Economic Research

3 February 2020

Week Ahead Economic Preview

Global overview

- **Worldwide manufacturing and services PMIs**
- **US employment report, including pay and payrolls**
- **Australia, India, Thailand and the Philippines policy meetings**

The coming week starts with the publication of worldwide PMI surveys for January and ends with the US non-farm payroll report, though also sees no fewer than 538 companies reporting earnings, including Alphabet, BP and a host of auto makers. In the US the democrat primaries get underway. Markets will also be eyeing Wuhan coronavirus and Brexit developments.

Monday sees the release of worldwide manufacturing surveys for January, followed on Wednesday by service sector updates. The surveys will be eyed for signs that the global business environment has continued to improve after the **global PMI** closed off 2019 at an eight-month high. The surveys brought indications that the global goods-producing sector has stabilised after a mid-year decline, accompanied by the fastest services growth since July. Notably, the surveys showed the smallest worldwide exports fall since April, largely as a result of easing trade tensions.

Signs of the Wuhan coronavirus impacting business are unlikely to be seen yet in the final PMI data, with the majority of survey responses having been collected prior to 25th January. In fact flash PMI data for January have so far shown encouraging signs. Business rebounded in the UK and Japan after weak fourth quarters. The former showed business perking up after a conclusive general election in December, while business in Japan saw demand revive after typhoon disruptions and the hit from October's sales tax hike. Growth in the US meanwhile struck a ten-month high despite ongoing export-related woes in manufacturing. Eurozone growth remained subdued, but forward-looking indicators brought encouraging gains.

In the US, the PMIs are accompanied by the official monthly employment report and factory orders data (see page 3), while in the eurozone, Germany trade and industrial production data will give important steers on whether recession has been avoided (see page 4)

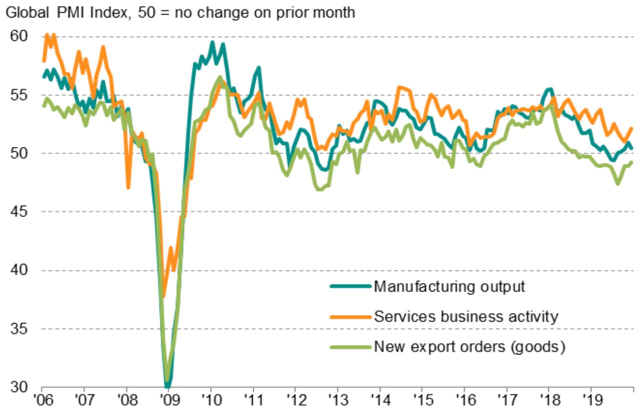
In Asia Pacific, China PMI data are joined by GDP updates from Hong Kong SAR and Indonesia and monetary policy meetings in Australia, India, Thailand and the Philippines (see page 5).

Special reports

Wuhan virus: an analysis of the economic risks to the Asia-Pacific region from the Wuhan coronavirus outbreak (**page 6**).

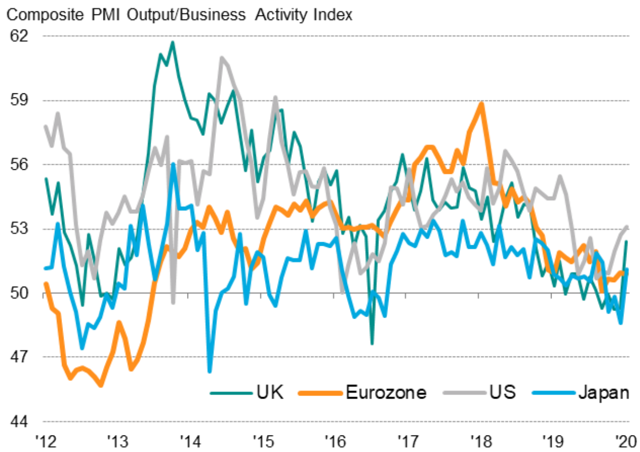
Brexit. We look at the outlook for the UK economy in the coming year as the country seeks to establish its new position in the world outside of the EU. (**page 11**)

PMI data brought signs of a positive impact from an easing in global trade woes at the end of 2019, and worldwide service growth remained encouragingly resilient



Sources: IHS Markit, JPMorgan.

Flash PMI surveys signalled stronger growth in the US, UK and Japan, while the eurozone eked out further rmodest growth



Sources: IHS Markit, Jibun Bank (Japan).

Key diary events (UTC)

Monday 3 February

Global release of IHS Markit manufacturing PMI (Jan)
Australia building permits (Dec)
China industrial profits (YTD, Dec)
Indonesia, Thailand and South Korea inflation (Jan)
Hong Kong SAR GDP (Adv, Q4)
Russia GDP (Prelim, Q4)
Singapore manufacturing PMI (Jan)
US ISM manufacturing PMI (Jan), construction spending (Dec)
US Iowa presidential caucuses (Democrat)
Brazil trade balance

Tuesday 4 February

Australia interest rate decision
Malaysia trade (Dec)
Hong Kong SAR retail sales (Dec)
UK Construction PMI (Jan)
Italy inflation (Prelim, Jan)
Brazil industrial production (Dec)
US economic optimism (Feb), factory orders (Dec)

Wednesday 5 February

Worldwide release of IHS Markit services PMI (Jan)
Singapore and Hong Kong SAR PMI (Jan)
Philippines inflation (Jan)
Indonesia GDP (Q4 and 2019)
Thailand interest rate decision
Euro area retail sales (Dec)
US ADP employment change (Jan), trade (Dec)
US Treasury refunding announcement
US ISM non-manufacturing PMI (Jan)
Brazil monetary policy meeting

Thursday 6 February

Australia trade, retail sales (Dec)
Indonesia and Thailand consumer confidence (Jan)
India and Philippines interest rate decision
Germany construction PMI (Jan), factory orders (Dec)
Taiwan inflation (Jan)
Japan household spending, cash earnings (Dec)

Friday 7 February

RBA statement on monetary policy
China trade (Jan)
Malaysia industrial output, jobless rate (Dec)
Taiwan trade (Jan)
Germany and France industrial output, trade (Dec)
UK Halifax House Price Index (Jan)
Russia interest rate decision
US non-farm payrolls, jobless rate, participation rate average earnings (Jan), wholesale inventories (Dec)
US Baker Hughes oil rig count (7 Feb)

Sat-Sun 8-9 February

9: Japan current account (Dec)

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Economic Research

3 February 2020

United States Week Ahead

PMI surveys, non-farm payrolls and factory orders

By Siân Jones

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The US data calendar starts with PMI data for January and ends with the monthly BLS employment report, the latter eyed for the latest labour market trends, including payrolls and pay growth.

Final PMIs

Markets will be eager to see the latest PMI data from IHS Markit and ISM, which have diverged in recent months. The opening month of the year has seen a stuttering start to 2020, according to IHS Markit's 'flash' PMI, with manufacturing growth easing but services remaining resilient. Although the composite PMI hit a ten-month high, factory conditions improved only marginally. The plight of the goods-producing sector contrasted with an expansion in service sector business activity which accelerated to the fastest since last March. Nonetheless, firms signalled historically soft demand, notable in terms of exports, albeit to a much lesser degree than indicated by ISM survey data. ISM data have been especially weak for manufacturing, dropping well below levels indicated by both IHS Markit's PMI and official data in recent months.

Non-Farm Payrolls

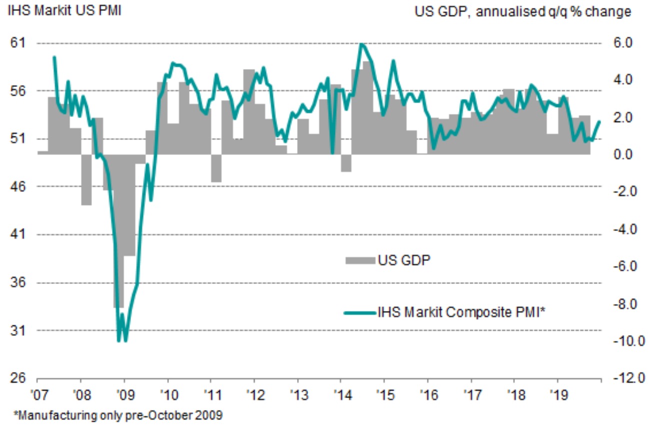
Flash PMI data for January also pointed towards a slight pick-up in non-farm payrolls numbers, with employment indicated to rise by around 150k in the opening month of 2020. December payrolls data came in below forecasts at 145k, the lowest since May, and annual wage growth softened to 2.9%, below estimates of 3.1%. The unemployment rate meanwhile held steady at 3.5%.

Factory Orders

The consensus expects December factory orders to return to expansion, following a marginal contraction in November. The underlying weak trend matches HIS Markit PMI data for the final month of 2019, which corresponded with broad stagnation in manufacturing new orders as firms struggled to attract new customers, especially foreign clients.

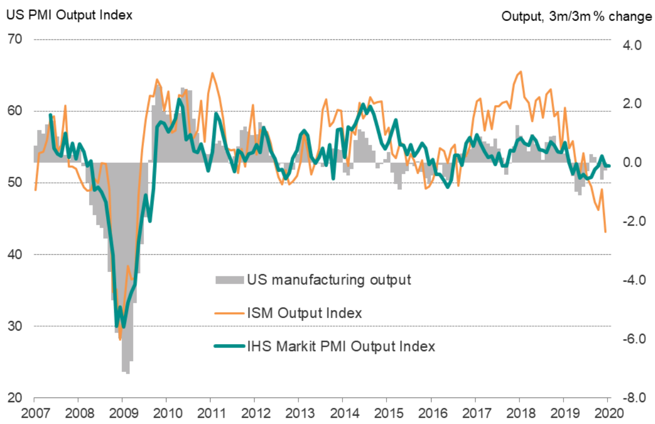
Also released this week are an update to trade data, plus ADP employment numbers.

IHS Markit's flash PMI hit a ten-month high to signal a tentative upturn at the start of 2020



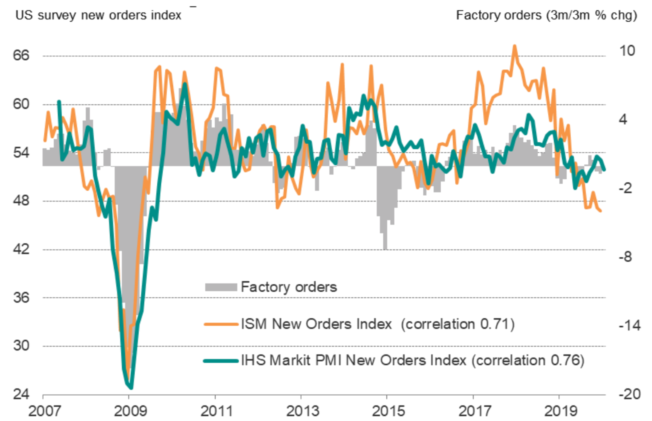
Sources: IHS Markit, BEA.

PMI surveys have diverged in recent months, sending markedly different signals on the health of the US manufacturing sector



Sources: IHS Markit, ISM, US Federal Reserve.

Official factory orders data are expected to show a return to growth yet the trend to remain subdued



Sources: IHS Markit, ISM.

Europe Week Ahead

January PMIs, Germany trade and industrial data, eurozone retail sales

By Joe Hayes

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January PMIs across Europe, including the final prints for the eurozone and UK, will provide a fuller insight into how economic conditions across the continent have developed in the opening quarter of 2020. Official manufacturing data from Germany will help guide expectations as to how the eurozone's biggest economy performed in the final quarter of 2019, while euro area retail sales give an update on consumer spending trends.

January PMIs

The PMI surveys across Europe will give updated clues into how the continent is performing at the start of the new decade after flash data showed a subdued eurozone but a post-election bounce in the UK. Given the more data-dependent approaches that the central bankers in the region have adopted, regional growth performances could have a crucial steer on the near-term outlook for monetary policy, especially in the UK. With phase one of the US-China trade deal having helped diminish prospects of further escalation, the survey data will be closely watched for signs of a pick-up in global trade, but markets will also be keen to assess any near-term effects of the US trade focus on Europe, Brexit developments and Wuhan virus-related economic impact.

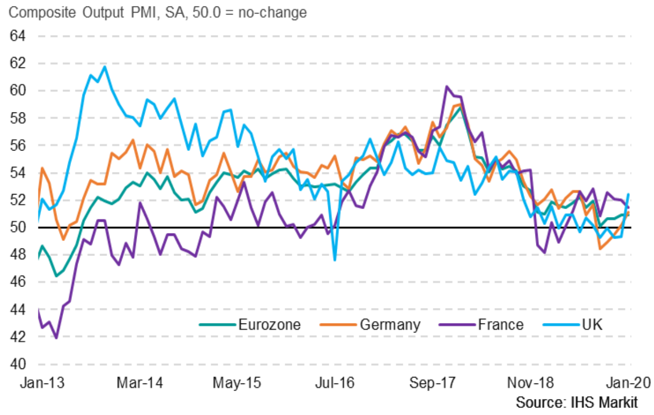
German industrial and trade data

A slew of December data from Germany is due next week. Industrial production, factory orders and international trade figures have the potential to significantly alter expectations of fourth quarter GDP growth. Full-year German GDP data for 2019 imply that the eurozone's biggest economy may have expanded marginally in the final quarter of last year, but the December data could sway the quarterly GDP estimate due later in February.

Eurozone retail sales

Domestic consumer spending growth has been a key mainstay through 2019, offsetting much of the manufacturing malaise dragging the eurozone economy. Signs of this trend turning would be concerning for the European Central Bank, who would be keen to see sustained demand-push inflationary pressures.

Flash PMIs point to renewed growth in the UK; while the euro area continued to expand marginally



Source: IHS Markit

Manufacturing data could have vital steer on whether Germany avoided a contraction late last year

Sources: IHS Markit, FSO

Euro area consumer spending has been resilient and provide an important offset to the weakness evident in manufacturing

Source: Eurostat

Asia Pacific Week Ahead

PMI data to steer key central bank policy meetings

By Bernard Aw

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Markets are facing a data-heavy week in which the January update to worldwide PMI surveys will give an early look into global economic trends at the start of 2020 and important steers on future policy directions. Particular focus is on China, Japan and Australia, although investors will also assess PMI data of Asian economies that may be negatively affected by the Wuhan coronavirus outbreak. Policy action will come from Australia, India, Thailand and the Philippines.

Meanwhile Hong Kong SAR and Indonesia publish fourth quarter GDP figures, with the former under particular scrutiny amid renewed protests. Trade numbers from China and Taiwan will also gather interest, while inflation updates from a number of Asian economies will be in focus as well.

Asia-Pacific monetary policy

The next week sees Australia, India, Thailand and the Philippines deciding on interest rates. While the monetary policy stance of all four remains dovish, not all are expected to cut rates in February. A spike in inflation in India constrains the Reserve Bank of India's ability to loosen policy, although expectations of an easing in price pressures could see the next rate cut as early as April, according to IHS Markit estimates.

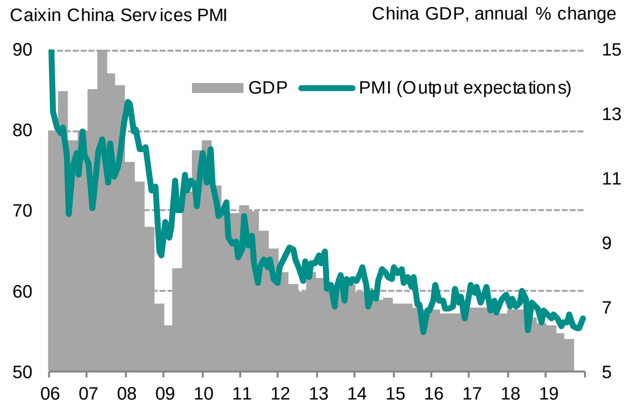
The Bank of Thailand is also expected to keep policy rate on hold for the moment, although a delay in the passing of the budget bill and further evidence of a growth slowdown could raise the prospect of rate cuts.

IHS Markit meanwhile expects the Reserve Bank of Australia to cut the policy rate once more to a record low of 0.50%, although market expectations of a rate cut have been reduced, according to the OIS market. Finally, the Philippines central bank is expected to cut interest rates further to support economic growth.

GDP updates

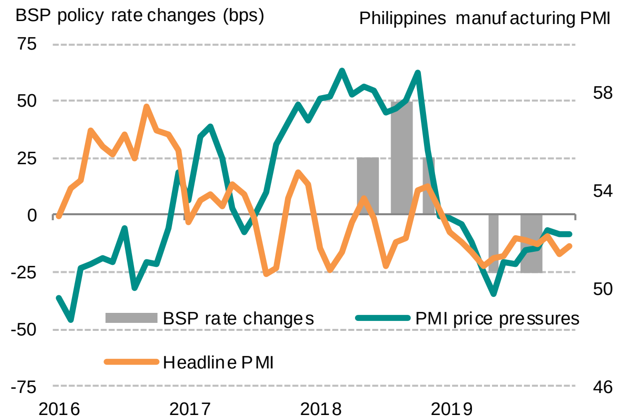
The Hong Kong SAR economy is expected to have shrunk an annual rate of 5.8% in the fourth quarter, according to IHS Markit, notably sharper than the decline in the third quarter. A more forward looking view of economic performance at the start of 2020 will be gleaned from January PMI update. IHS Markit also projects Indonesia's fourth quarter GDP annual growth to run at an unchanged rate of 5%.

China services PMI and economic growth



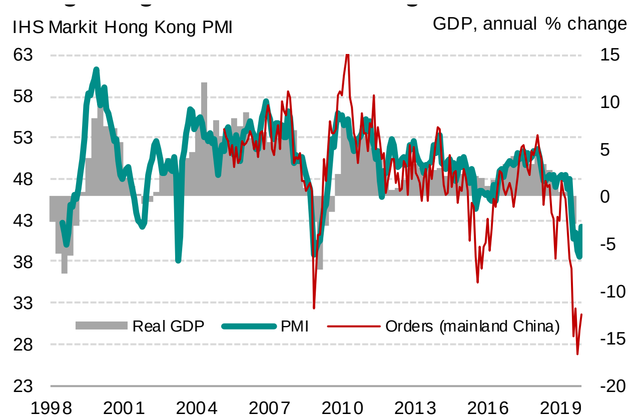
Sources: IHS Markit, Caixin, NBS

Philippines PMI remains stuck in territory associated with looser monetary policy



Sources: IHS Markit, BSP

Hong Kong PMI points to deeper fall in Q4 GDP



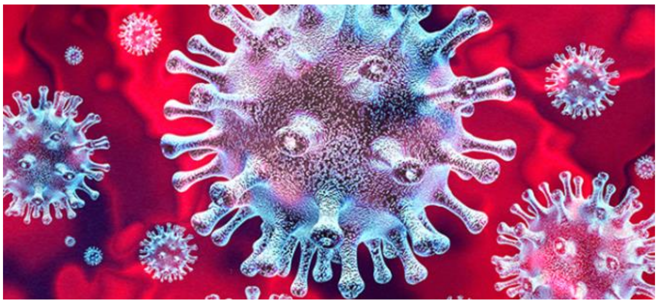
Sources: IHS Markit, C&SD

Economic Research

3 February 2020

Asia Pacific Special Focus

Wuhan virus: economic risks to the Asia-Pacific region



By Rajiv Biswas

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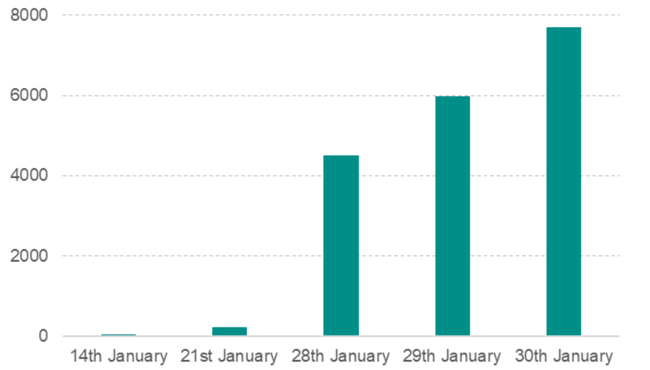
The rapid escalation in the number of Wuhan virus cases in China during late January has heightened concerns about the negative economic impact on the Chinese economy as well as wider economic shocks to the rest of the Asia-Pacific region if the pandemic cannot be quickly contained. Industry sectors that are particularly vulnerable to a SARS-like virus epidemic that can be spread by human-to-human transmission are retail stores, restaurants, conferences, sporting events, tourism and commercial aviation.

Escalation of Wuhan virus epidemic

The outbreak of a SARS-like coronavirus (2019-nCoV) in Wuhan is developing into a major potential economic risk to the Asia-Pacific region now that there is medical evidence of human-to-human transmission and that it appears to be highly contagious. A total of 224 cases of pneumonia caused by the new Wuhan coronavirus had been confirmed in China by Monday 20th January 2020. Just over a week later, by 30th January 2020, the total number of confirmed Wuhan virus cases in China had escalated to 7,711, with a total of 170 reported deaths attributed to the Wuhan virus. At least fifteen medical staff in Chinese hospitals, who were treating patients with the Wuhan virus, have also contracted the virus. China's National Health Commission has also stated that there are a further 12,167 suspected coronavirus cases as of 30th January 2020.

The number of confirmed Wuhan virus cases in mainland China now already significantly exceeds the total number of SARS cases recorded in mainland China during the 2003 SARS epidemic, which reached a total of 5327 persons according to World Health Organization data.

Confirmed Wuhan Virus Cases in China



Source: Chinese Government

China's President Xi Jinping has stated that China is "Faced with the grave situation of an accelerating spread of the new coronavirus".

China has responded to the Wuhan virus crisis by taking strong measures to limit the spread of the new coronavirus strain, including a lockdown of many cities in Hubei province. A total lockdown has been imposed on movements in and out of the provincial capital of Wuhan, a megacity of around 11 million people, where the coronavirus is believed to have originated.

A number of foreign governments are implementing measures to evacuate their citizens trapped in Wuhan city, with the US State Department having arranged a flight to transport US Consulate staff and other US citizens out of Wuhan. The French government has also arranged for the evacuation of French citizens in the Wuhan area and many other governments are taking similar measures to evacuate their citizens out of Wuhan.

Disruption to economic output

The Wuhan virus has already caused significant negative shockwaves for the Chinese economy within weeks, due to the lockdowns of cities in Hubei province, and negative impact effects on retail trade, tourism and transport. In addition to restricting public transport movements in and out of certain badly impacted cities such as Wuhan, China has also banned all group tourism travel sales by travel agencies in China for travel both within and outside of China with effect from 27th January 2020.

Furthermore, the China's State Council has announced that the Lunar New Year holiday period, which had originally been from 24th to 30th January, has been extended by an additional three days of public holiday due to the coronavirus outbreak, which will further impact upon economic output in Q1 2020.

A number of major Chinese provinces have announced further postponement timetables for the reopening of companies after the Lunar New Year, with the Shanghai government having announced that companies will not be allowed to reopen until 10th February 2020. Guangdong Province has also announced on 28th January that resumption of work at companies will be delayed until 10th February. As Shanghai and Guangdong are major industrial production hubs in China, this will have a significant negative impact on China's industrial output in Q1 2020, with transmission effects to the wider Asia-Pacific manufacturing supply chain exporting intermediate goods and raw materials to China. On 29th January the Beijing, Chongqing, and Zhejiang provinces also announced delays to the reopening of factories and offices until 10th February 2020.

A key industrial sector that will be impacted by the delayed restart of manufacturing production is the automotive sector, with the IHS Markit Automotive team having undertaken initial analysis of the potential near-term impact on China's auto production (see "*Coronavirus Initial Impact on Light Vehicle Production*", IHS Markit AutoInsight, 28th January 2020). According to the IHS Markit Automotive team's assessment, disrupted light vehicle production due to delays of factory re-openings until 10th February already account for around 57% of total Chinese light vehicle production.

An increasing number of multinational firms in the retail sector have announced closures of some operations in mainland China in recent days due to the Wuhan virus epidemic. Starbucks has announced that more than half of its 4,300 stores in China will be temporarily closed due to the epidemic. Sasseur Real Estate Investment Trust, listed on the Singapore Stock Exchange, has announced that four of its shopping malls in China will be temporarily closed as measures to help stop the spread of the epidemic. Singapore's Capita Land has also announced that four of its shopping malls in Wuhan and two malls in Xian will be temporarily closed due to the epidemic. Sweden's IKEA announced on 29th January that it would close half its stores in China temporarily.

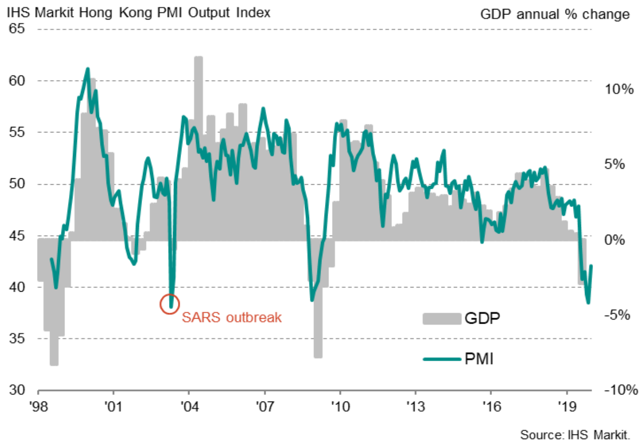
Meanwhile the government of China's Hong Kong Special Administrative Region (Hong Kong SAR) has announced severe new restrictions on travel from mainland China to Hong Kong SAR from 28th January 2020. These measures include the suspension of high-speed rail and other rail services and a large reduction in total airline flights between Hong Kong SAR and mainland China.

With consumption spending having become the most important growth driver for the Chinese economy in recent years, a key near-term risk is from the negative impact on consumer confidence if the Wuhan epidemic continues to escalate.

The impact of the SARS epidemic on the Hong Kong economy provides a potential benchmark for assessing the potential economic impact of the Wuhan virus epidemic, although there are clearly considerable uncertainties about how the current epidemic could evolve.

The IHS Markit Hong Kong SAR PMI reflects how the SARS epidemic had a sharp negative impact on the Hong Kong SAR economy in 2003, but there was a rapid return to more normal activity levels once the SARS epidemic was brought under control. The deep negative impact of the SARS epidemic in 2003 was comparable to the large negative shocks to the Hong Kong SAR economy in 2019 due to combined impact of the US-China trade war on the export sector and the political protests that hit the retail and tourism sector.

Hong Kong SAR PMI and GDP



The preliminary estimate of the IHS Markit China Economics team is that mainland China's GDP could be reduced temporarily by about 1% in 2020 as an upper bound estimate based on the impact of the SARS epidemic on the Chinese economy. However, the Wuhan virus epidemic is still escalating rapidly, and there are considerable uncertainties about how the current crisis will evolve in coming weeks (see IHS Markit research note "*Impact of Coronavirus*", 24th January 2020.)

Economic impact on Asia-Pacific region

Over the past two decades, the rapid economic growth of China has made it a key export market for many Asia-Pacific nations. However, China's growing importance in Asia-Pacific trade and investment flows has also created considerable vulnerability for the Asia-Pacific region to this type of unpredictable "black swan" event currently hitting the Chinese economy.

With a number of Wuhan virus cases having already been detected outside of China, this outbreak is particularly concerning as it has occurred during the Chinese New Year season, with millions of Chinese tourists travelling both within China and to many popular Asian tourist destinations, such as Thailand, Vietnam, Japan, Singapore and South Korea.

Globally, the number of confirmed coronavirus cases reported outside of mainland China has reached 55 as of 27th January 2020, with cases having been identified in many parts of the world, including the US, Australia, France, Singapore, Malaysia, Thailand, Japan and South Korea already.

While temperature screening measures are being implemented in international airports globally, their effectiveness is uncertain since Chinese health authorities are reporting that the Wuhan virus may be contagious even before significant symptoms emerge.

Governments in the Asia-Pacific region are continuing to roll out new defensive measures to limit the transmission of the Wuhan virus. For example, Singapore has announced that Singaporean students and workers in schools, as well as workers in health care and elderly care roles will be required to take a 14-day compulsory leave of absence after returning from China. New visitors from Hubei province or who have recently visited Hubei province who are not residents of Singapore will no longer be allowed to enter Singapore.

The Malaysian government announced on 27th January that it has decided to suspend all temporary immigration for China nationals from Wuhan city and Hubei province.

Now that the Wuhan coronavirus has been found to be able to be transmitted from human to human, the economic consequences could be extremely concerning for the Asia-Pacific region. The 2003 SARS crisis created a severe negative impact on GDP growth for the Chinese economy and also hit the economies of a number of Southeast Asian nations, including Malaysia, Singapore and Vietnam. However, other economies could also be vulnerable, with the SARS epidemic having also had a negative impact on the economies of Canada and Australia.

Sectors of the economy that are particularly vulnerable to a SARS-like virus epidemic that can be spread by human-to-human transmission are retail stores, restaurants, conferences, sporting events, tourism and commercial aviation. Therefore, containing the current Wuhan virus outbreak has become a key priority for Chinese and international health care authorities, with enhanced screening of travellers now being put into place in many major airports worldwide.

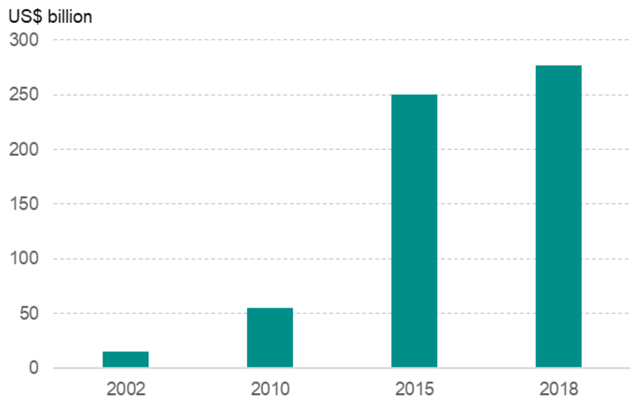
Vulnerability of the Asia-Pacific tourism industry

Among the most vulnerable sectors to the Wuhan virus epidemic are the Asia-Pacific travel and tourism sectors. Since the 2003 SARS crisis, outbound international tourism visits from China to the rest of the world have boomed, so the risks of a global SARS-like virus epidemic spreading rapidly globally have become even more severe.

In 2003, China's per capita GDP was only USD 1,260 per person, whereas by 2018, China's GDP per capita rose to USD 9,700 per person. The rapid rise in household incomes in China has triggered a boom in Chinese tourism visits abroad, which have risen from 20 million in 2003 to 150 million in 2018. Consequently, the vulnerability of many Asia-Pacific economies to a slowdown in Chinese tourism visits has increased significantly over the past two decades.

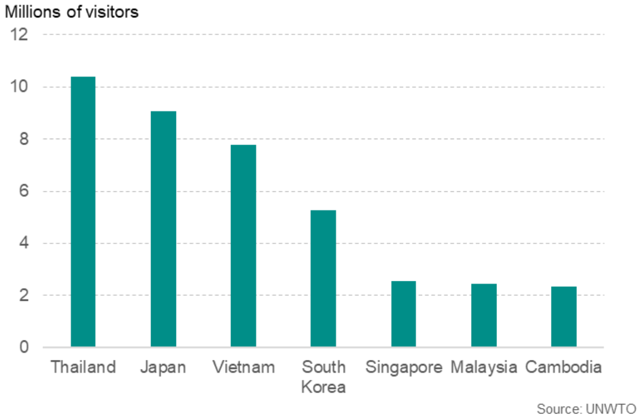
The decision of the Chinese government to suspend all Chinese group tours combined with severe restrictions being put in place on visitors from mainland China by many Asian governments are already resulting in significant economic impact effects on the Asia-Pacific travel and tourism industry.

Mainland Chinese international tourism spending



Source: UNWTO

Top APAC destinations for Chinese tourism, 2018



Thailand has been one of the most notable beneficiaries of the boom in Chinese tourism, with total annual Chinese tourist visits to Thailand having risen from 2.7 million in 2012 to 11 million in 2019. Chinese tourism spending in Thailand was estimated to have reached USD 18 billion in 2019, amounting to over 25% of total international tourism spending in Thailand. Direct tourism spending accounts for an estimated 12% of Thai GDP, with Chinese tourism having played an increasingly important role in underpinning the Thai tourism economy. The Thai Tourism and Sports Minister Phiphat Ratchakitprakarn has stated that Thai tourism revenue could be 50 billion baht lower if China maintains its restrictions on group tours for a period of three months.

Chinese tourism has also become increasingly important for Japan's tourism industry, with total Chinese tourist visits to Japan having reached 9.6 million in 2019, accounting for 30% of total foreign tourist visits. A key concern for Japan is also the potential risk from the Wuhan virus for tourism visits related to the Tokyo Summer Olympics in July-August 2020 if the virus has not been contained by early summer 2020.

Chinese tourism travel is also a key pillar for Vietnam's tourism industry, with total Chinese tourism arrivals having reached 5 million in 2018, accounting for one-third of total international visits.

For Singapore, mainland Chinese tourism visits have become a major part of the tourism economy, with 3.4 million mainland Chinese tourist visits in 2018, accounting for around 18% of total international tourist visits. The tourism sector is an important part of the Singapore, economy, accounting for an estimated 4% of Singapore's GDP.

Chinese tourism has also been growing rapidly in the Philippines, and accounted for an estimated 20% of total international tourism visits in 2019.

Chinese tourist visits to Malaysia reached 2.9 million in 2018, or around 11% of total international tourist visits.

China has also become the largest source country for international tourist visits to Australia, accounting for 1.4 million visits in the 2018-2019 financial year, or around 15% of total international tourist visits.

For the Hong Kong SAR economy, which was already badly hit in 2019 by the negative impact of political protests on the tourism and retail sectors, mainland Chinese tourism visits are now expected to fall further in early 2020 due to the decision by the Hong Kong SAR government to restrict mainland Chinese tourist visitors. Consequently, the impact of the Wuhan virus epidemic is likely to further increase the negative shocks to the Hong Kong SAR economy in the near term.

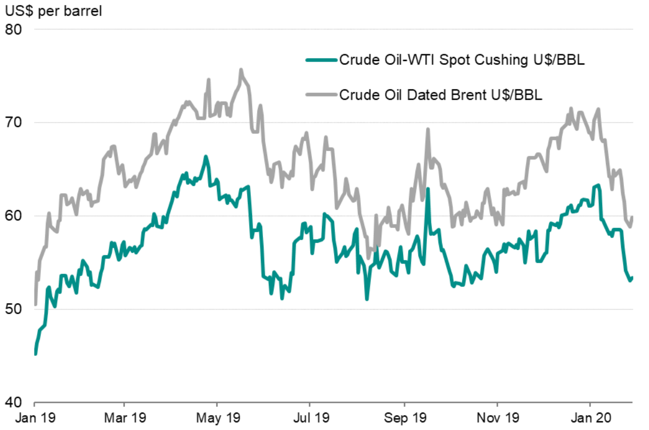
The Asia-Pacific commercial aviation industry is also vulnerable to the impact of the new restrictions on Chinese tourism travel abroad, which initial indications that the regulatory restrictions on group travel will remain in place for at least a couple of months, depending on how the Wuhan epidemic evolves in coming weeks. Due to the boom in Chinese international tourism travel in recent years, many Asian airlines have ramped up their direct flights between major Chinese cities and many popular Asian destinations. Air travel on these routes will inevitably be hit hard, at least in the short-term, due to the new travel restrictions.

A number of major international airlines have also announced cancellations of their flights to some mainland Chinese cities. British Airways has announced that it is temporarily suspending flights from the UK to mainland China, while American Airlines and United Airlines have suspended some of their flights to mainland China temporarily. Air Canada has suspended all direct flights to Beijing and Shanghai until the end of February 2020.

Among Asian airlines, Lion Air Group has announced that it will suspend all flights to China from 1st February 2020. Jetstar Asia has announced the temporary suspension of services to Hefei, Guiyang and Xuzhou until the end of March 2020.

With China having become the world's largest importer of crude oil, the expected negative impact on oil demand in China due to the economic impact of the Wuhan virus epidemic has resulted in Brent crude oil prices falling below USD 60 per barrel on 28th January. This follows the spike in Brent crude oil prices above USD 70 per barrel in early January due to concerns about geopolitical risks to oil supply following the US drone strike that killed Iran's Major General Qasem Soleimani, commander of Iran's elite Quds Force on 3rd January 2020, followed by Iran's launch of more than a dozen ballistic missiles on 8th January against US military and coalition forces in Iraq.

Oil Prices



Source: IHS Markit via Datastream.

Near-term outlook

The rapidly escalating Wuhan coronavirus epidemic poses a significant downside risk to the near-term Asia-Pacific economic outlook in 2020 if the epidemic continues to spread across mainland China and if cases in other Asia-Pacific nations continue to rise in coming weeks. A key risk to regional trade is from the transmission effects to the Asia-Pacific supply chain as Chinese economic growth momentum softens in the first half of 2020, since China is by far the largest economy in the Asia-Pacific region.

A number of service sector industries in the Asia-Pacific region, notably tourism and travel, are expected to be among the worst hit, as Chinese outbound tourism slumps sharply in coming months. The retail trade, restaurants and entertainment sectors are also highly vulnerable to a downturn in consumer confidence, as consumers become more apprehensive about contagion risks. However online sales, which have already been growing very rapidly in many Asian economies during recent years, notably in China, are expected to be strongly boosted while the epidemic persists.

Asia-Pacific governments are likely to respond to the economic shock with a range of fiscal and monetary policy stimulus measures to support near-term growth momentum, particularly measures to help the tourism and travel sectors, which are particularly vulnerable to this economic shock.

Europe
Special Focus

Brexit: what next for the UK economy?

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Although a clear Brexit pathway is emerging, accompanied by a retreating risk of a "no-deal" departure, the entire process is expected to weigh down on UK economic activity in the short and medium term. The first step of "getting Brexit done" on 31st January 2020 signifies a clearer legal position but does little to provide greater clarity on the type of relationship the UK will have with the EU once the transition period ends. UK firms are far from sure that the final trade deal will deliver the frictionless trade that they currently enjoy with the EU.

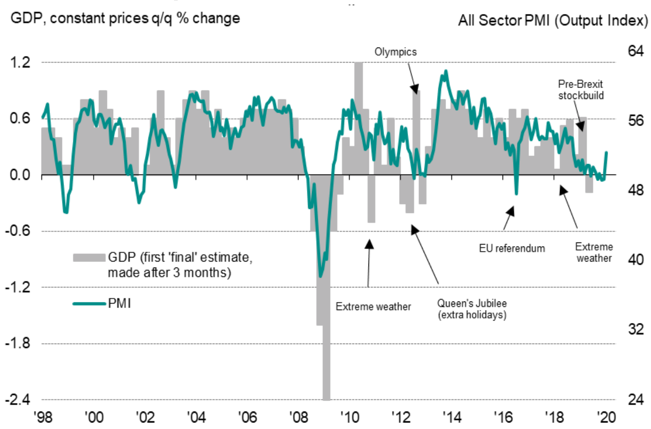
Clearer Brexit pathway and growth bounce

The UK will leave the European Union (EU) at 11pm on 31st January under the terms of the Withdrawal Agreement, removing the immediate threat of a “no-deal” departure. The new prime minister Boris Johnson hopes his comfortable general election win to prevent a Labour government with a manifesto targeting corporate activity and his rapid ratification of the Brexit deal will lift investor sentiment and provide a growth bounce.

Surveys complied after the general election are more encouraging, and hint at a “Boris growth bounce” in January after the economy was close to stagnation in the three months to November 2019.

The IHS Markit/CIPS Flash UK Composite PMI highlighted an expansion in private sector activity in January, which was the first gain in five months, and partly resulted from “the sharpest increase in new work since September 2018.” Specifically, the headline index improved from 49.3 in December 2019 to a 16-month high of 52.4 in January. The survey revealed widespread reports from companies that reduced political uncertainty following the general election had a positive impact on business and consumer spending decisions at the start of the year.

UK flash composite PMI and GDP

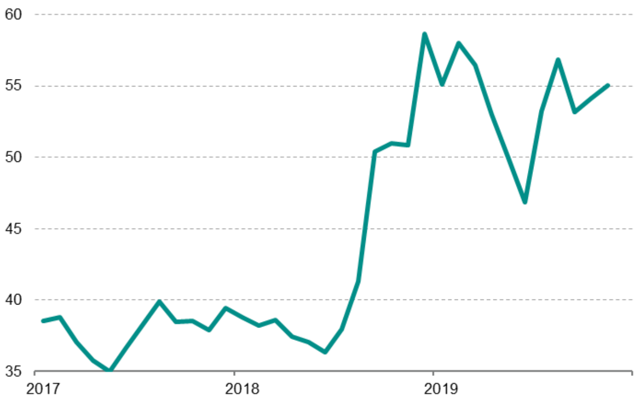


Sources: IHS Markit, CIPS, ONS.

But any “growth bounce” could peter in the second half of 2020 with new Brexit risks emerging. The UK government has legislated against extending the transition period beyond December 2020, risking a “cliff edge” exit if the UK-EU trade deal is not ready. Or, whether the limited transition period to 31st December 2020 provides enough time to reach an agreement on the final UK-EU future relationship, and whether it is the right deal for the UK firms.

Importantly, the first step of “getting Brexit done” on January 31st signifies a clearer legal position but does little to provide greater clarity on the type of relationship the UK will have with the EU once the transition period ends.

Brexit uncertainty index



Source: Bank of England's agents' survey of 320 firms

Cliff-edge exit after the transition period is unlikely

We believe that the key players in the Conservative government acknowledge privately that a cliff-edge Brexit at the end of the transition period would be a painful outcome for the UK economy. Johnson probably fears that it would damage his chances of winning multiple terms as prime minister.

In addition, EU is suggesting that it will be possible to negotiate the "principle elements" of a free trade agreement (FTA) by the end of the transition period. Specifically, the EU's chief Brexit negotiator, Michel Barnier, who will lead the trade negotiations, believes that it is impossible to negotiate the UK's entire future with the EU in the "very, very short" time of 11 months, although he thinks it would be possible to negotiate "the principle elements" of an FTA to avoid an "economic cliff edge before the end of 2020".

Trade talks covering goods, which way?

The guiding principles of the imminent trade talks covering goods are spelled out in the reworded Political Declaration:

- This specifies that both sides are committed to a "comprehensive and balanced Free Trade Agreement" with "zero tariffs, fees, charges or quantitative restrictions" between the two sides.
- However, it also pledges that the parties will "retain their autonomy and the ability to regulate economic activity according to the levels of protection each deems appropriate in order to achieve legitimate public policy objectives".

The new government's comfortable majority will allow the UK prime minister to pursue his stated goal of having regulatory independence as part of a future relationship with the EU. Currently, the UK and the EU are committed to an FTA, but the UK government wants a "best in class" FTA, allowing it to set its own regulatory standards with a view to improving its chances of obtaining significant trade deals outside the EU, particularly with the United States and China.

Indeed, UK Chancellor of the Exchequer (Finance Minister) Sajid Javid, as quoted by the Financial Times on 18th January 2020, insisted that “there will not be alignment" with EU regulations after Brexit, arguing that UK manufacturers “had three years to prepare for a new trading relationship”. He warned that “there will not be alignment, we will not be a rule-taker, we will not be in the Single Market and we will not be in the Customs Union — and we will do this by the end of the year".

But an FTA based on regulatory autonomy represents risks to UK economy

This represents a risk to the UK growth benefits of a future FTA, with the potential for regulatory divergence between the EU and UK risking the emergence of non-tariff barriers and new customs checks. According to the UN Conference on Trade and Development classifies 16 types of non-barrier which can occur both at or behind the border, and they are grouped three broad categories, namely regulations, rules of origin and quotas.

Despite the comments from Sajid Javid, the new UK government could face considerable pressure to concede on regulatory autonomy, fearful that any use of non-tariff barriers will place huge strain on already misfiring economy. We suspect Boris Johnson will face notable domestic pressures to abandon the pursuit of regulatory autonomy. They include

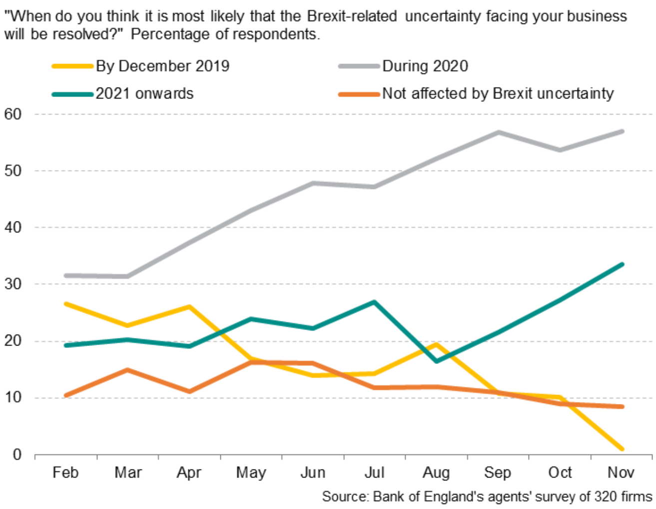
- The economy is in poor shape to absorb a shock of a limited or “bare bones” FTA.
- UK's largest industrial sectors will demand reassurances that their interests will be protected in post-Brexit trading arrangements. They insist that regulatory alignment should continue after Brexit as a critical element of the UK's future trade relationship, led by continued participation in EU regulatory institutions. They warn that pulling out of the key EU agencies would present a serious risk, leading to "huge new costs and disruption to UK firms", and that it would be disruptive to "our complex international supply chains and has the potential to risk consumer and food safety, and confidence, access to overseas markets for UK exporters and vital future investment in innovation in this country."
- Any retreat from the goal of pan-European regulatory alignment will impede the UK industry's ability to compete for investment and could even result in some firms relocating from the UK. This would imply a significant downside risk to how the economy fares after the transition period ends.
- Some EU customers will be increasingly tempted to resource away from UK exporters to avoid potential supply disruptions in the event of new non-tariff barriers and custom checks after the transition period ends.

However, our Brexit baseline assumes that the EU will demand a more rigorous regulatory framework with the UK than currently being suggested in the reworded political declaration. The EU Brexit negotiator Michel Barnier has warned the UK not to diverge from EU regulatory standards that protect the environment and workers, and he warns that tariff and quota-free access to the EU will be proportional to the commitments taken to the common rules." Also, the European Commission President Ursula von der Leyen warns that "without a level playing field on environment, labour, taxation and state aid, you cannot have the highest quality access to the world's largest single market."

They are several regulation pathways. The first includes a non-regression causes, which means the UK and EU agree not to distil the shared rules they currently have. A more demanding stance is that the EU wants the UK to adhere to a "dynamic alignment" process, which implies any changes in EU rules triggers the same changes in the UK

The EU ratification process of the final trade deal could also force the UK to concede on regulatory autonomy, with some member states only prepared to accept an FTA agreement that doesn't allow any regulatory divergence. Indeed, some EU countries already appear to be taking a tougher line, demanding "dynamic alignment" in several policy areas, including state aid and environmental regulations. Clearly, Sajid Javid has ruled out "dynamic alignment", with both sides predictably far apart ahead of the trade negotiations. Still, we expect the UK will edge ever close to a robust commitment to a level playing field regime, but this is likely to take several negotiating iterations, and is unlikely to be in place by the end of transition period, implying continued uncertainty.

Brexit resolution



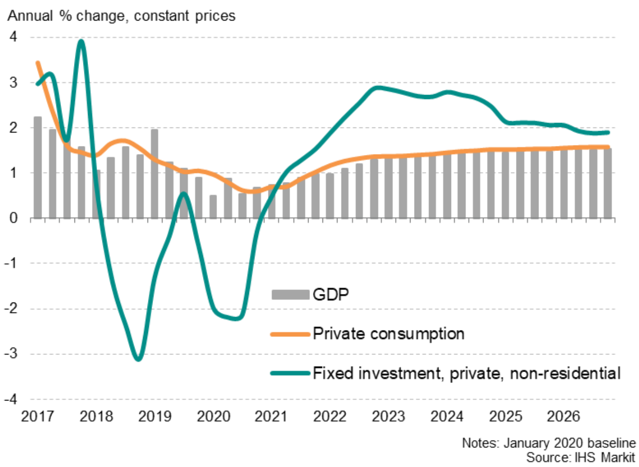
The UK growth outlook

We are relatively cautious about the UK's growth prospects both in the short and medium term. According to our January baseline, we expect the economy to expand by 0.6% in 2020, 0.8% in 2021, 1.1% in 2022, and 1.4% in 2023, which is generally a more downbeat assessment than the market consensus.

As noted earlier, we anticipate a modest pick-up in growth in the first half of 2020 as some of the uncertainties facing the economy are diluted. But any recovery in corporate investment during 2020–21 will be constrained by prevailing obstacles. These include:

- A challenging global economic environment.
- New Brexit risks, namely the 11-month transition period providing a limited window for the UK and EU to reach an FTA, while others fret about the exact nature of the UK-EU longer-term relationship.
- Corporate fears remain, worsened by Javid insisting that there will not be realignment with EU regulations in the final trade deal.
- Large firms will wait for greater clarity about the final UK-EU relationship before they give the green light to big-ticket investment plans.

GDP, key components



Johnson proposes a Canada-style FTA with the EU whereby the UK leaves its Customs Union and Single Market and attains regulatory autonomy, implying a relatively hard Brexit. Alternatively, the EU will expect the UK to adhere to stricter rules than those underpinning recent EU trade agreements with China or Japan to reflect the UK's "geographical proximity". Ultimately, it is the gulf between the two negotiating positions regarding the future trade relationship that will heighten economic uncertainty in the UK.

Our Brexit baseline is well aligned with the anticipated pathway suggested by the renegotiated Withdrawal Agreement, but we continue to argue that the UK will have little choice but to drop its goal of minimal alignment with regards to goods.

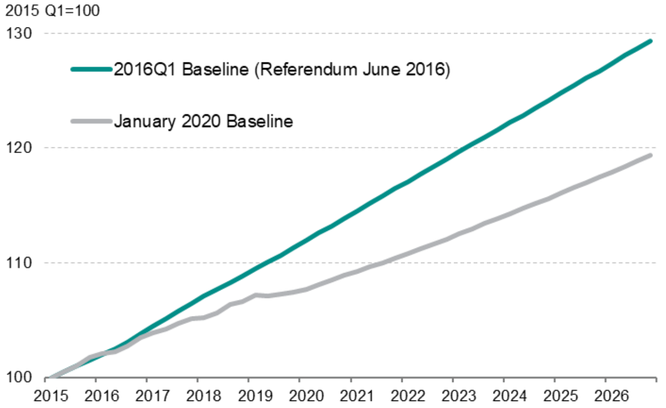
Should the UK insist on regulatory autonomy as part of an FTA with the EU, we would anticipate further downward pressure on the UK's growth prospects beyond the transition period to reflect disrupted just-in-time supply chains, non-tariff barriers, and higher bureaucratic costs for UK firms. The main transmission channels would be higher consumer prices and another blow to investment decisions.

Our cautious medium-term growth outlook also factors in the likely costs associated with the UK leaving the Single Market and the EEA, namely the unavoidable damage to its exports of services to the EU via the disruption of cross-border trade (and the loss of UK passporting rights for the key financial and insurance sectors).

Our Brexit baseline assumes that frictionless trade will eventually be in place for goods but non-tariff barriers will hinder the free movement of services, particularly UK financial service exports to the EU. This implies some damage to the overall UK economy, with financial services accounting for around 7% of GDP.

A comparison between our January 2020 and first-quarter 2016 (prior to the referendum) baselines shows that real GDP is now expected to be 8.2% lower in 2026 in our current assessment. The estimated output loss partly reflects the impact of the stretched and uncertain Brexit process and the loss of frictionless trade for UK service providers. In addition, like other advanced economies, the UK has suffered some collateral damage from the tougher global economic backdrop, characterised by sluggish trade flows, the fallout from the US-China trade war and struggling global manufacturing activity.

UK real GDP pre-referendum and January baseline



Source: IHS Markit