Euro wrap-up

Overview

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- Ahead of Sunday's Italian referendum and the coming week's ECB meeting, Bunds largely reversed yesterday's losses.
- Gilts also made gains after the ruling Conservative Party lost a by-election as voters clearly expressed dissatisfaction at its handling of Brexit.
- The Italian referendum result will set the tone for investors on Monday while the ECB's policy announcement on Thursday will clarify the future of its QE programme with significant implications for bond markets.

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.738	-0.004
OBL 0 10/21	-0.421	-0.039
DBR 0 08/26	0.284	-0.085
UKT 1¼ 07/18	0.116	-0.041
UKT 3¾ 09/21	0.584	-0.078
UKT 1½ 07/26	1.385	-0.112

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

Euro area

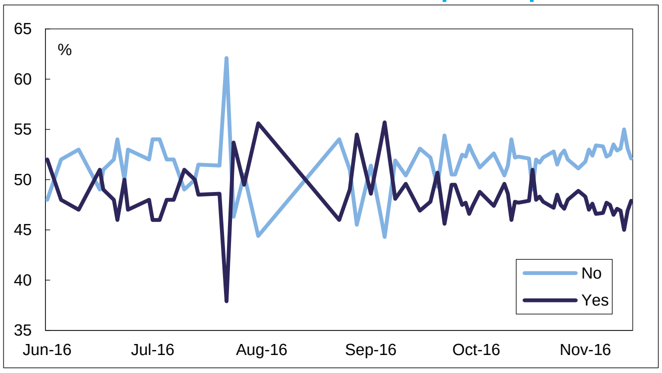
Italian referendum to set the mood

The mood in financial markets on Monday will almost certainly be set by the outcome of Sunday's Italian referendum. Results of exit polls, which might not prove reliable, are likely to be available from about 11pm CET on Sunday night, while the final results are expected any time from around 3am CET on Monday morning. Regardless of the narrow constitutional pros and cons of the measures being voted upon – which would strengthen the hand of any Italian government by shrinking parliament's upper house and stripping it of most of its legislative powers and power of veto – investors are most concerned about the immediate political ramifications as Prime Minister Renzi has staked his future on the outcome. Should Renzi see the referendum endorse his proposals, investors would seem likely to breathe a sigh of relief and give new support to Italian asset prices, which until the start of this week had significantly underperformed. But given the opinion polls published before the blackout period commenced two weeks ago, it seems more likely that Renzi's proposals will be rejected and Italian asset prices will take a further hit. Indeed, while reports suggest that the ECB would be prepared to increase its purchases of Italian bonds to try to ease some of the immediate pain, we suspect that it would be a while before support from Frankfurt became apparent and that the central bank would not consider a rise in Italian spreads to be inappropriate.

Several possible political paths ahead after the vote

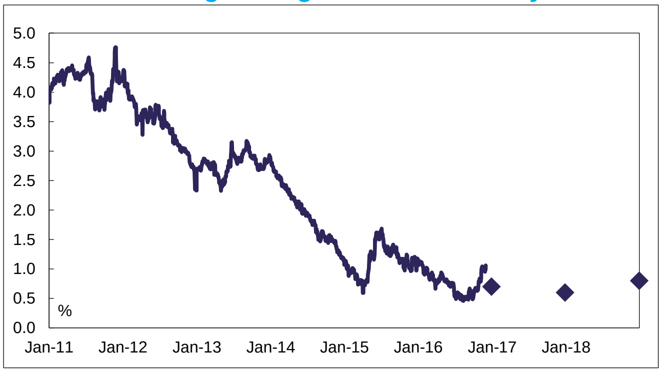
In the event that Renzi's proposals are rejected, political uncertainty would certainly be once again to the fore and economic policy drift – as seen in Spain when left without effective government over the past year – would seem inevitable. Given the major challenges faced to sustain Italy's economic recovery and deal with the huge stock of non-performing loans in the banking sector, that is definitely cause for concern. But the ultimate political consequences of a 'no' vote would not necessarily be dire. While the populist Five Star Movement, which has advocated a consultative referendum on Italian membership of the euro, might possibly win the largest share of the vote in any snap general election, opinion polls suggest that is less likely. Moreover, the rejection of Renzi's reforms to the upper house would diminish the scope of any such future populist government to take such drastic action in future. If voter turnout is very low, it is even possible that Renzi would be asked by President Matterella to stay on as Prime Minister. More likely, however, would be the installation of a new technocrat government, perhaps led by current Finance Minister Padoan, to oversee a transition to new elections in 2017 or early 2018. And in that case, there might well be sufficient support, from Renzi's centre-left Democratic Party, Berlusconi's centre-right Forza Italia and certain others, for new reforms to the process for electing the lower house, which might further diminish the possibility of a future majority Five Star Movement government, to be enacted before any new general election.

Italian constitutional referendum opinion polls*



*Last poll before the blackout period conducted 17 November.
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area average 10Y government bond yield*



*Diamonds represent ECB projections from September 2016.
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

ECB set to announce QE extension

The other main event of the coming week will, of course, be Thursday's ECB monetary policy announcement, which looks set to determine the future of the asset purchase programme beyond next March. Regardless of the outcome of Renzi's referendum, the policy decision will be dictated by the ECB's updated forecasts. While recent economic surveys have suggested a slight pickup in recovery momentum in the current quarter, particularly in Germany, policymakers seem unlikely to revise significantly their previous forecasts for GDP growth of 1.6% in both 2017 and 2018. Most important, however, will be the forecast for inflation. Members of the Governing Council will expect headline CPI to rise back above 1%Y/Y as energy prices start to make a positive contribution and the recent depreciation of the euro provides a modest boost. However, with core inflation stuck stubbornly at just 0.8%Y/Y over each of the past four months and wage growth weaker than previously anticipated, they will expect CPI to remain below the ECB's target of close to 2%Y/Y over the forecast horizon, perhaps forecasting it to reach about 1.6% in 2019. At the Governing Council's previous meeting in October, Draghi committed to 'preserve the very substantial degree of monetary accommodation that is necessary… [to meet the inflation target] without undue delay'. And given previous ECB assessments of the impact of its policies on inflation, we expect the coming week's meeting to announce an extension of the QE programme beyond next March with the extra asset purchases amounting to roughly €500bn.

What rate of purchase?

In his interview published in the Spanish newspaper El Pais on 30 November, Draghi acknowledged that the ECB 'can deliver the appropriate [policy] stance by different combinations of instruments, for instance the amount of monthly purchases or the length of time over which they take place'. And so, the precise timeframe for the purchase extension, and hence the implied monthly rate, is uncertain. However, not least since a decision to buy the additional assets at a slower rate would be interpreted by financial markets as tapering and trigger a tightening of financial conditions – against the backdrop of already significant recent increases in bond yields well above levels previously expected by the ECB – we expect the rate of asset purchases to be maintained at the current rate of €80bn per month until at least September 2017.

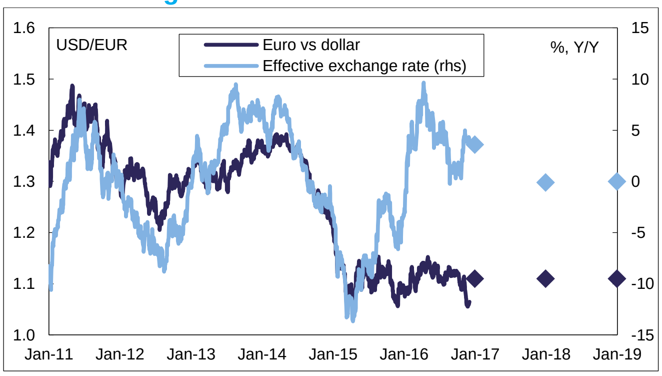
Which rules to be relaxed?

While rising bond yields have recently increased the pool of bonds available for the ECB to buy under current rules, to achieve the extra purchases the ECB will still need to relax some of those self-imposed constraints. With 2Y German yields still firmly below -70bps, the bond market is positioned for the -40bp floor yield on purchases to be removed. However, the Governing Council might simply prefer to raise the issue limit for bonds without collective action clauses above the current limit of 33% (but still below 50%), a measure which seems less controversial. And the introduction of greater flexibility with respect to the share of purchases of each member state, which is currently relatively strictly determined by the ECB's capital key, would seem practical and harmless. Reports have also suggested that the Governing Council will announce changes to its securities lending facility to support market liquidity. Whichever measure or combination of measures is agreed by the Governing Council, expect bond markets to adjust accordingly.

The week ahead in the euro area and US

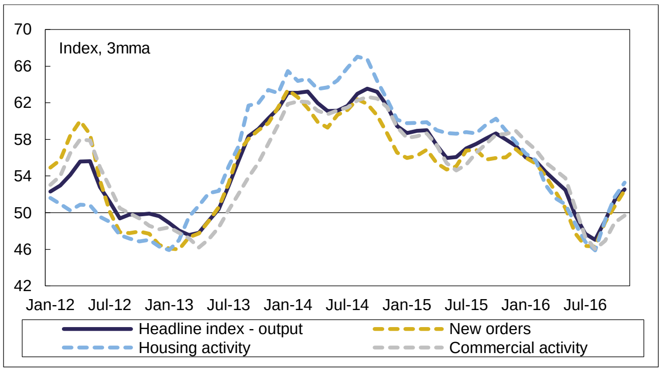
Data-wise, the coming week also brings a handful of notable releases from the euro area. Monday brings the final services PMIs for November, for which the flash headline euro area index rose more than 1pt to 54.1, the highest so far in 2016. Also due at the start of the week are retail sales numbers for October, which are expected to post vigorous growth following a modest drop in September. Tuesday, meanwhile, will bring revised euro area GDP figures for Q3, including the first release of the expenditure breakdown, which is set to confirm that the expansion was driven by domestic demand while net trade subtracted from growth. There is also a possibility that GDP growth will be revised up by 0.1ppt to 0.4%Q/Q. German factory orders figures for October are also due on Tuesday with the equivalent industrial production data out the following day and goods trade numbers scheduled for release on Friday. And French goods trade figures are due on Wednesday with the equivalent IP data due on Friday and the Bank of France's latest business sentiment survey out before the ECB policy announcement on Thursday. In the bond markets, Germany will hold a 2Y auction on Wednesday.

Euro exchange rates*



*Diamonds represent ECB projections from September 2016.
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Construction PMIs



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

In the US, the coming week gets underway with more top-tier data, with the release on Monday of November's non-manufacturing ISM to be followed on Tuesday by October's final trade report and factory orders figures, as well as revised productivity and labour costs data for Q3. Meanwhile, Wednesday brings October's JOLTS report and consumer credit numbers, followed by the usual weekly jobless claims figures on Thursday and December's preliminary University of Michigan's consumer sentiment survey on Friday. Ahead of the Fed's seven-day blackout period starting Tuesday, FOMC members Dudley, Evans and Bullard are due to speak at various events on Monday. And in the UST market, there are no bond auctions scheduled.

UK

Construction sector outlook remains positive

Having rebounded quickly following the initial Brexit shock, sentiment in the construction sector edged higher in November, with today's construction PMI rising from 52.6 to 52.8, the highest level in eight months. The housing activity indicator was unchanged at 53.0, not surprisingly given that sentiment in the housing market has remained resilient in the wake of the Brexit vote. Meanwhile, consistent with the stabilisation in the commercial real estate sector following significant turmoil in the summer months, the commercial activity index increased to above 50 for the first time in six months. And the new orders index, which rose 2pts to 53.2, posted the most significant increase, suggesting that activity in the construction sector should pick up at the end of the year.

The week ahead in the UK

At the start of the coming week on Monday we will see the release of the UK's services and composite PMIs for November. Both are expected to be little changed from the post-referendum highs of 54.5 and 54.8 reached in the previous month. Meanwhile, the data focus in the latter part of the week will be on hard economic data, including releases of the latest industrial production and trade figures. The former, due on Wednesday, are likely to show that manufacturing production increased for a third successive month in October. Nevertheless, the annual pace of growth is expected to have remained below 1%Y/Y for a fifth successive month. And following a sharp increase in the headline trade deficit in September, trade balance figures on Friday are expected to show an improvement in October. Also due on Friday are data from the construction sector, which should show that output increased slightly in October. Among other releases in the coming week are the BRC Retail Sales Monitor (Tuesday), the NIESR monthly GDP estimate (Wednesday) and the RICS Residential Market survey (Thursday).

European calendar

Today's results						
Economic data						
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
Spain	Unemployment M/M '000s	Nov	**24.8**	-25.6	44.7	**-**
UK	Construction PMI	Nov	**52.8**	52.2	52.6	**-**
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

Key data releases

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Monday 05 December 2016					
EMU	09:00	Final services PMI (final composite PMI)	Nov	54.1 (54.1)	52.8 (53.3)
	10:00	Retail sales M/M% (Y/Y%)	Oct	0.8 (1.7)	-0.2 (1.1)
	14:45	ECB public sector asset purchases €bn	Weekly	*16.6*	14.3
Germany	08:55	Final services PMI (final composite PMI)	Nov	55.0 (54.9)	52.4 (55.1)
France	08:50	Final services PMI (final composite PMI)	Nov	52.6 (52.3)	51.4 (51.6)
Italy	08:45	Services PMI (composite PMI)	Nov	51.6 (51.5)	51.0 (51.1)
Spain	08:00	Industrial production M/M% (Y/Y%)	Oct	0.5 (1.3)	1.2 (0.8)
	08:15	Services PMI (composite PMI)	Nov	55.2 (54.9)	54.6 (54.4)
UK	00:01	BRC shop price index Y/Y%	Nov	-	-1.7
	09:00	New car registrations Y/Y%	Nov	-	1.4
	09:30	Services PMI (composite PMI)	Nov	54.0 (54.6)	54.5 (54.8)
Tuesday 06 December 2016					
EMU	10:00	GDP – third release Q/Q% (Y/Y%)	Q3	*0.3 (1.6)*	0.3 (1.6)
Germany	07:00	Factory orders M/M% (Y/Y%)	Oct	0.6 (1.6)	-0.6 (2.6)
UK	00:01	BRC Sales like-for-like Y/Y%	Nov	1.7	1.7
Wednesday 07 December 2016					
Germany	07:00	Industrial production M/M% (Y/Y%)	Oct	0.8 (1.5)	-1.8 (1.2)
France	07:45	Trade balance €bn	Oct	-4.4	-4.8
	07:45	Current account balance €bn	Oct	-	-3.4
Italy	09:00	Unemployment rate %	Q3	11.6	11.5
UK	08:30	Halifax house price index M/M% (3M/Y%)	Nov	0.2 (5.9)	1.4 (5.2)
	09:30	Industrial production M/M% (Y/Y%)	Oct	0.2 (0.5)	-0.4 (0.3)
	09:30	Manufacturing production M/M% (Y/Y%)	Oct	0.2 (0.8)	0.6 (0.2)
	15:00	NIESR GDP 3M/3M%	Nov	0.4	0.4
Thursday 08 December 2016					
EMU	12:45	ECB refinancing rate %	Dec	*0.00*	0.00
	12:45	ECB deposit rate %	Dec	*-0.40*	-0.40
	12:45	ECB asset purchase target €bn	Dec	*80*	80
France	07:30	Bank of France manufacturing sentiment indicator	Nov	100	99
UK	00:01	RICS house price balance %	Dec	26	23
	15:00	BoE corporate bond purchases £mn	Weekly	-	3964
Friday 09 December 2016					
Germany	07:00	Trade balance €bn	Oct	22.2	24.2
	07:00	Current account balance €bn	Oct	22.0	24.2
	07:00	Imports (exports) M/M%	Oct	1.0 (0.9)	-0.7 (-1.2)
France	07:45	Industrial production M/M% (Y/Y%)	Oct	0.6 (-0.6)	-1.1 (-1.1)
	07:45	Manufacturing production M/M% (Y/Y%)	Oct	0.7 (0.1)	-1.1 (-0.9)
UK	09:30	Visible trade balance £bn	Oct	-11.8	-12.7
	09:30	Total trade balance £bn	Oct	-4.4	-5.2
	09:30	Construction output M/M% (Y/Y%)	Oct	0.2 (-0.1)	0.3 (0.2)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions

Country		GMT	Event / Auction
			Monday 05 December 2016
UK		14:50	BoE APF operation: To purchase 3-7Y Gilts
			Tuesday 06 December 2016
UK		09:30	BoE publishes record of FPC meeting held on 23 November 2016
		10:30	Auction: To sell £2.5bn of 1.5% 2026 bonds (22-Jul-2026)
		14:50	BoE APF operation: To purchase 15Y+ Gilts
			Wednesday 07 December 2016
Germany		10:30	Auction: To sell €3bn of 0% 2018 bonds (14-Dec-2018)
UK		10:30	Auction: To sell £2.25bn of 1.5% 2047 bond (22-Jul-2047)
		14:50	BoE APF operation: To purchase 7-15Y Gilts
			Thursday 08 December 2016
			- Nothing scheduled -
			Friday 09 December 2016
EMU		15:15	ECB's Couré scheduled to speak in Paris

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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