Euro wrap-up

Overview

- Bunds made losses today, largely reversing the gains seen on Friday as Italian Prime Minister Renzi announced his resignation.
- Gilts also made modest losses today, as the UK's composite PMI was consistent with another quarter of solid economic growth in Q4.
- Tomorrow brings revised euro area Q3 GDP figures, along with German factory orders and a UK retail sales survey.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.706	+0.029
OBL 0 10/21	-0.378	+0.045
DBR 0 08/26	0.337	+0.055
UKT 1¼ 07/18	0.115	+0.002
UKT 3¾ 09/21	0.591	+0.011
UKT 1½ 07/26	1.412	+0.032

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

Euro area

Financial markets respond to Italian referendum with a shrug

Euro area financial markets were barely troubled by Sunday's Italian referendum result, with the euro ending the day just above $1.07, slightly higher than the level before the result became apparent, and Italian 10Y yields only about 11bps higher close to 2.0%, still roughly 20bps down from their recent peak a few weeks ago. The modest response partly reflects unconfirmed reports last week that the ECB stands ready to support the Italian bond market if pressure built too far. And it certainly reflected the fact that rejection of Renzi's proposals was widely expected. However, there remains significant uncertainty how events in Italy will pan out from here, with no shortage of political and financial risks. So, in due course, investors might not be quite so sanguine.

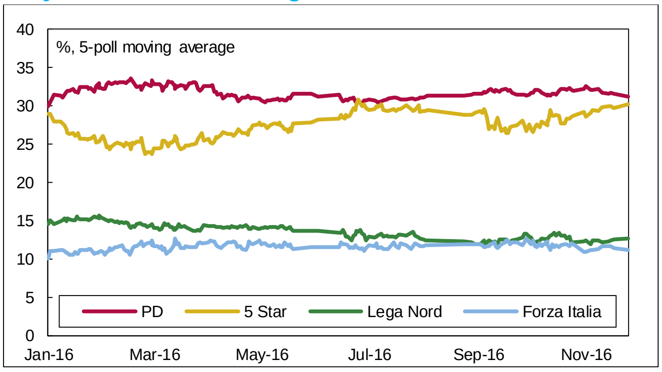
Looking for a new Prime Minister

While the rejection of Renzi's proposals was anticipated, the larger-than-expected margin of defeat – close to 40:60 – means that his resignation as Prime Minster seemed bound to be accepted later in the day by President Mattarella. (At the time of writing it remained to be seen whether he would also quit as leader of his Democratic Party.) But given a legislative inconsistency between the laws governing the electoral processes for the lower and upper houses of parliament, a snap general election looks highly unlikely. Instead, the President will need to invite someone else to form a new government tasked principally with passing a new electoral law and thus paving the way for new elections in 2017 or, at the latest, early 2018.

Banking sector weakness still to be addressed

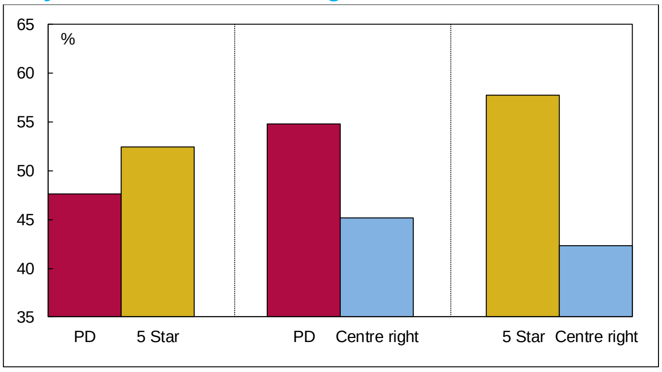
Respected Senate President and anti-mafia magistrate Pietro Grasso has been among those touted as a possible new Prime Minister. However, from the perspective of the financial markets, former OECD Secretary General, IMF staff member and academic Finance Minister Padoan might seem best suited to the task, not least since the interim government also seems likely to be preoccupied with resolving the problems in the ailing banks, which remain weighed down by €360bn of NPLs. Certainly, given yesterday's result, the planned €5bn recapitalisation of Monte dei Paschi di Siena is now reported to be in some doubt, with a strong probability that the government will ultimately have to step in as a last resort to provide the necessary funds, triggering bond bail-ins. And while hopes are higher for Unicredit's reported planned capital-raising, several smaller lenders might also eventually have to head cap-in-hand to the government. And the more that the public sector is required to provide funds, the more investors might cast a more inquisitive eye on the Italian government's debt stock, which is above 130% of GDP.

Italy: First-round voting intentions



Source: Various polling companies and Daiwa Capital Markets Europe Ltd.

Italy: Second-round voting intentions



Source: EMG Acqua and Daiwa Capital Markets Europe Ltd.

New electoral reform might limit Five Star risk

Admittedly, in due course a new general election will have to be held. And that will provide cause for trepidation, with the latest opinion poll by EMG suggesting that the populist Five Star Movement, which has proposed a (non-binding) referendum on Italy's euro membership, would be well placed – under current electoral rules – to win a majority. However, there might well be sufficient support from Renzi's centre-left Democratic Party, Berlusconi's centre-right Forza Italia and others, to reform the lower house election process in such a way to significantly diminish the possibility of a future majority Five Star Movement government. Such a system would, however, almost guarantee coalition governments in future, making persistently weak government in Italy much more likely – just the kind of situation that Renzi's proposed upper house reforms were meant to prevent.

Data still suggest pickup in euro area growth in Q4

Fortuitously perhaps, the current Italian political woes coincide with a period of relatively steady economic expansion, with GDP up in Q316 for the seventh successive quarter, by 0.3%Q/Q and 1.0%Y/Y. And with data released today showing its services PMI up in November to a nine-month high, Italy's composite PMI similarly rose more than 2pts to 53.4, likewise the highest since February, signalling ongoing economic growth in Q4 close to the rate of the previous quarter. There was a similar story from certain other member states too, e.g. Spain's composite PMI rose to 55.2, a seven-month high, suggesting GDP growth of a pace akin to the 0.7%Q/Q rate of Q3. And Germany's composite PMI was revised up slightly from the flash estimate to 55.0, the second highest level of 2016 so far and implying a pick-up in the pace of expansion from 0.2%Q/Q last quarter. So, while the equivalent index for France was revised down almost 1pt to a three-month low of 51.4 consistent with ongoing modest growth circa 0.2%Q/Q, the euro area composite PMI was revised down only slightly to 53.9, still the highest since last December, to suggest an acceleration in GDP to 0.4%Q/Q in Q4. Judging from the survey detail, new orders in the euro area rose in November at the firmest pace so far in 2016 while input and output price pressures were also the most notable since last year. And with retail sales in the euro area starting the quarter on the front foot – rising more than 1%M/M in October following two months of declines – economic conditions in the euro area in Q4 appear as favourable as one might arguably dare to hope at a time of such heightened political uncertainty.

The day ahead in the euro area and US

Tuesday 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 non-negligible probability that GDP growth will be revised up by 0.1ppt to 0.4%Q/Q. Tomorrow also brings German factory orders figures for October, which are expected to reverse the decline of 0.6%M/M in September.

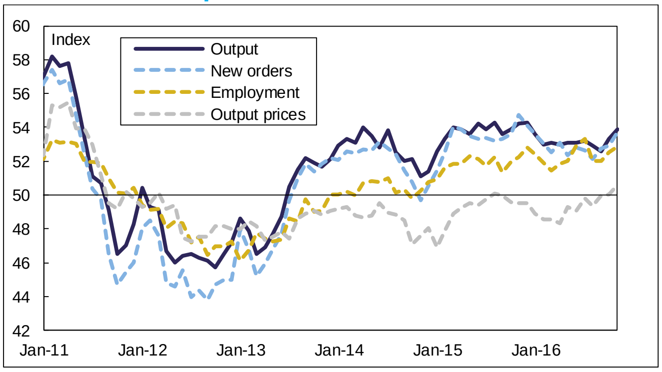
In the US, Tuesday will be a busy day for economic data bringing the final trade report for October, factory orders figures for the same month and Q3 unit labour cost and productivity numbers.

UK

GDP growth is set to remain firm in Q4

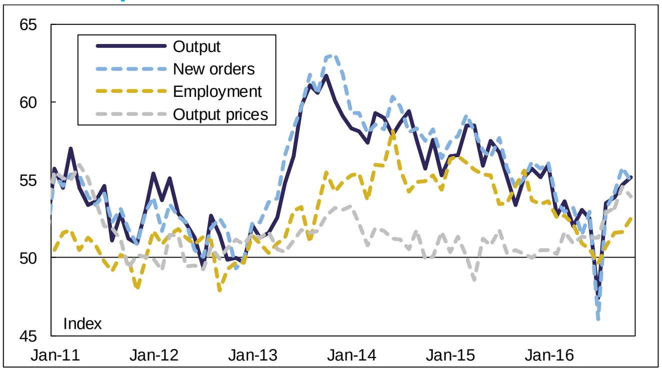
While the start of the Government's appeal to the Supreme Court over the triggering of Article 50 attracted a great deal of media attention today, the judgement in the case is not expected until January. Meanwhile, on the data front, the focus in the UK today was on the last of the November PMIs. After some mixed manufacturing and construction PMIs last week, with the manufacturing PMI coming in below expectations and the construction index surprising on the upside, today's services PMI saw the headline indicator rise by 0.7pt to 55.2, the highest level since January. Within the detail, the outstanding business and employment components inched higher, with the former reaching 51.6, the highest level in fifteen months. More forward

Euro area: Composite PMIs



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

UK: Composite PMIs



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

looking indicators were less encouraging, however, with the new business index dropping by 0.8pt to 54.9, while the business expectations indicator eased to its lowest level since July. So while the pace of growth in services might moderate over coming months, according to the PMIs, growth in the UK economy remained solid in November. Indeed, the composite PMI rose from 54.7 to a ten-month high of 55.2, suggesting that GDP is on track to record growth of 0.5%Q/Q in Q4, unchanged from Q3.

Meanwhile, the composite output prices PMI fell in November for the first time since the Brexit vote, suggesting that, with sterling having recently strengthened, the upward pressure on output prices eased somewhat. Consistent with that and given that many retailers remain hedged against the sharp drop in sterling, the BRC Shop Price index, also released today, showed that retail price inflation was unchanged in November at -1.7%Y/Y, a level well within the recent range.

The day ahead in the UK

Tomorrow brings only the November BRC Retail Sales Monitor.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		Final services PMI (final composite PMI)	Nov	**53.8 (53.9)**	54.1 (54.1)	52.8 (53.3)	-
		Retail sales M/M% (Y/Y%)	Oct	**1.1 (2.4)**	0.8 (1.7)	-0.2 (1.1)	**-0.4 (1.0)**
		ECB public sector asset purchases €bn	Weekly	**14.5**	*16.6*	14.3	-
Germany		Final services PMI (final composite PMI)	Nov	**55.1 (55.0)**	55.0 (54.9)	52.4 (55.1)	-
France		Final services PMI (final composite PMI)	Nov	**51.6 (51.4)**	52.6 (52.3)	51.4 (51.6)	-
Italy		Services PMI (composite PMI)	Nov	**53.3 (53.4)**	51.6 (51.6)	51.0 (51.1)	-
Spain		Industrial production M/M% (Y/Y%)	Oct	**0.1 (0.5)**	0.8 (1.4)	-1.4 (0.8)	**-1.5 (0.6)**
		Services PMI (composite PMI)	Nov	**55.1 (55.2)**	55.0 (54.9)	54.6 (54.4)	-
UK		BRC shop price index Y/Y%	Nov	**-1.7**	-	-1.7	-
		New car registrations Y/Y%	Nov	**2.9**	-	1.4	-
		Services PMI (composite PMI)	Nov	**55.2 (55.2)**	54.0 (54.6)	54.5 (54.8)	**- (54.7)**
Country		Auction					
UK		BoE APF operation purchased £1bn of 3-7Y Gilts (1.72 cover ratio)					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data						
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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
Auctions and events						
Country		GMT	Auction / Event			
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			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.