Economic Update

NBK Economic Research Department I 16 November 2020

International Scene

Resurgent virus sparks economy worries, before markets rally on vaccine news

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Highlights

- **A surge in virus cases in the US and Europe in October sparked fears of a 'double dip' recession, but sentiment rallied strongly in early November on positive vaccine news and post-US election relief.**
- **The (still contested) US presidential election win for Democrat Joe Biden has brought the prospect of a fresh fiscal stimulus nearer, though economic optimism due to vaccine progress could result in a smaller support package.**
- **Lockdowns across Europe will push the region back into recession in Q4 after Eurozone growth rebounded 12.7% in Q3. UK and EU negotiators are approaching the endgame in seeking a last-ditch trade agreement ahead of year-end.**

Benchmark equity indices saw a second consecutive down month in October, fueled by a fresh surge in virus cases across the US and Europe with the latter introducing fresh lockdown measures that raised fears of a 'double dip' recession. The Eurostoxx 50 plunged 7.4% on the month, while the US S&P 500 fell 2.8%. Sentiment improved markedly in early November however with the conclusion (if still contested) of the US election bringing stimulus prospects nearer, and positive testing results from a Covid-19 vaccine generating hopes of a return to economic normality in 2021. Still, lags in production and distribution of any vaccine mean that virus concerns will be pivotal for the economic climate for some while yet. Oil prices also shared in the early November rally with Brent jumping to $43/bbl on improved prospects for oil demand.

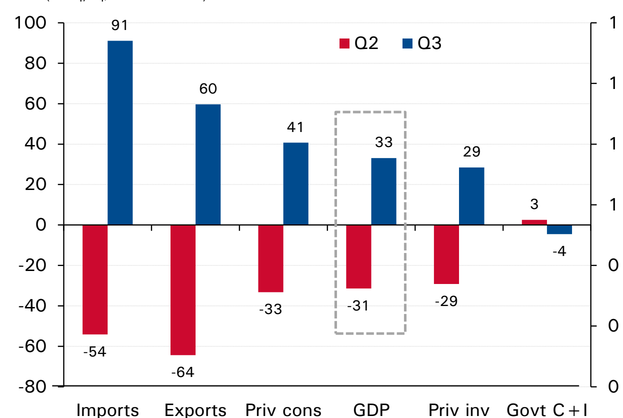
Biden win sparks acrimony, moves stimulus nearer

The Presidential election yielded a win for Democratic candidate Joe Biden versus incumbent Donald Trump by a margin of 51-48 of the popular vote and a projected 306-232 of the electoral college, although Trump will mount a legal challenge over the results in some states which were very close. While the prospect of a contested election result could in principle be a worry for investors, the chances of a successful Trump challenge at this point seem remote enough to avoid serious complications to the economic outlook. Indeed, markets seem content with the possible failure of Democrats to take control of the Senate (two seats in Georgia are up for grab), which could lead to slower and less streamlined policy-making but also reduce the chances of Biden implementing some of the more contentious parts of his policy agenda including tax hikes on corporates and investors. Positive news on the virus vaccine could also take some of the sting out of the fiscal stimulus debate, with both Republicans and Democrats more likely to agree on a smaller, targeted support package of well below $2 trillion if the economic outlook has seriously improved. Passage of any bill may have to wait until the new Congress is sworn in in January.

Just ahead of the election, GDP was revealed to have bounced back a record-breaking annualized 33.1% in 3Q20 following a 31.4% contraction in Q2 when restrictions and business closures were at their peak. (Chart 1.) The recovery was driven by a 40.7% surge in private consumption, though investment (especially housing) was also strong.

Chart 1: US GDP by component

(% q/q, annualized)



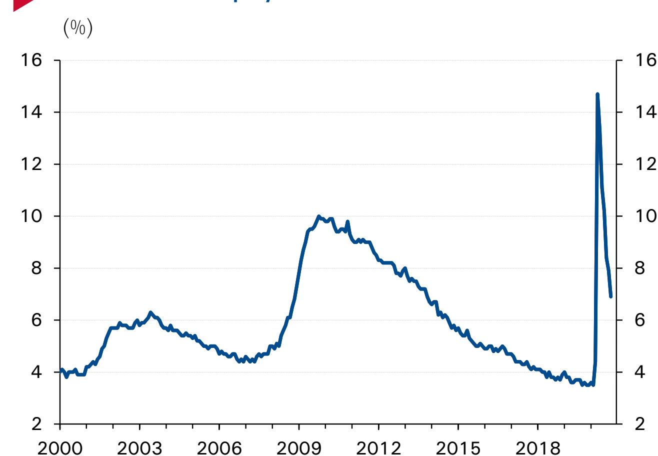
Source: Refinitiv

A huge climb in virus cases to more than 140,000 per day in early November has however generated worries about renewed restrictions on movement and business activity, with Biden having promised a tougher approach to lockdowns than Trump during his campaign. High frequency economic data has

remained uneven if mostly positive, including a continued downtrend in unemployment (6.9% in October), solid October ISM activity survey scores for both services (56.6) and manufacturing (59.3), though the rebound in consumer spending appears to be fading (still -0.6% y/y in September). (Chart 2.) The Federal Reserve left policy on hold in November (0.0-0.25% Fed Funds target rate and asset purchases of $120 billion per month). Chair Jay Powell admitted that the recovery was 'moderating' but despite core PCE inflation remaining well below target at 1.5% in September and virus cases surging, the bank may need to see clearer evidence of economic deterioration before easing already ultra-loose policy further.

Chart 2: US unemployment rate

(%)



Source: Refinitiv

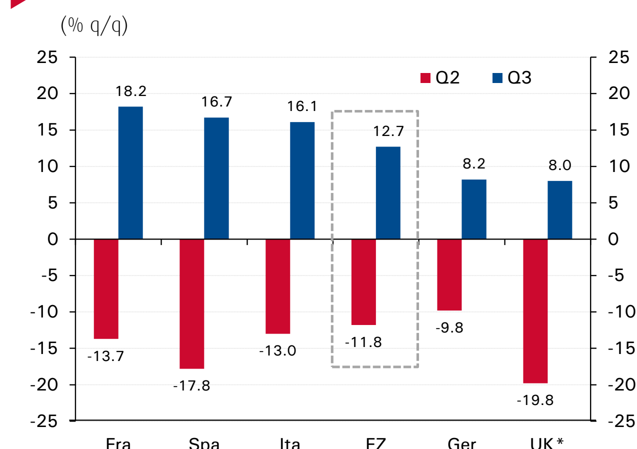
Europe's lockdowns to trigger fresh downturn in Q4

In Europe, economic conditions have been set back by the imposition of fresh lockdowns to contain a dramatic rise in Covid-19 infections from October, including in Germany, France, Italy and Spain. The restrictions are generally less severe than those implemented in the first wave and together with now better-adapted businesses should result in a smaller economic impact, but are still likely to tip the region back into recession in 4Q20 after a stronger-than-expected rebound in the third quarter. Eurozone GDP in 3Q20 rose by 12.7% q/q (consensus 9.6%). (Chart 3.) This followed contractions of 3.7% and 11.8% in Q1 and Q2 respectively, still leaving output around 4% below pre-Covid levels (4Q19).

The composite PMI stood at 50 in October signaling stagnation (and the service sector contracting), but this should deteriorate as lockdown effects kick-in. Indeed more generally, the 'stop-go' European approach to lockdowns – although sensitive to health worries – risks a cycle of uncertainty that inhibits spending by both households and businesses, which could in turn undermine the recovery until an effective vaccine is rolled out. Meanwhile, the unemployment rate has held up quite well so far at only 8.3% in October from 7.3% in February, with underlying weakness masked by furlough schemes.

Chart 3: European GDP

(% q/q)



Source: IHS Markit * Growth in the 3 months to August for the UK

The European Central Bank (ECB) as expected left policy on hold in October, but pledged to 'recalibrate' it as appropriate to support the recovery and counteract the negative impact of the pandemic on inflation. This was seen as a strong hint of further easing at its December meeting, likely involving an extension or expansion of its €1.35 trillion PEPP asset purchase program currently due to end next summer at the earliest. Core inflation remained well below the 2% target in October and at its all-time low of 0.2% y/y, albeit depressed in part by the temporary cut in German VAT that will expire at year-end.

In the UK, the Bank of England expanded the size of its asset purchase program from £745 billion to £895 billion by end-2021 ahead of an anticipated economic slowdown due to the imposition of a new one-month lockdown across England from early November. The policy rate remained at 0.1% but the bank is considering a move to negative interest rates. The government also announced the extension of its furlough program until next March, which pays up to 80% of workers' salaries for any work lost and should prevent any sharp increase in unemployment from its current 4.8% in the near term. Meanwhile, UK and EU negotiators are approaching the endgame in seeking a last-ditch Brexit trade deal before the current transition period expires at year-end. A deal needs to be secured by mid-November to ensure enough time for ratification by national parliaments, and failure would see the imposition of tariffs and quotas, trigger economic disruption and potentially a serious deterioration in relations between the two sides.

BoJ lowers Japan's 2020 growth outlook

The Bank of Japan (BoJ) lowered its growth forecast for FY2020/21 to -5.5% from the July estimate of -4.7%. The bank continues to see a sluggish economic recovery due to hesitant domestic demand and business investment, even while industrial activity and exports were recovering in line with an improving global economy. The outlook for 2021 is better, with growth projected at 3.6%. There was no change to monetary

policy, with the bank maintaining interest rates at -0.1% and its government bond-buying program to keep 10-yr bond yields at around zero percent. Prime Minister Suga did, however, recently announce the preparation of a third additional budget to support economic growth. The stimulus package, which could be anywhere between ¥10-30 trillion ($95-286 billion on top of the $2.2 trillion across two stimulus deployed this year), will this time be more targeted and focus on boosting private demand and investment as well as offer support to the still-struggling services sector through the extension of travel and job retention subsidies, for example.

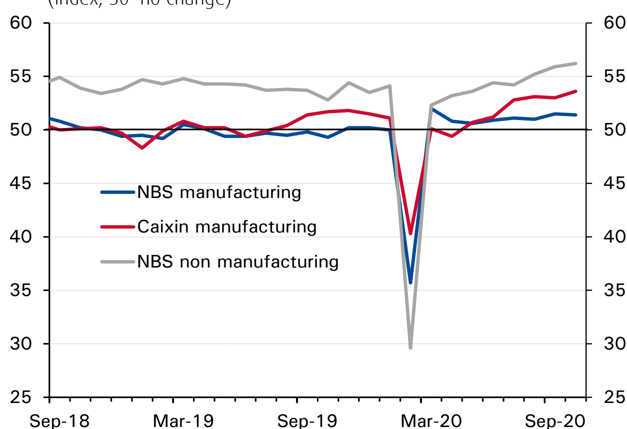
Business sentiment in October, however, continued to improve, rising to its most bullish in almost seven years (54.5). Equities are also on something of a run, with the Nikkei 225 stock index closing last week at a 29-year high of 24,325.

China a positive growth outlier in 2020

The recovery in China's economy continued in the third quarter, with GDP expanding by 4.9% y/y on higher industrial and especially services output. Services activity improved further in October, with both the NBS PMI (56.2) and the Caixin/Markit PMI for smaller businesses (56.5) extending multi-month runs in expansion territory. (Chart 4.) This was driven by domestic rather than overseas demand, as new export orders fell further into contraction territory during the month due to the coronavirus resurgence in Europe and the US. Another positive was the uptick in hiring, for the third month in a row, and at the fastest pace in a year. Manufacturing also expanded in October (51.4), though due to the longer than usual Golden week holiday, the expansion pace eased slightly from September.

Chart 4: China PMIs

(index, 50=no change)



Source: Refinitiv

China's economy has grown 0.7% so far in 2020, thanks to exports and manufacturing initially and consumption more recently. China is on track to be the only large economy to expand in this coronavirus-affected year. The IMF reasons that it is due to China's contribution that global GDP will be higher by 0.6% in 2021 compared to 2019. China's leadership, however, is prioritizing growth quality rather than speed, with the next 5-year plan focusing on technological improvements and domestic consumption as the primary growth drivers. Moreover, President Xi told his party's Central Committee that China's economy could reach high-income status in 5 years (GNI per capita >$12,375) and double in size by 2035 from the current $14.3 trillion.

India's economic activity improves as virus cases decline

India's economy continued to show improvement after the steep contraction in GDP seen in 2Q20 due the adverse effects of the pandemic. Business activity has gradually picked-up, with the manufacturing PMI reaching 58.9 in October from 56.8 in September, while the services PMI surged to 54.1 (from 49.8) in its first expansion since February. Both readings easily beat expectations. Improved activity came on the back of higher new orders and an increase in exports, reflecting a pickup in demand, despite a continued decline in employment amid ongoing social distancing measures. On the fiscal front, the government approved a fresh round of stimulus in October amounting to a relatively modest $10 billion, which may temporarily boost sentiment, though unlikely to greatly lift the economy.

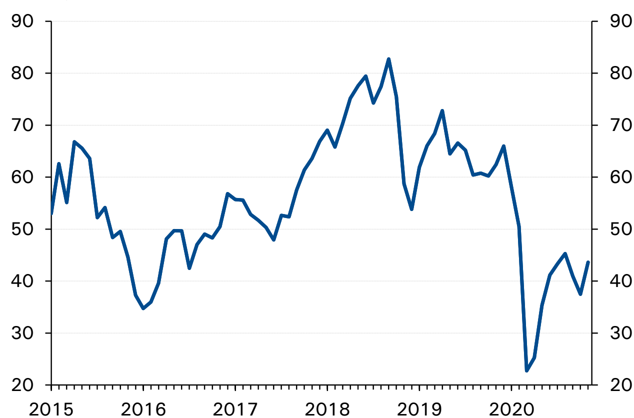
The significant decline in the number of daily confirmed coronavirus cases (by less than half to 38,000 as of Nov 10) since the peak in September could augur well for the economy due to the possible easing of restrictions. However downside risks related to a second wave of global cases and a possible delay in vaccine approval or administration could weigh down on external demand and lead to a slower recovery. As inflation continues to rise (7.3% in September from 6.7% in August) and fiscal pressures continue to mount, the room for fiscal and/or monetary support is becoming increasingly narrow. The consensus forecast is for GDP to contract 9.1% in FY2020/21, and to rise by 9.3% in FY2021/22.

Oil prices under pressure before vaccine boost

Oil demand worries pushed Brent oil futures down 8.5% m/m in October, closing at a five-month low of $37.5/bbl, amid record coronavirus cases and a return to lockdown in major European economies. Markets were also disappointed that the mooted US crude stock drawdown failed to consistently materialize, part of which is related to bad weather on the US Gulf Coast since September, and by the inability of US Congress to pass a fresh stimulus bill before November's elections. Since then, oil prices have ticked up slightly, relieved to some extent over the possible failure of the Democrats to make a clean sweep of the US legislature, which may augur for an anti-fossil fuel move. The positive vaccine news of early November then saw oil jump the most in one day (+7.5%) since June. Nevertheless, oil fundamentals remain stressed.

Chart 5: Brent crude oil price

($ per barrel, end of month*)



Source: Refinitiv   * Latest figure is for November 11

In terms of oil demand, energy reporting agencies such as the IEA and OPEC largely kept their forecasts unchanged from September (IEA -8.4 mb/d in 2020; +5.5 mb/d in 2021), but noted that the balance of risks was heavily skewed to the downside in light of Covid's autumn resurgence. Demand is not expected to return to pre-pandemic levels until 2022 at the earliest. Supply-side pressures are also rising due to returning Libyan crude flows amid a ceasefire between warring factions, with output jumping to around 1 mb/d, from only 156 kb/d in September. This could require compensating cuts from OPEC+ producers to prevent the market becoming more oversupplied. OPEC+ notched up another month of output cuts over-compliance in September (102%), and will meet on 30 November to decide a course of action. Anything less than a delay in the scheduled easing of cuts will likely cause oil prices to fall severely.

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