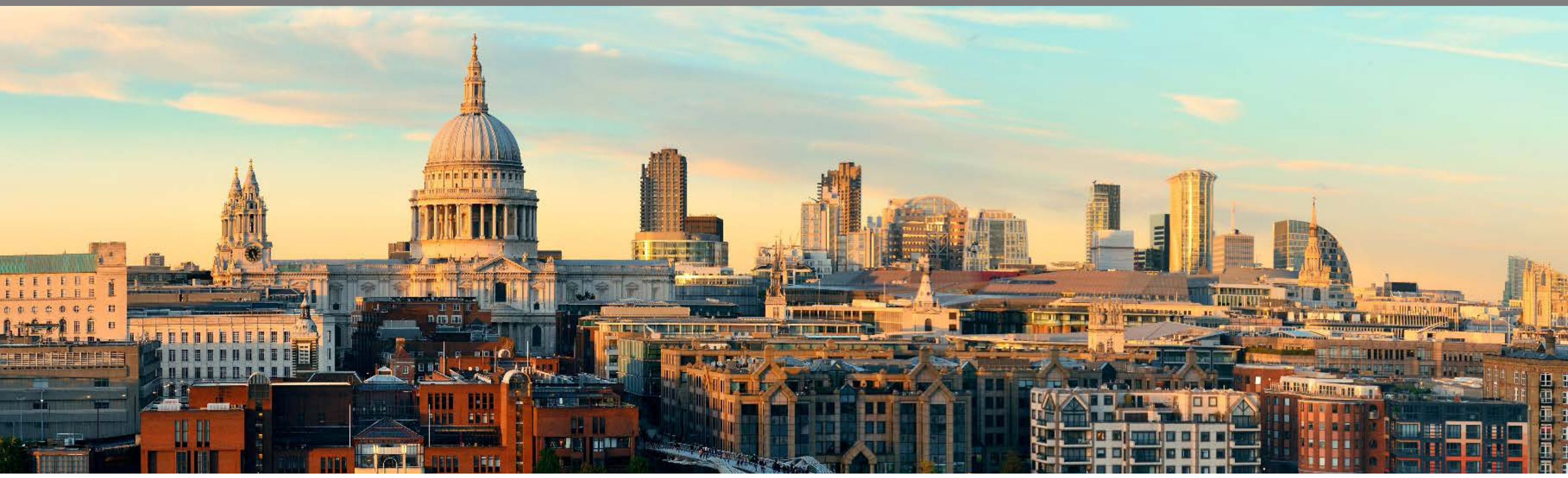
BEA 東亞銀行

Economic Research

June 2021

Market Monitor – United Kingdom

Recovery gaining steam, but threats remain



British economy picks up further

The British economy contracted 1.5% quarterly in Q1 2021 when lockdown measures were re-introduced, in contrast to the 1.3% growth seen in Q4 2020. Nevertheless, the drop is milder than the market expectation of a 1.6% decrease, reflecting the fact that individuals and businesses have become more adaptive to lockdown measures.

With the subsequent easing of the lockdown measures from March onwards, including the reopening of schools and a boost from increased construction, the economy is gaining steam. From a month-on-month analysis, GDP rose 2.1% in March after a 0.4% increase in February, while the unemployment rate saw further improvement at 4.8%, down from 4.9% previously.

High-frequency economic data shows the British recovery staying robust. A flash reading of the manufacturing purchasing managers' index rose further to 66.1 in May, up from 60.9 previously, while the services PMI rose to 61.8, up from 61.0. GfK Consumer confidence improved further to -9 in May, up from -15 in April, which helped retail sales beat market expectation with a staggering 37.7% yearly growth in April.

In addition, inflation reached 1.5% in April, its sharpest rise since February 2020. This figure is set against a low base of 0.8% from April 2020, but inflation was also boosted by the increase in the fuel cap set by the Office of Gas and Electricity Markets. Core inflation rose to 1.3% in April, up from 1.1% in March. Despite the Bank of England (BoE) now expects the inflation to reach 2.5% by the year end then gradually back to its 2% target, the Governor Andrew Bailey considered the inflation to be short-term and the BoE is closely monitoring the situation. The dovish interest rate-setting committee also signalled a rate-hike in late-2022, showing the BoE is in no hurry for the time being.

- **UK economy sees a stronger rebound recently, but further recovery may be hampered by the spread of the new variant.**
- **The BoE will slow its pace of bond purchases, bolstering the pound but weighing on stocks and bonds.**
- **Recovery optimism and relief about the Scottish election outcome boost market sentiment, but the threat from the new mutant limits market performance.**

Looking ahead, the British economy will continue to benefit from the country's vaccination progress and the easing of the lockdown measures. As of 30th May, over 39 million UK citizens, or 58.9% of the population, have received at least one dose of vaccine. More than 25 million people, or 38.2% of the population, are fully vaccinated. As of 17th May, people are allowed to gather in groups of up to 30, while restaurants and bars are allowed to resume indoor services. People entering the UK from green list countries, including Australia, Singapore, and Iceland, are exempt from quarantine. With the final stage of lockdown easing set for 21st June, business and consumer sentiment is expected to improve further, supporting investment and consumption. However, the new COVID-19 variant poses a downside risk as it spreads in the UK. Another ongoing issue is the UK's difficult negotiations with the EU over the fishing industry.

Bank of England tapers off bond purchasing in view of improved outlook

The recent upbeat economic figures caused the BoE to revise up its economic forecast to 7.25% growth in 2021, compared to February's forecast of 5% growth. It also revised down the forecasted unemployment rate, with the peak now expected to reach 5.5% in Q3 2021, down from 7.75% in the middle of 2021 as projected previously.

In view of the improving economic fundamentals, the BoE kept its Bank Rate unchanged at 0.10% in its May meeting, while the scale of its bond purchasing programme stood at GBP 895 billion. But it plans to slow the pace of bond purchasing to GBP3.4 billion each week during May to August, down from the current GBP4.4 billon. Despite this hawkish move, the BoE stressed that this does not represent a change in its monetary policy stance, and that clear evidence of economic recovery is required before monetary policy can be tightened.

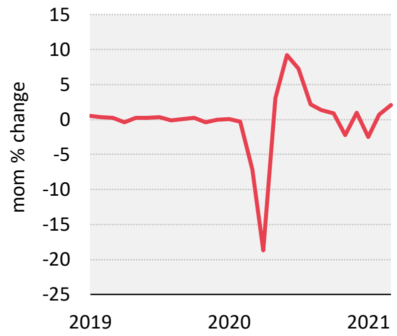
Markets relieved by Scottish election result

Besides the BoE's more optimistic outlook, investors were also relieved by the outcome of the Scottish election and its impact on the UK political landscape. The Scottish National Party (SNP), which supports independence for Scotland, failed to obtain an outright majority despite remaining the biggest party in the Scottish parliament. Its leader, Nicola Sturgeon, has been treating the pandemic as the first priority, but intends to push for a second independence referendum after the pandemic is dealt with. An independence referendum would require permission from Westminster however, which is highly unlikely.

Financial markets supported by recovery optimism, but impacts from the BoE's decision differ across the markets

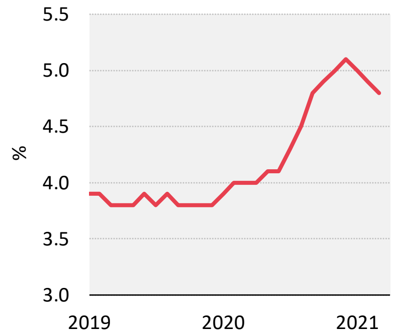
In the stock market, the FTSE 100 Index rose 0.8% in May. The better-than-expected economic data and the easing of lockdown measures boosted market sentiment already fuelled by an improved economic outlook. However, the stock market rise was constrained by concern over US inflation, the new variant spreading across the UK, and the BoE's hawkish decision.

GDP



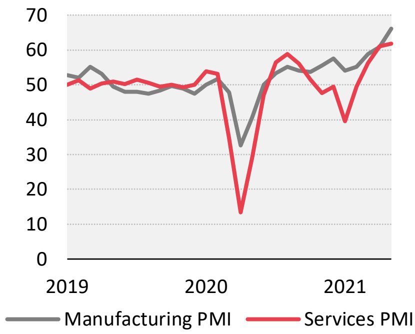
Source: Bloomberg, data as of 25/5/2021

ILO Unemployment Rate



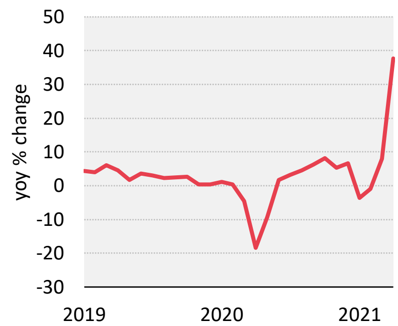
Source: Bloomberg, data as of 25/5/2021

Purchasing Manager Index (PMI)



Source: Bloomberg, data as of 25/5/2021

Retail Sales excluding Auto Fuel



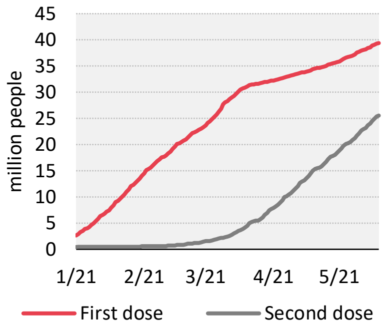
Source: Bloomberg, data as of 25/5/2021

In the bond market, the 10-year UK government bond yield dropped 47 basis points in May. Despite the BoE being set to slow down on bond purchasing, bond yields experienced drag from market concern over US inflation and the spread of the new mutant in the UK.

In the foreign exchange market, the pound rose 1.1% against the euro in May. The pound was boosted by upbeat economic data and forecasts amid the easing of lockdown measures. Its appreciation was driven still further by the BoE's hawkish decision and market relief about the Scottish election. The pound appreciated 2.8% against the US dollar during the same period. The dollar has weakened amid concerns about US inflation.

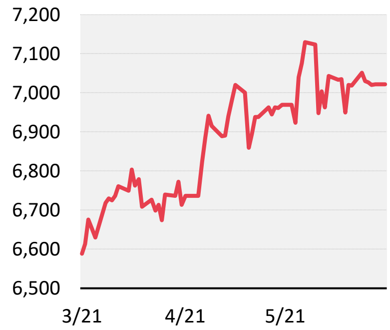
Looking ahead, continued economic recovery will have a positive impact on the UK financial markets. The recent domestic political issues appear to be over for the time being, which is expected to improve investor confidence in the UK markets. However, alongside negotiations with the EU, the spread of the new variant may delay the June lockdown easing schedule and limit market performance in the coming weeks.

Number of People Vaccinated



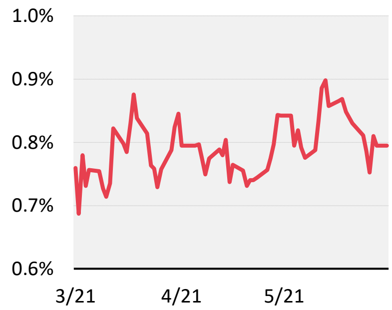
Source: UK Government, data as of 31/5/2021

FTSE 100 Index



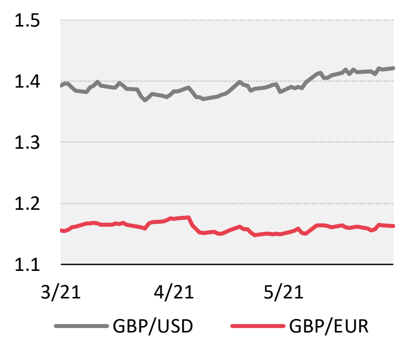
Source: Bloomberg, data as of 31/5/2021

UK 10-year Government Bond Yield



Source: Bloomberg, data as of 31/5/2021

British Pound Exchange Rate



Source: Bloomberg, data as of 31/5/2021

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