Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds were little changed but the euro weakened to a six-month low against the dollar as euro area consumer confidence ticked higher.
- Gilts were also little changed despite some disappointing UK public finances data.
- The coming week brings key euro area sentiment surveys for October, the flash estimates of CPI for the same month from the largest member states, and the first Q3 GDP figures from France, Spain and the UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.660	+0.006
OBL 0 10/21	-0.498	+0.009
DBR 0 08/26	0.005	+0.002
UKT 1¼ 07/18	0.236	+0.021
UKT 3¾ 09/21	0.480	+0.017
UKT 1½ 07/26	1.081	+0.004

*Change from close as at 4.30pm BST.
Source: Bloomberg

Euro area

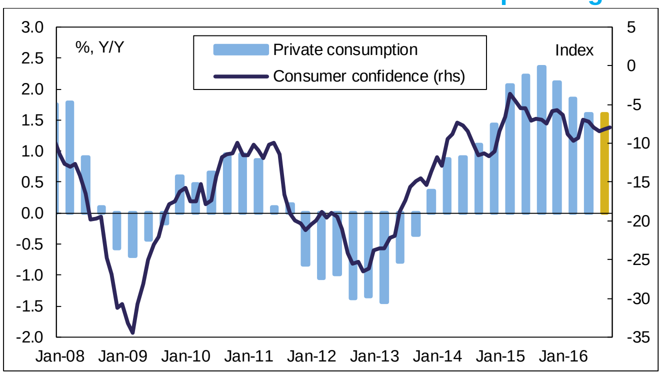
Consumer confidence a touch firmer, inflation expectations a touch weaker

As investors awaited this evening's announcement by DBRS on the outcome of its review of its Portuguese sovereign credit rating, today brought a couple of economic releases of interest to ECB policymakers. In particular, the Commission's flash estimate of euro area consumer confidence in October posted a very small rise for the second successive month, up to a three-month high of -8, above the long-run average but still below the Q2 level. Indeed, the broad trend in consumer sentiment over the past eighteen months has been down, coinciding with the recent moderation in momentum in consumption growth. Looking ahead, we expect consumer spending growth to slow in response to a moderation in the pace of real disposable income growth. Meanwhile, the ECB's survey of professional forecasters saw a slight downwards shift to average inflation expectations for 2016, 2017 and 2018 to 0.2%, 1.2% and 1.4% respectively, very close to our own forecast for those years. While the 2018 forecast is 0.2ppt below that of the ECB's most recent forecast published last month, and tallies with our expectation that the ECB will revise down its forecast when it is updated in December, policymakers might take some comfort from the fact that longer-term inflation expectations measured by the survey remain relatively well anchored, unchanged at 1.8%. However, this measure contrasts with longer-term inflation expectations measured by financial market indices, such as the 5Y5Y inflation forward swap rate which is still below 1.45%. And, given the euro area's significant structural challenges, we think that inflation over the longer term could struggle to be sustained above 1.6%.

The week ahead in the euro area and US

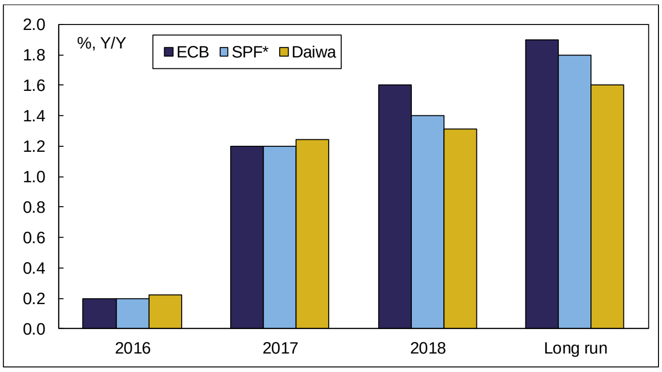
The coming week brings plenty of top-tier euro area economic data, including the most informative surveys for October, first estimates of inflation from a number of member states for the same month, and the first Q3 GDP figures from certain member states too. In terms of economic sentiment, the flash October PMIs are due on Monday, followed by the German Ifo and French INSEE business surveys (Tuesday), German and French consumer confidence indices (Wednesday), Italian economic confidence indices (Thursday), and the comprehensive Commission survey results (Friday). The flash inflation figures from Germany, France and Spain, which are likely to rise further from their levels in September as past energy price declines continue to fall out of the arithmetic, come on Friday. Likewise, the first estimates of French and Spanish GDP growth in Q3 are also due at the end of the week. French GDP is set to have returned to growth of around 0.3%Q/Q following a drop of 0.1%Q/Q in Q2 while Spanish GDP is expected to have slowed slightly by 0.1ppt to a still-robust 0.7%Q/Q. In the bond markets, Germany will sell 5Y Bunds on Wednesday while Italy will sell a range of bonds on Wednesday and Friday.

Euro area: Consumer confidence and spending*



*Consumption forecast for Q316.
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



* ECB Survey of Professional Forecasters average.
Source: ECB and Daiwa Capital Markets Europe Ltd.

In the US, the coming week brings a number of top-tier releases, including the first estimate of Q3 GDP on Friday. The consensus expectation is for annualised growth to have risen from 1.4%Q/Q in Q2 to about 2½%Q/Q, which would be the strongest pace for six quarters. Ahead of this, the week brings the Chicago Fed's September activity index (Monday), the Conference Board's October consumer confidence index (Tuesday), and the advance goods trade report (Wednesday) and preliminary durable goods orders figures (Thursday), both for September. There are also various housing market indicators due, including the FHFA and Case-Shiller home prices indices (Tuesday), new home sales figures (Wednesday) and pending home sales figures (Thursday). Policy-wise, the Fed's Dudley, Powell, Bullard and Evans are due to speak publicly on Monday. Supply-wise, the Treasury will sell 2Y notes (Tuesday), 2Y floating-rate notes and 5Y notes (Wednesday) and 7Y notes (Thursday).

UK

Fall in sterling triggers rate hike speculation

The precipitous fall in sterling since 23 June, which has seen only the Mozambique New Metical and the Sierra Leonean Leone perform worse, was a predictable response to the referendum outcome to leave the EU. Countries that pursue policies that are damaging to their growth prospects can expect to see their currencies adjust downwards to reflect the lowered attractiveness of that economy to investors. And the fact that the recent leg down in sterling came on the back of announcements from the Government suggesting that it favours a 'hard' Brexit, including departure from the Single Market, strengthens the evidence that sterling's fall is being primarily driven by the economy's much-diminished economic prospects. The fall in sterling inevitably makes Britons poorer, not least as import prices rise in response. There is little evidence that has had any meaningful impact on consumers yet – the rise in inflation reported earlier in the week to 1%, a two-year high but still only half of the BoE's target rate, was more about the impact of past energy prices dropping out of the numbers. But as firms' currency hedges roll off over coming months the impact on inflation of the drop in sterling will be profound – we expect headline inflation to hit 3% or more by the end of next year. In response to the worsening in the inflation outlook, Gilts have also sold off over the past couple of weeks, taking the 10Y yield from 67bps at the end of September back to close to 1.10% today. At the same time, markets have further priced out the possibility of a further rate reduction from the BoE, and the probability of a rate cut by the time of the Bank's February meeting implied by swaps prices is now barely more than 10%. In fact, some commentators have begun to suggest that, faced with a lower pound, higher inflation and rising inflation expectations, the BoE could be forced into the sort of interest rate hikes that emerging market central banks regularly have to implement to restore confidence in their currencies and policy frameworks.

Past actions provide guide to how MPC will react this time

That seems far-fetched. While the prospect of Brexit, and the associated deterioration in the quality of Government economic policy-making, has certainly dented confidence in the UK's institutional framework, it is not (yet) at emerging market standards. And, neither, does higher inflation automatically imply the need for tighter monetary policy. For sure, a period of above-target inflation complicates the MPC's job – having spent several quarters writing letters to the Chancellor explaining why inflation has been so far below target, before long Mark Carney will have to start writing letters explaining why it is so far above target. But Carney's discomfort will not determine policy – the economic outlook will. One guide to how the MPC will react to the coming period of higher inflation is to look back at the post-crisis period (see charts on page 4). Twice the MPC was very happy to ease policy aggressively (shaded areas represent easing periods) even as inflation hit 5% and (in the 2008/09 period at least) inflation expectations were elevated. And easing continued even as uncertainty (as measured by the VIX) declined. Key to these easing decisions was the MPC's view of the economic outlook and, in particular, the behaviour of wages.

Brexit to provide enormous shock to economy

In terms of the economy, the medium-term outlook is arguably as uncertain as at any time since the dark days of 2008. While the economy likely grew by about 0.4%Q/Q in Q3, the subsequent realisation that a hard Brexit is the most likely outcome is putting further downward pressure on growth, not least as firms, and foreign-owned ones in particular, reassess their investment plans. And with a triggering of Article 50 in March next year pointing towards the UK leaving the EU in early 2019, the likelihood that it will leave with no trade deals with the EU (or possibly anyone else) in place, will result in a huge negative economic shock as firms face tariff and non-tariff barriers on their exports and imports become subject to tariffs. This shock (a shock that will become increasingly apparent as the leave date approaches) will ensure a sharp retrenchment in economic activity and higher unemployment.

Weakening labour market will see MPC ease further

And higher unemployment will ensure that higher inflation does not feed through into higher wages – the BoE will therefore feel no need to tighten. Indeed, if as in the two most recent periods of easing, it merely serves to depress real wage growth, putting downward pressure on household expenditure, higher near-term inflation is actually an additional reason for the MPC to loosen policy further. As for market expectations of inflation, the MPC will ignore those, even if they spike – what's happening to wages will be front and centre to its decision making. So, we continue to expect further easing from the MPC, most likely at its February meeting, via a cut in Bank Rate and additional Gilt purchases. And that is even on the back of our expectation of a further fall in sterling as the triggering of Article 50 gets ever closer, which will put further upward pressure on inflation. But whatever the Bank does, it will not be able to fully offset the negative shock to the economy of hard Brexit, which will leave the UK perpetually poorer than it otherwise would have been. Indeed, knowing the storm that is coming, and given the recent political briefings against him, whether Mark Carney will want to hang around for much longer is uncertain. If he does indeed decide later this year that he would prefer to move on in 2018 as was his original intention, expect markets to react with horror as one of the few grown-ups left in UK economic policymaking departs the scene.

The week ahead in the UK

All eyes next week will be on the first release of the Q3 GDP figures on Thursday, which will provide the first official estimate into how much the economy slowed in the aftermath of the EU referendum. Some economic data released since the vote in June have been stronger than expected previously. For example, retail sales growth of 1.8%Q/Q in Q3 suggests that household spending remained firm, while exports are on track to have outpaced imports. However, investment growth looks set to have fallen sharply. On balance, we think GDP growth slowed to 0.4%Q/Q from 0.7%Q/Q in Q2. However, with sentiment having been particularly volatile in the wake of the referendum, and given that the ONS does not fully incorporate data from the last month of the quarter into its initial GDP estimate, that figure may be more prone to revision than usual. Also notable in the coming week will be the CBI indicators – the Industrial Trends survey is due Monday and the Distributive Trades survey on Thursday – and BBA lending data from the major High Street banks. Elsewhere, Mark Carney will appear before the House of Lords Economic Affairs Committee on Tuesday. With unwarranted pressure continuing to be heaped on him from various senior Conservative politicians, this hearing will no doubt attract more attention than usual.

European calendar

Today's results

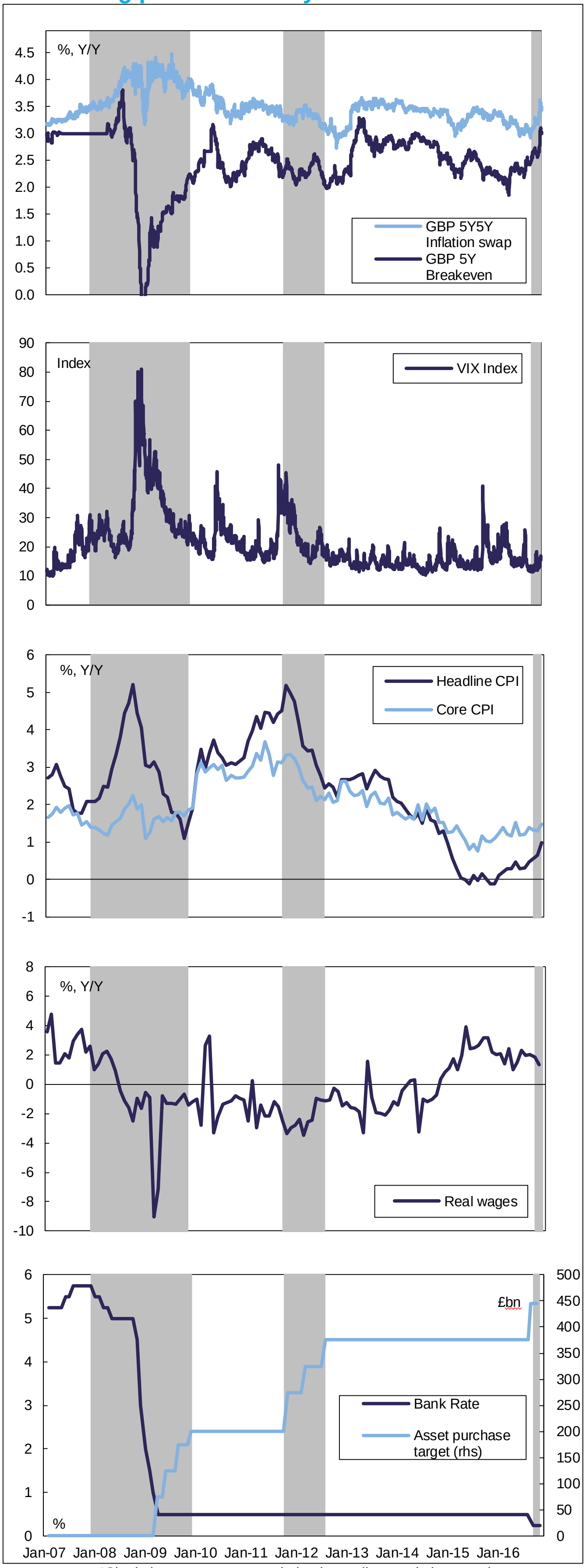
Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Preliminary consumer confidence	Oct	**-8.0**	-8.0	-8.2	**-**
UK	Public sector net borrowing excluding interventions £bn	Sep	**10.6**	8.5	10.5	**10.8**

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

BoE easing periods and key indicators*



*Shaded areas represent periods when policy was being eased.
Source: Bloomberg, Thomson Reuters, BoE and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

Key data releases					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
		Monday 24 October 2016			
EMU	09:00	Preliminary manufacturing PMI	Oct	52.7	52.6
	09:00	Preliminary services PMI (preliminary composite PMI)	Oct	52.4 (52.8)	52.2 (52.6)
	14:45	ECB public sector asset purchases €bn	Weekly	*17.6*	18.1
Germany	08:30	Preliminary manufacturing PMI	Oct	54.4	54.3
	08:30	Preliminary services PMI (preliminary composite PMI)	Oct	51.5 (53.3)	50.9 (52.8)
France	08:00	Preliminary manufacturing PMI	Oct	50.0	49.7
	08:00	Preliminary services PMI (preliminary composite PMI)	Oct	53.0 (52.8)	53.3 (52.7)
UK	11:00	CBI Industrial Trends survey, total orders	Oct	-5	-5
		Tuesday 25 October 2016			
Germany	09:00	Ifo business climate index	Oct	109.6	109.5
	09:00	Ifo current assessment balance (expectations)	Oct	114.9 (104.5)	114.7 (104.5)
France	07:45	Business confidence indicator (production outlook)	Oct	102 (8)	102 (7)
Italy	09:00	Industrial sales M/M% (Y/Y%)	Aug	-	2.1 (-0.7)
	09:00	Industrial orders M/M% (Y/Y%)	Aug	-	-10.8 (-11.8)
		Wednesday 26 October 2016			
Germany	07:00	GfK consumer confidence survey	Nov	10.0	10.0
France	07:45	Consumer confidence survey	Oct	98	97
Italy	09:00	Retail sales M/M% (Y/Y%)	Aug	0.3 (0.5)	-0.3 (-0.2)
UK	09:30	BBA loans for house purchase 000s	Sep	37.4	37.0
		Thursday 27 October 2016			
EMU	09:00	M3 money supply Y/Y%	Sep	5.1	5.1
Italy	09:00	Consumer confidence indicator	Oct	108.6	108.7
	09:00	Manufacturing (economic) confidence	Oct	102.1 (-)	101.9 (101.0)
Spain	08:00	Unemployment rate %	Q3	19.3	20.0
UK	09:30	GDP – preliminary release Q/Q% (Y/Y%)	Q3	*0.4 (2.2)*	0.7 (2.1)
	09:30	Index of services M/M% (3M/3M%)	Aug	0.1 (0.8)	0.4 (0.6)
	11:00	CBI Distributive Trades survey, retail sales	Oct	-2	-8
	15:00	BoE corporate bond purchases £mn	Weekly	-	1559
		Friday 28 October 2016			
EMU	10:00	Economic sentiment indicator	Oct	104.8	104.9
	10:00	Services (industrial) sentiment	Oct	10.0 (-1.6)	10.0 (-1.7)
	10:00	Final consumer confidence	Oct	*-8.0*	-8.2
Germany	13:00	Preliminary EU-harmonised CPI Y/Y%	Oct	0.6	0.5
France	07:45	GDP – preliminary release Q/Q% (Y/Y%)	Q3	*0.2 (1.3)*	-0.1 (1.3)
	07:45	Preliminary EU-harmonised CPI Y/Y%	Oct	0.6	0.5
	07:45	Consumer spending M/M% (Y/Y%)	Sep	0.3 (1.1)	0.7 (1.0)
Spain	08:00	Preliminary EU-harmonised CPI Y/Y%	Oct	0.3	0.0
	08:00	GDP – preliminary release Q/Q% (Y/Y%)	Q3	*0.7 (3.1)*	0.8 (3.2)
UK	07.00	Nationwide house price index M/M% (Y/Y%)	Oct	(0.2) 4.9	(0.3) 5.3

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions			
Country		BST	Event / Auction
			Monday 24 October 2016
UK		-	BoE's Haldane and Shafik scheduled to speak in Hong Kong
		14:50	BoE APF operation: To purchase 3-7Y Gilts
			Tuesday 25 October 2016
EMU		15:30	ECB's Draghi scheduled to speak in Berlin
UK		14:50	BoE APF operation: To purchase 15Y+ Gilts
		15:35	BoE's Carney scheduled to appear at House of Lords Economic Affairs Committee
			Wednesday 26 October 2016
Germany		10:30	Auction: To sell €3bn of 0% 2021 bonds (8-Oct-2021)
Italy		10:00	Auction: To sell bonds
		10:00	Auction: To sell index-linked bonds
UK		14:50	BoE APF operation: To purchase 7-15Y Gilts
			Thursday 27 October 2016
EMU		18:00	ECB's Praet scheduled to speak in Brussels
			Friday 28 October 2016
EMU		08:30	ECB's Coeure scheduled to speak in Frankfurt
Italy		10:00	Auction: To sell bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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