Appendix A

Detailed economic commentary on developments during quarter ended 30th September 2020

During the quarter ended 30th September 2020 (quarter 3 of 2020):

- There was a quicker-than-expected recovery in GDP in June and July;
- Retail spending rose 4.0% above its pre-virus level, but the recovery in investment lagged behind;
- There was a second wave of the virus and a tightening in COVID-19 restrictions in September;
- In September, the Chancellor announced a new fiscal package worth £5bn (0.2% of GDP) to support the economy;
- Concerns about a second wave and a no deal Brexit weighed on the FTSE 100 and the pound;
- There were divisions on the Monetary Policy Committee over the possible use of negative interest rates;

The initial economic recovery appears to have been quicker than anticipated. GDP rose by 2.4% m/m in May as manufacturing and construction work resumed, by 8.6% m/m in June as non-essential retail stores reopened, and by 6.6% m/m in July as pubs and restaurants reopened. The rise in the all sector PMI from 57.1 in July to 58.7 in August suggests that recovery continued at a strong pace in August. Indeed our 'CE BICS Indicator' suggests that the economy grew by 5.0% m/m in August.

Consumer spending appears to have recovered strongly. Retail sales rose by 0.8% m/m in August, pushing them 4.0% above their pre-pandemic level. The mini-boom in the housing market meant transactions rose by 28.9% y/y in August. Nationwide house prices rose by 0.9% m/m in September, which pushed up the annual rate to 5% – a four-year high. The Eat Out to Help Out, (EOHO), restaurant discount scheme and pent-up demand, also suggest that non-retail spending did well in August.

But this strength largely reflects the success of the government's fiscal support since March. Indeed, it is encouraging that the bulk of the 4 million workers that have come off the furlough scheme between May and the end of July have gone back to their jobs rather than into unemployment or inactivity.

Even so, there have been signs that households' appetite for credit is waning. Consumer credit rose by only £0.3bn in August compared to July's £1.1bn rise. Admittedly, it could be that consumers are just using cash saved during lockdown to finance big ticket purchases. Indeed, the household saving rate surged from 9.6% in Q1 to a record-high of 29.1% in Q2. But consumer confidence has also weakened, slipping from -16.6 in August to -17.9 in September according to the EC.

What's more, having fallen by 26.5% q/q in Q2, business investment still seems to be well below pre-pandemic levels. According to the latest ONS Business Impact of the COVID-19 Survey (BICS), 38% of businesses said their plans to expand had been scaled back or cancelled since the pandemic. And the Bank of England's Agents survey suggested that investment intentions remain close to their record lows.
Meanwhile, there have been worrying signs that activity started to drop in September. Footfall on UK high streets had fallen to -45% y/y by mid-September. And despite not

even having returned to its pre-crisis level, seasonally adjusted car production dropped by 24% m/m in August.

The Chancellor announced further fiscal support in September. The centerpiece of his Winter Economic Plan (WEP) was the six-month long “Job Support Scheme” starting on 1 November. Under the scheme, the government will pay a maximum of 22% of worker’s salaries and the company pays a minimum of 55%, as long as the employee is working a third of normal hours. The WEP also included an extension of the VAT cut for hospitality/tourism from 20% to 5% from 13 January to 31 March. All in, the Chancellor’s new measures will probably cost around £5bn (0.2% of 2019 GDP), bringing the total cost of the government’s direct fiscal measures to about £220bn (10% of GDP).

The mounting fiscal cost of the crisis is being reflected in public finance figures. Indeed, the government borrowed another huge sum of £35.9bn in August, leaving borrowing in the year to date at £173.5bn. That’s already the highest cash figure on record, with seven months of the financial year still to go (the previous record was £158.3bn in 2009/10). Add in the effects of the weak economy and we think that the Chancellor could end up borrowing a huge £370bn (18.4% of GDP) in 2020/21 as a whole.

But the new package is unlikely to fully offset the hit to GDP and employment from the government’s COVID-19 restrictions announced on 22 September. Indeed, the UK has begun to grapple with a second wave of coronavirus infections, with daily cases averaging about 5,500 during the last week of September (up from just 1,000 per day a month earlier). Consequently, new restrictions were brought in so that bars and restaurants have to close at 10pm, the reopening of other parts of the sports and hospitality sectors will be delayed, and people were advised to resume working from home if they can. This won’t prevent some sectors from continuing to recover but will cause others to go backwards.

That is why we think that an impressive rebound in GDP of about +18% q/q in Q3 will give way to no rise at all in October. Add in some further restrictions as well as the drag on activity from the uncertainty over Brexit, and GDP may not rise in November and December either. Meanwhile, we still expect the unemployment rate to rise further, from 4.1% in July to 7% in Q4 2021.

This supports our existing view that the Bank of England will ease monetary policy further. Admittedly, the sharp drop in CPI inflation from +1.0% in July to +0.2% in August, due to the effects of the cut in VAT for hospitality/tourism and August’s EOHO restaurant discount scheme, probably represents the low point for inflation. We expect CPI inflation to have risen to +0.6% in September and it could temporarily rise to 2.0% at the end of 2021. But the big picture is that it will be a few years before the economy is strong enough to sustain CPI inflation at the Bank of England’s 2% target.

However, unlike the financial markets, we do not think the Bank will use negative rates in the next six months. Admittedly, in its September minutes, the MPC commented that it “had been briefed on the Bank’s plans to explore how a negative Bank Rate could be implemented effectively”. And MPC member Silvana Tenreyro noted the “encouraging” evidence on the use of negative rates in Japan and the euro-zone. But Bank of England Governor Andrew Bailey, and other MPC members such as Dave

Ramsden and Andy Haldane, have talked down the prospect. So for the next 6-12 months, we think that QE will remain the tool of choice and that another £250bn of QE will be used over the next year, significantly more than the consensus forecast.

There are two key downside risks to the outlook. The first of these is the possibility that restrictions are tightened much further to contain the spread of coronavirus. If the government resorted to a two-week national lockdown at some point, that could reduce the level of GDP by 5% and push the point at which the economy returns to its pre-crisis level back by a year. This would also increase the possibility that the Bank of England has to do more at a later stage.

The second risk is a no deal Brexit at the end of the transition period on 31 December 2020. With just two weeks to go until Boris Johnson's 15 October deadline to reach a deal before the UK walks away and only three months until the transition period expires, it doesn't appear as though the two sides are nearing an agreement. A no deal on 31 December is unlikely to spell disaster for the economy. But it could lead to a hit to GDP of 1-3% depending on the type of no deal, setting back the UK's recovery from the recession.

The concerns about the consequences for the economy from a second wave of COVID-19 and a no deal Brexit have reduced the FTSE 100 almost back to May's level and weakened the pound from $1.35 to $1.28. Some spreads of corporate bonds over gilt yields such as BBB ones, have started to tick up. With COVID-19 and a no deal Brexit risks rising, the risks to our forecast that the FTSE 100 will rebound to its pre-crisis level by the end of 2022 and that the pound will climb back to $1.35 if there is a Brexit deal are firmly on the downside.

In the euro-zone, there is further evidence that the economic recovery is grinding to a halt. This has resulted in short-time working policies being extended in Europe's Big Four until the end of the year at a minimum. And there is a good chance that the ECB will provide additional stimulus soon, perhaps making the TLTROs more generous.

The continued economic recovery in the US in the face of its second wave in June and July has been impressive, but GDP remains below pre-virus levels. And while the Fed adopted "a flexible form of average inflation targeting" in August, it has offered no hints it is contemplating adding more stimulus soon. But the calls for more stimulus may grow louder if the recovery slows, particularly if Congress can't agree on more fiscal support.