Investec Europe Market Bulletin

December 2020

Out of the Ordinary®

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Executive Summary

Our Market Bulletin for December takes a look at recent economic data, both in Ireland and globally. Following the publication of remarkable Q3 GDP figures, economic growth in Ireland could well top the international league tables this year, although we explain why this is not representative of the pandemic's impact on the domestic economy. Meanwhile, the OECD's latest global economic forecasts paint a much brighter picture than its previous set of forecasts despite a resurgence of COVID cases in many areas.

Investec Treasury dissects the recent ECB policy changes and examines recent backwardation in the oil market.

Best wishes for a safe and healthy Christmas and New Year and don't hesitate to contact us if we can be of assistance.

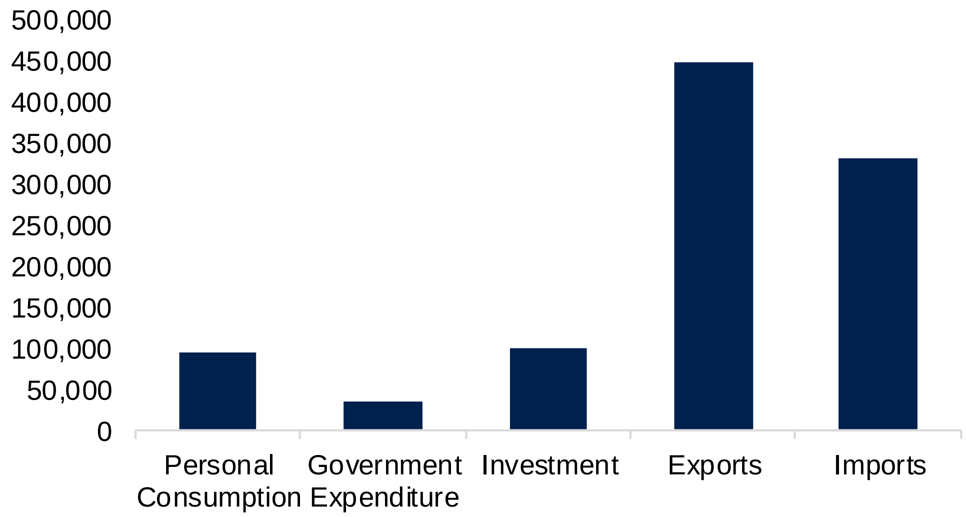
Economic Update: Ireland

GDP recovery in Q3 only tells half a story

Quarterly GDP in Ireland

Source: CSO

Components of annual GDP in Ireland (€m)



Source: Investec forecasts for 2020

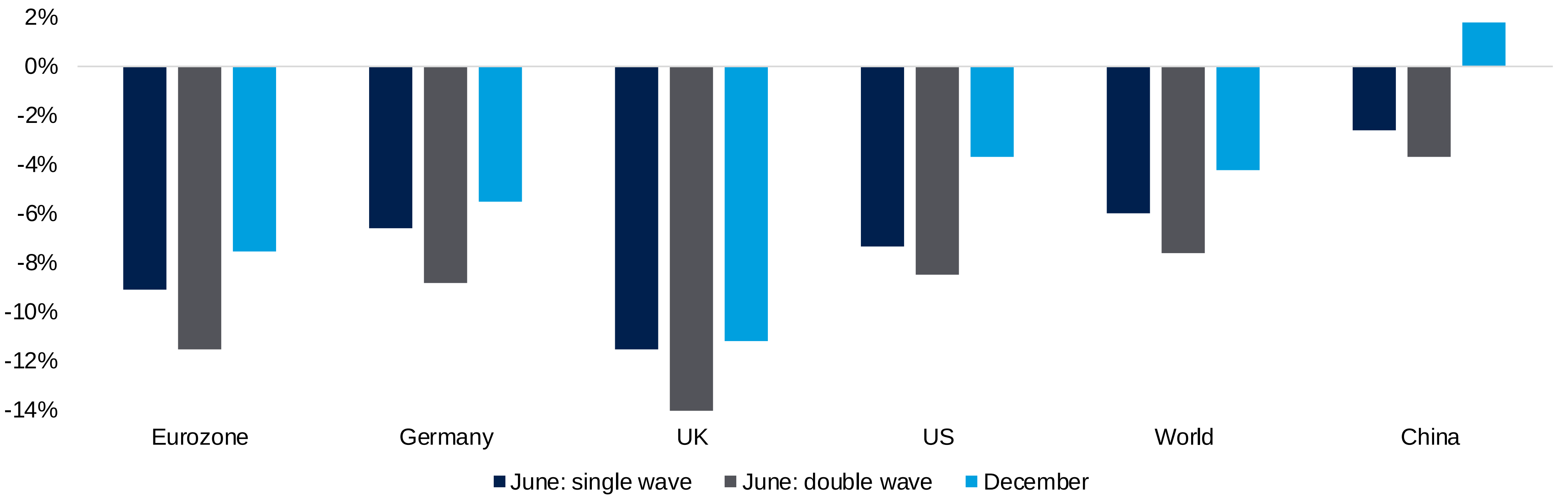
Expect Ireland to come out top of the international growth charts in 2020 – but the hit to the domestic economy will be similar to elsewhere

- The CSO recently published Quarterly National Account figures for Ireland for Q3. On the face of it, the numbers were astonishing. The fall in economic output in the first half of the year had been completely recovered and quarterly GDP had rebounded to a new high.
- Despite the unprecedented economic and social turmoil this year, GDP in Q3 was 8.1% higher than in the same quarter of last year. In the first three quarters of the year, economic output was 3.8% higher than in the first three quarters of 2019. By our revised forecasts, the economy is on course to expand by around 3% this year. This could well be the highest growth rate amongst developed countries globally and compares with an expected contraction of 7.5% in the Eurozone economy (see page 4).
- While the figures are diligently compiled by the CSO in accordance with international standards, in Ireland's case they tell an incomplete story.
- By international standards, Ireland has an exceptionally large export sector which accounts for a much larger slice of the GDP 'pie'. Ireland's export performance therefore has a much greater effect on GDP than any other component. We expect that Modified Domestic Demand – a proxy for the domestic economy – will fall by around 7% this year. However, the make-up of our export sector – heavily dependent on pharma products and IT services – is almost ideally-suited to a pandemic situation and is pushing economic output in Ireland to new heights, seemingly against all odds.

Economic Update: International

As end comes into view, economic hit has not been as bad as feared

OECD's December forecasts noticeably higher than June's



Source: OECD

- The OECD's economic forecasts in June painted a very bleak picture of the economic landscape. Reflecting the uncertainty of the situation, it published two sets of forecasts (which could have been coined 'very bad' and 'even worse') – one for a scenario in which there was no second wave of infections requiring further economic lockdowns and one where this happened. It assigned a 50/50 probability to each outcome.
- As it happened, the latter scenario is what transpired during the autumn in many parts of the world, but the organisation now expects that the economic outturn will be better than what it assumed under a single wave scenario in June.
- While the economic hit will obviously still be very severe, unprecedented government and central bank actions have been key in limiting the damage. Economic activity in many sectors recovered rapidly once restrictions were eased, but the recovery will continue to be uneven.
- At the global level, the OECD expects economic output will have returned to pre-pandemic levels by the end of 2021. Countries that can instigate vaccination programmes relatively quickly and that have effective test, track and isolate systems will perform relatively well. China, which started its recovery earlier, will rebound strongly in 2021, but there is likely to be further near-term declines in countries that experience renewed outbreaks, such as in many European economies.

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Investec Treasury: Currencies

Additional ECB stimulus can't halt a surging euro

EUR/USD rate

Source: Bloomberg

- As was widely expected, the ECB on Thursday put forward a policy recalibration, announcing several policy adjustments in light of the continued headwinds to economic activity from COVID and the protracted period of low inflation. There were no changes in the key policy rates; the Deposit rate remaining at -0.50%, the Main refinancing rate at 0.00% and the Marginal lending rate at +0.25%. Justifications for today's measures were predominantly focused on COVID and the more protracted impact of the pandemic on economic activity than previously anticipated. This was framed by the latest set of macroeconomic projections, which saw the near-term outlook pushed lower.

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Investec Treasury: Currencies

Additional ECB stimulus can't halt a surging euro

- The key ECB announcements included:

- **PEPP (QE) increase**: In a continuation of its previous pandemic response, the ECB announced a €500bn increase in asset purchases under its Pandemic Emergency Purchase Programme (PEPP), taking the total size of the scheme up to €1.85trn. The programme duration was also extended by nine months, to March 2022. Meanwhile, it confirmed that the underlying pace of purchases under its Asset Purchase Programme (APP) will continue at €20bn a month until there is a robust convergence in inflation to its target (which doesn't look like happening any time soon). The combination of the two programmes will therefore see the ECB purchase circa €90bn in bonds a month on average until March 2022, assuming the full €1.85trn is used under the PEPP.

- **Liquidity operations**: There was also adjustments to two schemes in the liquidity space. First, the terms of TLTRO-III were updated, with the programme extended with three new operations being introduced between June and December 2021. In addition, the period over which the most favourable borrowing rates will be applied was extended by one year, to June 2022. This means that for banks meeting lending benchmarks the rate applied to TLTRO borrowing will continue to be 50bps below the average deposit rate. To add to this, the total amount that banks can borrow has also been increased by 5 percentage points, so that the maximum funds that banks can draw from TLTRO-III is equivalent to 55% of their stock of eligible loans. Second, the ECB introduced four additional liquidity operations under the PELTRO (Pandemic Emergency Longer-Term Refinancing Operations) banner for 2021.

- **Looking ahead**: Markets seemed dissatisfied that the ECB did not go further, as evidenced by the euro rising and the benchmark EUR/USD rate reaching a peak of $1.2150 (32 month high) during Ms. Lagarde's press conference. Looking forward, we suspect that the ECB will stick with its current policy stance but be reactionary to any change in the macro and market environment. For example, the ECB is currently placing a degree of attention of financial conditions: the update to TLTRO III, at least in part, was in response to some signs of tightening in bank lending conditions to the private sector. However, with regards to longer-term policy prospects, the recovery, or rather lack of one, in inflation is going to be critical:, today's estimates forecast HICP inflation at 1.4% even in Q4 2023, some way below target and an argument for additional easing. We suspect that the ECB might take greater stock of this expected undershoot when its delayed strategy review is concluded, potentially around mid-2021, coinciding any further action with the review's conclusions.

Investec Treasury: Commodities

Oil rises steadily over $50/Barrel with OPEC Agreement

Brent Crude Front Contract

Source: Bloomberg

- Brent Crude traded over $51/barrel for the first time since March 20 after the recent OPEC meeting which agreed to steady supply growth from OPEC+ in the new year.

- But perhaps the most surprising development in recent days has been that the oil curve is now backwardated (forward prices are below the price of the front contract). This feature is usually a sign of the market being in tight supply as it makes storing oil uneconomic (i.e. you need to be able to sell stored oil forward at a premium to the spot price you paid for it in order to cover storage and financing costs, otherwise storing is a loss making exercise), but while inventories have come down significantly from historic highs, it seems hard to describe the market as in tight supply. We have to go back to 2004 to see the 12th Brent contract trading below the front contract at a time when the market generally was as low as it is now. 2004 was before Brent had ever traded above 50 $/b.

- A more likely explanation of the current backwardation is an absence of buying demand from consumers that would normally be jumping at the chance to hedge at these levels - airlines. In many cases there is still far too much short and long term uncertainty for the industry to be comfortable hedging significant volumes.

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