Euro wrap-up

Overview

- Bunds made losses at the short end of the curve despite weaker German trade and labour costs data.
- Gilts made losses as the UK government reached an agreement with the EU in the first phase of Brexit negotiations.
- In the coming week the focus will be on the ECB and BoE policy meetings, the European Council summit, and numerous data releases, including euro area IP and PMIs, and UK inflation and labour market figures.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/19	-0.778	+0.014
OBL 0 10/22	-0.374	+0.014
DBR 0½ 08/27	0.303	+0.010
UKT 1¾ 07/19	0.519	+0.002
UKT 0½ 07/22	0.787	+0.029
UKT 4¼ 12/27	1.292	+0.039

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

Euro area

French manufacturers post a big upside surprise

In marked contrast to yesterday's weaker than expected German numbers (down 1.4%M/M), the French October IP figures released this morning brought a massive upside surprise, with total output rising by 1.9%M/M and manufacturing production increasing by 2.7%M/M, both among the strongest rates in recent years. Within the manufacturing sector, production of capital goods encouragingly led the way (up 4.6%M/M), while growth in output of intermediate goods posted a more modest rise, and consumer goods production fell back after a notable increase the previous month. In contrast, output of construction and energy declined in October. Looking through the monthly volatility, the underlying picture for French manufacturers appears very upbeat – on a three-month basis, production in the sector was up 1.2%3M/3M and 3.7%3M/Y, the strongest since early 2011. And, while we expect to see negative payback in November, with economic surveys pointing to an increase in momentum – e.g. last month the headline manufacturing PMI rose to a level beaten only once in the past seventeen years, while the new orders PMI rose to the highest since 2010 – we fully expect the industrial sector to make a substantive positive contribution to French GDP growth in Q4.

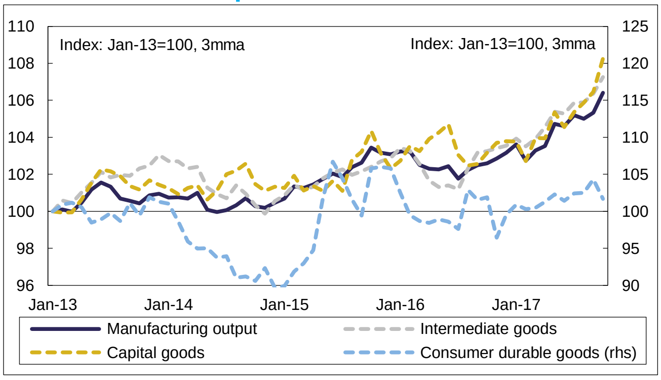
Weakness in German exports to be temporary

Consistent with other German economic data releases of late, which have suggested weaker activity at the start of Q4 than implied by sentiment surveys, today's October trade figures from the largest euro area member state were also soft. The headline seasonally adjusted trade surplus declined by more than €2bn to a six-month low of €19.8bn as exports fell 0.4%M/M and imports rose 1.8%M/M. On a three-month basis, however, exports were still up by 1.2%3M/3M, beating the equivalent growth rate of imports (0.8%3M/3M). So, overall, the underlying export picture still seems to be much stronger than today's headline figures might be suggesting. And given calendar effects – there was an extra holiday in Germany at end-October preceded by a bridge day – economic momentum seems bound to remain much stronger too.

Weakness in German labour costs proves long-lasting

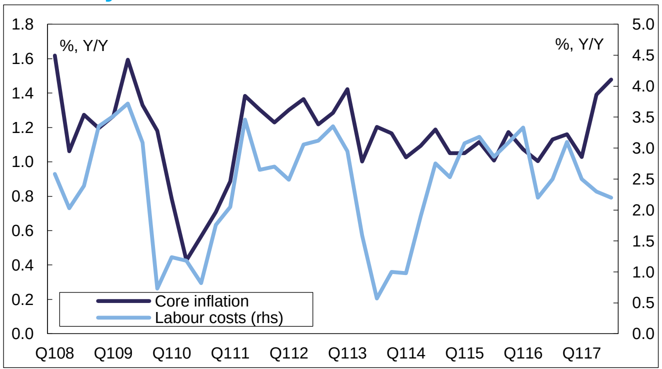
Perhaps less eye-catching but arguably more important from the ECB's point of view, today brought the release of Q3 German labour cost figures, which suggested that cost pressures have eased slightly. Indeed, labour cost growth inched down from 2.3%Y/Y in Q2 to 2.2%Y/Y, matching the weakest rate in more than three years. So, despite strong economic growth momentum and a seemingly very tight labour market, cost pressure – and hence underlying inflation – remains subdued in the euro area's most cyclically-advanced economy. And that is a key reason why the ECB will be able to move only very slowly indeed towards monetary policy normalisation.

France: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Inflation and labour costs



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The week ahead in the euro area and US

The main event in the euro area in the coming week will be the conclusion of the ECB's latest Governing Council meeting on Thursday. This will clearly not be as eventful as the previous policy meeting in October, when the ECB announced that it would reduce the pace of its asset purchases to €30bn from January to September 2018. Those plans are now seemingly set in stone, and it would also seem inconceivable for the ECB to amend any of its forward guidance, on either asset purchases or rates, at the coming meeting. So, the main policy announcement might well relate to the relative shares of public-sector and private-sector assets within the overall €30bn per month envelope. We know from the account of the last meeting that the private sector programmes will not be adjusted in strict proportion to the overall scaling-down of the purchase programme, but the December meeting could provide more precision.

In addition, the ECB will publish its updated economic forecasts, which seem likely to nudge up the expected near-term growth profile, which previously foresaw GDP rising 2.2%Y/Y in 2017 and 1.8%Y/Y in 2018. As such, while recent CPI outturns have been weaker than the ECB will have hoped, the inflation forecast for 2018 and 2019, of 1.2%Y/Y and 1.5%Y/Y respectively, might be revised up too, due also to the recent increase in oil prices. And, notably, for the first time the ECB will also publish economic forecasts for 2020. The extent of the revisions to the inflation forecast, and the proximity of the 2020 inflation forecast to the ECB's target of below but close to 2%Y/Y, will ultimately provide the benchmark for determining whether Draghi's announcements are eventually judged to be hawkish or dovish.

Data-wise, the coming week brings a mix of new survey, activity, labour market and inflation data from the euro area. Survey-wise, the highlight will be the flash December PMIs, due Thursday, which seem bound to signal strong momentum growth heading into 2018. Other new surveys include the November Bank of France business survey (Monday) and December ZEW survey of investors (Tuesday). Activity-wise, euro area IP figures for October are due on Wednesday and look set to show a second successive monthly decline, while trade data for the same month are due on Friday. With respect to the labour market, Q3 euro area employment figures are out on Wednesday. Finally, ahead of the equivalent figures for the euro area due the following week, final November CPI figures are scheduled for release from Germany on Wednesday, with the equivalent numbers from France, Italy and Spain due the following day. In the markets, Germany will sell 2Y Schatz on Tuesday while Spain will sell bonds on Thursday.

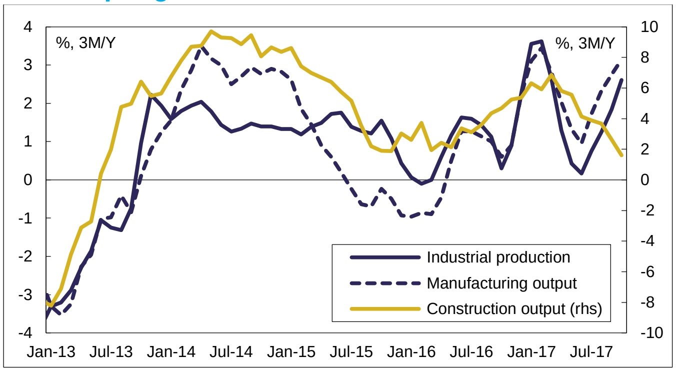
In the US, the coming week will be a very busy one, highlighted by the conclusion of the final FOMC meeting for this year on Wednesday and the November retail and CPI reports due Wednesday and Thursday respectively. As far as the Fed is concerned, there seems little doubt that the FOMC will announce a further 25bps hike in the target range for the fed funds rate (FFR), to 1.25-1.50%. So, most interest will be on the accompanying Fed projections, including the FFR dot-plots, and outgoing Fed Chair Yellen's final press conference. Turning to the CPI data, a further 0.2%M/M lift in the core index would return annual headline inflation to 2.2%Y/Y. In addition, while lower auto sales will weigh on overall retail spending, high levels of consumer confidence and solid income growth suggests a decent increase should still be seen. The coming week also sees a number of other economic reports, including the BLS JOLTS report on Monday (containing some of the Fed's favourite labour market indicators); the PPI on Tuesday (relevant for determining the healthcare component of the core PCE deflator); the flash Markit manufacturing and services PMIs on Thursday; and the November IP report and New York Fed manufacturing survey on Friday. In the bond market, the Treasury will auction 3Y and 10Y notes on Monday and 30Y bonds on Tuesday.

UK

A first-phase Brexit deal at last

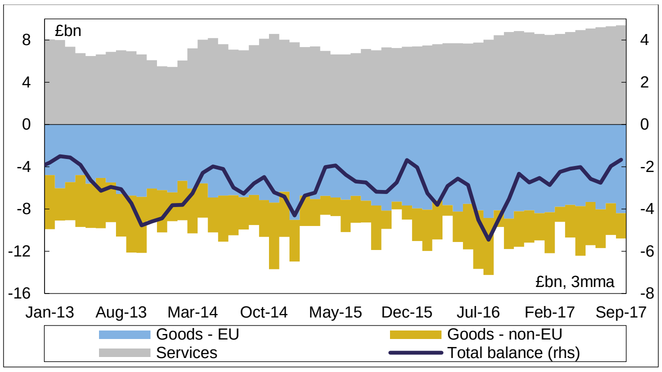
After a week of on-off negotiations, today saw the UK Government and European Commission reach a deal on all first-phase Brexit issues. And while this agreement needs to be ratified by EU leaders at their Summit on 14-15 December, that now seems a formality, allowing talks to move onto the key issue of a transition deal early in the New Year and, after that, the longer-term trade issues. On all of the major stumbling blocks of this first phase – including the continued role for the ECJ in protecting EU citizens' rights and the net €50bn divorce bill, the UK Government caved in to the EU's demands, highlighting the power of the EU27 in these negotiations. Of course, it was the issue of the Irish border that had proved the major obstacle earlier in the week.

UK: Output growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Trade balance



Source: Thomson Reuters and DaiwaCapital Markets Europe Ltd.

And, here, the text agreed by the UK Government guarantees that no hard border will be put in place between Northern Ireland and the Republic of Ireland, and that, if solutions to this cannot be found as part of the trade agreement talks, "the United Kingdom will maintain full alignment with those rules of the Internal Market and the Customs Union which support the 1998 [Good Friday] Agreement." This text is important in two ways. First, it explicitly rules out a "no-deal" scenario (as that would result in a requirement for a border), which means the UK's leverage in the next phase of negotiations is even less than in this past first phase. Second, assuming (and it's a safe assumption) that ideas for the greater use of technology to prevent a border come to naught, this also implies that in many areas the UK will have to remain closely aligned to EU Single Market and customs regulations.

Transition talks up next

Attention now turns to phase 2 of the negotiations, which will first focus on agreeing the terms of a transition period. The EU has already set out what it is prepared to offer, which is essentially continued EU membership for the UK with all the rights and obligations that entails, but with no voting rights in the European Council or any British MEPs. Such a transition agreement will be anathema to many brexiteers, as it would involve continued Single Market and Customs Union membership, continued ECJ jurisdiction and continued free movement. However, the UK will have no choice but to accept what is on offer. Moreover, only once a transition is agreed will thoughts turn to the future trading arrangements. And agreement here is likely to take several years – even on the incredibly brave assumption of a relatively stable UK political backdrop from now on, a future trade deal would seem unlikely to be signed, sealed and delivered before the middle of the next decade.

Transition likely simply to delay the damage

Therefore, the UK faces a lengthy purgatory in a transition phase in which it has neither full EU membership nor policy autonomy. And, given the massive imbalance in power between the EU and UK, the need to maintain the integrity of the EU Treaties, as well as the sheer complexity of all trade negotiations, when any new trade deal is eventually agreed and implemented – if the UK government insists upon sticking to Theresa May's self-harming red lines – the long-term arrangements would have to be based on the recent EU-Canada agreement. That would represent the imposition of significant new barriers to trade in goods and services – a very bad outcome for the UK. That is for the future, and – not least given the extremely fluid state of UK politics – many things could change between now and then. And what has been agreed today, which sets the stage for a long transition period incorporating Single Market and Customs Union membership, is at least a positive for UK-based companies and, by extension, the economy, compared to what might have been the case. If the UK eventually does end up with just a Canada-type deal, however, then this is just putting off the eventual damage to a later date.

Anaemic start to Q4

Compared to developments on the Brexit front, today's UK economic data releases were very much of secondary importance. The latest industrial production figures aligned with expectations, showing output unchanged in October from the previous month, while manufacturing production rose only 0.1%M/M. But given the very sharp decline in the same month a year ago, that was sufficient to raise the respective annual growth rates to 3.5%Y/Y and 3.9%Y/Y, the highest since the end of last year. The news from the construction sector, however, was worse, with output falling sharply for the second consecutive month to leave it down 0.2%Y/Y, the weakest annual rate since July 2016. More encouragingly, however, the trade data took a modest turn for the better with goods export volumes rising by 3.2%3M/3M, having been broadly flat in September, while import growth eased to 0.5%3M/3M. So, although the goods trade deficit edged up to £10.8bn, and the total deficit increased slightly to £1.4bn, thanks also to some favourable revisions to earlier estimates, these imbalances were much lower than previously expected.

The week ahead in the UK

While focus in the coming week will remain on Brexit, there will be plenty of other economic events worth following. Most notably, the MPC will meet, with the policy statement to be published on Thursday. Having last month raised Bank Rate to 0.5%, this time the committee will keep policy unchanged, merely taking stock of recent developments. Policymakers are likely to acknowledge that the latest inflation figures surprised on the downside. And while there is significant uncertainty about growth momentum in the current quarter, with business surveys and consumer spending indicators sending mixed signals and the NIESR GDP nowcast for the three months to November remaining at 0.5%3M/3M, they will expect GDP growth to have remained relatively subdued. In addition, while today's first-phase Brexit deal has reduced the tail risks of a disorderly Brexit, uncertainty related to the UK's future relationship with the EU persists. So, we do not think that recent developments warrant any additional hawkishness in the MPC's communication.

The coming week will be no less busy on the data front, with figures due on inflation (Tuesday), the labour market (Wednesday), and retail sales (Thursday). We expect the headline CPI rate to have moved sideways at 3.0%Y/Y for a third consecutive month, while the core rate looks likely to have eased by 0.1ppt to a four-month low of 2.6%Y/Y. With regard to the labour market, the headline three-month employment growth rate for October is set to have remained weak, most likely in negative territory, but we might well see a decline in the unemployment rate to a new forty-two-year low of 4.2%. And although the three-month wage growth rate is set to inch up to around 2.5%3M/Y, this would likely reflect higher bonus payments. Indeed, regular wage growth is likely to have remained unchanged at 2.2%3M/Y for a fourth consecutive month. Finally, retail sales are likely to have been slightly stronger in November, but this will not change the underlying weak picture for consumer spending. Indeed, the expected monthly increase would still leave retail spending only slightly up compared to a year ago, having last month reported the first annual decline in four and a half years.

In the absence of any significant developments,
the next edition of the Euro wrap-up will be published on 12 December 2017.

Daiwa economic forecasts

	2017				2018				2016	2017	2018
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP forecasts %, Q/Q											
Euro area	0.6	0.7	0.6	0.6	0.5	0.4	0.4	0.4	1.8	2.3	2.0
Germany	0.9	0.6	0.8	0.7	0.6	0.4	0.4	0.5	1.9	2.6	2.4
France	0.5	0.6	0.5	0.5	0.4	0.4	0.3	0.3	1.1	1.8	1.8
Italy	0.5	0.3	0.4	0.4	0.3	0.2	0.3	0.3	1.1	1.5	1.2
Spain	0.8	0.9	0.8	0.6	0.6	0.5	0.6	0.7	3.3	3.1	2.6
UK	0.3	0.3	0.4	0.4	0.3	0.3	0.3	0.3	1.8	1.5	1.3
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.8	1.5	1.4	1.4	1.2	1.4	1.6	1.4	0.2	1.5	1.4
Core CPI	0.8	1.1	1.2	0.9	1.0	1.0	1.1	1.2	0.9	1.0	1.1
UK											
Headline CPI	2.1	2.7	2.8	3.0	2.8	2.6	2.5	2.4	0.7	2.7	2.6
Core CPI	1.8	2.5	2.6	2.6	2.6	2.4	2.3	2.3	1.3	2.4	2.4
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	-0.40	-0.40	-0.40	-0.40
Net asset purchases*	80	60	60	60	30	30	30	5	80	60	5
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/ <u>*Daiwa forecast*</u>	Previous	**Revised**
Germany	Trade balance €bn	Oct	**18.9**	21.9	24.1	-
	Current account balance €bn	Oct	**18.1**	20.0	25.4	**25.8**
	Imports (exports) M/M%	Oct	**1.8 (-0.4)**	1.0 (1.0)	-1.0 (-0.4)	**-1.1 (-)**
France	Industrial production M/M% (Y/Y%)	Oct	**1.9 (5.5)**	-0.1 (2.9)	0.6 (3.2)	**0.8 (-)**
	Manufacturing production M/M% (Y/Y%)	Oct	**2.7 (6.9)**	-	0.4 (3.1)	**0.6 (3.2)**
UK	Industrial production M/M% (Y/Y%)	Oct	**0.0 (3.6)**	0.0 (3.5)	0.7 (2.5)	-
	Manufacturing production M/M% (Y/Y%)	Oct	**0.1 (3.9)**	0.0 (3.8)	0.7 (2.7)	-
	Construction output M/M% (Y/Y%)	Oct	**-1.7 (-0.2)**	0.1 (1.8)	-1.6 (1.1)	-
	Trade (goods) balance €bn	Oct	**-1.4 (-10.8)**	-3.0 (-11.5)	-2.8 (-11.3)	**-1.1 (-10.5)**
	NIESR GDP estimate 3M/3M%	Nov	**0.5**	0.4	0.5	-
Auctions						
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

Key data releases

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
		Monday 11 December 2017			
EMU	14:45	ECB public sector asset purchases €bn	Weekly	*11.0*	10.9
France	07:30	Bank of France manufacturing sentiment indicator	Nov	107	106
Italy	09:00	Retail sales M/M% (Y/Y%)	Oct	-0.1 (-)	0.9 (3.4)
		Tuesday 12 December 2017			
EMU	10:00	ZEW expectations balance	Dec	-	30.9
Germany	10:00	ZEW current assessment balance (expectations)	Dec	88.7 (18.0)	88.8 (18.7)
UK	09:30	CPI (core CPI) Y/Y%	Nov	*3.0 (2.6)*	3.0 (2.7)
	09:30	Input PPI (output PPI) Y/Y%	Nov	6.7 (3.0)	4.6 (2.8)
	09:30	House price index Y/Y%	Oct	5.2	5.4
		Wednesday 13 December 2017			
EMU	10:00	Industrial production M/M% (Y/Y%)	Oct	-0.2 (3.0)	-0.6 (3.3)
	10:00	Employment Q/Q% (Y/Y%)	Q3	-	0.4 (1.6)
Germany	07:00	Final EU-harmonised CPI Y/Y%	Nov	*1.8*	1.5
Italy	09:00	Industrial production M/M% (Y/Y%)	Oct	0.6 (3.4)	-1.3 (2.4)
UK	09:30	Average earnings (excl. bonuses) 3M/Y%	Oct	*2.5 (2.2)*	2.2 (2.2)
	09:30	ILO unemployment rate 3M%	Oct	*4.2*	4.3
	09:30	Employment change 3M/3M '000s	Oct	*-20*	-14
	09:30	Claimant count rate % (change 000s)	Nov	-	2.3 (1.1)
		Thursday 14 December 2017			
EMU	09:00	EU27 new car registrations Y/Y%	Nov	-	5.9
	09:00	Preliminary manufacturing PMI	Dec	59.7	60.1
	09:00	Preliminary services PMI (preliminary composite PMI)	Dec	56.0 (57.2)	56.2 (57.5)
	12:45	ECB refinancing rate %	Dec	*0.00*	0.00
	12:45	ECB deposit rate %	Dec	*-0.40*	-0.40
Germany	08:30	Preliminary manufacturing PMI	Dec	62.0	62.5
	08:30	Preliminary services PMI (preliminary composite PMI)	Dec	54.6 (57.2)	54.3 (57.3)
France	07:45	Final EU-harmonised CPI Y/Y%	Nov	*1.3*	1.2
	08:00	Preliminary manufacturing PMI	Dec	57.2	57.7
	08:00	Preliminary services PMI (preliminary composite PMI)	Dec	60.0 (59.6)	60.4 (60.3)
Italy	09:00	Final EU-harmonised CPI Y/Y%	Nov	*1.1*	1.1
Spain	08:00	Final EU-harmonised CPI Y/Y%	Nov	*1.7*	1.7
UK	00:01	RICS house price balance %	Nov	0	1
	09:30	Retail sales excluding petrol M/M% (Y/Y%)	Nov	0.4 (0.2)	0.1 (-0.3)
	09:30	Retail sales including petrol M/M% (Y/Y%)	Nov	0.4 (0.3)	0.3 (-0.3)
	12:00	BoE Bank Rate %	Dec	*0.50*	0.50
		Friday 15 December 2017			
EMU	10:00	Trade balance €bn	Oct	24.3	25.0

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions		
Country	GMT	Event / Auction
		Monday 11 December 2017
		- Nothing scheduled -
		Tuesday 12 December 2017
Germany	10:30	Auction: To sell €3bn of 0% 2019 bonds (13-Dec-2019)
		Wednesday 13 December 2017
UK	10:30	Auction: To sell £800m of 0.125% 2036 index-linked bonds (22-Nov-2036)
		Thursday 14 December 2017
EMU	-	European Union Leaders to hold summit in Brussels
	13:30	ECB's Draghi holds a press conference after a monetary policy meeting
Spain	09:30	Auction: To sell 0.05% 2021 bonds (31-Jan-2021)
	09:30	Auction: To sell 1.45% 2027 bonds (31-Oct-2027)
	09:30	Auction: To sell 5.75% 2032 bonds (30-Jul-2032)
		Friday 15 December 2017
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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