Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds lost ground against a backdrop of rising global bond yields, with no domestic data of note to provide direction.
- Gilts followed suit, even as the European Council meeting confirmed that no progress had been made on the Brexit talks.
- In the coming week the ECB meeting on Thursday will provide the highlight. In the UK, the first estimate of Q3 GDP is out on Wednesday.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/19	-0.717	+0.013
OBL 0 10/22	-0.273	+0.039
DBR 0½ 08/27	0.453	+0.058
UKT 1¾ 07/19	0.451	+0.024
UKT 0½ 07/22	0.780	+0.038
UKT 4¼ 12/27	1.334	+0.054

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

Euro area

Surplus is source of support for the euro

A relatively low-key week for euro area economic data came to an end with just the August balance of payments report, which showed an increase of €1.8bn in the current account surplus to €33.3bn, back close to the series highs reached in 2015 and 2016. That left the 12-month cumulated current account surplus at €338.5bn – the largest of any country or currency area in nominal terms – and 3.1% of GDP, down just 0.2ppt from a year earlier, representing a continued structural source of support for the euro. Indeed, despite the appreciation of more than 11% in the euro over the six months to the end of that month, the increase in the current account balance in August was almost fully accounted for by an increase in the goods trade surplus to €28.2bn as exports outpaced imports.

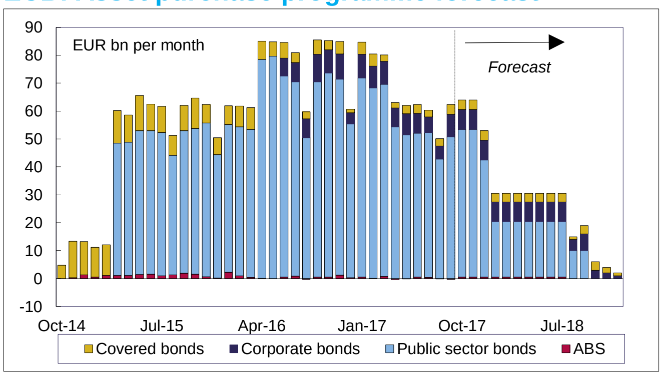
No significant harm to competitiveness from euro strength

Eventually, marked currency appreciation would normally be expected to reduce the trade balance, and GDP growth too, as exports become more expensive and imports become cheaper. But such effects can typically take several months to work through. And while the euro has slipped back only a couple of cents from the 33-month high above $1.20 reached early last month, the euro area's external competitiveness appears to remain strong. Judging from recent surveys, conditions in the euro area's manufacturing sector – which should be particularly sensitive to exchange rate movements – remain highly favourable. Indeed, the manufacturing PMIs suggest that production growth in the sector could be sustained at rates close to 4%Y/Y over coming months, and that new export orders are rising at the strongest rate for six and a half years. Regardless of the exchange rate, solid GDP growth close to the 0.6%Q/Q average rate of the first two quarters of the year is achievable over the near term at least.

But exchange rate is weighing on inflation

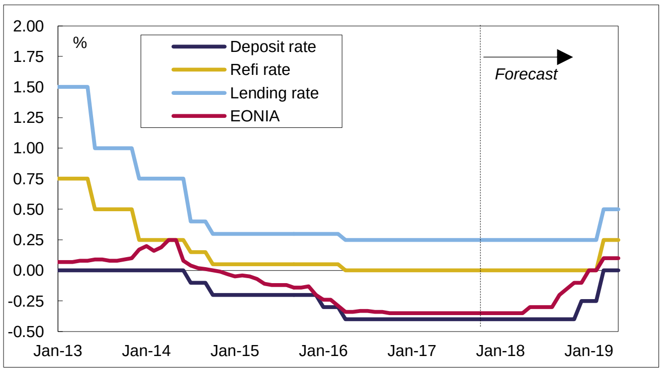
Of course, the ECB is more concerned about the impact of recent euro appreciation on inflation, which is why its last policy meeting saw the Governing Council pledge to monitor the currency closely. And euro strength is indeed one of many factors currently weighing on prices, particularly those of non-energy industrial goods which rose just 0.5%Y/Y in September. Coupled with continued subdued services inflation, undermined by weak wage growth, that left core CPI at a still-soft 1.1%Y/Y. But while past relationships suggest that recent currency appreciation could eventually push the average price level some ½% below where it would otherwise be, due to factors such as the increased prevalence of global value chains and invoicing of imports in euro, the relationship between the exchange rate and inflation in the euro area appears no longer to be quite as strong as it used to be.

ECB: Asset purchase programme forecast



Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

ECB: Interest rates



Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

And just as the marked bout of euro weakness from early 2014 through to the first quarter of 2015 failed to translate into notably higher inflation as producers and retailers absorbed some of the impact to protect market share, the current stronger domestic demand environment means that firms which export to the euro area might feel under no pressure to pass on the benefit of the exchange rate shift to consumers, instead choosing to rebuild their margins.

Next phase of QE to be announced on Thursday

So, with the economic growth outlook firm, and inflation still more likely than not to rise gradually over the next few years, the exchange rate will not be a show-stopper for the ECB as it moves to withdraw stimulus. However, together with the ECB's fear of triggering a taper tantrum, it is one of the reasons why the Governing Council last month agreed that it 'should proceed in a very gradual and cautious manner, while maintaining sufficient flexibility' as it slows its asset purchases. Of course, the 'bulk of decisions' on the central bank's plans for QE from January onwards will be announced on Thursday. And while there was scant information provided in the account of the September policy meeting on what might eventually be agreed, recent reports of unattributed comments of ECB staff certainly hint at what are likely to be the main numerical parameters and wider considerations guiding the decision.

Lower for longer in more ways than one

Among the recent reports to appear credible was the suggestion that, under current rules, some ECB policymakers see the limit to their potential bond-buying at roughly €2.5trn. And so, with purchases set to surpass €2.25trn by year-end, the discussions in the coming week will likely centre on the appropriate pace and time period to conduct purchases of the €250-300bn of bonds that might be available before running up against the programme's self-imposed constraints – with those for Bunds likely to be the first to bind significantly. The account of the September meeting noted that 'some general trade-offs inherent in various scenarios … and, in particular, the choice between the pace and the intended duration' were discussed last month. And the Governing Council is likely to have concluded that, for a given volume of purchases, a relatively longer intended purchase horizon and thus a somewhat greater reduction in the pace of buying might be considered the more dovish, not least since they would leave open greater scope to extend the programme in future if necessary, and push back the likely timing of the first rate hike.

Is there scope for a surprise?

Overall, therefore, what should we expect on Thursday? With the ECB's most recent forecasts suggesting that inflation will fall short of its target even in two years' time, and given its fear of avoiding a taper tantrum and/or further appreciation of the euro, the Governing Council will not want to deliver a negative surprise. However, due to the policymakers' reluctance to relax the programme constraints and the resulting bond scarcity, as well as the need to balance the aforementioned trade-off between the pace of buying and duration, we continue to expect the asset purchases to be extended from January through to the third quarter of next year, but at an average pace of €30trn per month over that period – half the current pace and pretty much in line with the central scenario of some recent reports of ECB thinking. To try to provide a dovish tilt, Draghi might well insist that this would not imply a definitive end-date to QE, with forward guidance leaving open the door to extra stimulus if it proves necessary. And he also seems bound to repeat that the first rate hike is still expected to come well after the end of the asset purchase programme. In addition, while some detail is likely to be left to finalise at the December meeting, we might see a shift in the relative shares of government and corporate bonds bought under the QE programme (with the amount of the latter perhaps to be left unchanged from current rates from January on) and additional information (e.g. related to duration) provided on the ECB's reinvestment policy too.

The week ahead in the euro area and US

The aforementioned ECB policy announcement on Thursday will clearly dominate attention in the coming week. Meanwhile, on the political front, after the Spanish Government yesterday pledged to trigger Article 155 of the national Constitution and move to take control of at least some of the region's semi-autonomous powers, a special Cabinet meeting tomorrow will decide its proposed way forward, which will subsequently require the approval of the Senate to be implemented.

Data-wise, the week will be dominated by economic survey results for October. In particular, Monday will bring the Commission's flash estimate of consumer confidence, which in September reached -1.2, the highest level since early 2001. The following day will bring the flash PMIs, for which the euro area composite index rose in September to 56.7, just 0.1pt below the six-year high reached in the second quarter. The French INSEE business conditions indices are also due on Tuesday with the equivalent German Ifo indices coming the following day. And the German GfK consumer sentiment and Italian ISTAT economic sentiment indices are due Thursday. In addition to those monthly survey results, the ECB's Q3 quarterly bank lending survey is also scheduled for Tuesday, while October bank lending data will be released on Thursday. In the bond market, Germany will sell 10Y Bunds on Wednesday and Italy is scheduled to sell bonds the following day.

In the US, the focus in the coming week will likely be on Friday's first estimate of Q3 GDP, with growth expected to have slowed to about 2.5%Q/Q annualised from 3.2%Q/Q ann. in Q2. However, ahead of Friday, estimates might well be refined depending on the outcome of Wednesday's September durables goods orders report and Thursday's advance September goods trade and inventory reports. Other reports of note this week include the flash PMIs for October (Tuesday) and the final

University of Michigan consumer survey results for October (Friday). Adding to a busy diary, more than a third of the companies in the S&P500 will report their Q3 earnings. And while there is no Fed-speak due to the black-out period ahead of the 1 November FOMC meeting, investors will be attuned to any news on who President Trump might announce as his nominee to be the next Fed Chair when Janet Yellen's current term expires. In the markets, the Treasury will sell 2Y notes on Tuesday, 5Y notes and 2Y FRNs on Wednesday, and 7Y notes on Thursday.

UK

Brexit impasse persists after Summit

As expected, the European Council meeting saw no substantive progress made in terms of the Brexit negotiations. While the EU27 leaders agreed to commence internal discussions on possible talks around the nature of the future trading relationship between the EU and the UK, further progress was required from the UK side on the issue of the divorce bill in particular. While Theresa May has effectively offered €20bn, the EU is looking for a settlement closer to €60bn and, without a "firm and concrete commitment" from the UK, talks cannot move on to the next stage. So, for the December Council meeting to have any chance of allowing talks to move on beyond the "divorce agreement", Theresa May is going to need to tame her Eurosceptic Ministers, who have so far proved implacably opposed to offering more money without talks moving on to the question of future arrangements, before then,

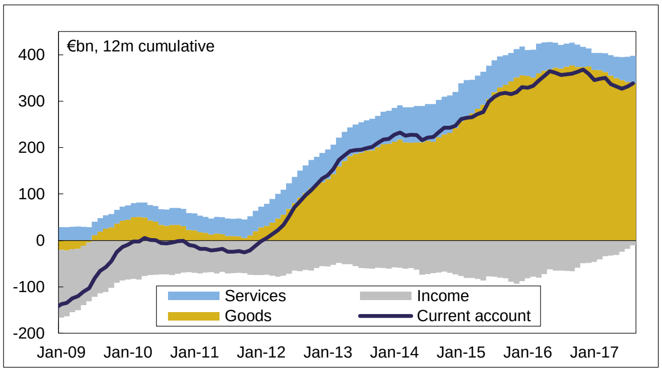
Public finance figures better for now

Data-wise, the latest UK public finances figures were once again better than expected, with public sector net borrowing (excluding public sector banks) in September down £0.7bn from a year earlier to £5.9bn. Following revisions to the figures for previous months, that left net borrowing over the first half of the current fiscal year down £2.5bn from the same period in FY16/17 to £32.5bn, representing the lowest half-year figure since 2007, as growth in central government receipts (up 4%YTD/Y) outpaced growth in spending (up around 3%YTD/Y). As such, the government appears currently to be on track to undershoot the OBR's forecast for net borrowing this fiscal year of £58.3bn (2.9% of GDP), and indeed might well better the FY16/17 total of £45.7bn (2.3% of GDP). However, with the OBR set to revise down significantly its assumption of potential GDP growth, its updated projections to be published in conjunction with the Budget announcement next month might yet show a deterioration in the underlying health of the public finances.

The week ahead in the UK

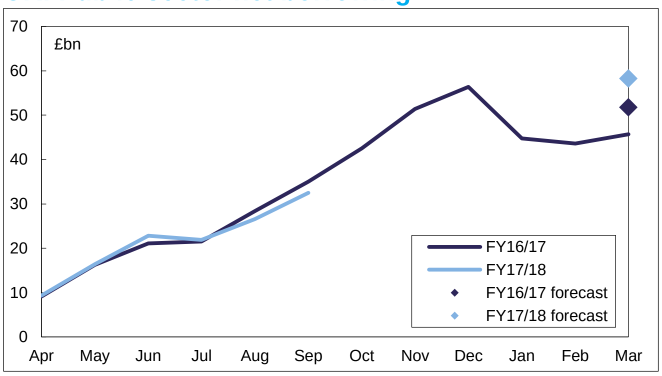
The main focus in the UK in the coming week will be the release of the first estimate of Q3 GDP on Wednesday. In line with the consensus, we expect another quarter of tepid growth at the 0.3%Q/Q, 1.5%Y/Y rate of Q2, which might nevertheless prove sufficiently strong to persuade a majority of MPC members to vote for a hike in Bank Rate on 2 November. While there will be no expenditure breakdown provided, the GDP release will likely show moderate growth in both the services and industrial sectors. Other new data will be thin on the ground in the coming week, although BBA bank loan data for September are also due on Wednesday, the CBI's industrial trends survey for October is due on Monday and its distributive trades survey, also for the current month, is due on Thursday. In the bond markets, the DMO will sell index-linked Gilts on Tuesday.

Euro area: Current account balance



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

UK: Public sector net borrowing*



**Excluding public sector banks. Source: ONS, OBR and Daiwa Capital Markets Europe Ltd.*

In the absence of any significant developments, the next edition of the Euro wrap-up will be published on 24 October 2017.

Daiwa economic forecasts

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2016	2017	2018
GDP forecasts %, Q/Q											
Euro area	0.5	0.6	0.5	0.4	0.4	0.4	0.4	0.4	1.8	2.2	1.8
Germany	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.5	1.9	2.2	2.1
France	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.3	1.1	1.7	1.6
Italy	0.5	0.3	0.3	0.2	0.1	0.1	0.3	0.3	1.1	1.4	0.9
Spain	0.8	0.9	0.7	0.6	0.6	0.5	0.6	0.7	3.2	3.1	2.6
UK	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	1.8	1.5	1.2
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.8	1.5	1.5	1.5	1.2	1.3	1.5	1.4	0.2	1.6	1.4
Core CPI	0.8	1.1	1.2	1.2	1.2	1.1	1.2	1.2	0.9	1.1	1.2
UK											
Headline CPI	2.1	2.7	2.8	3.1	2.9	2.8	2.7	2.4	0.7	2.7	2.7
Core CPI	1.8	2.5	2.6	2.8	2.8	2.7	2.6	2.5	1.3	2.4	2.6
Monetary policy											
ECB											
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.40	-0.40	-0.25
Net asset purchases*	80	60	60	60	30	30	30	0	80	60	0
BoE											
Bank Rate %	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.25	0.50	0.50
Net asset purchases**	0	0	0	0	0	0	0	0	0	0	0

**Monthly target €bn, end of period. **Monthly target £bn, end of period. Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Current account balance €bn	Aug	**33.3**	-	25.1	**31.5**
Italy	Current account balance €bn	Aug	**3.7**	-	8.6	**-**
Spain	Trade balance €bn	Aug	**-3.2**	-	-2.1	**-**
UK	Public sector net borrowing excluding interventions £bn	Sep	**5.9**	6.5	5.7	**4.7**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

Key data releases						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 23 October 2017			
EMU		14:45	ECB public sector asset purchases €bn	Weekly	-	12.5
		15:00	Consumer confidence indicator	Oct	-1.1	-1.2
			Tuesday 24 October 2017			
EMU		09:00	Preliminary manufacturing PMI	Oct	57.8	58.1
		09:00	Preliminary services PMI (preliminary composite PMI)	Oct	55.6 (56.5)	55.8 (56.7)
Germany		08:30	Preliminary manufacturing PMI	Oct	60.0	60.6
		08:30	Preliminary services PMI (preliminary composite PMI)	Oct	55.6 (57.6)	55.6 (57.7)
France		07:45	Business confidence (production outlook)	Oct	110 (23)	110 (23)
		08:00	Preliminary manufacturing PMI	Oct	56.0	56.1
		08:00	Preliminary services PMI (preliminary composite PMI)	Oct	56.9 (56.9)	57.0 (57.1)
			Wednesday 25 October 2017			
Germany		09:00	Ifo business climate index	Oct	115.0	115.2
		09:00	Ifo current assessment balance (expectations)	Oct	123.5 (107.3)	123.6 (107.4)
Italy		09:00	Industrial sales M/M% (Y/Y%)	Aug	-	-0.3 (4.0)
		09:00	Industrial orders M/M% (Y/Y%)	Aug	-	0.2 (10.1)
UK		09:30	GDP Q/Q% (Y/Y%)	Q3	0.3 (1.5)	0.3 (1.5)
		09:30	Index of services M/M% (3M/3M%)	Aug	0.3 (0.4)	-0.2 (0.5)
			Thursday 26 October 2017			
EMU		09:00	M3 money supply Y/Y%	Sep	5.0	5.0
Germany		07:00	GfK consumer confidence survey	Nov	10.8	10.8
Italy		09:00	Manufacturing confidence indicator	Oct	110.1	110.4
		09:00	Consumer confidence indicator	Oct	114.7	115.5
		09:00	Business sentiment indicator	Oct	-	108.0
Spain		08:00	Unemployment rate %	Q3	16.60	17.22
UK		11:00	CBI Distributive Trades survey, retail sales	Oct	- (14)	44 (42)
			Friday 27 October 2017			
Germany		07:00	Retail sales M/M% (Y/Y%)	Sep	0.5 (3.0)	-0.2 (2.8)
France		07:45	Consumer confidence indicator	Oct	101	101
Spain		08:00	Retail sales Y/Y%	Sep	1.9	1.6

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions

Country		BST	Event / Auction
Monday 23 October 2017			
- Nothing scheduled -			
Tuesday 24 October 2017			
UK		10:30	Auction: To sell £650m of 0.625% 2042 index-linked bonds (22-Nov-2042)
Wednesday 25 October 2017			
Germany		10:30	Auction: To sell €3bn of 0.5% 2027 bonds (15-Aug-2027)
Thursday 26 October 2017			
EMU		10:30	ECB to hold press conference after Governing Council meeting
Italy		10:00	Auction: To sell bonds
Friday 27 October 2017			
- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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