Euro wrap-up

Overview

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- Bunds made gains as euro area inflation rose by less than expected, but the unemployment rate fell to the lowest since early 2009.
- Gilts also made gains despite a report suggesting that the UK and the EU are close to reaching an agreement on the Irish border issue.
- The end of the week brings November manufacturing PMIs from the euro area and the UK.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/19	-0.720	-0.003
OBL 0 10/22	-0.305	-0.006
DBR 0½ 08/27	0.369	-0.016
UKT 1¾ 07/19	0.519	+0.008
UKT 0½ 07/22	0.809	-0.010
UKT 4¼ 12/27	1.327	-0.010

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

Euro area

Inflation up, but by less than expected

After an upside surprise from yesterday's equivalent German data, today's flash euro area inflation figures surprised on the downside. Headline CPI rose just 0.1ppt to 1.5%Y/Y, with the increase principally due to higher energy inflation, which rose to 4.7%Y/Y, the highest in seven months. With inflation of services and non-energy industrial goods unchanged at 1.2%Y/Y and 0.4%Y/Y respectively, core CPI remained unchanged at just 0.9%Y/Y, contrary to expectations of an increase. So, the ECB's long-awaited uptrend in underlying inflation remains elusive. And with the impact of energy inflation now set to go into reverse due to the base effects related to past shifts in the oil price, we currently expect headline inflation in the euro area to fall in December, and again in the New Year to just 1.1%Y/Y in January and February, hardly the kind of figures to suggest that the ECB needs urgently to tighten monetary policy.

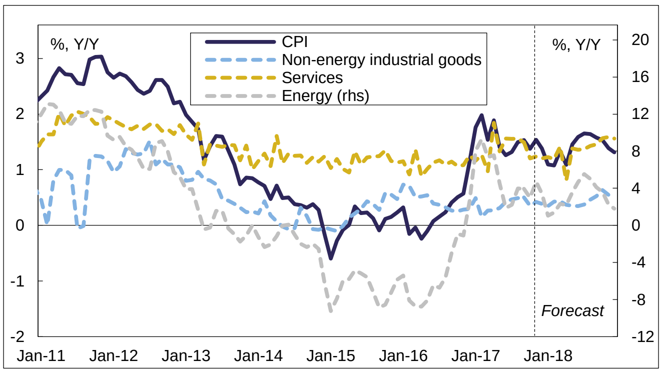
Underlying inflation to remain subdued despite falling unemployment

Looking further ahead, most important will be what happens to core inflation, particularly inflation of services, for which labour costs often play a dominant role. And while the ECB will have been pleased to see a further drop in the euro area unemployment rate in October to 8.8%, the lowest since the start of 2009, there remains little sign of the increase in labour costs required to push underlying inflation significantly higher over coming quarters. Several factors, including globalisation, technological change and the impact of post-crisis structural reforms appear to have significantly diminished the bargaining power of labour. And despite the lower headline unemployment rate, there appears to remain vast amounts of spare capacity in the labour market. The underemployment rate – a broader measure of spare capacity which also includes persons working part-time who would like to work longer hours as well as those seeking work but not immediately available, among others – remains about double the unemployment rate. Indeed, with the exception of Germany, underemployment across the member states and at the aggregate euro area level remains well above its pre-crisis level. As a result, we expect wage growth, services inflation, and core inflation overall, to rise only very gradually over the coming couple of years, reinforcing the case for keeping ECB interest rates unchanged well into 2019.

A weak start to Q4 for consumption

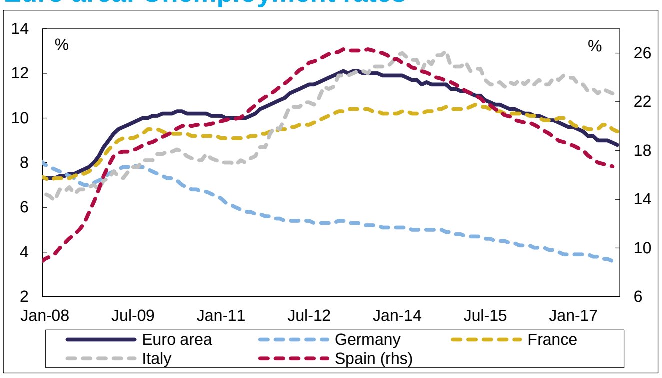
Since the economic recovery begun more than four years ago, consumer spending has accounted for roughly half of all growth in the euro area. However, while the expenditure breakdown of GDP last quarter has yet to be published, national data point to a more subdued performance for consumer spending. Indeed, in Germany, private consumption fell for the first time in almost four years in Q3. And spending figures from the largest two member states suggest that consumption has started Q4 on a surprisingly soft note too. Contrasting with the widely anticipated increase, German retail sales fell 1.2%M/M in October to leave them 1.4% lower than a

Euro area: CPI inflation*



*EU-harmonised measure. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates



Source: Eurostat and Daiwa Capital Market Europe Ltd.

year earlier and 0.4% lower on a three-month basis. And in France, household expenditure on goods fell 1.9%M/M in October to leave them down 0.6%Y/Y and remain unchanged on a three-month basis. With German consumer confidence still close to its highest levels in sixteen years, and French consumer confidence up in November to well above the long-run average, we expect to see a rebound in spending in both countries in November and December. However, these spending figures suggest the risks to euro area consumption in Q4 appear skewed to the downside.

The day ahead in the euro area and US

Friday will bring the final November euro area manufacturing PMIs, for which the flash estimates released a week ago signalled rapid growth in the sector. Indeed, the preliminary headline PMI rose 1.5pts, the most since July 2013, to 60.0, the highest since mid-2000 and indeed a level beaten only once since the inception of the euro. The preliminary headline indices from Germany and France also posted big jumps to their highest levels since 2011. Beyond the PMIs, updated Italian GDP data for Q3, including a first release of the expenditure breakdown, are also due and expected to confirm the preliminary estimate of growth of 0.5%Q/Q and 1.8%Y/Y.

In the US, the focus seems likely to remain on tax reform, with a make-or-break vote on the Senate floor possible. If the Senate passes the bill, negotiators from the lower and upper chambers of Congress would then prepare compromise legislation with the aim of adoption by year-end. Data-wise, the week will end with the November manufacturing ISM indices, auto sales for the same month, and October construction spending data.

UK

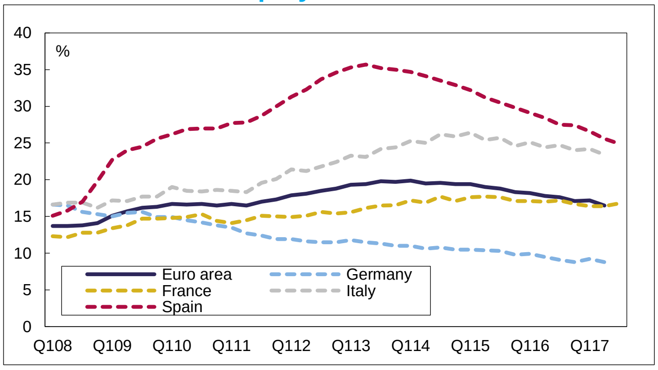
Further progress in Brexit negotiations?

All focus in the UK remains on the Brexit negotiations. And after the news earlier this week that the UK government has caved in on the financial settlement, one notable report in The Times today suggested that a deal could be close to being reached on what has become the thorniest issue for this phase of talks, the Irish border. In particular, the deal would reportedly be one that would see greater devolution powers passed to Northern Ireland, so that while the rest of the UK goes its own way after Brexit, Northern Ireland would avoid ‘regulatory divergence’ from the EU, implying that it could effectively remain in the Customs Union and Single Market in all but name (and, of course, without a say on those regulatory arrangements). That, of course, would raise plenty of additional issues, not least that it would also imply a hard border between Northern Ireland and Britain, something that the Democratic Unionist Party – upon which Theresa May relies for her parliamentary majority – insists it will not accept. Nevertheless, today’s report suggested that the agreement is close, and that this could well also open the door to a further deal in January on a transition period of at least two years, with talks on future trade arrangements to start shortly thereafter.

Consumer sentiment worsens to match post-Brexit-referendum pessimism

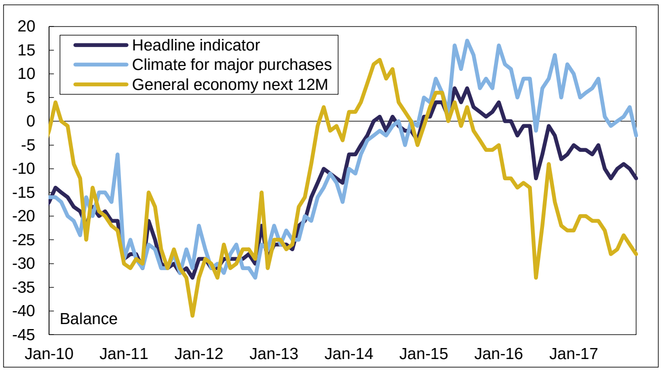
The UK dataflow, however, remains soft, as the Brexit chickens gradually come home to roost. The GfK consumer confidence survey released today suggested that UK consumers have become more downbeat, with the survey headline indicator inching lower in November from -10 to -12, the joint lowest level since the end of 2013, matching the reading immediately after the Brexit vote. While consumers’ assessment of their personal incomes was weaker, the overall pessimism was driven mainly by a judgement that the economic situation has deteriorated. Indeed, with real wages continuing to fall but the BoE having raised Bank Rate, adding to mortgage costs for many borrowers, consumers’ assessment of the economic situation over the last twelve months dipped to the lowest level since July 2013, while the expectations index fell closer towards the bottom of the range on the series. And British retailers will be worried that the index for major purchases declined sharply, suggesting that the festive season, a crucial time of the year on the High Street, might be even more challenging than previously expected.

Euro area: Underemployment rates*



**Includes the unemployed, persons available to work but not seeking work, persons seeking work but not immediately available to work and underemployed part-time workers. 25-75 year basis. Source: Eurostat and Daiwa Capital Market Europe Ltd.*

UK: GfK consumer confidence



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

The day ahead in the UK

The focus at the end of the week will be on manufacturing PMI for November. Business sentiment in this sector has been relatively elevated in recent months, with the headline survey indicator fluctuating around 56.5 and a similar level is expected to have been maintained this month.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Unemployment rate %	Oct	**8.8**	8.9	8.9	-
	Flash CPI estimate Y/Y%	Nov	**1.5**	*1.6*	1.4	-
	Flash core CPI estimate Y/Y%	Nov	**0.9**	*1.0*	0.9	-
Germany	Retail sales M/M% (Y/Y%)	Oct	**-1.2 (-1.4)**	0.3 (2.8)	0.5 (4.1)	-
	Unemployment change `000s (rate %)	Nov	**-18 (5.6)**	-10 (5.6)	-11 (5.6)	-12 (-)
France	Preliminary EU-harmonised CPI Y/Y%	Nov	**1.3**	1.2	1.2	-
Italy	Unemployment rate %	Oct	**11.1**	11.1	11.1	-
	Preliminary EU-harmonised CPI Y/Y%	Nov	**1.1**	1.2	1.1	-
Spain	Current account balance €bn	Sep	**2.4**	-	2.6	-
	GDP – final release Q/Q% (Y/Y%)	Q3	**0.8 (3.1)**	*0.8 (3.1)*	0.9 (3.1)	-
UK	GfK consumer confidence indicator	Nov	**-12**	-11	-10	-
	Lloyds business barometer	Nov	**24**	-	26	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09:00	Final manufacturing PMI	Nov	60.0	58.5
Germany	08:55	Final manufacturing PMI	Nov	62.5	60.6
France	08:50	Final manufacturing PMI	Nov	57.5	56.1
Italy	08:45	Manufacturing PMI	Nov	58.3	57.8
	09:00	GDP – final release Q/Q% (Y/Y%)	Q3	*0.5 (1.8)*	0.3 (1.5)
Spain	08:15	Manufacturing PMI	Nov	56.5	55.8
UK	09:30	Manufacturing PMI	Nov	56.5	56.3

Auctions

Country	GMT	Auction / Event
- Nothing scheduled -		

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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