Economic Update

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International Scene

Vaccine progress and stimulus hopes fuel economic optimism, stock market surge

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Highlights

- **Equity markets enjoyed dramatic advances in November on positive vaccine news and the potential for fresh policy support in both the US and Europe. Crude oil prices also leapt despite OPEC+'s decision to hike output from January.**
- **President-elect Biden has started to nominate his economic team including former Fed chair Janet Yellen as Treasury secretary. Yellen's cross-party backing could help smooth the way to a new albeit reduced fiscal stimulus package worth $0.9 trillion.**
- **The ECB loosened monetary policy at its December meeting by expanding its PEPP asset purchase program. Trade deal talks between the UK and EU are in the balance, but the prospect of a 'no deal' Brexit have risen.**

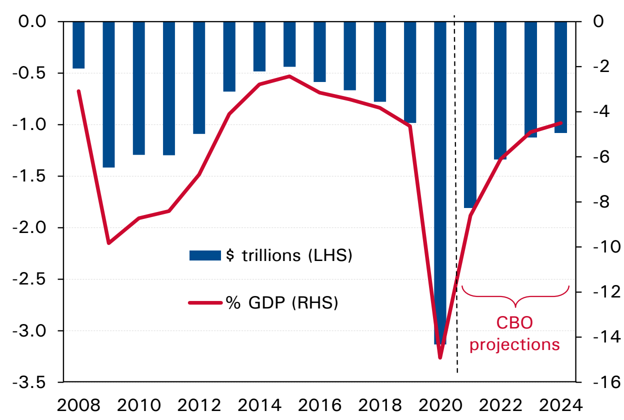
Global equity markets enjoyed dramatic advances in November, buoyed by the positive trials and imminent – albeit protracted – rollout of vaccines for the Covid-19 virus that has decimated the global economy this year. The US S&P 500 rose 11% and the Eurostoxx 50 shot up 18%, brushing off continued pressure on the near-term outlook due to record high virus cases and economically costly lockdown measures. The potential for fresh or extended policy support including another US fiscal stimulus package and looser European monetary policy has also underpinned a more upbeat mood. Brent crude oil prices meanwhile leapt 27% to nearly $48/bbl on hopes that economic recovery will support oil demand, and despite OPEC+ agreeing on a (less than initially scheduled) production hike from January.

Biden builds economic team as stimulus hopes rise

With President Trump's prospects for overturning the election result having all but disappeared, President-elect Biden has started to select nominees for his economic team, including veterans of previous Democratic administrations such as former Fed chair Janet Yellen as Treasury Secretary and labor economist Cecilia Rouse as the first black woman of the Council of Economic Advisers. Yellen in particular is seen as an experienced hand with bipartisan support, which may help improve policy coordination between the government and central bank and smooth the way for a new stimulus deal compared to a more controversial or left-wing appointment. (See below.)

The new administration faces numerous economic challenges including a small business sector devastated by a still-raging virus and state-specific lockdowns, a massive fiscal deficit (15% of GDP in 2020), rising public debt (98% of GDP), high-if-falling unemployment (6.7% in November) and disputes with key international trading partners. (Chart 1.) However, the likely rollout of several Covid-19 vaccines in coming quarters are giving rise to more optimism on the outlook and despite pandemic pressures, near-term data in some areas including business activity surveys and the housing market are solid, indicating perhaps a decent quarter of GDP growth in 4Q20 after Q3's record 33% rebound. Though downside risks from fragile confidence and a weak labor market persist.

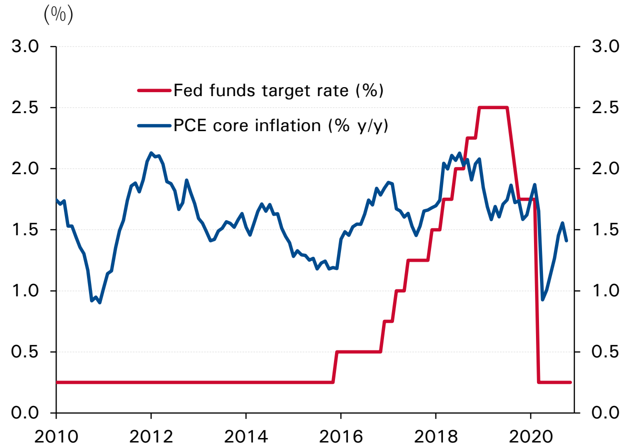
Chart 1: US fiscal balance



Source: Refinitiv / Congressional Budget Office projections from Sep 2020

On the policy front, Congress may be zeroing in on a new stimulus package worth $0.9 trillion (4% of GDP) – much smaller than House Democrats had previously rejected but including help for small businesses ($288 billion), local governments ($160 billion), and an extension in enhanced unemployment benefits ($180 billion) scheduled to expire at year-end. But the deal is not yet secured in Congress, while the Whitehouse has proposed a similar-sized plan of different composition. Either could be followed with a larger package after Biden's inauguration on January 20. Meanwhile, the Federal Reserve remains committed to ultra-loose monetary policy including a Fed funds rate of 0.0-0.25% and asset purchases of $120 billion per month for an indefinite period and could even loosen policy further (perhaps by increasing the pace of bond purchases or buying longer maturity bonds) at its December 15-16 meeting. Core PCE inflation edged back down to 1.4% y/y in October and remains well below the Fed's 2% target. (Chart 2.)

Chart 2: US inflation and policy interest rates*



Source: Refinitiv   * Shows upper bound of Fed Funds target rate

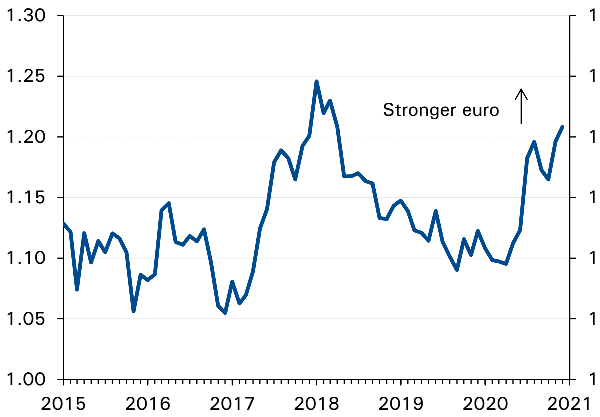
Eurozone faces Q4 downturn; Brexit deal in the balance

Lockdowns across Europe aimed at combatting the wave of new virus infections since October appear to have been partially successful though are expected to plunge the Eurozone back into recession in 4Q20. GDP in 3Q20 rebounded 12.5% but remains 4% below end-2019 levels. Indeed, the Eurozone composite PMI dropped sharply to 45.3 in November from 50.0 in October, confirming a renewed economic contraction on the back of the weakest score for services, 41.7, since May. Contractions were especially heavy in France (40.6) and Spain (41.7). Still, the declines are less severe than during the first wave of infections earlier in the year, reflecting according to the report stronger performance in manufacturing partly due to better external demand (which in turn is supporting ancillary services), and also looser lockdown measures this time around.

Given the deteriorating economic picture and a previous pledge to 'recalibrate' policy as appropriate to support the recovery, the European Central Bank announced a further policy loosening at its December meeting. It expanded its €1.35 trillion PEPP asset purchase program by €500 billion and extended it by nine months now due to end March 2022 at the earliest. It also extended its program of cheap loans for banks provided they continue to lend. At the same time, the bank revised down its growth projections for 2021 to 3.9% from the previous 5.0% (and from an improved -7.3% in 2020), while inflation next year was unchanged at 1.0%, still well below the near-2% target (though above November's -0.3% y/y). Inflation is also being kept low by the continued strength of the euro which has climbed 13% versus the US dollar since mid-March. (Chart 3.) Meanwhile fiscal policy could also provide additional support from next year, with the EU finally approving a €1.8 trillion seven-year budget and recovery fund. The latter allows the EU to issue some €750 billion in debt which can be disbursed to the most affected EU members as grants.

Chart 3: Euro-US dollar exchange rate*

($ per euro, end month)



Source: Refinitiv   * Latest figure is for December 9

Talks between the EU and the UK on a post-transition period Brexit trade deal remain in the balance at time of writing, with the issues of fishing rights, the so-called 'level playing field' competition rules and deal enforcement the key sticking points. Failure to agree a deal would see both sides resort to WTO trading terms from January 1, involving the imposition of new tariffs and quotas. These would include for example a 10% tax on car imports, though the UK will also simultaneously cut tariffs on various goods from all countries including the EU. Several 'last minute' deadlines for a deal have already passed, with both sides now agreeing to continue talks past the latest Sunday 13 December cut-off. The UK economy has received a boost from the early rollout of a mass Covid-19 vaccination plan which began on December 8 with inoculation of the most vulnerable demographic scheduled to be completed by April. Still, regional restrictions are likely to remain in place until at least mid-year and a no-deal Brexit would weigh on the recovery in 1H21. GDP growth is forecast at around +6% in 2021 from –11% this year.

Japan's PM announces fresh stimulus

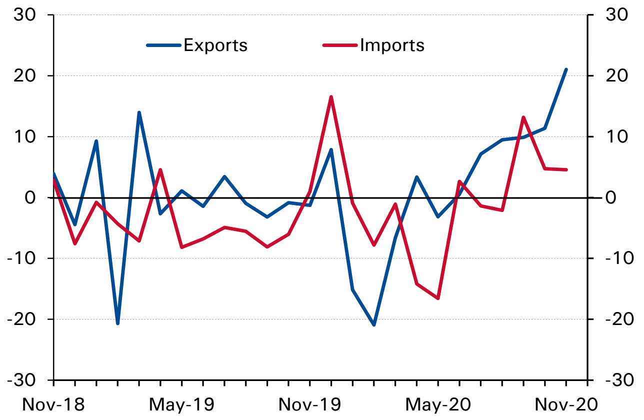
Japan's Prime Minister Suga unveiled another stimulus package early in December as his government struggles to contain daily coronavirus infections that have risen to new highs in areas like Tokyo and as his cabinet faces a slide in popularity. The total package is worth ¥73.6 trillion ($708 billion), including ¥40 trillion worth of fiscal measures (loans, investments etc.), and will be partly financed by a third budget this year of around ¥19.2 trillion. Spending will be directed towards virus containment, healthcare, employment and structural changes for the post-pandemic economy, including funding for green technologies and increased digitalization. The additional spending comes as the government's approval rating fell more than 12 percentage points from 63% in November to 50.3% in December.

Rising exports boost Chinese economy

According to the official PMI from China's National Bureau of Statistics, Chinese manufacturing activity in November expanded at the fastest rate in more than three years. The headline PMI increased to 52.1 from 51.4 in October, which is the best reading since September 2017 and higher than median forecasts. Improvements were recorded across many of the sub-indices, such as new export orders, which rose to 51.5 from 51 a month earlier benefitting from external demand for medical supplies, including personal protective equipment, and electronics. This was also supported by export data showing that Chinese companies notched up goods shipments of $268 billion (+21% y/y) in November, the highest volume on record and helped by a jump in exports to homebound US consumers (+46%) – despite US tariffs. (Chart 4.) With import growth easing to 4.5%, China's trade surplus surged to a new monthly high of $75 billion. The surplus (and a weaker dollar) helped boost the country's foreign reserves by more than $50 billion in November to a more-than-four year high of $3.18 trillion.

Chart 4: China international goods trade

(% y/y)



Source: Refinitiv

Economic contraction in India eases in Q3

India's GDP in 3Q20 (2Q FY20/21) contracted 7.5% y/y, confirming the recession, though a vast improvement over the steep 24% contraction of Q2. The smaller drop came despite a sharp fall in government spending and a pickup in imports, which were more than offset by a much smaller contraction in private consumption as lockdown measures were eased during the quarter. More recently in November, the pace of expansion in the manufacturing and services PMIs eased to 56.3 and 53.7 from 58.9 and 54.1 respectively in October, in a sign that the recovery may be losing traction due to factors such as still-high unemployment and lingering containment measures. On the fiscal front, the government approved a third stimulus package worth $36 billion, bringing stimulus spending since the start of the pandemic to about 2% of GDP. Measures include a labor subsidy to assist in job creation, and spending on sectors hit by the pandemic.

Although economic activity has improved notably over the past few months, several factors pose a downside risk to near and medium-term growth, including ongoing labor market weakness which is likely hurting private spending, relatively high inflation, mounting fiscal pressures, and a still uncertain virus outlook despite the recent advent of vaccines. The consensus estimate is for GDP to contract by 9.3% this fiscal year, and to rebound by 9.2% in FY21/22.

Oil prices surge amid vaccine optimism

Brent crude oil prices surged 27% m/m in November ending at $47.6/bbl, propelled by positive vaccine news. (Chart 5.) This helped lift the gloom that had settled over the markets linked to autumn lockdowns and also helped the market brush off the decision by OPEC+ to raise production by 500 kb/d from January, despite still-weak oil market fundamentals. Markets had been expecting an extension of the current production cuts (amounting to around 7.7 mb/d) for at least three months, after which producers would reassess the state of world oil demand and potentially raise output by 1.9 mb/d.

Chart 5: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv * Latest figure is for December 8

Underling the decision were two opposing views: One that was concerned about the weak state of world oil demand whereas the other was more confident of a demand rebound thanks to the vaccines and was unhappy that other serial non-compliant producers were failing to compensate for overproduction. A compromise solution was eventually agreed involving monthly assessments of the market and the option to increase or decrease production accordingly.

According to the International Energy Agency, which does not see the coronavirus vaccines boosting oil demand significantly until well into 2021, oil fundamentals are "too weak to offer firm support for oil prices". The agency, in its November oil market report, shaved 0.4 mb/d off oil demand in 3Q20 and a whopping 1.2 mb/d off demand in 4Q20. 1Q21 will see demand reduced by 0.7 mb/d from previous estimates as well. For 2020 as a whole, oil demand is expected to contract by 8.8 mb/d, before growing by 5.8 mb/d in 2021. Should demand growth underperform expectations and/or oil supplies from either the OPEC-3 (Iran, Venezuela and Libya) not subject to production cuts – Libyan output topped 1 mb/d recently – or non-OPEC (e.g. US) continue to rebound, price pressures will likely resume.

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