Economic Research

March 2021

Market Monitor – United Kingdom

Vaccination progress dictates economic recovery

The UK economy has avoided a contraction in the fourth quarter 2020 with a 1.0% quarterly growth, beating the market expectation of a 0.5% growth. Firms and individuals are now better adapted to the lockdown measures. Nevertheless, the economy contracted 9.9% in 2020, the largest drop on record.

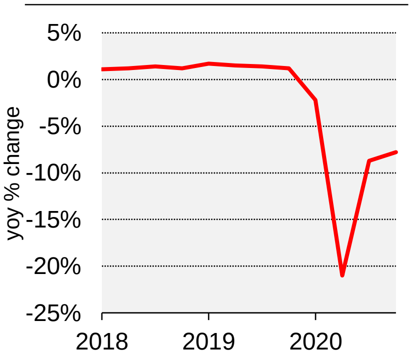
Vaccination is the key to economic recovery

The third nationwide lockdown imposed since early January is more stringent than the one in November. These containment measures are expected to bring on another economic contraction (year-on-year) for the UK in the first quarter of 2021. The Purchasing Managers Index (PMI) for manufacturing has dropped from 57.5 in December to 54.1 in January, while the services sector PMI fell from 49.4 to 39.5, reflecting subdued economic activity amid the lockdown.

Starting from the second quarter, the economy is expected to pick up, assuming the vaccination programme remains on track. As of 27th February, over 20 million UK citizens have received their first dose of vaccine, which meets the government target of vaccinating the riskiest group with the first dose. The UK government announced a four-stage plan to ease the national lockdown, and aim to lift all social distancing measures by late-June. The corresponding implementing date of the phases depends on several criteria, including the vaccination progress, infection rate and virus mutant. The first phase of easing will start from 8th March. Schools can reopen, while two people are allowed to gather outdoor.

- **With the vaccination programme remaining on track, we expect the UK economy to pick up from the second quarter.**
- **The Bank of England is unlikely to impose negative interest rate as we expect inflation should bounce close to the 2% target by the third quarter.**
- **Home purchasing demand is tapering as the housing stamp duty holiday is ending in March 2021.**

GDP



Source: Office for National Statistics, data as of 19/2/2021

The Bank of England (BoE) is also optimistic about vaccination progress, as it expects the government to fully withdraw all restrictions by end-September. This optimism led the BoE to keep its Bank Rate at 0.1% and the scale of quantitative easing unchanged at its February meeting.

Negative interest rate is unlikely

The BoE is keeping negative interest rates in its tool box, but has given no signal that it would implement them in the near term. Banks require at least six months to prepare for negative rate implementation. However, by the time banks could potentially be ready, which is the third quarter of this year at the earliest, the economy is expected to have picked up and inflation to be close to the BoE's 2% target again.

The housing market mini-boom loses steam

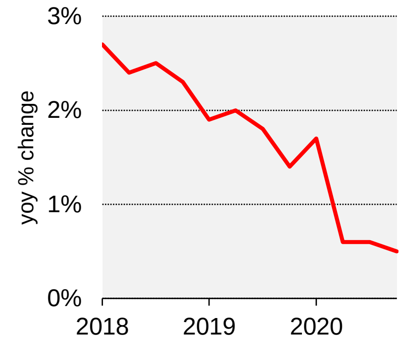
Despite the economic drop-off, the housing market has been supported by a stamp duty holiday. The government temporarily raised the threshold for paying stamp duty to GBP500,000 during July 2020 to March 2021. As the stamp duty holiday came to an end, home buying demand started to taper off. The Nationwide House Price Index dropped 0.3% monthly in January, the first time since July last year.

In the coming months, housing price growth is expected to remain subdued, although a new preference for larger and more remote homes is expected to provide some support to the market. The end of the stamp duty holiday and the weakening of the labour market will weigh on housing prices. Given the cloudy housing market outlook, the government will launch a mortgage guarantee scheme, providing 95% mortgages for buyers purchasing houses selling at GBP600,000 or below. Also, the government is reported to announce extending the stamp duty holiday until end-June in its March Budget.

Market sentiment supported by vaccination progress and reduced chance of negative rates

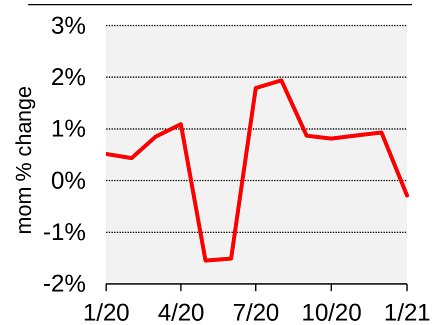
The UK's fast vaccination progress helped improve market sentiment and created hope for a faster recovery in Britain than on the European continent. The UK ranks third in terms of the proportion of population vaccinated, behind only Israel and the UAE. As of 27th February, around 30% of the UK population were vaccinated, compared with 7% in the EU. Despite the disappointing economic data and the dampened market sentiment by the volatility in the global bond market, the FTSE 100 Index increased 1.2% in February.

Inflation rate



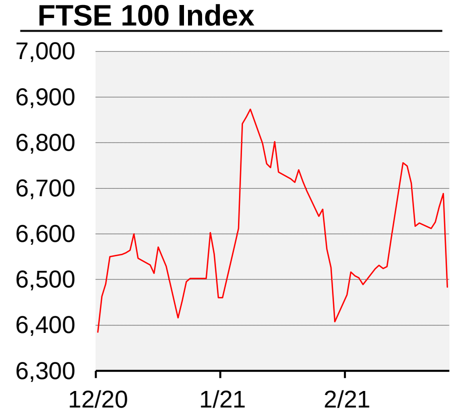
Source: Office for National Statistics, data as of 19/2/2021

Nationwide housing price index



Source: Nationwide Building Society, data as of 19/2/2021

FTSE 100 Index



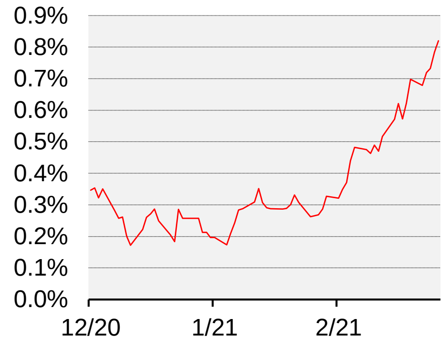
Source: Bloomberg, data as of 26/2/2021

Following the swift vaccination rollout there is greater market confidence about the UK's economic outlook. In addition, negative interest rates now look unlikely. These factors are supporting risk-on market sentiment and lowering demand for risk-averse assets such as bonds. The 10-year UK government bond yield has risen by 49.3 basis points.

In the foreign exchange market, dragged by the volatility in the global bond market, the US dollar index rose 0.3% over the same horizon. However, the pound has been supported by optimism about the UK's vaccination progress and the economic outlook. The pound has appreciated 1.6% against the US dollar, while appreciated 2.2% against the euro.

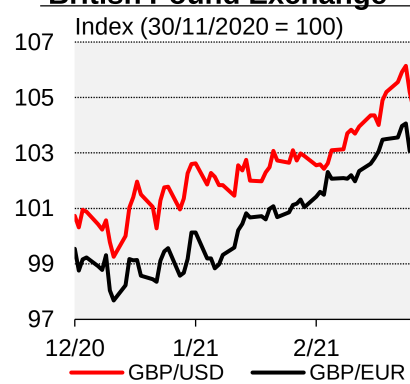
In the coming weeks, the UK's financial markets are expected to be supported by the vaccination progress if the UK stays on track in inoculating its mass population. Looking ahead, the financial markets, though enjoying an uptrend, are still subject to volatilities such as negative news concerning the vaccines, such as low efficacy rates towards new virus mutants. This could dampen market sentiment and drag down financial market performance. In the meantime, lingering talks about the financial service sector in the post-Brexit era could limit growth in the financial markets.

UK 10-year Government Bond Yield



Source: Bloomberg, data as of 26/2/2021

British Pound Exchange



Source: Bloomberg, data as of 26/2/2021

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