Ukraine	2.5	3.3	3.3	3.4	3.8
Latin America					
Brazil	1.1	1.1	1.0	2.1	2.3
Mexico	2.1	2.0	0.5	1.4	2.1
Argentina	2.7	-2.5	-3.0	-2.0	1.5
Chile	1.3	4.0	2.3	3.0	3.3

(f) = forecast

Source: HSBC Global Research (*Global Economics*, Q4 2019; *European Economics*, Q4 2019)

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Forecasts

Policy interest rates

Interest rate (%) at end-period		Forecast for year-end		
	1 Nov 2019	***2019***	***2020***	***2021***
North America				
USA*	1.75	1.75	1.75	1.75
Canada	1.75	1.75	1.25	1.25
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	0.75	0.75	0.75	0.75
Norway	1.50	1.50	1.50	1.50
Sweden	-0.25	0.00	0.00	0.00
Switzerland*	-0.75	-0.75	-0.75	-0.75
Emerging Europe				
Poland	1.50	1.50	1.50	1.50
Hungary	0.90	0.90	0.90	0.90
Czech Republic	2.00	2.00	2.00	2.00
Romania	2.50	2.50	2.50	2.50
Asia/Pacific				
Japan	-0.10	-0.10	-0.10	-0.10
China	4.20	4.00	3.75	3.75
India	5.15	4.90	4.90	4.90
Australia	0.75	0.75	0.50	0.50
New Zealand	1.00	0.75	0.25	0.25

* Upper end of target range
Source: HSBC Global Research: *Global Policy Rates*, 4 November 2019

Currency exchange rates

NOTE The sterling forecasts shown below reflect a probability-weighted blend of different Brexit outcomes. Taking the US dollar rate, for example, equal probabilities are attached to a range of possible Brexit outcomes as follows:

(1) a 'no deal' Brexit, where sterling could fall to $1.10
(2) a deal (e.g. something like Theresa May's ill-fated deal), lifting sterling to $1.45
(3) 'no Brexit', which could see sterling revert towards $1.55

As the UK's chosen path (or default path) becomes clearer, the probabilities attached to these different outcomes will change.

Exchange rate at end-period			Forecast at end of quarter				
		2019 Q3	**2019 Q4**	**2020 Q1**	**Q2**	**Q3**	**Q4**
Rates against £							
US dollar	USD/GBP	1.23	1.28	1.37	1.37	1.37	1.37
Euro	EUR/GBP	1.13	1.16	1.25	1.25	1.25	1.25
Other rates							
US dollar / euro	USD/EUR	1.09	1.10	1.10	1.10	1.10	1.10
Chinese yuan / USD	CNY/USD	7.15	7.20	7.25	7.25	7.30	7.30

Source: HSBC Global Research (*Currency Outlook,* November 2019)

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Forecasts

UK economy

annual % change, adjusted for inflation (except where otherwise stated)		*forecast*		
	2018	**2019**	**2020**	**2021**
GDP	1.4	1.1	1.0	1.4
Consumer spending	1.6	1.7	1.3	1.2
Government spending	0.6	2.4	1.5	1.6
Investment	-0.1	0.4	1.4	2.0
Stockbuilding (% of GDP)	0.3	0.1	-0.3	-0.3
Domestic demand	1.6	2.1	0.5	1.4
Exports	0.1	0.6	0.8	1.6
Imports	0.7	4.1	-1.0	1.6
Manufacturing output	0.9	-0.2	-0.6	0.8
Unemployment rate (%)	4.1	3.9	4.1	4.1
Average earnings	2.9	3.7	3.5	3.4
Inflation - CPI	2.5	1.5	1.6	1.8
Current account (US$ bn)	-109	-124	-114	-114
Current account (% of GDP)	-3.9	-4.4	-3.9	-3.9
PSNB (% of GDP)	1.4	1.7	2.2	2.8
Exchange rate[1] US$ / £	1.28	1.37	1.37	--
Exchange rate[1] € / £	1.11	1.25	1.25	--
UK Bank Rate[1] (%)	0.75	0.75	0.75	0.75

1 at end-period. See exchange rates table above for important notes on exchange rate forecasts
Forecast as at November 2019; data and forecasts are subject to revision
Source: HSBC Global Research (*European Economics*, Q4 2019)

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