23 February 2021

Investec Bank plc (UK)

Economics

Global Economic Overview

Vaccines speak louder than words

Global

Despite decidedly mixed news on Q1 output from around the world, the trend in market sentiment has been firmly upbeat in the past month. Driving this has been the expectation that pent-up household savings will unleash demand as vaccine rollout proceeds, helping to restore economic activity. Outside of the UK, it now looks as though the fastest growth may take place in Q3 rather than Q2, but nevertheless, we have lifted our global GDP growth forecasts for both 2021 and 2022, from 6.2% and 5.1% to 6.5% and 5.2%, respectively. However, we feel bond markets may have got a little ahead of themselves: central banks are unlikely to tolerate much more by way of yield rises as yet before intervening, to keep financial conditions sufficiently loose to aid the recovery.

United States

Congress is debating President Biden's $1.9trn Covid relief bill. The Democrats are using a reconciliation bill to pass the package without Republican support. After three consecutive falls, retail sales rebounded by 5.3% in January, helped by stimulus cheques from the $900bn stimulus bill at the end of last year. Indeed, fiscal policy should be a major driver of growth this year – we have raised our GDP forecast by 0.6ppts to 5.9%. Bond yields have continued to rise, signalling market jitters over inflation. We are inclined to the view that this is overdone. The official measure of unemployment hides significant slack in the form of marginally attached workers and misclassified individuals. While much attention is on the CPI, note that the Fed's price objective is based on the PCE index and also that the FOMC is mandated to compensate for low inflation periods by running inflation above 2% for a time. The committee is probably nowhere near signalling any tightening.

Eurozone

In the Eurozone several themes have been evident over the last month. Clearly, Covid remains central with vaccine rollout, or rather the slow progress relative to other developed markets, a focus. This we suspect will result in a more significant pick-up in activity taking place later, in Q3. Our revised forecasts for annual growth now stand at 4.6% (2021), 5.2% (2022). On the political front Mario Draghi's elevation to Italian Prime Minister and avoiding an early election has been a highlight. The immediate priority will be addressing the pandemic and finalising Italy's Recovery and Resilience Plan. And whilst PM Draghi has an overwhelming majority, comprising all the main political parties, keeping such a government together over the full parliamentary term will be no easy feat.

United Kingdom

Speculation persists over possible tax rises at the Budget on 3 March. Meanwhile GDP rose by 1.0% in Q4. Putting together the various moving parts, we have nudged up our view of 2021 GDP growth to 6.4% from 6.2%. The recovery looks set to be underpinned by the UK's impressive vaccine rollout, enabling the economy to return to more normal conditions in line with the government's latest roadmap. Indeed, the yield curve has removed the pricing of the risk of negative rates. That said, the Bank of England still plans to include this in its toolkit, which looks set to include a tiered system of bank reserve remuneration. Sterling has risen beyond our end-year target of $1.40. It is the speed rather than the direction which is a surprise. For now, we are holding fire on our forecast, and also for that at end-2022 of $1.53.

Please click here for a summary of our economic and market forecasts

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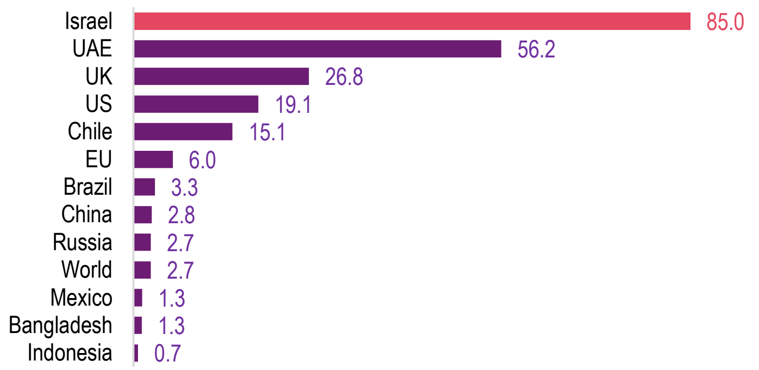
Global

The vaccine rollout continues to gather pace globally, with Israel still leading the way. The UK and the US are vaccinating rapidly, Chile is ahead in South America and Singapore and China lead in Asia. After an initial slow start, vaccination rates in the EU are starting to pick up too but are still modest. For now, governments worldwide continue to err on the side of caution as regards social restrictions, with stringent lockdowns still in place in the UK and several EU countries, holding back activity. But falling cases globally and increased vaccinations point to some loosening of restrictions and a rebound from Q2. As such, we pencil in global growth of 6.5% in 2021 and 5.2% in 2022.

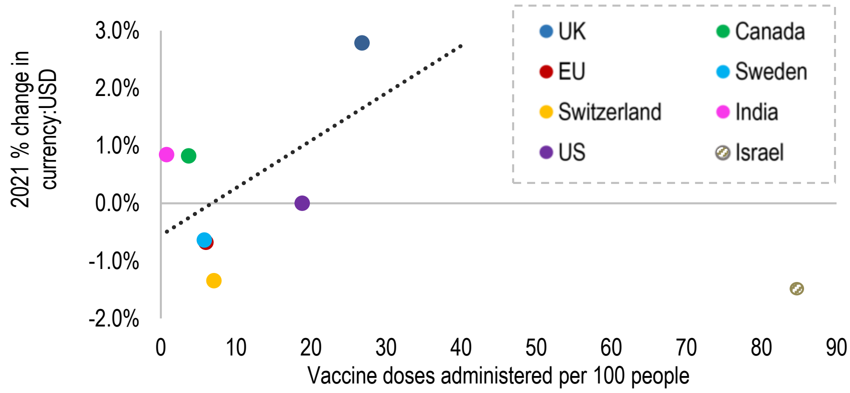
Chart 1: Global economies to open up in Q2? Doses administered per 100 people…



Source: Investec, Our World in Data

Since the turn of the year, vaccine rollouts, enhancing prospects of recovery, have helped buoy market sentiment. It could be argued, tentatively, that FX has reacted too: Chart 2 shows that USD has depreciated against GBP, CAD and INR, which may reflect greater risk appetite. Meanwhile, the Israeli Shekel has underperformed. But we note that vaccine rollout, although a key factor, will not be the only driver. For example, GBP may have benefitted from the UK's FTA with the EU; the BoE ruling out negative rates in the near-term; and a more supportive global equity scene. That said, it is worth keeping an eye open for further FX moves as vaccine rollouts ramp up.

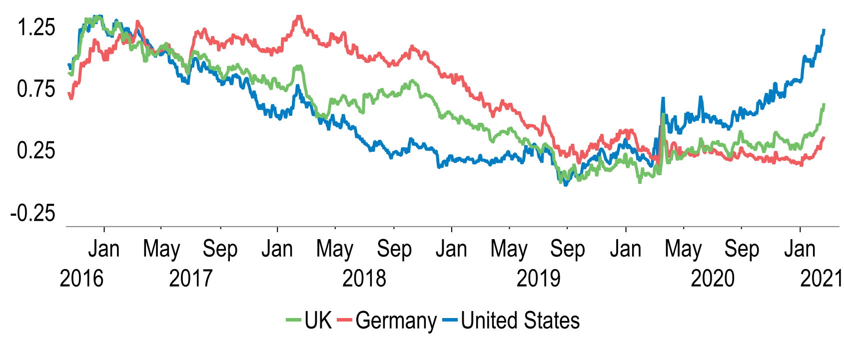
Chart 2: Vaccinations and currency moves (Israel not included in the data set)



Source: Investec; Our World in Data; Macrobond

Meanwhile bonds have been catching some attention: US 10yr yields breached 1.3% for the first time since Feb-2020, whilst gilt and Bund yields have been on the march too. This trend is evident in steepening yield curves as well, the US 2-10 spread now at its highest since 2017. The notion of a reflation trade remains the key driver of nominal yields, with inflation expectations contributing much of the rise, although real yields also ticked up in the last week. The expansion of US fiscal stimulus has been a key factor in Treasury moves and is also likely to have lifted gilt and Bund yields too. We suspect that vaccinations may also be a factor at play, mimicking the trends seen in FX markets. For example, the faster vaccine rollout in the UK likely contributed to the greater steepening in yields relative to Germany.

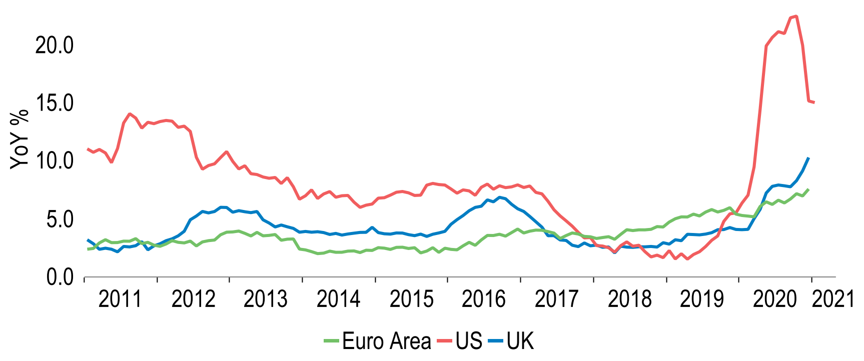
Chart 3: Yield curves have been steepening globally: 2y-10y spreads (%)



Source: Macrobond

Aside from steepening yield curves, a further noticeable theme across major economies has been the acceleration in the stock of household bank deposits. With social restrictions initiating a change in spending patterns, and government support schemes protecting incomes, household savings have increased over the past year. In the UK, we estimate the magnitude of these 'excess savings' to be 4.3% of 2020 GDP, with the US at 3.5%* and the Euro area at 1.8%. What is yet to be seen is how much of these extra savings will translate into consumer spending; the BoE assumes that 5% of the UK's extra savings will be consumed, but there could be an upside surprise.

Chart 4: The year of the savers as household deposits soar

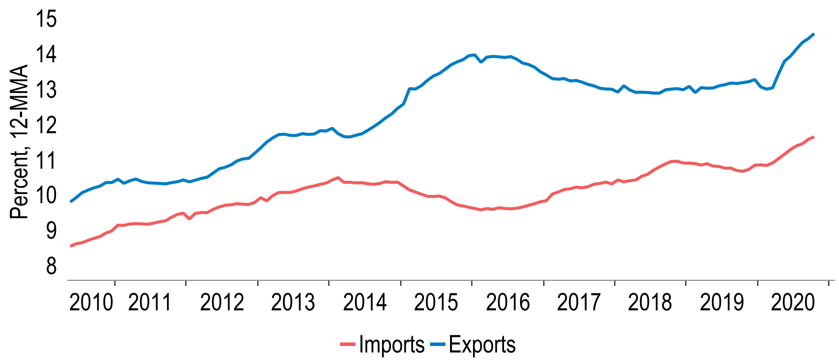


*Household deposit measure for the US is non-M1 M2.

Source: Investec, Eurostat, Macrobond:

Turning attention to Asia, as one of the few economies to report economic growth in 2020, one may wonder whether China can help revive world economic activity. There certainly is a precedent for it: China played a dominant role following the 2008/09 global financial crisis, supported by large fiscal packages. Policymakers have refrained from large-scale stimulus this time, but the economy has still managed to hold its ground, especially in terms of production, translating into China taking a larger share in global exports. The consumer economy has struggled to keep pace, but a recent strengthening suggests that modest gains are being made to enhance China's role as an important source of global demand.

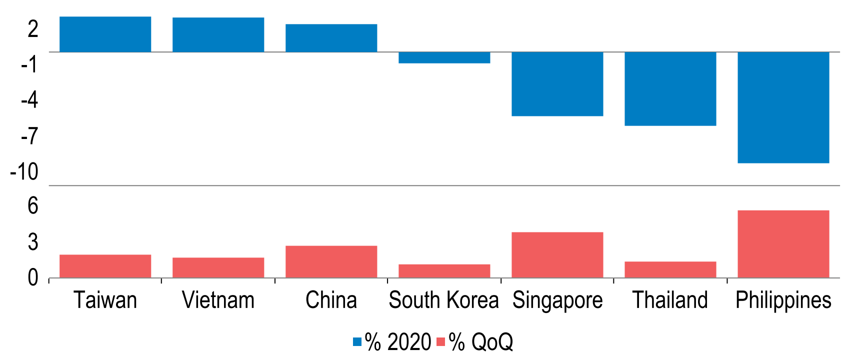
Chart 5: China's contribution to world trade (12 month moving average)



Source: Investec, Macrobond :

Indeed, China is not the only nation in the spotlight, with several of its neighbours also experiencing economic success. Many Southeast Asian economies have reported positive quarterly growth profiles in the latter of 2020, with the likes of Taiwan and Vietnam even managing to join China's small club of economies that experienced growth over the course of 2020 as a whole. We expect these economies to continue their recovery into 2021, with emerging and developing Asia acting as a beacon of hope for global growth prospects.

Chart 6: Southeast Asia's shining end to 2020

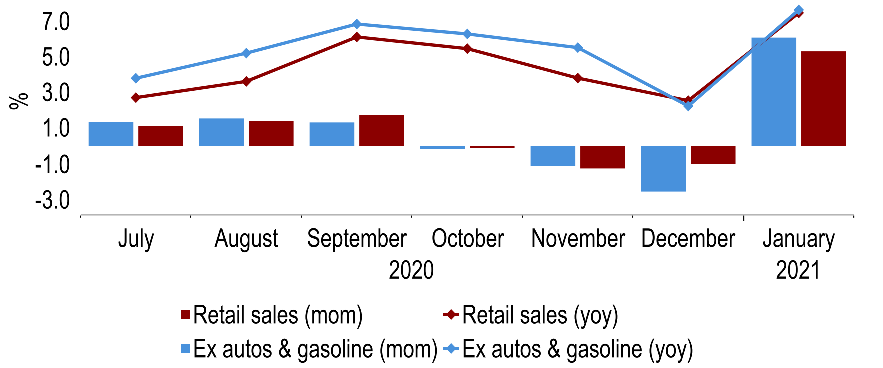


Source: Investec, Macrobond:

United States

As with his first, former President Trump's second Senate impeachment trial also resulted in an acquittal - 7 GOP Senators voting to convict was insufficient for a two thirds majority. Arguably more significant was the short duration of the trial – just 5 days – freeing time to debate President Biden's $1.9trn coronavirus relief bill. After a brief flirtation with bipartisanship, the Democrats have decided to go it alone to pass the package into law. Indeed, via the use of a 'reconciliation bill', approval can be with a simple majority rather than 60 (i.e. it disables the filibuster). The exact shape of the final package is uncertain, but we still view this as the key economic driver over 2021.

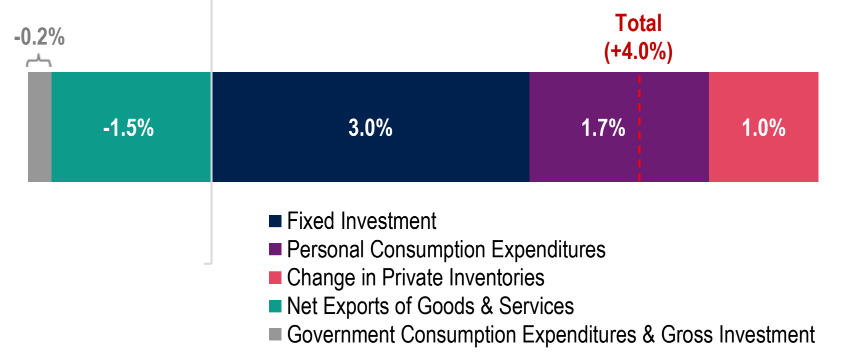
Chart 7: Retail sales have recovered following three monthly declines



Source: Macrobond

GDP chalked up annualised growth of 4.0% in Q4, despite a subpar contribution from consumer spending. Indeed, retail sales fell back in each month during the quarter. Recent data though show the efficacy of fiscal policy- retail sales surged by 5.3% in January, thanks to $600 stimulus cheques to households, part of the $900bn bill passed late last year. Our 2021 GDP forecast is now 5.9% (was 5.3%). Indeed, the earmarked fiscal stimulus is substantial - $1.9trn+$900bn equates to 13% of GDP. Work on Mr Biden's infrastructure package will start later in the year too. Moderate Democrats may insist on curbing its size, but even so, fiscal policy seems set to lend material medium-term support to the economy.

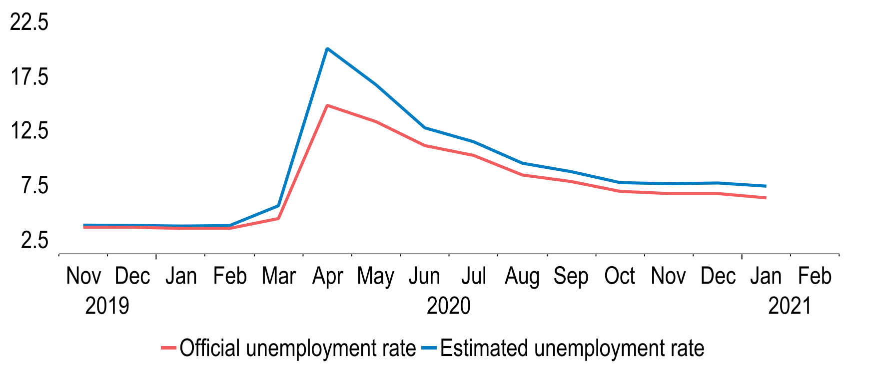
Chart 8: Q4 GDP growth was driven by investment rather than consumption (rates are saar)



Source: Macrobond

Despite the official unemployment rate falling to 6.3% in January, this may not represent the true extent of labour market slack. An alternative measure, the U6, which captures so called 'hidden unemployment', such as those that have left the labour market due to discouraging job prospects and the underemployed, suggests that true unemployment could be as high as 11.1%. The spread between the pair hit a record high in April 2020 as the pandemic took hold, but this has since narrowed. Although we believe the U6 to be a better indicator of slack, there could still be unemployment unaccounted for, with BLS misclassifications on pandemic-related unemployment potentially further inflating U6 by an estimated 0.6pp.

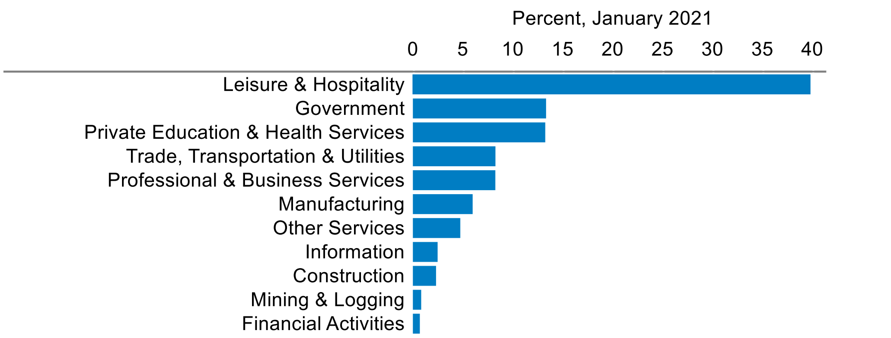
Chart 9: US hidden unemployment – even not fully revealed by U6? (%)



Source: Investec, Macrobond, BLS:

The January report also revealed that non-farm payrolls contracted by 6.1% annually. In terms of the sectoral composition of this contraction, unsurprisingly 40% of the fall can be attributed to leisure & hospitality, a sector decimated by ongoing social restrictions. The civil service also takes a lion's share. However, this is skewed by the size of the group, with government payrolls actually contracting by less than average at 5.5% annually. Conversely, the large contribution of private education and health services is significant. This is partly driven by a large drop in child day care payrolls, but also from a big fall in nursing and residential care facilities payrolls, which is perhaps more surprising.

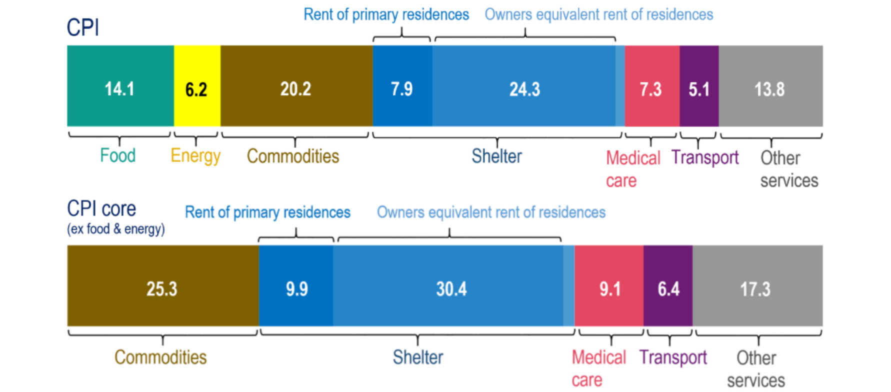
Chart 10: US sectoral contribution to annual change in non-farm payrolls



Source: Investec, Macrobond:

Treasury yields have risen again – those at 10y are a little short of 1.40%. While the trend has still largely been due to rising inflation expectations (breakeven yields), real yields have rebounded by some 20bps (to -78bps) over the past 2-3 days. TIPS compensation is based on the CPI index, where the inflation rate is currently 1.4% (both headline and 'core'). We would note that rental related items make up a material proportion of the CPI – rent and "owners' equivalent rent" account for 40.3% of the core index! Moreover, the Fed's objective is based on the PCE price index, which has consistently run below the CPI measure over the past 10 years, and which has undershot the 2% inflation objective 89% of the time. We suspect …

Chart 11: Rents effectively make up 40% of the core CPI (weights in %)

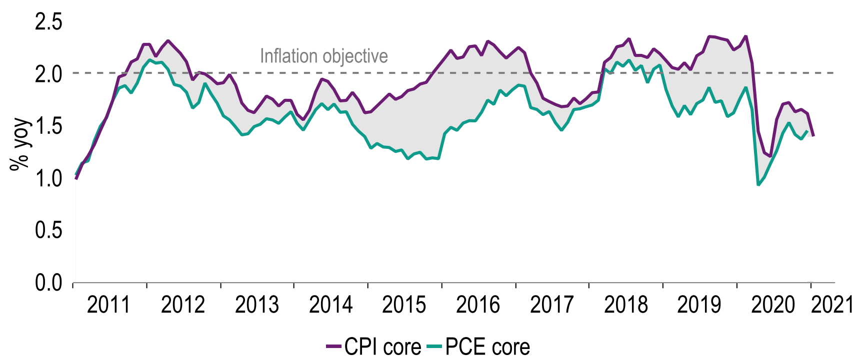


Source: Investec, Bureau of Labor Statistics

Third sub-category within 'shelter' has weights of approximately 1.2 & 1.5, total ≠ exactly 100 due to rounding.

… that economic strength will push rent prices higher, pulling CPI inflation higher, relative to the PCE measure. With substantial labour market slack still available and the Fed's mandate explicitly insisting on running inflation above 2% for a while to compensate for a period of low inflation, the FOMC is nowhere near tightening, other than perhaps technical moves on its IOER and reverse repo rates. We still see the Fed reversing QE in 2023 and raising the Fed funds target in 2025. Our 10y Treasury forecasts remain at 1.25% end-2021 and 1.75% end-2022, the pullback from current levels occurring perhaps on Fed warnings about financial conditions tightening too quickly.

Chart 12: Core PCE inflation tends to undershoot the core CPI measure

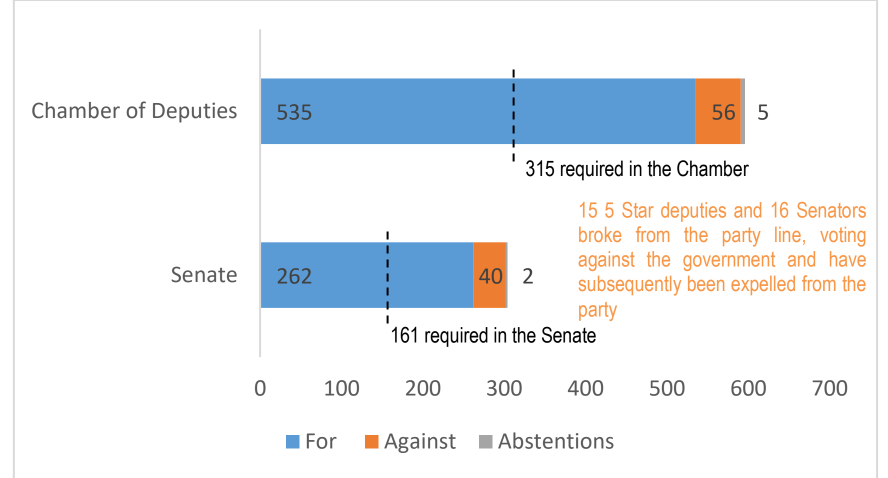


Source: Macrobond

Eurozone

This month has seen Mario Draghi elevated to Italian Prime Minister, heading a government of national unity. Following confidence votes in the Senate and Chamber of Deputies, PM Draghi and his cabinet, which comprises a good mix of technocrats (Daniele Franco appointed as Finance Minister) and mainstream politicians, will turn to the priorities of the pandemic and finalising Italy's Recovery and Resilience Plan by April, to unlock €200bn of EU funds. Beyond this Draghi will also need to address Italy's long-term growth and structural issues, at the same time as holding together a government which comprises all the main political parties, including the League following its surprise U-turn. Historically this has been no mean feat with Mario Monti's unity government lasting only 18 months.

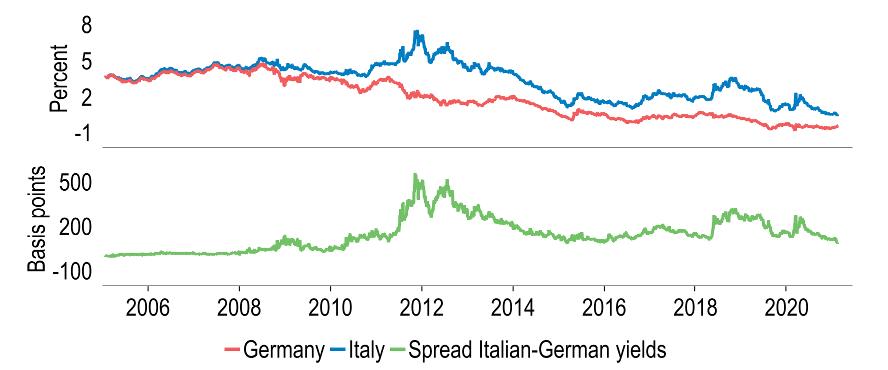
Chart 13: Resounding confidence votes for Draghi



Source: Reuters

Markets have given the thumbs up to the new Italian administration: spreads of Italian 10-year government bonds to their German equivalent have fallen by 34bps since their peak on 22 January, following the withdrawal of Italia Viva from the previous government on 13 January. This is a five-year low (Chart 14). Yet BTP yields are only 15bps lower over the past month. This is as the spread compression occurred against a wider market backdrop of rising bond yields: in the Eurozone, as elsewhere, risk-on sentiment has prevailed on hopes of an easing in social restrictions later this year, pushing German 10-year Bund yields up to -0.32%, a high since mid-June 2020.

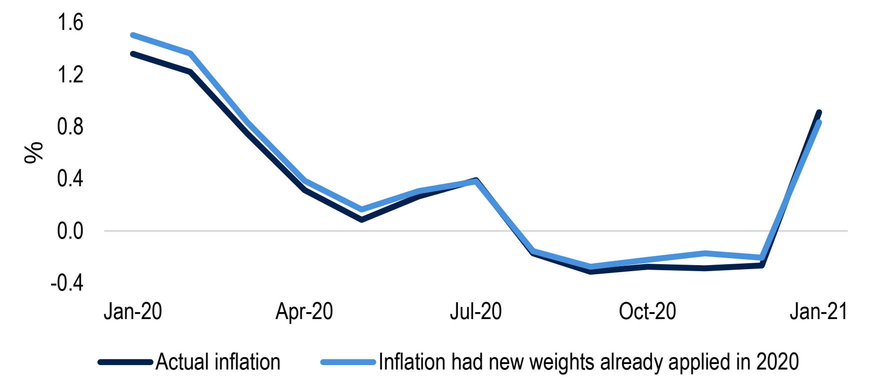
Chart 14: 10-year government bond yields in Italy and Germany and their spread



Source: Macrobond

Adding to the rise in bond yields in the Eurozone has been higher inflation: January's HICP flash estimate printed at +0.9% y/y, up from -0.3% in December. The surge was boosted by the restoration of the usual VAT rates in Germany after last summer's temporary cuts and the introduction of carbon pricing. But inflation also jumped in France, Italy and Spain, by 0.8pp, 1.0pp and 1.0pp, respectively. Some of this – 0.14pp at the Euro area level – reflects an update in the weights of the constituents of the price basket: the new weights now reflect the substitution in the pandemic away from services such as travel and hospitality and towards goods. As the weights are updated only annually, inflation was understated a little last year.

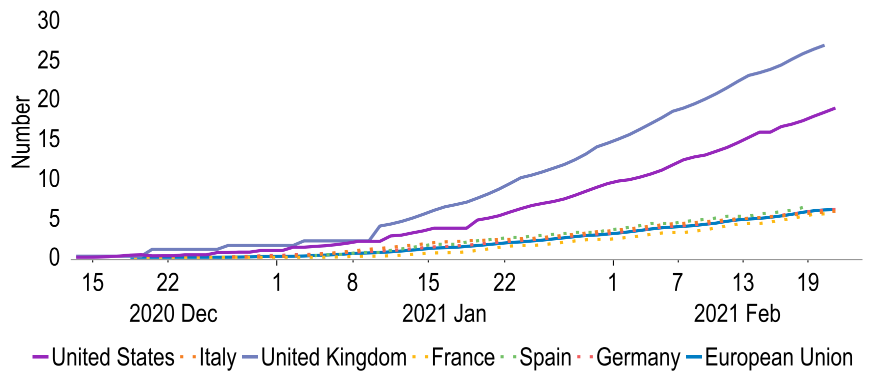
Chart 15: Eurozone inflation would have been a little higher in 2020 had the new weights applied



Source: Eurostat and Investec

Looking ahead, unsurprisingly Covid developments remain the central theme. A key consideration is vaccine roll out, where the EU19 has lagged behind other developed economies: in the eurozone's four largest countries*, vaccinations per 100 people stand at just 6, whereas in the UK the figure is five times higher. This implies that social restrictions may remain in place for longer, or even tighten – a new lockdown has been touted in Italy. Hence, whilst we still look for a recovery in Q2 from a likely 1.2% Q1 contraction, we have redistributed the extent of the GDP rebound, with Q3 expected to see the more significant pickup in activity. On an annual basis our GDP forecasts now stand at 4.6% for 2021 and 5.2% for 2022.

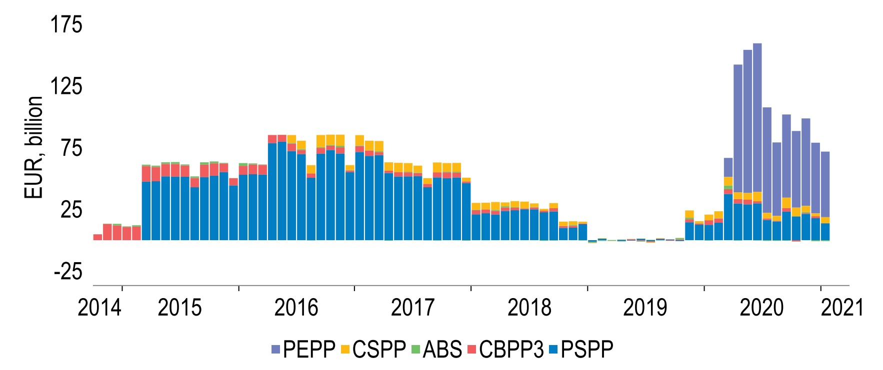
Chart 16: Europe lags the other developed economies: Vaccinations per 100 people



*Germany, France, Italy and Spain — Source: Macrobond

For the ECB this is set to lead to exceptionally accommodative policy for an extended period of time. Indeed, we do not envisage the ECB altering its Deposit rate until Q4 2023. In the meantime, QE remains the marginal policy tool of choice. Given the December decision to raise the PEPP envelope by €500bn to €1.85trn, and this programme running to March 2022, any adjustment to policy, if needed, is likely to come via this lever. An area that the ECB has been watching closely is financial conditions. Should these see an unwarranted tightening, this could be addressed by frontloading purchases, making use of the flexibility of PEPP. The converse is obviously also true.

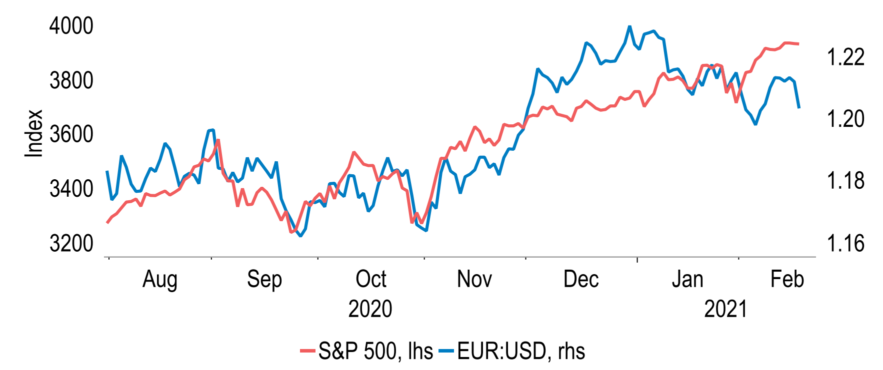
Chart 17: Monthly ECB net asset purchases (€bn)



PEPP- Pandemic Emergency Purchase Programme, PSPP- Public Sector Purchase Programme, CSPP- Corporate bonds, ABS- Asset backed securities, CBPP3- Covered bonds — Source: Macrobond

Of late the euro's strength has been one additional worry for the ECB. Over the last six months, general risk sentiment has clearly been a factor pushing the euro higher as the US dollar has weakened. However, over the last month upward momentum in €:$ has stalled around the $1.20 level. One might question whether the rise in US Treasury yields has supported USD. However, this argument is certainly not conclusive given that yields in the likes of Germany have also increased; in fact, the rise in 10yr US yields since the end of January has only outpaced that in Bunds by 4bps. Broadly we still expect the euro to rise this year, reaching $1.25 by Q4, and increasing further to $1.30 by Q4 2022.

Chart 18: Improving risk sentiment has supported EUR:$: €:$ vs S&P 500

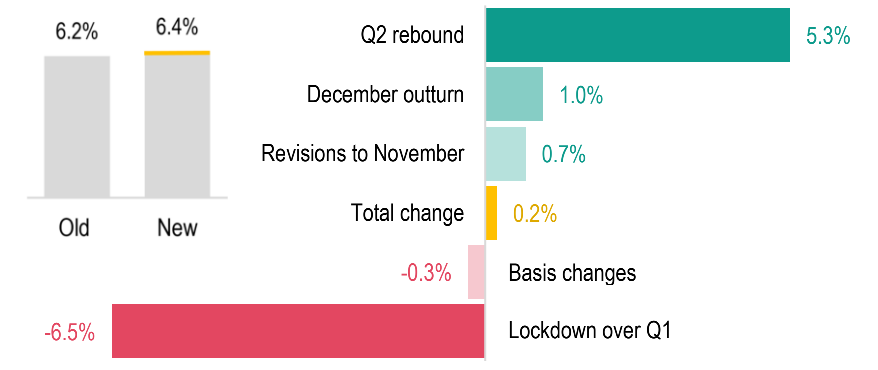


Source: Macrobond

United Kingdom

GDP rose by 1.0% (qoq) in Q4 helped by a 1.2% (mom) rise in December. We have lowered our expectations for Q1 due to the duration of the lockdown (now -5.3% (qoq) from -2.5%) but pushed up Q2 (to +10.1% from +6.9%). Our 2021 GDP forecast now stands at 6.4%, 0.2ppts higher. Chart 19 shows individual effects of the changes, including a 0.7ppt addition from ONS revisions up to November! We now see growth of 6.5% in 2022 (was 5.3%), with pre-pandemic levels of GDP now reached in Q4 this year. The rapid vaccine rollout supports our general outlook. So does our estimate of 'excess' household savings; this stands at £93bn (Dec), up from £76bn in Nov.

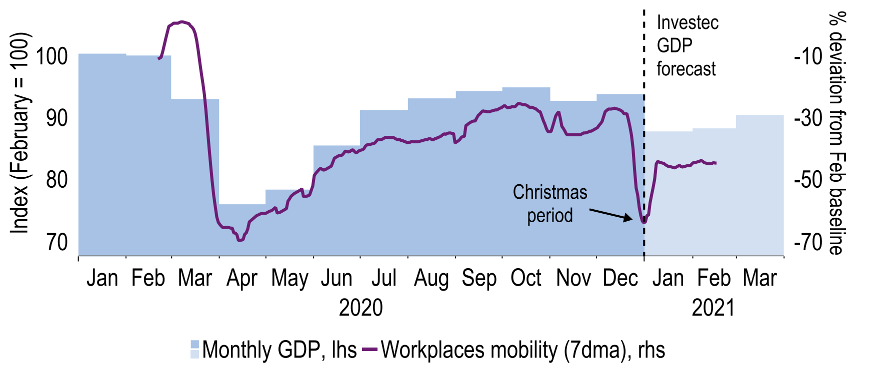
Chart 19: New 2021 GDP forecast after December release – breakdown of changes



Source: Investec forecasts

There are good reasons to expect a sizeable fall in output during Q1: Google's mobility reports suggest that the drop in workplace mobility between pre-Christmas levels and the start of January's lockdown was around twice that of November's lockdown (Chart 20). A slightly stricter set of restrictions this time around also saw schools, colleges and universities forced to switch to online learning. In addition, the emergence of new, more infectious variants of the virus drove case numbers up to record levels, prompting British workers and firms to take more caution with non-home working. However, we expect the economy to make up ground as restrictions begin to ease from March.

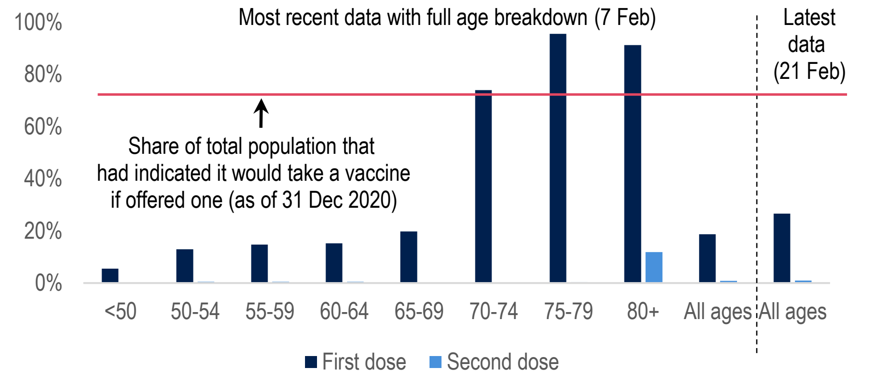
Chart 20: Google mobility data reveals a deeper drop in activity in January than November



Source: Macrobond, Investec forecasts

PM Johnson's roadmap for such an easing through the coming months, allowing the economy to recover, is underpinned by the vaccine roll-out. This has been rapid to date; the government hit its initial target of offering a vaccine to all those in its top four priority groups by 15 February, which had comprised those aged 70 and over, as well as care home, health and social care workers and clinically extremely vulnerable people. Encouragingly, take-up of vaccines has been very high, and exceeded what surveys had previously indicated (Chart 21). The burden of Covid-19 on the health care system should hence ease without requiring lockdowns for much longer.

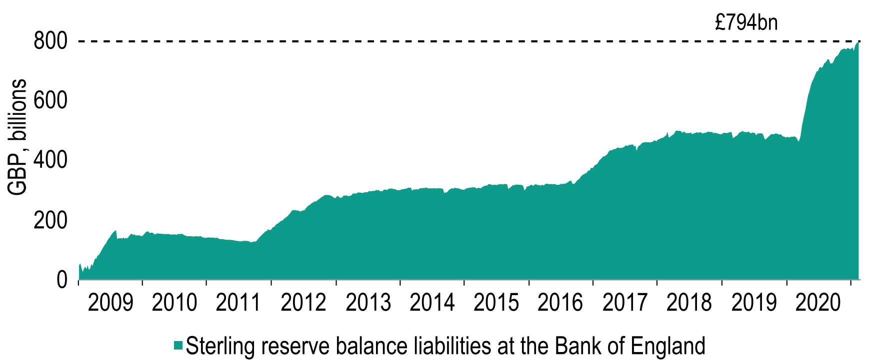
Chart 21: Share of population vaccinated against Covid-19 in England by age group



Source: National Immunisation Management Service (NIMS), UK government, *Our World in Data*

The BoE has given banks six months to prepare their systems for negative rates. As noted, before, mainly due to QE, bank balances at the BoE are high, currently £794bn. Remuneration at a subzero Bank rate would hit the banks: at -0.15% the aggregate annual cost would be £1.2bn. To dampen the impact, 'tiering' is being considered i.e. 'paying' interest on bank reserves at graduated rates. The ECB uses reserve requirements as the basis of its tiering structure, but in the UK these were suspended in March 2009. We still doubt that the policy rate will go negative. But preparing for the possibility requires some way of setting tiering thresholds, perhaps based on balance sheet size.

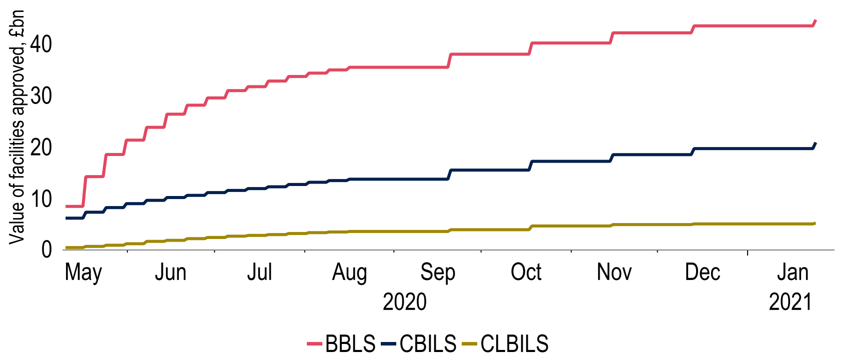
Chart 22: The rise of banks' balances at the BoE since QE started in 2009



Source: Bank of England

As the 31 March expiry for the Covid-19 business loan schemes comes into view, their use continues to increase. As of 24 January, £5.1bn has been lent under CLBILS, £21bn under CBILS and £45bn under BBLS. Chancellor Sunak has indicated a successor programme will be announced at the Budget on 3 March. Its shape remains to be seen. Speculation is that a new programme could entail lower government guarantees on loans. What is clear is that the schemes to date have helped stem business failures and have, in turn, propped up the labour market. All eyes therefore will be on No 11 come 3 March for 'Extra Time'.

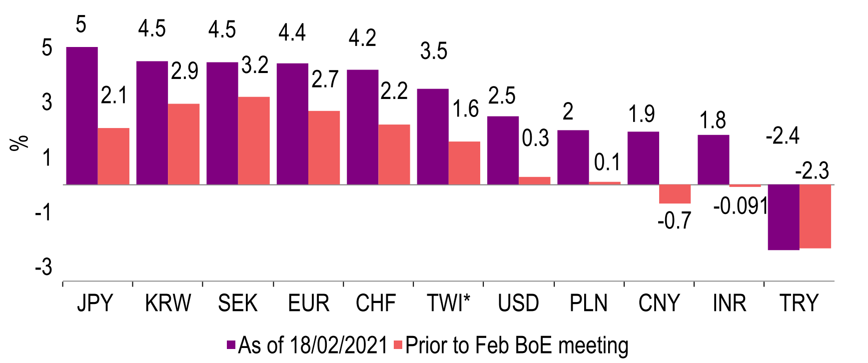
Chart 23: Sunak to call 'Full Time' on current loan schemes but 'Extra Time' to come...



Bounce Back Loan Scheme, Coronavirus (Large) Business Interruption Loan Scheme Source: Macrobond

Sterling has continued its steep climb that started around the start of the year, with further gains against both the US dollar and the euro. Indeed, cable is a little above our 2021 year-end target of $1.40, and EUR:GBP already where we had pencilled it in for some time during Q3 2022. That said, we have long identified sterling as fundamentally undervalued, so it is the speed of the move, not the ultimate direction, that is the surprise. GBP appears to be buoyed by the UK's relatively swift vaccination rollout, and by the MPC ruling out near-term negative rates at its last meeting. As others catch up, its momentum may slow, so we are not yet minded to make major changes to our GBP forecasts.

Chart 24: Sterling has climbed against nearly all its ten largest trading partners year-to-date



*: TWI = Bank of England narrow trade-weighted sterling exchange rate index Source: Macrobond

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2016	3.3	1.7	0.5	6.8	1.7	1.8	2.1	1.0	1.4
2017	3.8	2.3	2.2	6.9	1.7	2.7	2.9	2.4	1.7
2018	3.5	3.0	0.3	6.8	1.3	1.9	1.3	1.8	0.8
2019	2.8	2.2	0.7	6.1	1.3	1.3	0.6	1.5	0.3
2020	-3.4	-3.5	-4.9	2.1	-9.9	-6.8	-5.3	-8.3	-8.9
2021	6.5	5.9	4.1	9.8	6.4	4.6	3.3	7.5	3.3
2022	5.2	4.2	2.0	6.0	6.5	5.2	5.4	5.1	3.7

Source: IMF, Macrobond, Investec forecasts

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	0.00-0.25	0.00	-0.50	0.10	0.10
2021					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10
2022					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	1.36	-0.31	0.71
2021			
Q2	1.25	-0.50	0.65
Q4	1.25	-0.25	0.75
2022			
Q2	1.50	-0.25	1.00
Q4	1.75	0.00	1.25

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2021				2022				2020	2021	2022
		23-Feb	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.215	1.20	1.20	1.22	1.25	1.26	1.26	1.28	1.30	1.14	1.21	1.27
Sterling	€:£	0.863	0.87	0.88	0.88	0.89	0.88	0.86	0.85	0.85	0.89	0.88	0.87
	(£:€)	1.159	1.15	1.13	1.13	1.12	1.14	1.16	1.17	1.18	1.12	1.13	1.16
	£:$	1.408	1.38	1.36	1.38	1.40	1.44	1.46	1.50	1.53	1.28	1.38	1.47
Yen	$	105.2	105	105	105	104	104	104	104	104	107	105	104
	€	127.8	126	126	128	130	131	131	133	135	122	127	132
	£	148.2	145	143	145	146	150	152	156	159	137	144	152
Aussie Dollar	$	0.789	0.77	0.77	0.78	0.80	0.80	0.80	0.80	0.80	0.69	0.78	0.80
	€:AUD	1.539	1.56	1.56	1.56	1.56	1.58	1.58	1.60	1.63	1.65	1.56	1.59
	¥	83.07	80.9	80.9	81.9	83.2	83.2	83.2	83.2	83.2	73.9	81.3	83.2
	£:AUD	1.784	1.79	1.77	1.77	1.75	1.80	1.83	1.88	1.91	1.86	1.77	1.83
Swiss Franc	€	1.093	1.09	1.10	1.11	1.12	1.12	1.14	1.14	1.16	1.07	1.10	1.14
	$	0.900	0.91	0.92	0.91	0.90	0.89	0.90	0.89	0.89	0.94	0.91	0.89
	£	1.267	1.25	1.25	1.26	1.25	1.28	1.32	1.34	1.37	1.20	1.25	1.31

Source: Refinitiv, Investec