Europe | Economic Research | 11 December 2018

Euro wrap-up

Overview

- Bunds made gains but OATs made losses after President Macron announced measures to placate the Gilets Jaunes protestors.
- Despite a further pickup in UK wage growth, Gilts were little changed as Theresa May sought the help of EU leaders to sell her Brexit deal to UK MPs amid rumours of an imminent challenge to her leadership.
- Ahead of Thursday's ECB announcement and EU summit, tomorrow will see Theresa May visit Dublin and bring euro area IP data.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.595	-0.019
OBL 0 10/23	-0.295	-0.013
DBR 0¼ 08/28	0.235	-0.010
UKT 2 07/20	0.703	+0.003
UKT 0¾ 07/23	0.835	+0.011
UKT 1⅝ 10/28	1.201	+0.003

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

Euro area

OATs underperform as Macron seeks to appease protesters

Having already written off plans to increase fuel taxes, French President Macron yesterday evening announced a range of additional fiscal measures – including a €100 per month increase in the minimum wage, encouragement for firms to pay tax-free end-year bonuses, the removal of tax on overtime payments and a cancellation of the planned increase in Contribution Sociale Généralisée (CSG) social security payments on pensions of less than €2000 per month – to appease the Gilets Jaunes demonstrators. In response, today OATs underperformed other euro area sovereign bonds. A government junior minister suggested that, without public expenditure savings elsewhere, the cost of the measures would be between €8-10bn (roughly 0.4% of GDP). But, particularly with the economic outlook having recently deteriorated, the full cost might eventually be larger than that, with the likely effect of pushing the government deficit well above 3% of GDP, from the 2.8% level planned in the draft budget. With the European Commission having already flagged risks of 'non-compliance' with the EU's budgetary rules next year, its response to Macron's initiative will be watched. An exemption for France to exceed the 3% Stability and Growth Pact limit on a temporary basis at a time of intensified structural reform might be merited. But that would also serve to embolden Italy's Government as it continues its own dispute with the European Commission over its plans for a budget deficit of more than 2% of GDP.

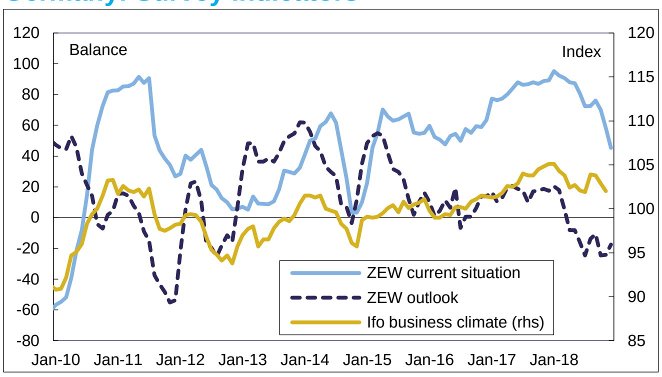
French employment growth slows, real wages decline

The recent loss of momentum in the French economy was reflected in today's dataflow as the rise in private sector employment in Q3 was confirmed to be less than originally thought. The increase of 22.4k left private sector payrolls up just 0.1%Q/Q (matching the weakest quarterly rate in three years) and 197k and 1.0% higher compared with Q317 (the weakest annual rate since 2016). There was also a further drop in public sector payrolls, down for the fourth quarter out of the past five to leave them 0.4% (22k) lower than a year earlier. Within the sectoral breakdown, payroll employment fell again in the manufacturing sector to its lowest level in a year. But employment in construction rose to the highest level since Q414 and, excluding temporary workers, service sector payrolls rose too. Against this mixed backdrop, however, average monthly wage growth slowed to 0.3%Q/Q in Q3, to leave the year-on-year increase unchanged at 1.5%, implying a real-terms decline of 0.7%Y/Y, perhaps one factor behind the recent deterioration in consumer sentiment and broader social discontent.

Another downbeat sentiment survey

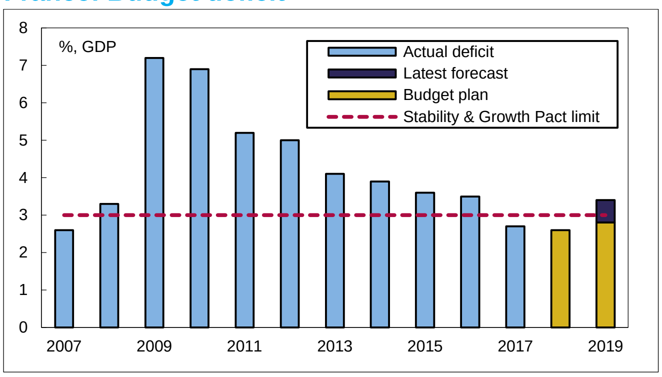
Of course, recent sentiment surveys have shown a deterioration in confidence among consumers and businesses across several member states. Today's ZEW survey revealed a further worsening of investor sentiment in December, with the

Germany: Survey indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

France: Budget deficit



Source: Thomson Reuters, French Ministry of Finance, and Daiwa Capital Markets Europe Ltd.

indicator of current German economic conditions declining for the third successive month to the lowest level since January 2015. And while the survey measure of future expectations rose, it remained close to the average of the past six months, and near the bottom of the range of the past six years. The flash PMIs due Friday, and the Ifo survey due one week today, will provide a better guide to the strength of German business activity heading towards year-end.

The coming two days in the euro area and US

Wednesday should be relatively quiet with October's industrial production report most notable. However, we already know that output fell in Germany, posted solid gains in France and Spain, and remained little changed in Italy, so aggregate euro area IP was likely broadly flat on the month following a dip of 0.3%M/M previously.

While no data are scheduled for release on Thursday, it will bring the main event of the week with the conclusion of the ECB's latest policy meeting. This will give Draghi an opportunity to acknowledge the recent deterioration in the performance of the euro area economy, not least as the Governing Council will discuss new Eurosystem macroeconomic projections, which will incorporate a view about 2021 for the first time. Since the last projections were published in September, Q3 GDP data surprised significantly on the downside, with euro area growth of just 0.2%Q/Q representing the weakest quarter since 2013 and just half the ECB's central forecast. Most surveys have suggested a further loss of momentum in Q4 while the global outlook appears to have clouded too. So, while the lower oil price and French fiscal easing might be expected to provide some extra support to demand next year, the ECB's central euro area GDP growth forecasts will need to be revised down from 2.0%, 1.8% and 1.7% in 2018, 2019 and 2020 respectively. Core inflation has also recently come in weaker than policymakers had expected. And so, given also the marked decline in oil prices and softer growth outlook, despite a pickup in labour cost growth, the ECB will also need to revise down its forecasts for headline inflation from 1.7% in each year from 2018 to 2020.

Recognition from Draghi that the economic outlook has deteriorated somewhat, and that the external risks to the outlook are skewed to the downside, would suggest an increased probability that the ECB will not manage to raise rates at all in 2019. Nevertheless, on this occasion, the ECB would seem unwilling to amend significantly its main forward guidance, likely restating that its key interest rates are expected "to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary". And certainly, the ECB is bound to confirm the end of net asset purchases at the end of this month. However, as it has been reviewing its reinvestment policy, greater flexibility might be introduced into the rules governing that process. The ECB might also provide a reminder that maturing proceeds will be reinvested in full until rates have been hiked to well above current levels. And the recent revisions to the capital key will have no significant impact. Finally, Draghi might signal that, over coming months, the ECB will review options regarding its liquidity provision, not least given the need, by June 2019, to announce new very long-term refinancing operations to mitigate the impact of the scheduled redemptions of loans conducted under the first TLTRO-II operation.

Beyond the ECB, the latest European Council meeting will kick off on Thursday with heads' discussions to include a first exchange of views on the next EU budget.

In the US, price indicators will be the main data focus of the coming two days. The CPI report for November is due on Wednesday – the expected 0.2%M/M increase in the core measure would likely nudge the respective annual inflation rate back up 0.1ppt to 2.2%Y/Y. Export and import price figures for the same month are due Thursday. Among other new data, the November monthly budget statement is due on Wednesday, with the following day bringing the latest weekly claims numbers. In the markets, the Treasury will sell 10Y notes on Wednesday and 30Y bonds on Thursday.

UK

May's whistle-stop tour won't deliver substantive change

Having ducked the Brexit 'meaningful vote' in the House of Commons previously scheduled for this evening, ahead of Thursday's EU summit, Theresa May today conducted a whistle-stop tour of European capitals. In particular, she visited Dutch PM Rutte, German Chancellor Merkel, Commission President Juncker and EU President Tusk, begging for help to sell her deal to UK MPs if and when she decides to try again to seek parliamentary approval. A further (or amended) political declaration clarifying the scope of the contentious 'backstop' – aimed at avoiding a hard border in Ireland – and stating that neither side in the negotiations wishes it ever to come into force, might yet be forthcoming. But this would be merely cosmetic rather than substantive from a policy perspective. Indeed, there will be no change made to the Withdrawal Agreement. And so, whatever May can achieve now would seem highly unlikely to shift the balance of opinion among MPs. While the PM's spokesperson (who might now be little trusted) today suggested that the 'meaningful vote' would be held before 21 January, it could legitimately be held later than that, although time would then be very short to adopt the additional legislation required to enact the Withdrawal Agreement ahead of Brexit day on 29 March. And since we do not expect sufficient numbers of MPs to change their minds about May's deal before then, while rumours persist that May will imminently face a vote of no confidence in her Conservative Party leadership, Brexit uncertainty seems likely to ramp a notch higher in the New Year.

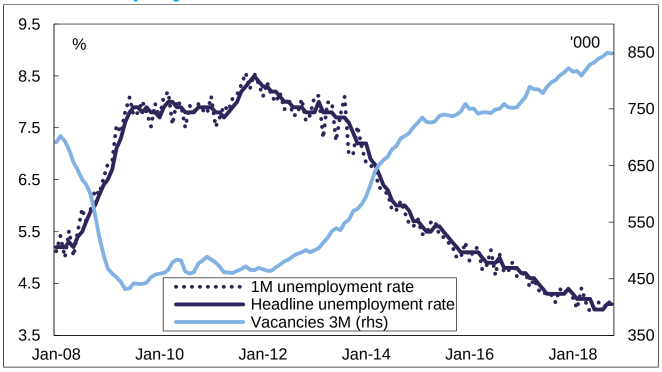
Wage growth maintains uptrend

While economic growth momentum has moderated significantly since the summer, the number of people in work continued to rise in the three months to October, with the 79k3M/3M rise the biggest in five months taking the employment rate back up to 75.7%, matching the series high. With the number of people out of work up 20k, however, the unemployment rate remained unchanged at 4.1% over that three-month period, with the same rate achieved on a single-month basis in October too. Nevertheless, the level of vacancies remained within a whisker of the series high, with firms seemingly demonstrating a preference for hiring new workers over investing in new physical capital. And with the labour market tight, growth in average weekly labour earnings rose to new decade highs of 3.3%3M/Y whether including or excluding bonuses. With those figures pointing to a pickup in domestically generated price pressure, we maintain our view that the BoE will raise Bank Rate in Q3 next year as long as the UK avoids a disorderly no-deal Brexit.

The coming two days in the UK

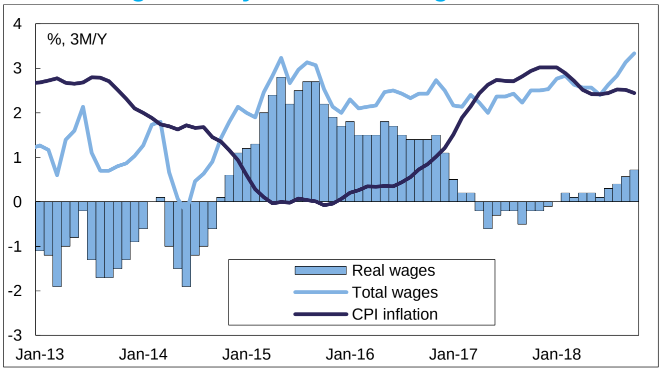
Theresa May continue her desperate tour of European capitals with a visit to Dublin on Wednesday for a meeting with Taoiseach Leo Varadkar before heading to the EU Summit on Thursday. Data-wise, Wednesday will be free of top-tier economic releases while Thursday will bring only the RICS residential property market survey for November. In the bond market, the DMO will sell 30Y index-linked Gilts on Wednesday.

UK: Unemployment rate and vacancies



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Average weekly labour earnings



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

In the absence of significant news, the next edition of the Euro wrap-up will be published on 13 December 2018.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		ZEW expectations indicator	Dec	**-21.0**	-	-22.0	**-**
Germany		ZEW current situation (expectations) indicator	Dec	**45.3 (-17.5)**	55.0 (-25.0)	58.2 (-24.1)	**-**
France		Total payroll employment (wages) Q/Q%	Q3	**0.1 (0.3)**	0.2 (0.3)	0.0 (0.4)	**0.1 (-)**
UK		Claimant count rate % (change '000s)	Nov	**2.8 (21.9)**	-	2.7 (20.2)	**- (23.2)**
		Average weekly earnings (excl. bonuses) 3M/Y%	Oct	**3.3 (3.3)**	*3.0 (3.2)*	3.0 (3.2)	**3.1 (-)**
		ILO Unemployment rate 3M%	Oct	**4.1**	*4.1*	4.1	**-**
		Employment change 3M/3M '000s	Oct	**79**	*20*	23	**-**
Country		Auction					
Germany sold		€2.4bn of 0% 2020 (11-Dec-2020) at an average yield of -0.58%					

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	Industrial production M/M% (Y/Y%)	Oct	0.1 (0.7)	-0.3 (0.9)
Country		GMT	Auction / Event			
UK		10:30	Auction: to sell £500mn of 0.125% 2048 index-linked bonds (10-Aug-2048)			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Thursday's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		12:45	ECB Main Refinancing rate %	Dec	*0.00*	0.00
		12:45	ECB Marginal Lending Facility rate %	Dec	*0.25*	0.25
		12:45	ECB Main Deposit rate %	Dec	*-0.40*	-0.40
Germany		07:00	Final EU-harmonised CPI Y/Y%	Nov	2.2	2.4
France		07:45	Final EU-harmonised CPI Y/Y%	Nov	2.2	2.5
UK		00:01	RICS house price balance %	Nov	-9	-10
Country		GMT	Auction / Event			
EMU		13:30	ECB Draghi's post-meeting press conference and publication of ECB's macroeconomic projections			
		-	Two-day European Council summit starts			
Italy		10:00	Auction: Italy to sell bonds			
Spain		09:30	Auction: Spain to sell bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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