Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Mantas Vanagas +44 20 7597 8318

- Bunds were little changed as the ECB left its forward guidance intact and inflation forecasts little changed despite a firmer GDP growth outlook.
- Despite some stronger-than-expected UK retail sales numbers, Gilts made gains as the BoE saw no urgency to tighten policy further.
- Friday will see EU27 leaders agree next steps for Brexit, while the latest euro area trade report is due.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/19	-0.761	+0.011
OBL 0 10/22	-0.341	+0.016
DBR 0½ 08/27	0.316	+0.002
UKT 1¾ 07/19	0.450	-0.033
UKT 0½ 07/22	0.714	-0.027
UKT 4¼ 12/27	1.176	-0.040

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

Euro area

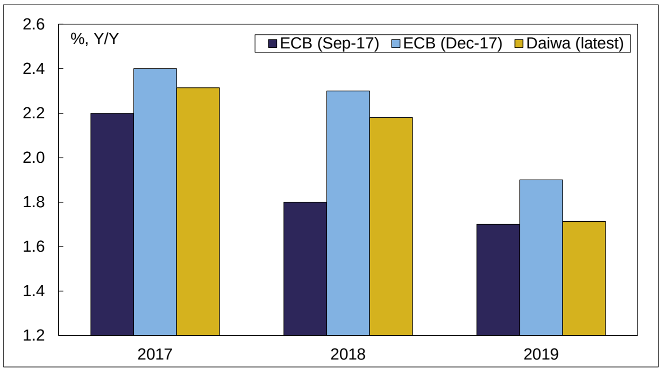
ECB offers nothing new on policy

Having after the previous policy meeting unveiled plans to halve the pace of its monthly net asset purchases to €30bn from January until end-September, the ECB's announcement today was always bound to be far more mundane. But Draghi was arguably even more tight-lipped than expected, offering nothing new of substance whatsoever on the policy front, and merely restating the ECB's plans for QE through the first three quarters of 2018 and its forward guidance on policy thereafter. So, even though some members, including Executive Board member Benoit Coeuré, had recently expressed some discomfort with the messages about how policy might evolve once the current QE commitment has been fulfilled, the Governing Council repeated that it remains willing to extend the net asset purchases beyond end-September if necessary, and also continues to expect the key interest rates to remain at current levels well past the horizon of its net asset purchases. Moreover, contrary to speculation before the meeting, there was no further detail announced on how the asset programme will be implemented in the New Year, with Draghi confirming that the Governing Council had not discussed issues related to composition, such as the split between public- and private-sector securities. So, in this respect, we have no greater precision than what we learned from the account of the October meeting, i.e. that the private sector purchases in the New Year will not be adjusted in strict proportion to the overall scaling-down of the programme.

Draghi tries to remain dovish despite upbeat growth outlook

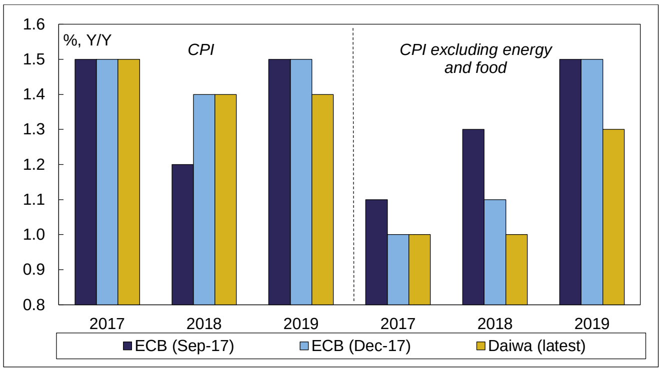
Today's announcements were not, however, entirely without interest, with the Eurosystem's updated economic forecasts illustrating why some (albeit very much a minority of) members of the Governing Council are becoming restless about policy. Most notably, reflecting recent economic surveys, of which today's flash PMIs were just the latest to suggest strong momentum heading towards year-end (see below), the forecasts saw a sizeable upwards shift to the GDP growth profile, by 0.2ppt to 2.4%Y/Y in 2017, 0.5ppt to 2.3%Y/Y in 2018, and 0.2ppt to 1.9%Y/Y in 2019. But, as Draghi emphasised today, it is the inflation profile that is most important in determining ECB policy. And while the headline inflation forecast for 2018 was revised up by 0.2ppt to 1.4%Y/Y, this was due principally to higher oil and food prices, while the forecast for core inflation next year was revised down by 0.2ppt to 1.1%Y/Y. In addition, despite a downwards revision to the outlook for unemployment and a slight upwards revision to the outlook for wage growth, the forecasts for both headline and core inflation in 2019 were left unchanged, both at 1.5%Y/Y. The forecasts for 2020, published for the first time, saw headline CPI rise further to 1.7%Y/Y and core CPI to 1.8%Y/Y. But Draghi refused to judge these figures to be consistent with the ECB's target of below but close to 2%Y/Y. Indeed, to be able to consider the outlook to be target-consistent, he reiterated that such higher inflation rates would need to be self-sustaining, and so not reliant on the ECB's exceptional monetary policy support. As such, despite the upbeat message on economic growth, Draghi still did his best today to be dovish.

Euro area: GDP forecasts



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

Euro area: Inflation forecasts



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

Festive PMIs suggest acceleration into New Year

It is undeniable that recent surveys point to increased growth momentum heading towards year-end. And that was certainly the case with today's flash PMIs for December. Most notably, the euro area composite PMI beat expectations, rising 0.5pt to 58.0, the highest since February 2011, leaving the Q4 average at a level consistent with GDP growth of 0.8%Q/Q, which would likewise be the strongest since Q111. Like other surveys, these PMIs suggested that manufacturing is leading the way, with that sector's headline PMI up 0.5pt to a series high of 60.6, with the output and new orders indices also up again to levels rarely beaten since the creation of the euro. In addition, the services PMI rose 0.3pt to the highest since April 2011. And with other survey detail suggesting that employment in Q4 is rising at the fastest rate in sixteen years, and that order books across the economy as a whole are the thickest in more than a decade, the PMIs raise the prospect of a strong start to the New Year. Moreover, while the PMIs for both input and output prices were a touch lower in December, their averages over the quarter were still improved from Q3 with the output price PMI the highest since Q111. To some extent these data might be treated with a degree of caution, e.g. strictly speaking, the higher PMIs for output suggest that economic growth is more broad-based but not necessarily significantly stronger, and euro area GDP rose slightly less than implied by the PMIs in Q3. Moreover, this month, the flash PMIs were published earlier in the month than normal and we might yet see significant revisions once the final data are published in early January. Nevertheless, it is impossible to argue that today's survey results were anything but strong and suggestive of the kind of economic conditions that in the past would have led the ECB to reconsider its monetary policy settings.

The day ahead in the euro area and US

It should be a far less eventful end to the week for euro area economic news with the October trade report the most notable among the data releases. Given the narrowing of the German trade surplus that month, we also anticipate a modest decline in the euro area headline balance, from €25bn in September. Meanwhile, in the US, the November industrial production report is due along with the Empire manufacturing survey for December. As far as the IP report goes, firm job growth in the factory sector as well as a buoyant production index on the ISM survey suggests that we should see another solid gain in manufacturing output in November. Moreover, higher crude oil prices are also likely to have incentivised greater activity in the mining sector. All in, we look for a gain of 0.5%M/M%.

UK

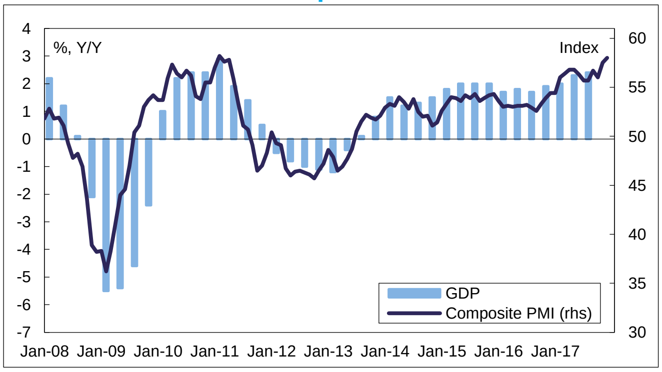
No surprises from the MPC

As we expected, today's MPC policy announcement was a non-event with all nine committee members voting to keep Bank Rate unchanged at 0.5%. Having tightened policy in November, the committee unsurprisingly concluded that it was too early to make any firm conclusions about its impact on the economy. However, the members assessed that GDP growth in Q4 might be weaker than the 0.4%Q/Q pace seen in Q3. And although the latest CPI figures were slightly different from that forecast in November, they acknowledged that the inflation outlook has not changed materially. Meanwhile, the MPC also took note of the latest political events. First, it expected that the Autumn Budget policy announcements are likely to reduce the drag from fiscal policy on GDP growth. Second, MPC members welcomed the deal reached in the first phase of Brexit negotiations and suggested that it will support household and business confidence. We would not be so optimistic, expecting that near-term Brexit uncertainty will be reduced significantly only if and when a deal on the transitional period is concluded. And with regard to inflation, we think CPI might start falling next year more quickly than the BoE expects. So, while today the MPC maintained its forward guidance that monetary policy will have to be tightened further over coming years to bring inflation back to the target, we expect no change to policy in the short to medium term.

Retail sales boost is set to be temporary

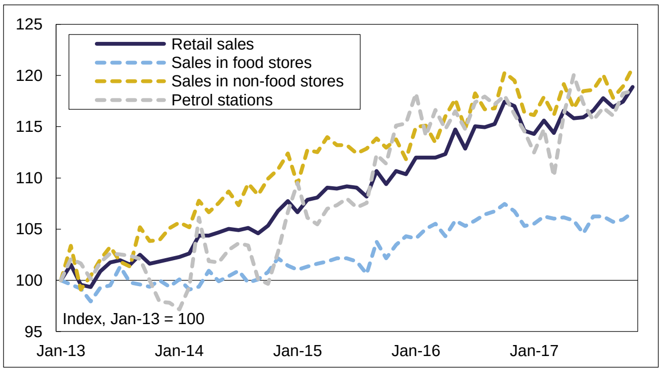
In contrast to the message from the labour market data yesterday, which showed a continuing decline in real wages and the biggest fall in employment in almost two-and-a-half years, today's figures from the retail sector surprised on the upside. In November, retail sales increased by 1.1%M/M, one of the strongest rates in the past couple of years. The growing prominence of Black Friday, which is a relatively new phenomenon in the UK, might be one of the reasons for the upward surprise, in particular given that household

Euro area: GDP and composite PMI



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

UK: Retail sales



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

goods, which seem to be most often targeted in the discounting period, showed the biggest increase of all (2.9%M/M). This left total non-food sales up by 1.5%M/M, while food sales rose at an also respectable 0.6%M/M pace. But on a three-month basis, growth in overall sales was lower at 0.8%3M/3M, down from 1.1%3M/3M in October. And we suspect that today's figures to some extent represent a shift in spending from other periods as more organized, discount-savvy, buyers made their Christmas purchases early. So, we expect to see some payback in the retail sales figures for December, which are likely to leave the quarterly pace of growth in Q4 broadly unchanged from Q3.

The day ahead in the UK

On a day bereft of major economic releases, attention will be on the European Council meeting where EU27 leaders will discuss the progress made in the Brexit negotiations. On the basis of the deal struck a week ago, they are expected to conclude that sufficient progress has been achieved to proceed to the second phase of the negotiations, which will first focus on agreeing the terms of the envisaged 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 (i.e. continued Single Market and Customs Union membership, continued ECJ jurisdiction and continued free movement and full compliance with EU trade policy, meaning that the UK will not be able to sign trade deals with other countries during that period), but with no voting rights in the European Council or any British MEPs. Only once a transition is agreed will thoughts turn to the future trading arrangements. However, with the UK government yet to spell out the details of the future relationship it would like to build, negotiations will not begin in earnest until after the end-March European Council, and then only if the UK Government has articulated what sort of future trade deal it is seeking.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	EU27 new car registrations Y/Y%	Nov	**5.9**	-	5.9	-
	Preliminary manufacturing PMI	Dec	**60.6**	59.7	60.1	-
	Preliminary services PMI (preliminary composite PMI)	Dec	**56.5 (58.0)**	56.0 (57.2)	56.2 (57.5)	-
	ECB refinancing rate %	Dec	**0.00**	*0.00*	0.00	-
	ECB deposit rate %	Dec	**-0.40**	*-0.40*	-0.40	-
Germany	Preliminary manufacturing PMI	Dec	**63.3**	62.0	62.5	-
	Preliminary services PMI (preliminary composite PMI)	Dec	**55.8 (58.7)**	54.6 (57.2)	54.3 (57.3)	-
France	Final EU-harmonised CPI Y/Y%	Nov	**1.2**	*1.3*	1.2	-
	Preliminary manufacturing PMI	Dec	**59.3**	57.2	57.7	-
	Preliminary services PMI (preliminary composite PMI)	Dec	**59.4 (60.0)**	60.0 (59.6)	60.4 (60.3)	-
Italy	Final EU-harmonised CPI Y/Y%	Nov	**1.1**	*1.1*	1.1	-
Spain	Final EU-harmonised CPI Y/Y%	Nov	**1.8**	*1.7*	1.7	-
UK	RICS house price balance %	Nov	**0**	0	1	-
	Retail sales excluding petrol M/M% (Y/Y%)	Nov	**1.2 (1.5)**	0.4 (0.2)	0.1 (-0.3)	**0.4 (0.0)**
	Retail sales including petrol M/M% (Y/Y%)	Nov	**1.1 (1.6)**	0.4 (0.3)	0.3 (-0.3)	**0.5 (-)**
	BoE Bank Rate %	Dec	**0.50**	*0.50*	0.50	-

Auctions

Country	Auction
Spain sold	€1.0bn of 0.05% 2021 bonds (31-Jan-2021) at an average yield of -0.005%
	€1.2bn of 1.45% 2027 bonds (31-Oct-2027) at an average yield of 1.488%
	€893m of 5.75% 2032 bonds (30-Jul-2032) at an average yield of 1.943%

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	Trade balance €bn	Oct	24.3	25.0

Auctions

Country		GMT	Auction / Event
UK		13:15	BoE's Haldane scheduled to speak in Italy

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope