Euro wrap-up

Overview

- Bunds followed Treasuries lower as another survey suggested that conditions in the euro area's manufacturing sector were the most favourable for almost six years.
- Gilts also made losses as the UK's manufacturing PMI signalled a further surge in price pressures at the start of the year.
- The BoE is widely expected to leave policy unchanged tomorrow. But Carney's post-meeting press conference and the associated Inflation Report will be closely watched for a more hawkish tone.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.713	-0.008
OBL 0 04/22	-0.289	+0.022
DBR 0¼ 12/27	0.469	+0.033
UKT 1¼ 07/18	0.143	+0.002
UKT 3¾ 09/21	0.636	+0.019
UKT 1½ 07/26	1.451	+0.034

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

Euro area

Manufacturing PMI at a near-six-year high

After yesterday's GDP release confirmed that the euro area's economic recovery gathered momentum in the final quarter of 2016, today's final manufacturing PMIs provided a further sanguine assessment of conditions at the start of 2017, with upward revisions made to the already-upbeat flash estimates published early last week. In particular, January's headline euro area PMI was nudged up to 55.2, the highest level in almost six years and more than 1pt above the average in Q4. Revisions to the components suggested the fastest pace of output growth in the sector since April 2014 and the most plentiful orders since April 2011. Likewise, the employment PMI suggested that last month firms in the sector were recruiting staff at the fastest rate in almost six years. And while a surge in input price pressures by the most since May 2011 suggests that manufacturers' profit margins continue to be squeezed, the ECB might also be encouraged by the further marked pickup in the output price PMI, which was similarly at its highest level since mid-2011 and comfortably in inflationary territory.

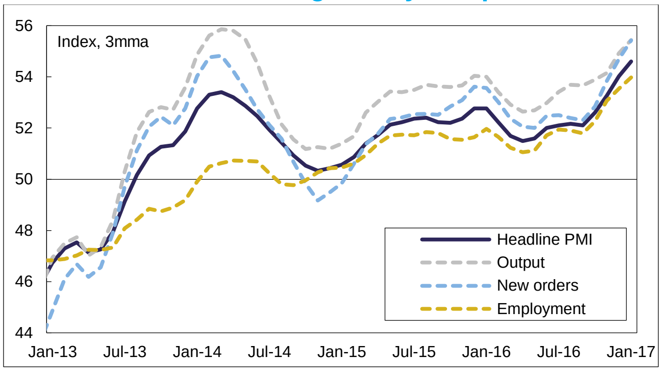
Robust manufacturing recovery seen across the large member states

At the country level, Germany's manufacturing sector inevitably continues to lead the way. Despite a very slight downwards revision from the preliminary estimate, at 56.4 the headline German PMI was still at its highest level for three years, with growth in output, new orders and employment appearing to gather momentum at the start of the year. There was good news from France too, where an upwards revision from the flash estimate saw the manufacturing PMI rise to 53.6, the highest since May 2011. And while the output and new orders indices were a touch weaker, they continued to signal solid expansion, while the employment PMI rose to its highest since mid-2011. The Italian PMI, at 53.0, was just a fraction below the six-month high hit in December and thus remained consistent with ongoing moderate recovery, while the Spanish PMI rose to a 20-month high of 55.6, the second-highest reading since early 2007. Once again, Greece was the only real source of disappointment, with the respective PMI declining to a sixteen-month low of 46.6, firmly in contractionary territory.

Momentum remains with Macron

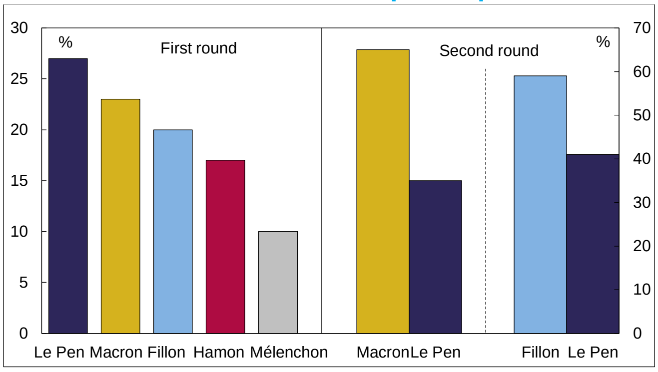
The news for the Republicans' right-wing candidate François Fillon, erstwhile favourite to become the next French President, goes from bad to worse. For the second successive week, today brought further revelations from the satirical newspaper Le Canard Enchaîné regarding allegations of large-scale payments made to his wife and children over several years. And the impact of this 'Penelopegate' affair on his public ratings was laid bare in the results of a new opinion poll conducted by Elabe

Euro area: Manufacturing PMI by component



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

France: Presidential election opinion poll*



**Opinion poll assuming François Bayrou does not stand.*
Source: Elabe for Les Echos (1 February 2017) and Daiwa Capital Markets Europe Ltd.

on 30-31 January and published today, suggesting that Fillon had slipped back to third place in voting intentions for the first round of the Presidential election due on 23 April. If this poll is correct, the two candidates to qualify for the second-round head-to-head would be the far-right National Front's Marine Le Pen and the centrist Emmanuel Macron. And while Le Pen remains on track to gain the largest share of the vote in the first round, today's survey results suggest that Macron might ultimately comfortably win the Presidency. Coinciding with the news that he has overtaken Fillon in the opinion poll, in an interview today Macron finally announced some policies, which included commitments to introduce greater flexibility into the 35-hour working week law, and reforms to welfare and the tax system to promote employment and investment. While such measures appear more deliverable than some of the aggressive Thatcherite measures previously espoused by Fillon that seem anathema to French sensibilities, the strong likelihood that Macron would fail to win anything close to a majority in the National Assembly election in June suggests that he might well still struggle to govern assertively if he becomes President.

The day ahead in the euro area and US

It should be a relatively quiet day for economic news from the euro area tomorrow, with just Spanish unemployment figures for January to be published alongside the ECB's latest Economic Bulletin. Supply-wise, France and Spain will sell bonds with various maturities (see calendar for details). In the US, meanwhile, ahead of Friday's payrolls report, Thursday will bring January Challenger job cuts figures, the latest weekly jobless claims numbers and preliminary productivity and unit labour costs data for Q4.

UK

Manufacturing sentiment remained firm in January

Today's manufacturing PMI survey for January was generally positive, with the headline indicator coming in at 55.9, only 0.2pt lower than the two-and-a-half-year high reached in the previous month. And the output PMI rose sharply for a second successive month, rising above 60 for the first time since May 2014. However, other details were on the soft side. In particular, foreign demand, which seems to have generated a significant amount of new business in recent months, took a sharp turn for the worse, with the relevant indicator falling from 55.6 to 50.9, the lowest level since May. So, it was only thanks to the resilience of domestic orders that the overall new orders index fell by only 0.6pt to 57.9. Overall, it remains to be seen how manufacturing output will evolve over the near term, but the lagged relationship between the output PMI and the official manufacturing production data suggests that we should see a stronger pick up in the second half of Q117 or early Q217.

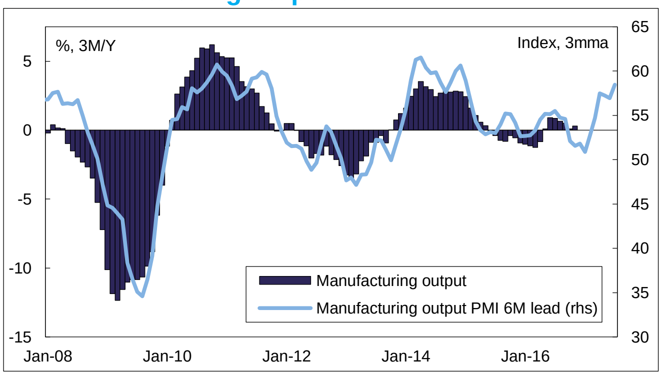
Inflation set to pick up pace in 2017

The future direction of the price level seems to be less uncertain, with today's survey showing that price pressures took another step up in January. Reflecting sterling weakness and rising commodity prices, the manufacturing input price index rose to 88.3 the highest level since records began in 1992. And the output price index increased by 4.5pts to 63.5, the highest level since 2011, a year when CPI inflation rose above 5%Y/Y. However, in sharp contrast, today's BRC Shop Price index showed that price pressures on the High Street eased in January, with deflation intensifying from -1.4%Y/Y to -1.7%Y/Y, a rate seen in October and November, perhaps reflecting softer-than-expected demand at the turn of the year, forcing retailers to cut prices. However, this seems likely to be a short-term blip and we expect the currency to continue to exert upward pressure on prices in the UK over coming months, pushing headline CPI inflation to around 3%Y/Y by the end of the year.

The day ahead in the UK

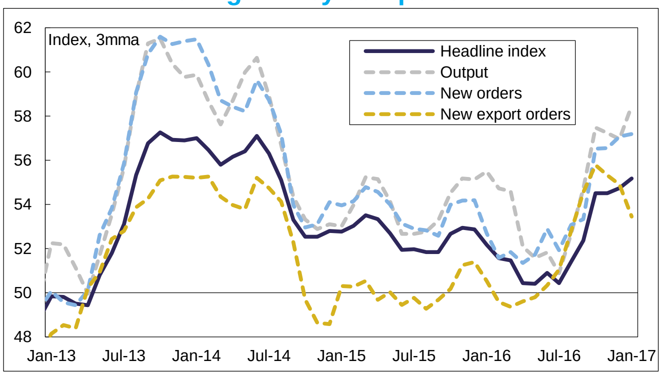
The main event tomorrow will be the BoE policy announcement. With UK GDP growth remaining firm in the second half of the year, a sharp pick-up in inflation towards the end of the year saw expectations that the MPC might eventually tighten monetary policy rise. But we do not think that the MPC will announce any changes to policy this time, or in the near future.

UK: Manufacturing output and PMI



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

UK: Manufacturing PMI by component



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

However, tomorrow's policy statement will most likely carry a more hawkish tone, and the possibility that one or two MPC members voted to raise rates cannot be discounted entirely. We might well also see confirmation that the Gilt purchase programme will not be extended. Meanwhile, the Bank's latest Inflation Report seems bound to contain an upward revision to the BoE's growth forecast over the near term, not least given that the GDP growth in Q416 was higher than expected. But with Theresa May having announced plans to take the UK out of the Single Market and the EU's Customs Union, the BoE will likely remain downbeat about longer-term growth prospects. And so, despite the possibility of a further modest upwards revision to inflation, we do not expect that the BoE will change Bank Rate at all during 2017. Data-wise, the most notable release tomorrow will be construction PMI.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ Daiwa forecast	Previous	**Revised**
EMU		Final manufacturing PMI	Jan	**55.2**	55.1	54.9	-
Germany		Final manufacturing PMI	Jan	**56.4**	56.5	55.5	-
France		Final manufacturing PMI	Jan	**53.6**	53.4	53.5	-
Italy		Manufacturing PMI	Jan	**53.0**	53.3	53.2	-
Spain		Manufacturing PMI	Jan	**55.6**	55.0	55.3	-
UK		BRC shop price index Y/Y%	Jan	**-1.7**	-1.0	-1.4	-
		Nationwide house price index M/M% (Y/Y%)	Jan	**0.2 (4.3)**	0.0 (4.3)	0.8 (4.5)	-
		Manufacturing PMI	Jan	**55.9**	55.9	56.1	-

Country		**Auction**
Germany sold		€3.2bn of 0% 2022 bonds (08-Apr-2022) at an average yield of -0.28%
UK		BoE APF operation purchased £1bn of 7-15Y Gilts (3.57 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
UK		09:30	Construction PMI	Jan	53.8	54.2
		12:00	BoE bank rate %	Feb	*0.25*	0.25
		12:00	BoE asset purchase target £bn	Feb	*435*	435
		15:00	BoE corporate bond purchases £bn	Weekly	-	5.76

Auctions and events

Country		GMT	Auction / Event
EMU		09:00	ECB publishes Economic Bulletin
		12:15	ECB's Draghi scheduled to speak in Slovenia
France		09:50	Auction: To sell 0.25% 2026 bonds (25-Nov-2026)
		09:50	Auction: To sell 1.5% 2031 bonds (25-May-2031)
Spain		09:30	Auction: To sell 0.25% 2019 bonds (31-Jan-2019)
		09:30	Auction: To sell 1.8% 2024 index-linked bonds (30-Nov-2024)
		09:30	Auction: To sell 1.95% 2030 bonds (30-Jul-2030)
		09:30	Auction: To sell 4.2% 2037 bonds (31-Jan-2037)
UK		12:00	Monetary policy announcement and MPC minutes
		12:00	BoE publishes Inflation Report

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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