

International Commentary — June 11, 2021

European Economic Update: U.K. Leads, Eurozone Follows

Summary

- The U.K. economy is showing strong signs of recovery as monthly GDP data continue to impress. In particular, the U.K. services sector is outperforming as restrictions are being lifted and consumer activity rebounds.
- While the Eurozone is also demonstrating a recovery, the bounce back in activity has been more measured than the U.K. Contributing to the slower recovery is a vaccination campaign that struggled to gather momentum earlier in the year, which resulted in restrictions being in place much longer. Conditions have certainly improved in the Eurozone, but the pace of rebound will likely only get closer to that of the U.K. as restrictions come off and the services sector improves.
- As the U.K. economy rebounds, the Bank of England has made a first initial step towards normalizing monetary policy. On that other hand, as the Eurozone rebound continues to lag the European Central Bank is likely to keep monetary policy very accommodative for the time being. To that point, we expect the Bank of England to further taper asset purchases in August, while the ECB is likely to maintain an elevated pace of asset purchases until at least Q4.
- Diverging paths of monetary policy have resulted in slightly diverging outlooks for the British pound and the euro. As monetary policy turns less accommodative in the U.K., we expect the pound to rally and risks around our forecast are tilted to the upside. As far as the euro, while we are forecasting a stronger currency, the pace of appreciation is likely to be more gradual as the ECB may be more cautious about paring back monetary policy accommodation in the near future.

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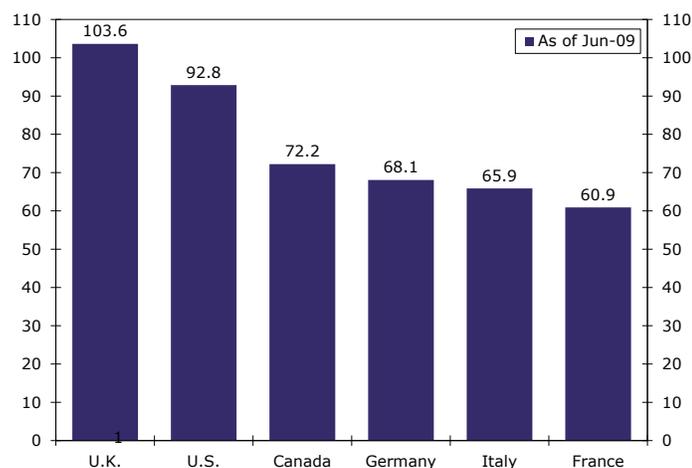
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A Strong Rebound in U.K. Activity is Underway

Today's U.K. April GDP data offered further evidence of the strong rebound that is underway for the U.K. economy. With the government having made good progress in vaccinating the population against COVID, restrictions have been steadily lifted in the United Kingdom during recent months. That is reflected by a 2.3% month-over-month increase in April GDP, coming on top of a 2.1% gain in March. The April gain in service sector activity was particularly noteworthy, with an increase of 3.4%, and clearly reflecting the impact of the re-opening. Accommodation and food service activities surged 44.1% in April, while education rose 11.2%. While not part of today's release, previously reported April retail sales rose 9.2% month-over-month, while the consensus forecast is for sales to rise 1.8% in May. If realized, that would level sales for the April-May period some 14.5% above the Q1 average, another indication of how the domestic and consumer sectors of the economy are leading the rebound.

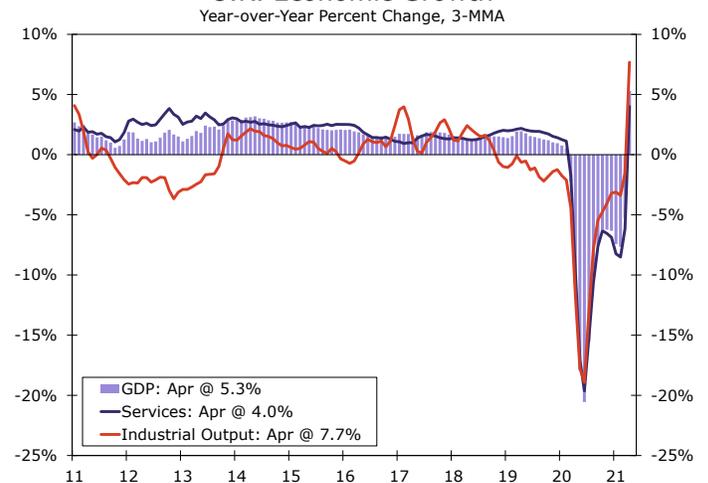
In contrast, U.K. April industrial output fell 1.3% month-over-month, although even here there are signs of resilience beneath the surface. Given a planned shutdown of oil field production sites for maintenance, mining and quarrying activity dropped by 15%, whereas manufacturing activity fell a more modest 0.3% month-over-month. Finally, while acknowledging the economy has enjoyed a strong recovery in activity in recent months, the level of U.K. GDP in April is still 3.7% below its pre-pandemic peak from February 2020.

Vaccine Doses Administered per 100 People



Source: Bloomberg LP and Wells Fargo Securities

U.K. Economic Growth



Source: Datastream and Wells Fargo Securities

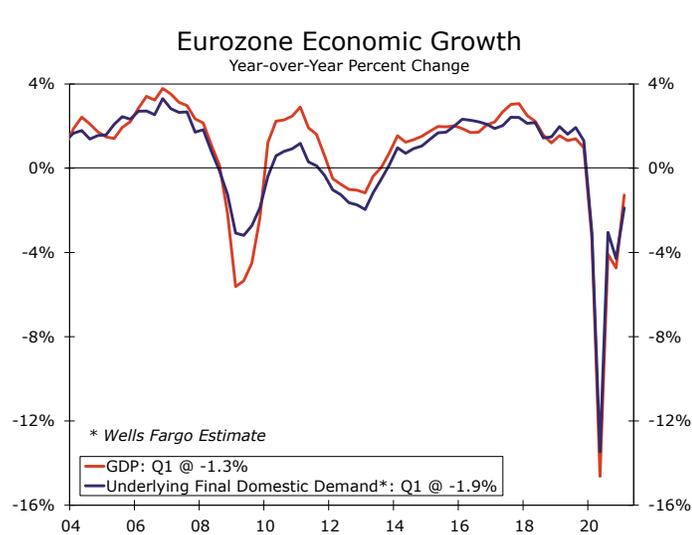
Eurozone Recovery Proceeding at a More Measured Pace

The Eurozone economy is also recovering, but the rebound in activity appears to be more measured. In part this reflects a slower start by many Eurozone governments in vaccinating their populations against COVID. This resulted in lockdowns still being in place in April in some Eurozone countries, and other restrictions were in some cases in place later. We also say "appears" because with Eurozone data slightly more dated than U.K. economic figures, it is not completely an "apples for apples" comparison. Even with these caveats in mind, the available Eurozone GDP figures point to subdued activity early this year. To be sure, revised Q1 GDP figures did show a smaller than previously reported fall of just 0.3% quarter-over-quarter. However, the details of that report also pointed to notable sluggishness in domestic activity. Q1 consumer spending fell 2.3% quarter-over-quarter, after a 2.9% decline in Q4. Meanwhile, Q1 fixed investment spending rose just 0.2%. As a result, our estimate of final domestic demand (which strips out fixed investment spending on intellectual property products, a lumpy and volatile sub-component of GDP) fell by 1.1% quarter-over-quarter, much more than the reported decline in overall economic activity.

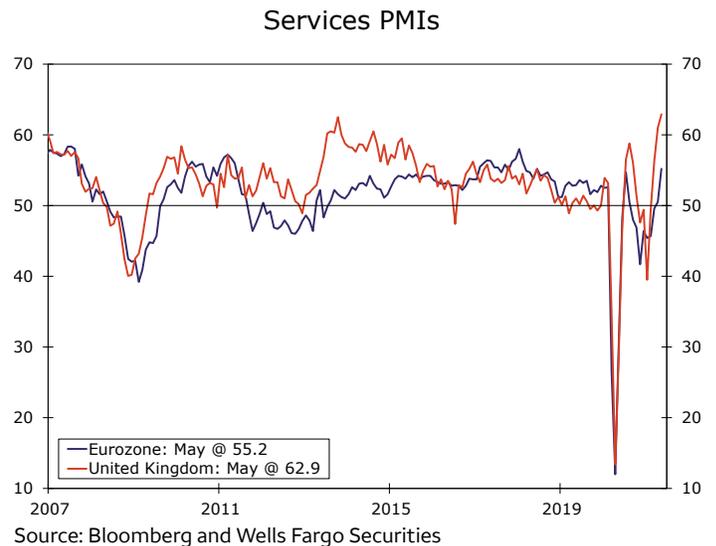
In addition, Eurozone April retail sales give a clear indication of the different pace at which the U.K. and some other Eurozone countries are navigating through the COVID crisis, with the U.K. economy opening up as some Eurozone economies still had restrictions in place. In contrast to a large reported increase in U.K. retail sales for April, Eurozone April retail sales fell 3.1% month-over-month, almost fully reversing a 3.3% sales gain in March. Accordingly, the level of Eurozone retail sales in April was only

0.3% above the Q1 average, a stark contrast to the much larger gain reported for the United Kingdom. We also observe that the level of Eurozone Q1 GDP was still 5.1% below its pre-pandemic peak from Q4 2019.

While things have improved since for the Eurozone, with the upswing gaining some momentum, this theme of Eurozone recovery but at a slower pace is also reflected in confidence surveys. In particular, the U.K. services PMI rose to 62.9, a multi-decade high. The Eurozone May services PMI rose but not by nearly as much to 55.2, the highest level since June 2018.



Source: Datastream and Wells Fargo Securities



Differing Pace of Rebound Means Different Paths for Monetary Policy and Currencies

While the United Kingdom and the Eurozone are both on an upswing, the differing pace of recovery is contributing to differing paths for monetary policy, and a differing outlook for their respective currencies. For the United Kingdom, the Bank of England has already made a small initial step towards less monetary policy accommodation, slowing the pace of its weekly bond purchases at its May monetary policy announcement. The Bank of England announced a reduction in the pace of its weekly asset purchases by £1 billion to £3.44 billion per week. In contrast, at this week's European Central Bank (ECB) monetary policy meeting, the ECB decided to maintain its accelerated pace of bond purchases, saying that:

"Based on a joint assessment of financing conditions and the inflation outlook, the Governing Council expects net purchases under the Pandemic Emergency Purchase Program over the coming quarter to continue to be conducted at a significantly higher pace than during the first months of the year."

We expect the Bank of England to announce a further slowing in the pace of its asset purchases at its August monetary policy meeting. So long as the Eurozone economy shows a further perceptible firming in growth in the months ahead, we expect the ECB to eventually follow suit by announcing a slower pace of its bond purchases from Q4 2021 at its September meeting. The U.K.'s faster economic rebound and the earlier move to less monetary policy accommodation also suggests greater upside risk to our medium-term GBP/USD target of \$1.4900 than our medium-term EUR/USD target of \$1.2800. For the immediate period ahead we anticipate the pound will perform more strongly versus the U.S. dollar, although the euro may catch up a bit over the longer-term as the economic recovery in the Eurozone gains further momentum.

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