HSBC Global Research

12 February 2021

Vaccine hopes, trade fears

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- As the reality of post-Brexit trade begins, the UK has applied to join the CPTPP to grow trading opportunities
- Consumers saved GBP170bn more in 2020 than 2019 and reducing savings could potentially drive a spending splurge
- The BoE has dampened expectations of negative policy rates, but it is way too early to think about rate hikes

Every month HSBC analysts who cover UK economics, fixed income, FX and equities meet to discuss the news and outlook. With trade and the consumer recovery in focus, we are sharing the key points of this month's discussions.

Trade: near-term EU export fears, longer-term global hopes

The UK formally applied to join the Comprehensive and Progressive Agreement for TransPacific Partnership (CPTPP), one year after it officially left the EU. Although the near-term implications are likely to be small, over the longer term the CPTPP could help UK businesses expand trade linkages in the dynamic Asia-Pacific region.

As for trade with the EU, the new arrangements go well beyond the scope of a typical trade deal. But there are significant new trade frictions. We think it is still too early to gauge the extent of disruption and its likely persistence. In part, this is because stockpiling last year means many UK manufacturers haven't needed to trade as much with the EU in 2021 so far. The extent to which EU manufacturers will shift permanently to non-UK suppliers also remains unclear.

Consumer sector: hopes for services, fears (or at least caution) for goods

All things considered, the labour market has held up. The renewed lockdown was a setback, but even in January hiring of temps continued to expand outside of London. We think UK households saved GBP170bn (7.7% of GDP) more in 2020 than they did in 2019. If savings rates return to more normal levels later this year, there could be a significant spending splurge. To the extent this happens, it won't be felt evenly. Sectors that have done well over lockdown (e.g. DIY, durable goods and food) may struggle to sustain growth. By contrast leisure and apparel should see a rebound.

Policy outlook: hopes negative rates can be avoided, fears they can't

The BoE published a fairly upbeat set of forecasts in February and said the financial system would not be operationally ready for negative policy rates within six months. While negative rates remain in the toolkit, the Bank did not want to send a signal they were imminent or even warranted. But depending on fiscal policy and the success of the vaccine roll-out, further cuts can't be ruled out entirely and rate hikes remain a distant prospect.

This is a redacted version of a report by the same title published on 12-Feb-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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Trade: near-term EU export fears, longer-term global hopes

Simon Wells, Chief European Economist
In a move that made a few headlines, the UK formally applied to join the Comprehensive and Progressive Agreement for TransPacific Partnership (CPTPP) on 1 February 2021. This was one year after the UK officially left the EU and it presumably wants to demonstrate potential post-Brexit trade opportunities. What are the near-term and longer-term implications?

Shanella Rajanayagam, Trade Economist
The CPTPP is a high-standards accord between eleven economies in the Pacific Basin, which collectively account for 13% (USD11trn) of world GDP (although four are yet to ratify the agreement). The agreement is widely regarded as the gold standard of trade deals as it aims to tackle a range of modern trade issues, from barriers to e-commerce to social concerns around labour and environmental standards, alongside measures to cut tariffs and reduce regulatory impediments to trade.

As well as ultimately benefiting from tariff-free access for some key UK goods exports (e.g. whisky and motor vehicles), trade in services is also liberalised under the deal. There are also specific provisions for financial services around liberalising foreign equity caps and ensuring transparency of regulations.

That said, the near-term implications are likely to be small. UK trade with CPTPP members currently remains relatively low, accounting for just 8% (GBP111bn) of total UK trade in goods and services in 2019. And the UK already has trade agreements with seven of the 11 members.

The key benefit of the CPTPP for the UK is that it aims to align trade and investment rules across all member economies, not just bilaterally. This means that UK manufacturers would be able to source intermediate inputs from across the entire CPTPP bloc, and would benefit from similar rules when trading into all CPTPP markets.

Over the longer term, the CPTPP would help UK businesses expand trade linkages in the dynamic Asia-Pacific region. The deal may provide new opportunities for UK businesses to deepen trade relations with existing partners and forge linkages with new markets. And, of course, more countries may join over time.

Simon Wells
While we are on the subject of trade, the new UK-EU trade deal has been in force for over a month now. This kind of 'trade divorce' is unprecedented, so no-one really knows how this will play out. But what have we learned so far?

Shanella Rajanayagam
The new deal goes well beyond the scope of a typical trade agreement (such as the EU-Canada deal) and means no tariffs or quotas on bilateral UK-EU trade, provided the rules of origin are met. However, it has inevitably led to new trade barriers between the UK and EU. In particular, UK service suppliers have lost their automatic right to offer services in the EU, there is no provision for the mutual recognition of many professional qualifications and the deal does not provide 'equivalence' for UK financial services.

One issue that made headlines in January is the application of 'rules of origin'. The deal allows UK exporters to use EU inputs and sets limits for other (non-UK, non-EU) inputs required to qualify for tariff-free UK-EU trade. But if there isn't sufficient UK 'transformation' in production (i.e. value-added to the product in the UK), UK exports to the EU could still be subject to tariffs, and vice versa for the EU. Under the trade deal, such goods are not counted as having UK origin and are therefore subject to tariffs (something that attracted headlines by affecting exports of 'Percy Pig' sweets). However, alternative transit procedures could be used to avoid tariffs in some cases. But to qualify for zero tariffs under the trade deal, there needs to be sufficient transformation in the UK, with limits on how much overseas inputs can be used.

Andrew Porteous, Co-Head, European Consumer Retail Research
The changes had an immediate impact on some retailers. One large UK retailer has said the disruption might raise costs by around 5% of a typical year's profits in 2021. To the extent that this is an industry-wide issue, we might expect much of the cost to be passed on to consumers.

Liz Martins, Senior Economist
It's still a bit early to know how much disruption there has been. Stockpiling in the run-up to the end of the transition period means many UK manufacturers haven't needed to trade as much with the EU so far this year. Also, given COVID-19, less than a third of manufacturers say they are operating at capacity. So the new arrangements haven't been significantly tested yet.

Although the government has pointed to data showing a 7% fall in cross-border truck traffic, this doesn't account for the trucks returning empty. The Road Haulage Association estimates the volume of exports from Britain to the EU was down 68% y-o-y in January.

Only much later in the year will it become clearer whether this reflects teething problems that can be ironed out or more permanent damage. Shortages of UK-made components mean some EU manufacturers are looking urgently for alternative suppliers. And as grace periods expire through the year, things could get worse before they get better.

Consumer sector: hopes for services, fears (or at least caution) for goods

Simon Wells
Shifting to domestic demand, consumer behaviour will be key to the recovery. A large amount of household savings was accumulated last year and the speed with which they are spent as restrictions are eased will set the speed of aggregate demand growth. How do you see consumer sentiment?

Chris Hare, Senior Economist
From a macro standpoint there are reasons to be optimistic about consumer spending later this year, provided the labour market holds up. We think UK households saved GBP170bn (a hefty 7.7% of GDP) more in 2020 than they did in 2019. To see a big rebound in spending, we don't even need to see these 'excess' savings spent. People only need to return savings rates closer to normal levels. Of course, low consumer confidence may suggest that households are keen to hold bigger 'rainy day' funds in a post-pandemic world. And some of the cash may be needed to cover the end of holidays on interest payments and taxes. But there is at least the possibility of a post-pandemic spending splurge.

Paul Rossington, Co-Head, European Consumer Retail Research
Generally spending over the Christmas period seemed good, all things considered. Food retail was particularly strong, but some of the clothing chains reported a decent festive trading too. But while the food space has been great, there are some concerns about the outlook and what happens as the economy re-opens.

In non-food, DIY, furniture, pets and even electronics retailers have done very well recently – with many posting double-digit like-for-like sales. Again, though, there are concerns about the outlook, given that this pace is unlikely to be sustained once the service sector opens up. Consumers may have purchased all the durable goods they need (and some) over lockdown. On the other hand, apparel might bounce back sharply as the leisure industry re-opens – particularly if there is a shift back toward high-margin designer clothes and away from loungewear.

Matthew Lloyd, Head of UK MidCap Equity Research

All things considered, the labour market has held up well. At least until the new nationwide lockdown began, hiring was up – with temp positions rising at the fastest pace in over two years in December. The renewed lockdown was a setback, however. Permanent staff appointments fell sharply in January according to the latest KPMG/REC report, with the rate of decline the steepest since June 2020. Even so, hiring of temps continued to expand outside of London.

Policy outlook: hopes negative rates can be avoided, fears they can't

Simon Wells

So what does this mean for policymakers and financial markets? After consulting with the financial sector, the BoE has concluded that taking the policy rate negative within six months would attract increased operational risk. After some internal debate, however, it concluded that it would be appropriate to ask banks to start making preparations – even though it definitely didn't want to send a signal that negative rates were imminent or warranted by its latest forecasts. So, as expected, negative rates remain in the toolkit. But given its rather upbeat forecasts, by the time negative rates are ready to be used, they are unlikely to be needed.

Daniela Russell, Head of UK Rates Strategy

The BoE's tone on negative rates caught many in the market by surprise. It has resulted in a sharp shift in the perceived balance of probabilities about the next rate move such that a 25bp hike is now fully priced in for three years' time. If negative rates have become far less likely because of an improvement in the economic outlook, then some re-pricing and rise in yields is warranted. But given the many uncertainties about the outlook, any policy tightening still seems like a distant prospect – a point that was made at the BoE's February press conference. And even if negative rates don't happen in the next six months, it is still possible they are needed eventually if the recovery in demand slows.

Dominic Bunning, Head of European FX Research

Sterling has started the year strongly and the BoE's tone only reinforced this, although the small rise in yields we've seen isn't a big deal for FX markets. One reason some investors have started the year bullish on sterling appears to be based on the idea that foreign investors have a large underweight in UK assets that is set to correct in 2021. But there's not much evidence of a sizeable underweight for FX or bonds, only for UK equities. And equities tend to be less important for GBP and the relationship between equity positioning and future GBP returns is patchy. In addition, the likely widening of the UK's current account deficit in 2021 as the UK economy normalises is likely to create more headwinds for GBP.

Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

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Source: HSBC

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Sell	46	24	21	46

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