Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds made gains as data revealed a slowdown in employment growth in the euro area.
- Gilts also made gains despite an upside surprise from the latest UK inflation data.
- Wednesday brings the latest euro industrial production and UK labour market data, which will be overshadowed by the Fed policy announcement.

Chris Scicluna +44 20 7597 8326

Grant Lewis +44 20 7597 8324

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.750	-0.001
OBL 0 10/21	-0.441	-0.026
DBR 0 08/26	0.354	-0.045
UKT 1¼ 07/18	0.131	+0.001
UKT 3¾ 09/21	0.584	-0.021
UKT 1½ 07/26	1.428	-0.040

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

Euro area

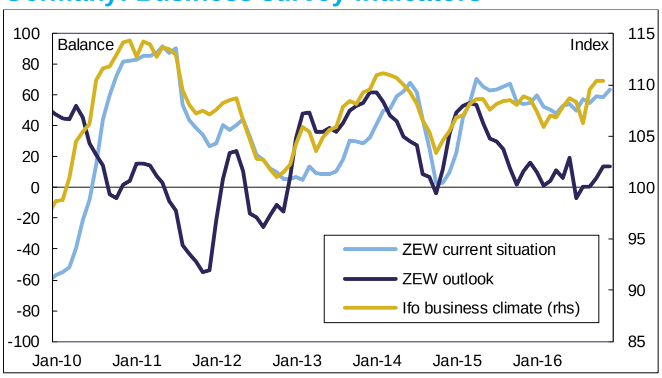
ZEW survey signals a favourable end to 2016 in Germany

Judging from the first results of the major sentiment surveys for December – the ZEW survey of financial market participants – economic conditions in the euro area's largest member state are the most favourable in 2016. In particular, the ZEW German current conditions index rose in December to a fifteen-month high close to the top of the range of the past five years and well above the long-run average. That assessment tallies with several leading indicators, not least the near-5%M/M surge in manufacturing orders reported last week, as well economic surveys for the first couple of months of the fourth quarter, which have similarly signalled an acceleration in output at the end of the year. To the extent that the ZEW current conditions index typically tracks closely the Ifo headline business climate index, we expect that measure of business sentiment for December, due for release on Monday, to remain close to or even surpass November's more than two-year high. However, once again, the expectations index of the ZEW survey failed to signal significant optimism about the outlook, moving sideways in December and at a level still below June's high for the year and also below the long-run average. And looking ahead, while we certainly do forecast a pickup in German GDP growth in Q4 to roughly twice the 0.2%Q/Q rate of Q3, we also expect full-year growth in 2017 to slow to about 1½% from about 1¾% in 2016.

Employment growth slowed in Q3

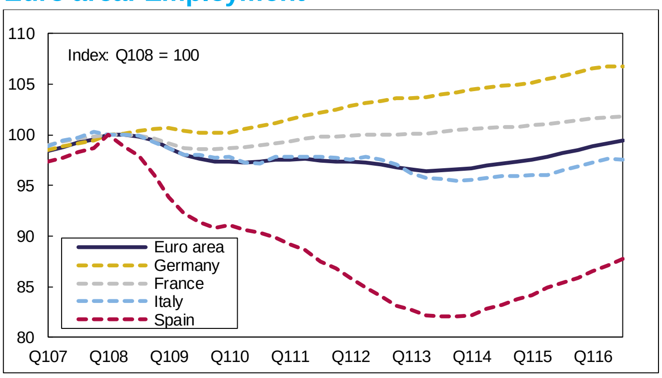
In the third quarter, the euro area extended its unbroken run of job growth to three years. However, the increase in employment slowed materially, to 317k (0.2%Q/Q), the least in six quarters and down from an average in excess of 500k over the previous five quarters and 536k (0.4%Q/Q) in Q2. Payroll growth slowed in certain services while the number of people in work in construction fell despite the strongest output growth in the sector in more than two years. A closer look at the country level suggests that some contradictory forces were at play. In Germany, employment growth slowed to just 23k, the least in more than six years likely at least in part due to the tightness of the labour market, which is forcing firms to respond to extra demand by increasing the average number of hours worked per employee rather than boosting the size of their workforce. In contrast, Italian employment fell 26k, the first decline in almost two years, as the lack of growth momentum and perhaps the return of political uncertainty appeared to weigh. But, elsewhere in Southern Europe, the trend remained encouraging, with employment growth in Spain rising to more than 150k, the most in five quarters, and Portugal also seeing its strongest job growth in two years. Overall, employment in the euro area has now risen more than 4.5mn from the trough in Q213, with about half of the increase accounted for (roughly equally) by Germany and Spain, but France and Italy accounting jointly for just one fifth. And while we expect euro area employment to rise to a new series high over the coming four quarters as job growth remains firm in Iberia, the slower overall pace of job growth seen in the latest quarter seems likely to be the new normal as labour shortages bind in Germany and the pace of economic expansion remains subdued in France and Italy.

Germany: Business survey indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Employment



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

Wednesday will bring euro area industrial production figures for October. With modest growth reported in the sector in Germany, Spain and the Netherlands but a decline registered in France and a flat month seen in Italy, industrial production growth in the euro area as a whole is likely to have been very subdued following a drop of 0.8%M/M in September. Also out tomorrow are the final estimates of inflation in November in France and Italy, which, like today's equivalent figures from Germany and Spain, are expected to align with the flash estimates of 0.7%Y/Y and 0.1%Y/Y respectively.

In the US, of course, all eyes will be on the conclusion of the Fed's latest FOMC meeting, with the policy announcement to be accompanied by updated economic forecasts. The Committee seems bound to increase the target range for the Fed Funds Rate by 25bps to 0.50-0.75% – indeed not to do so would be harmful for the Fed's credibility. And Yellen's press conference and updated forecasts will, of course, be closely scrutinised for insights into the near-term policy outlook. In particular, the dot-plot chart of FOMC member views will be watched closely for amendments to the median expectation for the FFR, which in September implied two hikes in 2017 to end the year at 1.00-1.25% and three hikes in 2018 ending the year at 1.75-2.00%. Ahead of the Fed announcement, several top-tier data releases are due including November's industrial production, advance retail sales and producer price numbers.

UK

Inflation surprises on upside…

Having surprised on the downside in October, the November inflation release showed a slightly larger-than-expected pickup in headline CPI of 0.3ppt to 1.2%Y/Y. This was the highest headline rate in two years, boosted of course by a mixture of higher energy prices (and the impact of past energy prices dropping out) and exchange rate effects. Indeed, both of those factors were reflected in the increased contribution from transport prices, which rose the most in four years (2.5%Y/Y) and accounted for one third of the 1.2%Y/Y headline inflation rate, while fuel prices rose more than 7%Y/Y, the most in almost five years. In terms of the increase in the headline year-on-year rate between October and November, however, the largest contribution came from the clothing and footwear category, effectively reversing the shift of similar magnitude the previous month thus maintaining the highly volatile trend in this component.

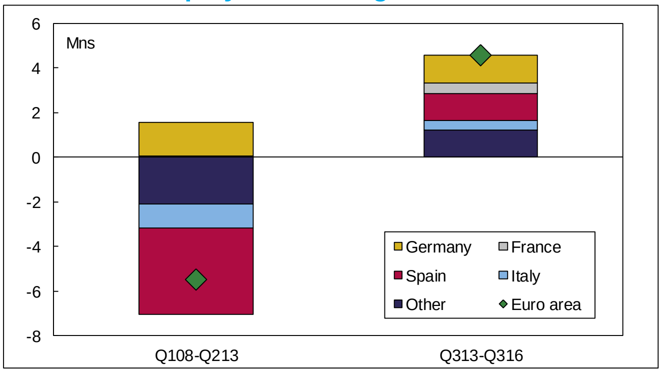
…and set to accelerate over coming quarters

Most notably perhaps, stripping out energy and food prices, the core CPI rate was also firmer than expected, up 0.2ppt to 1.4%, with inflation of services (not least from hotels and restaurants) and non-energy industrial goods both higher, the latter in positive territory for the first time in more than two years. However, this still left core inflation within the relatively narrow range seen throughout this year. Looking ahead, of course, inflation – both headline and core – looks set to accelerate strongly from here as the lagged impact of the post-referendum drop in sterling begins to be felt more forcefully, quite possibly reaching 3%Y/Y by the end of next year. But in the absence of an accompanying significant pick-up in wage growth, which appears relatively unlikely, we do not expect the MPC to react to what will prove a temporary inflation phenomenon. Indeed, if the weaker real wage growth that results from higher inflation has a more adverse impact on household spending than it currently anticipates, the MPC may well yet end up easing policy to ensure that inflation remains on track to meet its medium-term inflation target. For the time being, however, we expect Bank Rate to be left unchanged.

The day ahead in the UK

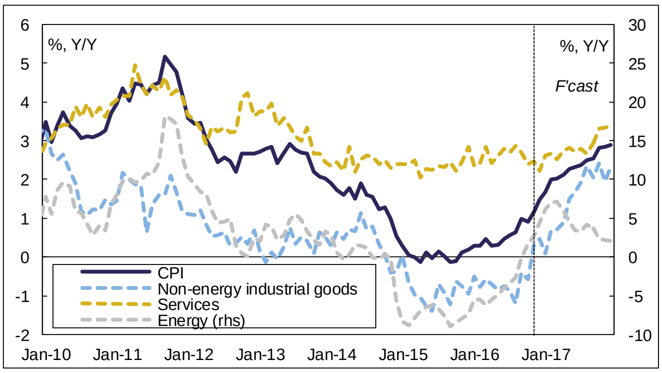
Wednesday will bring the latest UK labour market indicators, which are expected to be little changed from the previous month. Having inched lower in September, the headline three-month unemployment rate is expected to have remained at 4.8% in October, while three-month employment growth is expected to be close to the 49k3M/3M rate reported in the previous month. In the bond markets, the DMO will sell 20Y inflation-linked bonds.

Euro area: Employment change



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ <u>*Daiwa forecast*</u>	Previous	**Revised**
EMU		Employment Q/Q% (Y/Y%)	Q3	**0.2 (1.2)**	-	0.4 (1.4)	**- (1.3)**
		ZEW expectations balance	Dec	**18.1**	-	15.8	**-**
Germany		Final EU-harmonised CPI Y/Y%	Nov	**0.7**	0.7	0.7	**-**
		ZEW current assessment balance (expectations)	Dec	**63.5 (13.8)**	59.0 (14.0)	58.8 (13.8)	**-**
Italy		Industrial production M/M% (Y/Y%)	Oct	**0.0 (1.3)**	0.2 (1.5)	-0.8 (1.8)	**- (1.9)**
Spain		Final EU-harmonised CPI Y/Y%	Nov	**0.5**	0.5	0.5	**-**
UK		CPI (core CPI) Y/Y%	Nov	**1.2 (1.4)**	<u>*1.1 (1.3)*</u>	0.9 (1.2)	**-**
		PPI input (output) price inflation Y/Y%	Nov	**12.9 (2.3)**	13.5 (2.5)	12.2 (2.1)	**12.4 (-)**
		House price index Y/Y%	Oct	**6.9**	7.3	7.7	**7.0**
Country		Auction					
UK		BoE APF operation purchased £1bn of 15Y+ Gilts (2.80 cover ratio)					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ <u>*Daiwa forecast*</u>	Previous
EMU		10:00	Industrial production M/M% (Y/Y%)	Oct	0.1 (0.8)	-0.8 (1.2)
France		07:45	Final EU-harmonised CPI Y/Y%	Nov	0.7	0.5
Italy		09:00	Final EU-harmonised CPI Y/Y%	Nov	0.1	-0.1
UK		09:30	Average earnings incl. bonuses (excl. bonuses) 3M/Y%	Oct	2.3 (2.6)	2.3 (2.4)
		09:30	ILO unemployment rate 3M%	Oct	<u>*4.8*</u>	4.8
		09:30	Employment change 3M/3M '000s	Oct	<u>*70*</u>	49
		09:30	Claimant count rate % (change 000s)	Nov	2.3 (6.5)	2.3 (9.8)

Auctions and events

Country		GMT	Auction / Event
UK		10:30	Auction: To sell £800mn of 0.125% 2036 index-linked bonds (22-Nov-2036)
		12:15	BoE's Carney scheduled to speak in London
		14:50	BoE APF operation: To purchase 7-15Y Gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	**Revised**
EMU		ECB public sector asset purchases €bn	Weekly	**16.3**	_16.0_	14.5	**-**
UK		Rightmove house price index M/M% (Y/Y%)	Dec	**-2.1 (3.4)**	-2.1 (3.4)	-1.1 (4.5)	**-**

Auctions

Country		Auction
UK		BoE APF operation purchased £1bn of 3-7Y Gilts (3.19 cover ratio)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.