Daiwa Capital Markets

# Euro wrap-up

## Overview

- Bunds ended the day little changed despite further improvements in a German investor survey and the ECB's latest bank lending survey.
- Gilts were also little changed while sterling appreciated sharply following an upside surprise to the UK's inflation figures and as PM May ruled out future membership of the Single Market.
- Tomorrow brings final estimates of euro area and German inflation in December, as well as the latest labour market indicators from the UK.

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**Daily bond market movements**

| Bond | Yield | Change* |
|---|---|---|
| BKO 0 12/18 | -0.735 | +0.003 |
| OBL 0 10/21 | -0.504 | -0.002 |
| DBR 0¼ 08/27 | 0.313 | -0.010 |
| UKT 1¼ 07/18 | 0.170 | +0.022 |
| UKT 3¾ 09/21 | 0.535 | - |
| UKT 1½ 07/26 | 1.302 | -0.010 |

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

# Euro area

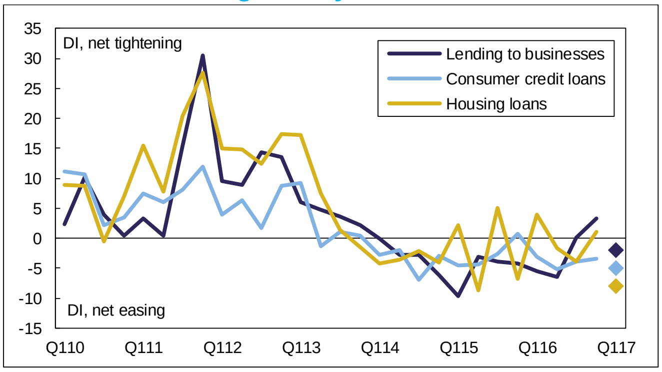
## Demand for bank lending set to rise further

While the ECB remains perturbed by the continued absence of underlying inflation pressures despite the various monetary policy measures implemented over recent years, there is no doubt that it has had a positive impact on financial conditions. Certainly, interest rates on new bank loans have fallen to record lows for non-financial corporations and households across the euro area, while total loans outstanding are rising at the fastest annual pace since 2011. And, on balance, today's ECB Bank Lending Survey suggested that accommodative lending conditions will continue to underpin loan growth over the near term too. Admittedly, the headline message from the latest survey was that credit standards for firms tightened somewhat in the final three months of 2016 for the first time in three years. But this principally reflected exceptional developments in the Netherlands, related to banks' lower risk tolerance towards certain SME firms, which are expected to prove temporary. Indeed, banks in all of the large member states, including the Netherlands, forecast an easing in credit conditions to firms and households alike in Q117. Furthermore, the survey reported an ongoing increase in demand for loans to enterprises and households due not least to the low level of interest rates. M&A activity and debt refinancing were drivers of increased demand from firms. Meanwhile, favourable housing market prospects, improvements in consumer confidence, and increased spending on durable goods were cited among the key factors behind the rise in housing loans and consumer credit. And with lending standards set to remain accommodative, demand for loans was anticipated to remain strong at the start of 2017 too.

## German ZEW signals further improvement in sentiment

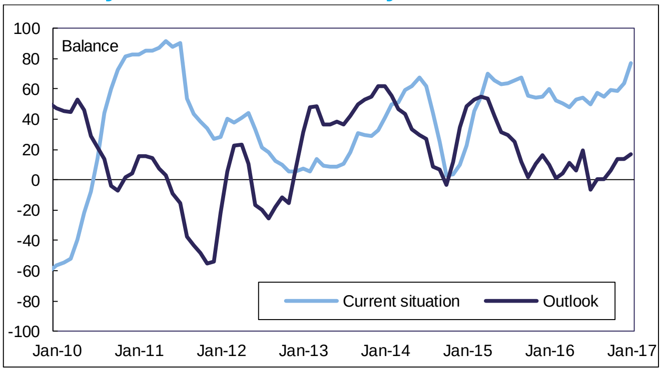
In other news, today's German ZEW investor survey provided one of the first insights into economic sentiment at the start of 2017. And with recent economic data suggesting the economic recovery gathered pace in the largest member state in the final quarter of 2016, today's survey signalled that positive momentum was likely maintained into the New Year. In particular, the current economic situation indicator leapt more than expected in January to 77.3, a level last exceeded in July 2011, while the survey's expectations index revealed optimism about the outlook too, with the relevant index rising almost 3pts in January, albeit to a level still below June's high. In addition, today's euro area new car registrations figures for December were broadly encouraging too, suggesting that consumers continued to spend on big-ticket items at the end of last year. In particular, new vehicle registrations were up for the second successive month to their highest level since March 2010, leaving them up 1%3M/3M, compared with a rise of just 0.3%3M/3M in September. So, with overall retail sales up on average in the first two months of Q4 by almost 1% compared with the Q3 average, we continue to expect private consumption to have made a substantive contribution to euro area GDP growth in the final quarter of 2016.

### ECB: Bank Lending Survey – credit standards*




*Diamonds represent net percentage of banks expecting to see a net easing in credit standards in Q117.
Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

### Germany: ZEW investor survey




Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

## The day ahead in the euro area and US

The data focus in the euro area tomorrow will be on the final reading of CPI in December. Assuming the equivalent German figures also align with the flash estimate showing the headline rate rising 1ppt to 1.7%Y/Y, a near-3½-year high, the aggregate euro area figures seem likely to confirm that the headline rate rose 0.5ppt in December to 1.1%Y/Y, the highest since September 2013, and that the core measure rose 0.1ppt to 0.9%Y/Y. Wednesday will also bring euro area construction output data for November.

Tomorrow will also see the release of December's CPI figures from the US. Consumer prices are expected to have posted the fifth consecutive monthly increase on the back of higher energy prices, to leave the headline annual rate rising above 2%Y/Y for the first time since mid-2014. Core CPI is expected to have edged slightly higher to 2.2%Y/Y, bang in line with the average in 2016. December's industrial production figures are also due for release and expected to show that total output rose for the second month out of the past three and by more than ½%M/M. Elsewhere, Fed Chair Yellen, and Governors Kashkari and Kaplan are due to speak publicly.

# UK

## Inflation rises by more than expected

The release of the latest CPI figures today confirmed that UK inflation continues to rise rapidly. Having been only 0.2%Y/Y a year earlier, headline CPI surprised on the upside in December rising 0.4ppt to reach 1.6%Y/Y, the highest level in almost two-and-a-half years. Meanwhile, the core rate also hit 1.6%Y/Y, up 0.2ppt from the previous month. A significant share of the pick-up was seemingly due to the effects of the depreciation in sterling increasingly being felt. Non-energy industrial goods inflation rose to 0.3%Y/Y, while food price growth reached -0.1%Y/Y, twenty-eight and twenty-five month highs respectively. However, there seems to have been significant one-off effects at play. Most notably, air fares increased particularly sharply last month, by 49%M/M, contributing significantly to the change in the headline rate. Some of that might be reversed in January, suggesting that today's figures might be overstating underlying inflationary pressures. But there is no doubt that a rapid acceleration in inflation will continue over the course of 2017, and we expect the headline rate to rise to above 3%Y/Y at the end of the year.

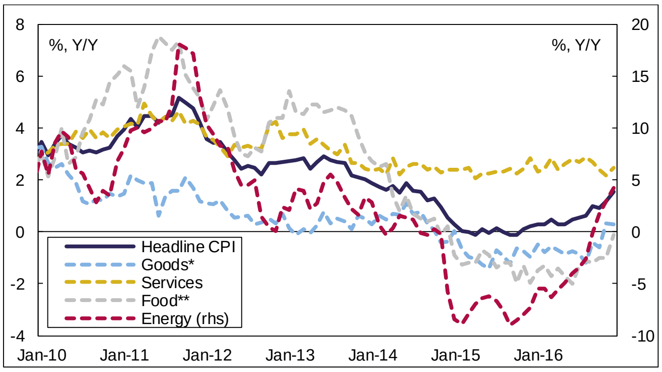
## Carney hits a hawkish note

The upside surprise to the inflation data came hot on the heels of last night's speech by Mark Carney in which, while reiterating the MPC's willingness to allow inflation to rise without tightening policy for the time being, also repeated the now-familiar refrain that "there are limits to the extent to which above-target inflation can be tolerated". Indeed, drawing particular attention to the recent surprising strength of consumer spending, funded by lower savings and increased consumer credit, he added risks related to economic imbalances to the MPC's previously stated factors – including the extent of second-round effects on inflation expectations and domestic costs – that might merit a hike. And underscoring that the near-term GDP growth outlook appears to have improved since the BoE last updated its economic forecasts, overall the speech had a more hawkish tone than Carney's other recent statements.

## May says 'goodbye' to the Single Market and Customs Union

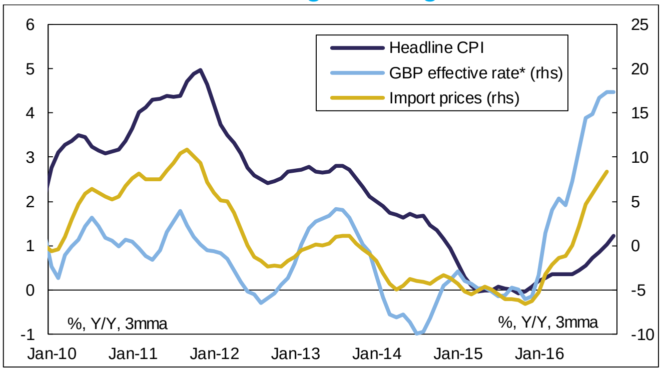
Of course, while the UK economy has performed better than anyone expected in the wake of the referendum thanks to the willingness of UK consumers to spend their socks off, Brexit remains the biggest single downside risk to the UK economic outlook. Ever since the referendum last June, speculation has centred on precisely what form Brexit would take. The options ranged from a 'soft' Brexit that saw the UK remaining in the Single Market, to a 'hard' one under which the UK leaves the Single Market and the Customs Union. During the referendum campaign, many high-profile 'leave' campaigners advocated

### UK: CPI inflation




*Excluding food and energy. **Including alcohol and tobacco.
Source: ONS, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

### UK: Inflation and sterling exchange rate




*Positive numbers correspond to depreciation.
Source: ONS, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

that the UK should remain in the Single Market. However, upon taking office, Theresa May was quick to commit to taking action to control immigration from the EU and also rejected the notion of continued ECJ jurisdiction for the UK – both commitments that seemed incompatible with Single Market membership. And, in her much-trailed speech today, which set out the Government's objectives as it looks to trigger Article 50 in March and then start the process of negotiating the terms of the UK's departure from the EU, May confirmed that the UK would therefore surrender Single Market membership. Moreover, to enable it to negotiate trade deals independently with non-EU countries, she also stated that the UK would leave the Customs Union, although it may seek to negotiate a new partial customs agreement covering, at a minimum, car and aeroplane manufacturing, but possibly all manufacturing.

## A costly and risky Brexit strategy

The overwhelming conclusion from all economic theory, models and evidence is that throwing up barriers to trading with the world's largest single market and the destination for nearly half your country's exports can only cause economic harm. So, leaving the Single Market and Customs Union will be economically costly. Indeed, it remains highly questionable whether the partial customs union membership proposed by May will be feasible. Moreover, the new comprehensive free trade agreement with the EU, which she also intends to seek, is highly unlikely to be agreed by the time the UK leaves. And since it is also unclear whether there will be any support in the EU for another of her proposals – a 'phased process of implementation' to try to ensure a 'smooth, orderly Brexit' – what May outlined could prove to be at the most damaging end of the spectrum, particularly if it results in the imposition of WTO tariffs between the EU and the UK following the two-year Article 50 negotiation process.

## Consumer to continue to drive growth for now

When the economic hit is finally felt remains to be seen. Firms have undoubtedly been holding off taking decisions around Brexit as they've awaited greater clarity. That clarity is now there. And the fact that continued Single Market membership is now ruled out is particularly pertinent for the UK's substantial (but largely foreign-owned) financial services sector. The loss of passporting rights from early 2019 now looms large, meaning that in many areas of the financial services arena firms will lose the automatic right to deal with EU clients from London. Firms will no doubt re-double their efforts to mitigate the impact on their businesses, with relocation plans that have been drawn up increasingly activated over coming months. At the same time, firms in other sectors which rely heavily on the Single Market for their wellbeing, notably foreign-owned firms located in the UK precisely because it provides an open door to the rest of the EU, will also be holding back or reassessing investment plans. All of this will result in very weak investment over coming quarters. But key to the near-term economic outlook will be whether consumers continue to spend with abandon. Given that real household income will increasingly be hit as inflation continues to rise, some slowdown can be expected as we head through 2017. But, of course, the UK consumer has proved in the past a resilient beast and – thanks partly to easy credit conditions – may yet once again surprise in the short term. Longer term, however, there is no doubt that the loss of Single Market membership will take a heavy toll on the UK economy.

## Sterling still vulnerable despite rebound

In terms of market reaction, having dropped precipitously on Monday in response to the weekend's leaks of the contents of the speech, today sterling more than reversed those losses. That reflected May's new commitment to give the UK Parliament a final vote on the deal, as well as the hoped for phased implementation and a partial customs agreement. However, with the UK running the largest current account deficit in the developed world, and the UK's successful service industries most threatened by the surrender of Single Market membership, further falls in sterling as we head into the negotiations look highly likely.

## The day ahead in the UK

Tomorrow's release of the latest labour market figures are likely to bring mixed messages, with the headline three-month employment growth rate set to have fallen sharply in November despite an anticipated increase in the employment level that month. The unemployment rate, meanwhile, is likely to have remained unchanged at a multi-year low of 4.8% for a third month in a row, while wage growth is expected to have accelerated from 2.5%3M/Y in October to reach the highest pace in more than a year.

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# European calendar

## Today's results

**Economic data**

| Country | Release | Period | **Actual** | Market consensus/ Daiwa forecast | Previous | **Revised** |
|---|---|---|---|---|---|---|
| EMU | EU27 new car registrations Y/Y% | Dec | **3.0** | - | 5.8 | **-** |
| | ZEW expectations balance | Jan | **23.2** | - | 18.1 | **-** |
| Germany | ZEW current assessment balance (expectations) | Jan | **77.3 (16.6)** | 65.0 (18.4) | 63.5 (13.8) | **-** |
| Italy | Trade balance €bn | Nov | **4.2** | - | 4.3 | **-** |
| UK | CPI (core CPI) Y/Y% | Dec | **1.6 (1.6)** | *1.4 (1.5)* | 1.2 (1.4) | **-** |
| | PPI input (output) price inflation Y/Y% | Dec | **15.8 (2.7)** | 15.5 (2.9) | 12.9 (2.3) | **13.3 (2.4)** |
| | House price index Y/Y% | Nov | **6.7** | 6.1 | 6.9 | **6.4** |

| **Country** | **Auction** |
|---|---|
| Germany sold | €4bn of 0% 2018 bonds (14-Dec-2018) at an average yield of -0.75% |
| UK | BoE APF operation purchased £1bn of 15Y+ Gilts (2.25 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 | Construction output M/M% (Y/Y%) | Nov | - | 0.8 (2.2) |
| | 10:00 | Final CPI (core CPI) Y/Y% | Dec | *1.1 (0.9)* | 0.6 (0.8) |
| Germany | 07:00 | Final EU-harmonised CPI Y/Y% | Dec | *1.7* | 0.7 |
| UK | 09:30 | Average earnings incl. bonuses (excl. bonuses) 3M/Y% | Nov | *2.7 (2.7)* | 2.5 (2.6) |
| | 09:30 | ILO unemployment rate 3M% | Nov | *4.8* | 4.8 |
| | 09:30 | Employment change 3M/3M '000s | Nov | *-120* | -6 |
| | 09:30 | Claimant count rate % (change 000s) | Dec | 2.3 (5.0) | 2.3 (2.4) |

**Auctions and events**

| Country | GMT | Auction / Event |
|---|---|---|
| UK | 10:30 | Auction: To sell £2.75bn of 0.5% 2022 bonds (22-Jan-2022) |
| | 14:50 | BoE APF operation: To purchase 7-15Y Gilts |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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