MAKING SENSE OF *THIS* WORLD

11 May 2020

R&R Weekly Column
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Will Covid Provide Boris Johnson With The Perfect Excuse For A No-Deal Brexit?

According to the most recent statistics, the UK is now third in the ranking of countries most affected by Coronavirus, after the US and Spain. It is second (after the US) in terms of number of deaths, with around 32,000 reported victims. Given the severity of the situation, the government, after initial hesitation, launched a complete lockdown of the country and its economy on March 23rd. Now, the government seems ready to relax some of these rules (for example, on daily exercise), while also tightening boarder controls (e.g. imposing a 14-day quarantine on anybody arriving in the UK). The central government – but not, for example, the devolved government in Scotland – is ready to move from the slogans "Stay Home/Protect the NHS/Save Lives" to "Stay Alert/Control The Virus/Save Lives".

The impact of the pandemic and lockdown on the UK economy was recently estimated by the Bank of England, in the "illustrative scenario" described in its May Monetary Policy Report. The Bank estimated a 14% drop in the UK's economic activity in 2020, followed by a V-shaped recovery of 15% in 2021. This estimate takes into consideration the overall policy response, namely a massive fiscal stimulus accompanied by a large monetary easing package, including rate cuts, increased QE and credit easing measures. The fiscal stimulus includes the innovative Job-Retention Scheme, by which the government will pay 80% of the salary of "furloughed" employees (up to GBP 2,500 a month) as long as their companies do not fire them, until June 30. The monetary stimulus includes a form of direct fiscal deficit, with the re-activation of the Bank's "Ways and Means", i.e. the Treasury account at the BoE.

While the pandemic and containment measures take their toll on the UK economy, the other major chapter of the UK's political economy, Brexit negotiations, has re-started. As we have discussed in our previous analysis, the UK has no intention to seek another extension to the implementation period beyond December 2020. The EU now seems to have accepted this position, which initially was motivated by the UK's intention not to repeat the experience of requesting multiple extensions as occurred during the prime ministership of Theresa May, which led to political chaos. But now there are two additional motivations, which we consider to be even stronger.

First, as we explained in our analysis, "no deal" Brxit is the only logical conclusion of the approach brought forward by Johnson and his political side of the Conservative party, which won in a resounding way at the December 2019 elections. *Second*, the economic damage caused by the pandemic and the containment measures will easily mask any economic damage deriving from "no-deal" Brexit. The most visible aspect, namely travel restrictions and border controls, would be implemented anyway due to Covid.

Thus for now the UK government has all the advantages of not seeking for an extension by June 30 while knowing that it can always get one at the very last minute). It will make "no deal" more likely, thereby strengthening its negotiating position at the table. And if a hard Brexit does occur, it is probably what hard-Brexiteers such as Boris Johnson and his chief advisor Dominic Cummings, Dominic Raab (currently foreign minister and senior secretary of state) and Michael Gove (in charge of Brexit planning) ultimately want.

What happens if a no-deal, hard Brexit eventually occurs as a result of this tough negotiating approach? Well, the economic damage deriving from leaving the customs union and the single market without a deal, as well as increased border controls and customs checks, will likely be attributed by the government to the pandemic and the lockdown, rather than to the hard Brexit. The UK will also be free to respond to the additional economic shock by completely dis-aligning itself from the EU in terms of taxation, regulation, as well as product and labour standards. In the post-Covid world, where every country will try to do as much as possible just to remain afloat, the UK position might even not be perceived particularly at odds with that of other European countries, including those who will remain in the EU.

Our Recent Publications

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Looking Ahead

The Week Ahead: US Retail Sales and Inflation Expected To Decline Further, EZ GDP Expected To Contract Sharply In Q1

In the US, retail sales are expected to decline by -10.0% m-o-m in April (p: -8.7%). April's CPI inflation is projected to drop to 0.8% y-o-y (p: 1.5%) - on account of lower energy prices - and core-CPI to decline to 1.7% y-o-y (p: 2.1%).

In the EZ, Q1-2020 preliminary GDP is forecasted at -3.3% y-o-y (p: 1.0%), as COVID-19 takes a toll on economic activity. March's IP is also expected to further contract by -12.0% (p: -0.1%).

In New Zealand, the RBNZ is expected to provide further stimulus while keeping its key policy rate unchanged at 0.25%.

The Quarter Ahead: Higher Debt, Disruptions To Global Supply Chains

The ***COVID-19-induced economic shock*** is deep and widespread, and will spur a sharp rise in public sector debt. Travel restrictions are likely to remain in place, with adverse impacts on trade and tourism.

In the US, while president Trump criticized China for "failing to hold up the January trade deal", his economic advisers released a reassuring statement, that "the agreement was valid and the truce intact". However, the Trump administration is reportedly planning to punish China for the pandemic, via: *i)* sanctions; *ii)* canceling US debt obligations; and *iii)* drawing up new trade policies. After large banks' earnings plummeted in Q1-2020 the Fed stated "the global banking system is more resilient and better placed to sustain financing to the real economy (…) than in the aftermath of the 2008 global financial crisis".

In the EZ, the EC decided to keep travel restrictions and internal border controls in place for another 30 days, until June 15, as "part of extraordinary measures that limit the spread of Coronavirus".

Systemic ***Central Banks*** policies will mostly focus on 'lending facilities', i.e.: ***i) the Fed's*** GFC-era revamped 'Commercial Paper Funding Facility'; *ii)* the expanded ***ECB***'s TLTROs; and *iii)* BoJ's new 'Special Operations'.

In the UK, the BoE forecast the economy to shrink by 14% in 2020, the biggest annual contraction since a decline of 15% in 1706.

In Australia, the RBA forecast GDP to shrink by around 10% in H1, and by 6% over 2020.

Last Week's Review

Real Economy: Unemployment On The Rise, Inflation Begins To Decline, Risks Remain Elevated

In the US, April's labor market suffered its worst month in history, as: *i)* nonfarm payrolls witnessed their largest drop ever, to -20.5m (c: 22.0m; p: 0.87m); *ii)* the unemployment rate spiked to 14.0%, a record high (c: 14.0%; p: 4.4%); and *iii)* average hourly earnings rose (a: 7.9% y-o-y; c: 3.3%; p: 3.3%) - as job losses mostly hit low-pay workers.

In the EZ, retail sales tumbled by -9.2% y-o-y (c: -10.5%; p: 2.5%), as lockdown measures forced: *i)* businesses closures; and *ii)* discretionary savings - as consumers stayed at home.

In the UK, the BoE forecast the deepest recession in 300 years, with GDP plunging by almost 30% in H1-2020; as a result, policymakers kept the key rate at its historical low of 0.10%, while maintaining the QE program at GBP 645bn.

In Australia, the RBA kept the cash rate at a record low of 0.25%.

In Norway, Norges Bank cut its policy rate by 25bps, to a record low of 0.00% (p: 0.25%), as economic activity was hit by: *i)* the sharp fall in oil prices; and *ii)* COVID-19's severe impact on surrounding countries.

Financial Markets: CBs Support Risk Appetite; Stocks Rise Despite US Labor Data, Bonds Flat

Market drivers: as extensive CB support keeps underpinning both safe and risky assets, the markets have likely priced in the upcoming severe economic recession, and investors look beyond tragic economic data.

Stocks: w-o-w, global indices rose (MSCI ACWI, +2.4%, to 490), driven by the US (S&P 500, +3.5% to 2,930), as investors focused on: *i)* the reopening of parts of the economy; along with *ii)* advances in the fight against COVID-19. EMs fell (MSCI EMs, -0.6% to 912) despite a positive performance from China (Shanghai Comp., +1.2% to 2,895). Volatility is declining from April levels (VIX S&P 500, -9.2 to 28.0), but it is still above its 52w and 10y averages.

Bonds: w-o-w, returns remained flat (BAML Global, -0.3% to 292.0) and 10y government yields rose across DMs (UST, +4bps to 0.68%; German bunds, +5bps to -0.53%; French OAT, +7 bps to -0.03%). The markets priced in expectations for the Fed to embark on a 'negative interest rates policy' (NIRP), despite the Fed's stated unwillingness to take official short-term rates below 0%.

FX: w-o-w, demand for USD strengthened (DXY, +0.7% to 99.734), and demand for EUR and GBP weakened (EUR/USD, -1.3% to 1.084; GBP/USD, -0.8% to 1.241). EM currencies fell marginally (MSCI EM FX index, -0.1% to 1,567).

Commodities: Industrial commodities prices posted gains and oil prices rose for the second consecutive week (Brent, +17.1% to 31.0 USD/b; WTI, +25.1% to 24.7 USD/b), as producers rapidly shut production. Gold maintained its safe haven appeal (+0.1 to 1,701 USD/Oz.), driven by abundant liquidity of monetary and fiscal stimuli.

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Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	*thousand*	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*