

Euro wrap-up

Overview

- Euro area government bonds made further losses, with Spanish and Italian bonds hardest hit.
- Gilts also followed the global trend lower as the UK manufacturing PMI signalled relatively firm expansion ahead in the sector.
- Wednesday brings the final euro area manufacturing PMIs, UK construction PMI, and German labour market data, all for October.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.619	-
OBL 0 10/21	-0.395	+0.006
DBR 0 08/26	0.176	+0.013
UKT 1½ 07/18	0.254	-0.013
UKT 3½ 09/21	0.607	+0.012
UKT 1½ 07/26	1.274	+0.029

*Change from close as at 4.35pm GMT.
Source: Bloomberg

Euro area

New budget among key tasks for new Rajoy government

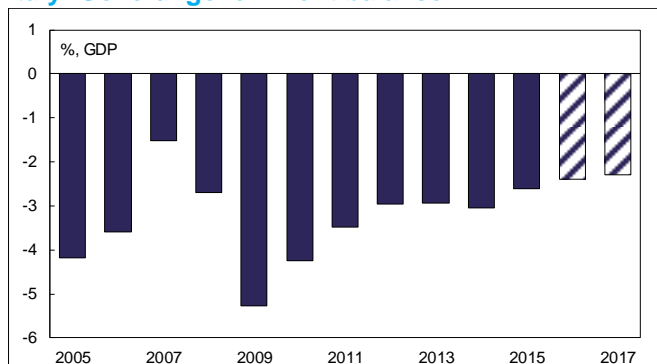
With many member states celebrating All Saints' Day, today was inevitably quiet for economic news from the euro area, although markets saw government bonds weaken across the board. And, after yesterday saw the spread between yields on Italian and Spanish bonds rise to a multi-year high above 45bps, today saw Spanish bonds underperform, perhaps in recognition that policy-making will not be plain sailing for Mariano Rajoy, who yesterday was again sworn in as Spain's Prime Minister to end the country's ten-month period without a government. Rajoy is set to make appointments to his cabinet on Thursday, perhaps proposing ministers from beyond his own Partido Popular to try to engender broader support for his policy proposals. And among the first tasks of the new government will be to devise a new budgetary plan.

In the context of the annual euro area budgetary planning process launched last month, the report submitted by the Spanish authorities to the Commission included no new fiscal measures for 2017, recognising the fact that the interim government did not have sufficient power to adopt a budget. As a result, while Spain's budget deficit in 2016 was expected to be consistent with the (arguably lenient) target of 4.6% of GDP previously agreed in light of the absence of a workable government this year, the 2017 deficit forecast of 3.6% of GDP was about ½ppt of GDP above target. When it is submitted, we expect the revised plan broadly to incorporate the required adjustments to meet the previous target and – despite the government's minority status – ultimately be endorsed by the Spanish parliament, not least because the main opposition Socialist party evidently has no appetite for a new general election. But the fiscal tightening that will imply will inevitably contribute to a gradual slowdown in Spanish GDP growth from about 3% in 2016 to less than 2½% in 2017.

Italian budget avoids formal Commission censure (for now)

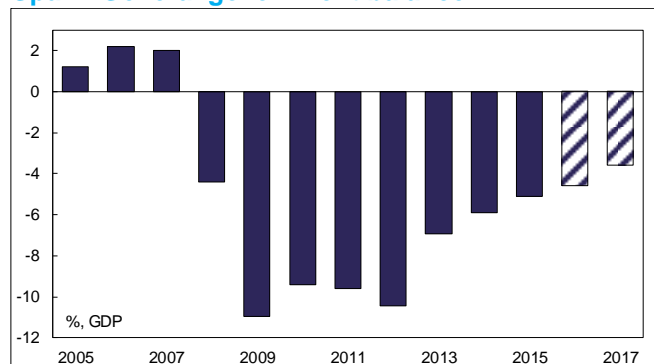
The Italian draft budgetary plan was most controversial, with the European Commission having judged the fiscal tightening planned for 2017 to be inadequate. Indeed, while Italy had been asked to *reduce* its structural budget deficit by more than ½ppt of GDP next year, the Commission assessed the plan to be expansionary and the headline deficit likely to *increase* by about ½ppt above the previous forecast to 2.3% of GDP. Of course, like the Spanish plans, the draft Italian budget needs to be considered in the context of the difficult political environment, with Prime Minister Renzi seeking to curry favour with voters ahead of the crucial referendum on constitutional reforms which opinion polls currently suggest will be rejected. But also in their defence, the Italian authorities cited weaker GDP growth and persistent low inflation in as reasons for slippage. And most notably, it blamed exceptional events including the migrant crisis, whereby Italy now represents the number one country of entry into the EU and is arguably bearing a disproportional burden compared to most other member states, and the need for reconstruction following this year's earthquakes.

Italy: General government balance*



*Government forecasts for 2016 & 2017. Source: Draft Budgetary Plan 2017, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Spain: General government balance*



*Government forecasts for 2016 & 2017. Source: Draft Budgetary Plan 2017, Thomson Reuters and Daiwa Capital Markets Europe Ltd.



Under the euro area's legislated fiscal rules, the European Commission had until today to decide if the Italian authorities were in 'serious non-compliance', and, if it did so, to force the Renzi government to come up with a new budgetary plan within three weeks. However, following the weekend's further earthquakes in Central Italy, which were the most damaging since 1980, the cost of reconstruction might well prove higher than originally planned. Moreover, it would seem insensitive to reject the budget outright at such a moment. So, the Commission pulled its punches and failed to exercise its rights to censure the Italian authorities. That is unlikely to be the end of the matter, however. The plans will be discussed at next week's Eurogroup meeting. And, perhaps once the referendum has passed, the Commission will no doubt in due course press the Italian authorities to amend their plans to bring the overall budgetary stance closer in line with the original target. Overall, that will likely mean that fiscal policy will offer minimal support to Italian economic growth next year, with GDP likely to rise less than 1% this year and next. Of course, it also remains a significant possibility that Renzi will lose the 4th December referendum, starting a chain of events that could yet result in the draft budgetary plan eventually being torn up completely.

The day ahead in the euro area and US

Wednesday will bring the final manufacturing PMIs for October from the euro area and most of its member states. Thanks in particular to a jump in the German index, the flash euro area manufacturing PMI rose above expectations to 53.3, the highest since January 2014. German labour market data for October are also due. And, in the bond markets, Germany will sell 10Y Bunds.

In the US, all eyes will of course be on the Fed, as the latest FOMC meeting concludes. While the Committee is expected to leave the target range for the fed funds rate unchanged, it is certainly possible that more members will vote for a hike than the three who did so at September's meeting. And although this meeting will not be accompanied by a press conference, we would expect the policy statement to provide a clear signal in that a 25bps rate hike will be on the cards at December's meeting. Data-wise, the ADP employment report for October is due.

UK

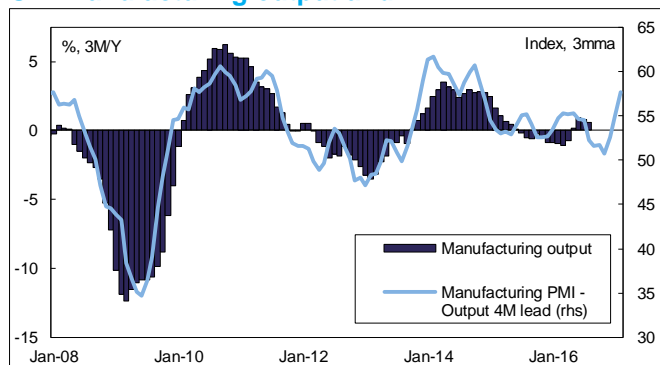
Manufacturing PMI down, but still firmly in expansionary territory

Today's release of October's manufacturing PMI suggested that positive momentum in the UK's manufacturing sector was maintained at the start of Q4, although most survey components took a step down compared with the previous month. Broadly in line with expectations the headline indicator fell 1.2pts from September's more-than-two-year high to 54.3, remaining significantly above its average over the recent quarters. The output index recorded the steepest fall of the survey components down from 60.5 to 56.0, still comfortably above the quarterly average back to Q214. And despite the further weakening of sterling over the past month, the survey suggested that the increase in new export orders had moderated slightly – the relevant index was down more than 1pt to 55.0 – while the total orders gauge was little changed (56.7). Overall, notwithstanding the slight easing at the start of Q4, today's survey suggested that manufacturing output might well grow at a relatively firm pace over coming months to recover from the 1%Q/Q fall in Q3. With respect to inflation, cost pressures resulting from rising input prices in sterling terms were also highlighted. The relevant indicator surged almost 10pts to 80.3, double the level a year ago and a reading exceeded only twice in the near-2½-decade series. So perhaps it is no surprise that output prices were also reported to have risen at the fastest pace since mid-2011, with the index up more than 5pts to 60.4. And we would expect additional pipeline price pressures to build over coming quarters too.

The day ahead in the UK

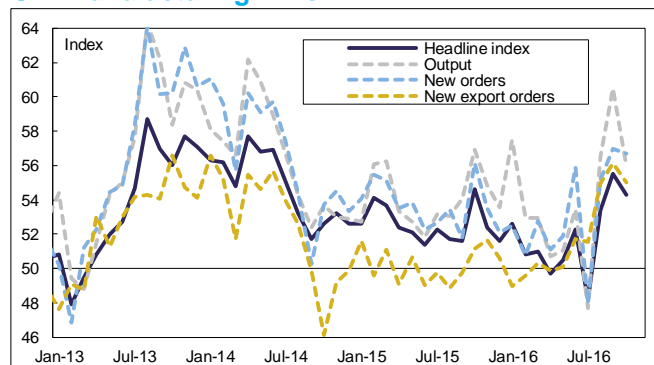
The flow of October PMIs continues on Wednesday with the construction sector survey. Having fallen to below 50 in the summer months, construction PMI recovered in September to 52.3. And while tomorrow's release is expected to show that the headline index moderated in October, it should remain above the neutral level.

UK: Manufacturing output and PMI



Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing PMIs





Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results










Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
UK	 Manufacturing PMI	Oct	54.3	54.5	55.4	55.5
Country	Auction					
UK sold	 £2.75bn of 0.5% 2022 bonds (22-Jul-2022) at an average yield of 0.775%					



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
EMU	 09:00	Final manufacturing PMI	Oct	53.3	52.6
Germany	 08:55	Unemployment change '000s (rate %)	Oct	-1 (6.1)	1 (6.1)
	 08:55	Final manufacturing PMI	Oct	55.1	54.3
France	 08:50	Final manufacturing PMI	Oct	51.3	49.7
Italy	 08:45	Manufacturing PMI	Oct	51.4	51.0
Spain	 08:15	Manufacturing PMI	Oct	52.6	52.3
UK	 00:01	BRC shop price index Y/Y%	Oct	-	-1.8
	 07:00	Nationwide house price index M/M% (Y/Y%)	Oct	0.2 (4.9)	(0.3) 5.3
	 09:30	Construction PMI	Oct	51.8	52.3

Auctions and events

Country	GMT	Auction / Event
Germany	 10:30	Auction: To sell €3bn of 0% 2026 bonds (15-Aug-2026)
UK	 10:30	Auction: To sell 0.625% 2040 index-linked bonds (22-Mar-2040)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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