Euro wrap-up

Overview

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- Bunds were little changed despite a weaker than expected German Q3 GDP release. BTPs continued to make losses as the Italian government defied the Commission's request to revise its budgetary plan.
- Gilts made very modest gains as markets awaited the outcome of the UK Cabinet's vote on the Withdrawal Agreement text.
- Tomorrow brings euro area trade and new car registrations figures, as well as UK and US retail sales data.

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.568	+0.001
OBL 0 10/23	-0.193	-0.011
DBR 0¼ 08/28	0.401	-0.008
UKT 2 07/20	0.790	-0.007
UKT 0¾ 07/23	1.071	-0.013
UKT 1⅝ 10/28	1.512	-0.008

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

Euro area

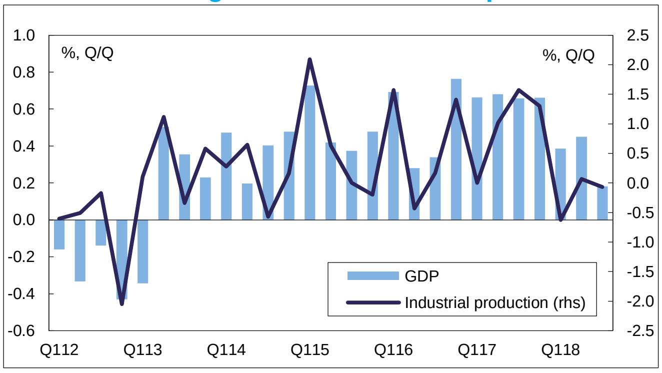
Euro area GDP growth confirmed at 0.2%Q/Q

There were no major surprises from today's euro area GDP report, with growth in Q3 confirmed at the preliminary estimate of 0.2%Q/Q, half the quarterly rate in the first half of the year and a notable step down from the quarterly expansion of 0.7% in 2017 and the weakest pace for more than four years. So, the annual rate of growth slowed to 1.7%Y/Y, from 2.2%Y/Y previously. There remains no expenditure breakdown, but national releases suggest net trade remained a drag. Certainly, from a sectoral perspective, today's IP report, which showed a drop in production of 0.3%M/M in September, underlined that the industrial sector continued to represent the principal cause of the slowdown in economic output through 2018. Indeed, industrial production contracted for the second quarter out of the past three in Q3, declining 0.1%Q/Q. And, at the end of Q3, the level of output was 0.8% lower than the end of 2017, a marked step down from the increase of 3½% in H217. And surveys so far in Q4, including the Commission's and the PMIs, point to a continued subdued near-term outlook for the industrial sector. Against the backdrop of slowing growth, it was not surprising to see a more limited rise in employment over the third quarter. In particular, employment rose just 0.2%Q/Q, the softest increase for 14 quarters and about half the pace of the past eight quarters. Nevertheless, the 314k increase in the number of people in employment in Q3 took the level to a new series high just above 158mn, up 9½mn from the post-crisis trough of Q213 and almost 4mn above the pre-crisis peak more than a decade ago. And although the composite employment PMI slipped back slightly at the start of Q4, it still remains consistent with ongoing steady jobs growth.

German economy contracts for first time in 3½ years

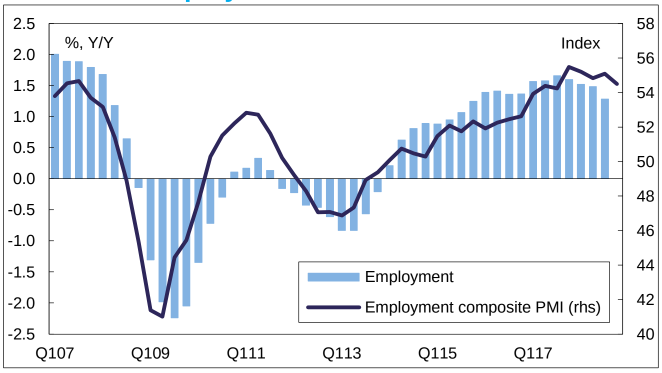
While recent monthly indicators out of Germany had implied a much weaker economic performance in Q3, today's GDP release came in at the lower end of expectations. GDP declined 0.2%Q/Q in Q3, the first quarterly contraction since Q115 and the steepest decline in 5½ years. This left the annual pace of growth easing to just 1.1%Y/Y, from 2.0%Y/Y previously. While we won't see an official expenditure breakdown until 23 November, Germany's statistics agency attributed the decline mainly to net trade, with exports down following growth of 0.7%Q/Q in Q2, while imports rose again, having posted a notable 1.7%Q/Q increase in Q2. Developments in domestic demand were mixed, with household consumption reportedly having declined for the first time since the end of 2013. In contrast, investment growth was again higher in Q3, to mark the ninth consecutive quarterly increase. Overall, GDP growth in the euro area's largest member state appears to have been affected by one-off factors – i.e. weakness in the automotive industry caused by a change in emission testing standards, as well as logistical disruptions in other sectors due to low water levels of the river Rhine. But while we would expect a somewhat

Euro area: GDP growth and industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Employment*



**Q418 PMI reading is based on October's survey. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

stronger pace of growth in Q4, recent survey indicators have maintained the downward trend seen throughout 2018, so far suggesting only limited, if any, recovery in the final quarter of the year.

Italy defies Commission's request

In keeping with the belligerent attitude of the Italian coalition government to the European Commission, the government's response to the Commission's calls for a revised fiscal plan came late in the day yesterday and, perhaps unsurprisingly, provided nothing new with respect to the headline numbers. Indeed, Italian Economy Minister Tria confirmed that the government would stick with its decision to embark on higher spending in a bid to kick-start Italy's economy. So, while defending the government's excessively optimistic GDP growth forecast of 1.5% next year (yesterday's IMF article IV provided a growth forecast of 1% in 2019, which we consider generous), he also stuck with the planned surge in the budget deficit forecast, 2.4% of GDP in 2019 (again this is a conservative estimate compared with the Commission and IMF). So, when the Commission publishes another Opinion on the plans on 21 November, it will likely reiterate its previous criticisms, noting again the budgetary plan represented a 'significant deviation' from what was required under the EU rules. So the confrontation will likely persist, with a formal disciplinary procedure, which theoretically might eventually lead to the imposition of fines on Italy, likely to be launched in due course. We do not, however, expect any significant progress, at least not until next spring's European Parliament elections are well out of the way.

The day ahead in the euro area and US

It should be a quieter day in the euro area, with perhaps the most notable release new car registrations figures for October, which should report some payback for the 23½%Y/Y decline recorded in September. Euro area trade data for September are also due and expected to report a drop in export values at the end of Q3. In addition, ECB Executive Board members Cœuré, Praet and de Guindos are due to speak at separate events.

In the US, the data focus tomorrow will be October retail sales, with expectations for a notable pickup at the start of Q4, underpinned by stronger vehicle sales and post-hurricane-related spending. Thursday will also bring the Empire Manufacturing and Philly Fed indices for November, import price data for October and weekly jobless claims figures.

UK

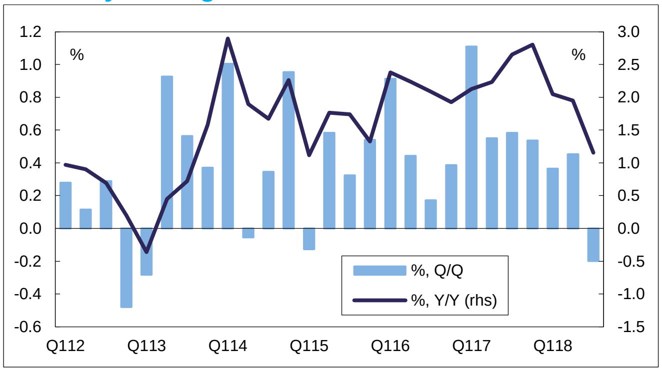
Cabinet considering Withdrawal Agreement

After EU and UK negotiators yesterday reached agreement on the text of the Withdrawal Agreement, at the timing of writing Prime Minister May's Cabinet was in a meeting to vote on this agreement. However, ahead of the meeting, while some reports suggested that a couple of Cabinet ministers might resign in protest, it appeared that key figures – including Dominic Raab – supported the agreement. So, if May succeeds in getting it approved, EU ministers could well give the green light for a special EU leaders' summit later this month (possibly 25 November), where the EU27 leaders will consider what the negotiating teams produced, in particular the text relating to the Irish border backstop where some countries apparently have some concerns. But the main obstacle will be the UK parliament, where it remains highly uncertain whether May will garner enough support. And if Parliament rejects this deal, then it will be back to the drawing board, with little time left to agree a different approach and with a Government holed below the waterline.

Inflation remained stable in October

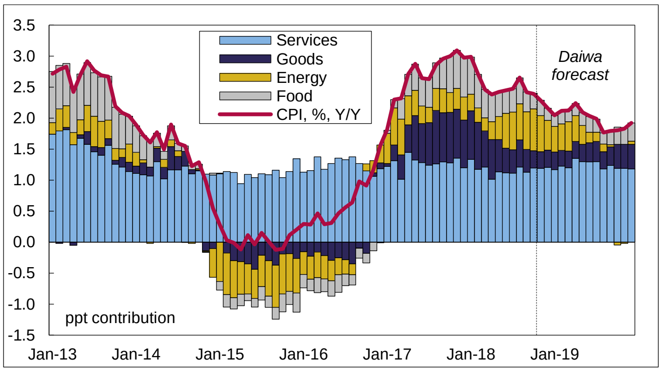
While yesterday's labour market data were consistent with growing domestic inflationary pressures, the message of today's inflation release was somewhat different. In line with our expectations, the headline CPI rate remained unchanged at 2.4%Y/Y in October, slightly lower than the forecast incorporated in the BoE's Inflation Report at the start of this month. Within the

Germany: GDP growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

detail, the major components provided offsetting contributions. Food inflation eased to a twenty-month low of 1.8%Y/Y, but energy inflation rose further and reached double-digits for the first time since early 2012. Indeed, in October, the price of auto fuel was 0.7% more expensive compared with September, while an increase in gas and electricity tariffs at major retail energy providers pushed inflation in this category also significantly higher. Excluding energy, however, goods inflation eased below 1.0%Y/Y for the first time since February 2017, driven mainly by cars, clothing and footwear prices. Overall, lower goods inflation was consistent with the diminishing effect of past sterling depreciation. Services inflation, meanwhile, strengthened and returned to the 2.5%Y/Y rate previously seen in August. So, core inflation was also unchanged in October at 1.9%Y/Y. Going forward, underlying inflationary pressures will be driven by how wage growth evolves relative to productivity. If the current trend of faster wage growth continues, while productivity remains subdued, domestic inflationary pressures might keep headline CPI elevated above the 2% target for a while yet. But at the same time, the oil price will likely provide a notable disinflationary impact on inflation over the near term. And much will depend on what happens on the Brexit front and the associated impact on sterling. We currently expect the headline rate to remain above the BoE's target in the first half of next year.

The day ahead in the UK

The data focus in the UK tomorrow will be October retail sales. While retail sector surveys have signalled a soft start to the fourth quarter, expectations are for a modest pickup in sales (0.2%M/M) in October albeit not enough to offset the decline seen in September. Supply-wise, the DMO will sell longer-dated (2037) Gilts.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	GDP - second estimate Q/Q% (Y /Y)	Q3	**0.2 (1.7)**	*0.2 (1.7)*	0.4 (2.2)	-
	Industrial production M/M% (Y/Y%)	Sep	**-0.3 (0.9)**	-0.4 (0.3)	1.0 (0.9)	**1.1 (1.1)**
	Employment Q/Q% (Y/Y%)	Q3	**0.2 (1.3)**	-	0.4 (1.5)	-
Germany	GDP - first estimate Q/Q% (Y/Y)	Q3	**-0.2 (1.1)**	*0.0 (1.4)*	0.5 (2.3)	-
France	Final EU-harmonised CPI Y/Y%	Oct	**2.5**	2.5	2.5	-
Spain	Final EU-harmonised CPI Y/Y%	Oct	**2.3**	2.3	2.3	-
UK	CPI (core CPI) Y/Y%	Oct	**2.4 (1.9)**	*2.4 (1.9)*	2.4 (1.9)	-
	Input (output) PPI Y/Y%	Oct	**10.0 (3.3)**	9.6 (3.1)	10.3 (3.1)	**10.5 (-)**
	UK House Price Index Y/Y%	Sep	**3.5**	3.2	3.2	**3.1**

Country	Auction
Germany sold	€1.2bn of 1.25% 2048 bonds (15-Aug-2048) at an average yield of 1.04%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	07:00	EU27 new car registrations Y/Y%	Oct	-	-23.5
	10:00	Trade balance €bn	Sep	16.3	16.6
UK	09:30	Retail sales excluding auto fuel M/M% (Y/Y%)	Oct	0.2 (3.4)	-0.8 (3.2)
	09:30	Retail sales including auto fuel M/M% (Y/Y%)	Oct	0.2 (2.8)	-0.8 (3.0)

Country	GMT	Auction / Event
EMU	12:15	ECB's Cœuré scheduled to speak in Basel
	13:10	ECB's Praet scheduled to speak in Brussels
	14:34	ECB's Vice President de Guindos scheduled to speak in Frankfurt
UK	10:30	Auction: to sell £2bn of 1.75% 2037 bonds (07-Sep-2037)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

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