Euro wrap-up

Overview

- Ahead of Thursday's ECB Governing Council meeting, Bunds made very modest gains as German IP fell short of expectations.
- Gilts also made gains as UK IP declined at the fastest monthly pace in four years.
- All eyes tomorrow will be on the ECB announcement, with its asset purchase programme expected to be extended beyond March 2017.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.675	+0.015
OBL 0 10/21	-0.636	-0.018
DBR 0 08/26	0.347	-0.025
UKT 1¼ 07/18	0.118	-0.016
UKT 3¾ 09/21	0.577	-0.032
UKT 1½ 07/26	1.366	-0.051

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

Euro area

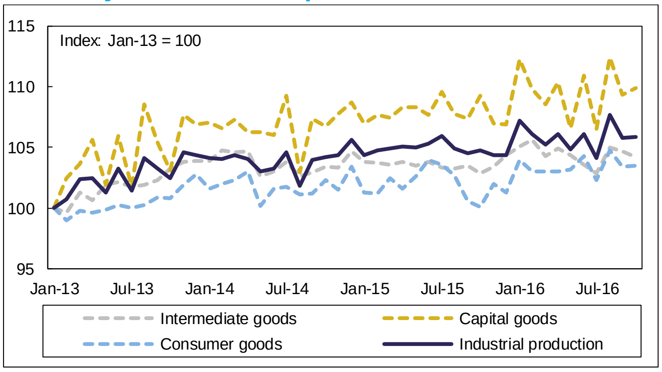
German IP falls short of expectations

Since the start of the fourth quarter, the news flow around Germany's manufacturing sector has been encouragingly positive, with the Ifo business climate index rising to a 2½-year high, the manufacturing PMI comfortably in expansionary territory and yesterday's factory orders data surging to their highest level since 2007. And with IP having declined sharply in September, expectations for October's output data had been high. But today's release reported only very modest growth of 0.3%M/M. And this increase was only thanks to construction output, which rose by more than 1½%M/M. Indeed, manufacturing output flatlined at the start of the quarter, having declined by more than 1½%M/M in September, with modest increases in production of capital and consumer goods offsetting a drop in production of intermediate goods. Admittedly, German IP has been very volatile over recent months and too much should not necessarily be read into one month's reading. Indeed, on a three-month basis output was actually up more than 1%3M/3M for the first month since March. And given the more upbeat surveys, we remain cautiously optimisitic that the manufacturing sector will continue to support Germany's expansion in the current quarter.

The day ahead in the euro area and US

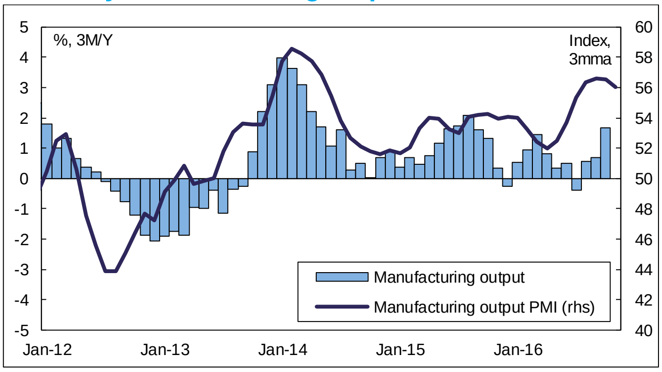
All eyes in the euro area tomorrow will, of course, be on the conclusion of the ECB's policy-setting meeting, where we expect the Governing Council to extend the asset purchase programme beyond next March on the back of the ECB's updated forecasts. While recent economic surveys have suggested a slight pickup in economic momentum in the current quarter, policymakers seem unlikely to significantly revise their previous forecasts for GDP growth of 1.6% in both 2017 and 2018. Most important, however, will be the forecast for inflation. While the ECB will expect headline CPI to rise back above 1%Y/Y in the New Year as energy prices start to make a positive contribution and the recent depreciation of the euro provides a modest boost, with core inflation stuck stubbornly at just 0.8%Y/Y and wage growth weaker than previously anticipated, it will expect CPI to remain below the ECB's target of close to 2%Y/Y over the forecast horizon. And so, with Draghi having committed at October's meeting 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 Governing Council to announce an extension of the QE programme with the extra asset purchases amounting to roughly €500bn. 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, we expect the rate of asset purchases to be maintained at the current rate of €80bn per month until at least September 2017.

Germany: Industrial output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output and PMI



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

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 hovering close to -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 both practical and harmless. Reports have also suggested that the Governing Council will announce changes to its securities lending facility to support market liquidity.

While the data flow will be of secondary importance, tomorrow brings the Bank of France's latest business sentiment survey for November. In the US, meanwhile, Thursday brings the weekly jobless claims figures as well as flow of funds data for Q3.

UK

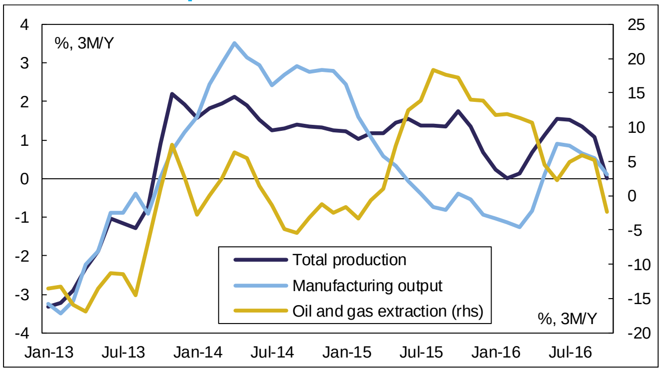
Manufacturing continues to disappoint

While there is no doubt that the fall in the value of sterling following the Brexit vote will push consumer prices higher, its impact on exports is less certain. But while economic survey indicators are suggesting that demand for UK-produced goods from abroad has risen, the evidence of that effect in the hard data remains non-existent. Indeed, today's industrial output figures disappointed, with manufacturing output down by 0.9%M/M in October to leave the three-month pace below zero for a third successive month. And with oil and gas extraction down by more than 10%M/M, total industrial production fell by 1.3%M/M, the steepest pace in four years. Of course, the lag from the currency depreciation to an increase in output might be longer and we might see the manufacturing sector starting to recover at the start of next year. However, for the time being manufacturing seems set to have remained a drag on GDP growth in Q4. This view was reinforced by the latest monthly NIESR GDP estimate, also released today, which showed that industrial output fell 1.2%3M/3M in the three months to November, the lowest rate since the start of the year. This notwithstanding, GDP growth was still unchanged at 0.4%3M/3M, consistent with our view for quarterly economic growth in Q4.

The day ahead in the UK

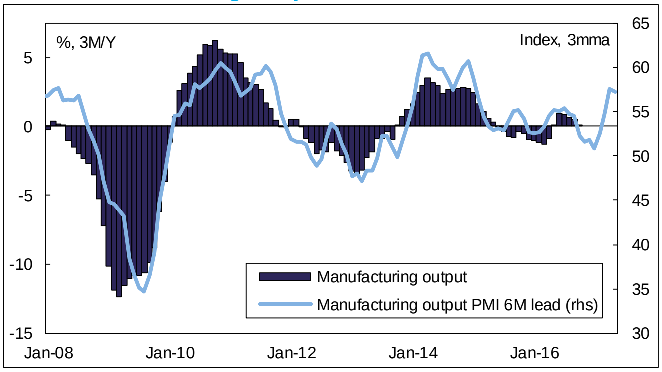
Tomorrow's RICS Residential Market survey is expected to show that the number of properties available on the UK housing market remained limited and therefore the upward pressure on prices persisted in November.

UK: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output and PMI



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

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
Germany		Industrial production M/M% (Y/Y%)	Oct	**0.3 (1.2)**	0.8 (1.6)	-1.8 (1.2)	**-1.6 (1.3)**
France		Trade balance €bn	Oct	**-5.2**	-4.4	-4.8	**-**
		Current account balance €bn	Oct	**-3.5**	-	-3.4	**-3.7**
Italy		Unemployment rate %	Q3	**11.6**	11.6	11.5	**11.6**
UK		Halifax house price index M/M% (3M/Y%)	Nov	**0.2 (6.0)**	0.2 (5.9)	1.4 (5.2)	**1.5 (-)**
		Industrial production M/M% (Y/Y%)	Oct	**-1.3 (-1.1)**	0.2 (0.5)	-0.4 (0.3)	**- (0.4)**
		Manufacturing production M/M% (Y/Y%)	Oct	**-0.9 (-0.4)**	0.2 (0.7)	0.6 (0.2)	**- (0.1)**
		NIESR GDP 3M/3M%	Nov	**0.4**	0.4	0.4	**-**
Country		Auction					
Germany sold		€2.6bn of 0% 2018 bonds (14-Dec-2018) at an average yield of -0.71%					
UK sold		£2.25bn of 1.5% 2047 bond (22-Jul-2047) at an average yield of 1.956%					
		BoE APF operation purchased £1bn of 7-15Y Gilts (2.84 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		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

Auctions and events

Country	GMT	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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