

Euro wrap-up

Overview

- Bunds made modest gains at the shorter end of the curve as the ECB judged that the balance of risks to the economic outlook is moving to the downside.
- Gilts made modest losses as Theresa May sought reassurances from the EU regarding the Brexit backstop arrangements.
- Friday's data highlight will be the December flash PMIs, while the Euro Summit will discuss policies to strengthen the euro area.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.583	-0.019
OBL 0 10/23	-0.271	-0.019
DBR 0¼ 08/28	0.283	+0.004
UKT 2 07/20	0.775	+0.029
UKT 0¼ 07/23	0.916	+0.024
UKT 1½ 10/28	1.289	+0.010

*Change from close as at 4.30pm GMT.

Source: Bloomberg

Euro area

A slightly more dovish ECB

There were no surprises whatsoever from today's ECB monetary policy announcement. Having been signalled long in advance, the Governing Council confirmed that its net asset purchases will be brought to a conclusion at the end of this month. But, at the same time, it enhanced its forward guidance on reinvestment, stating in particular that it "intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates". We have significant doubts, however, that anyone in the markets really thought the ECB would decide to phase out its reinvestments sooner than that. Meanwhile, the ECB's forward guidance on rates was left unchanged, restating that its key rates are expected "to remain at their present levels at least through the summer of 2019". But there was still a slightly more dovish tone to the post-meeting press conference, as Draghi announced modest downwards revisions to the near-term outlook for economic growth and inflation, and judged that the balance of risks is moving to the downside due to a range of external factors.

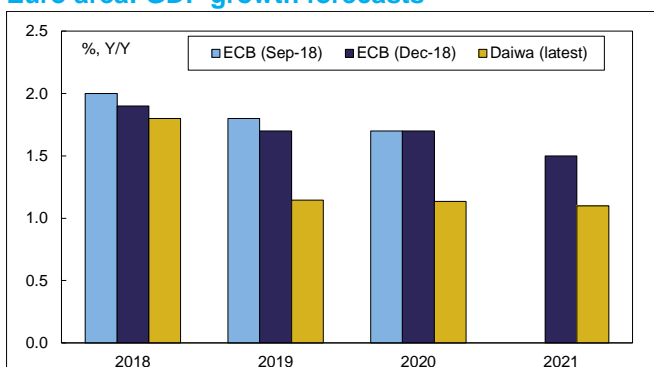
Revisions to ECB 2019 forecasts don't go far enough

The ECB was, however, still sanguine about prospects for domestic demand. And so it revised down its GDP growth forecasts for 2018 and 2019 by just 0.1ppt to 1.9%Y/Y and 1.7%Y/Y. On a quarterly basis, that still represents a pickup from 0.2%Q/Q in Q318 to 0.4%Q/Q in the current quarter and a further acceleration to 0.5%Q/Q in the first three quarters of 2019 – in our view an implausibly strong performance at a time of deteriorating economic confidence. Given recent weakness in underlying inflation, sharp declines in oil prices and softer growth, the ECB's forecast for headline CPI was also revised down by 0.1ppt next year to 1.5%Y/Y, while its outlook for core CPI was also nudged lower, by 0.1ppt next year to 1.4%Y/Y and 0.2ppt to 1.6%Y/Y in 2020. The Governing Council continued to expect, however, that inflation will return over the medium term to its target of below but close to 2.0%Y/Y, projecting headline and core inflation rates of 1.8%Y/Y in 2021. Like for GDP, however, we think those inflation forecasts are overoptimistic, which is why we don't expect the ECB to be able to raise rates in 2019, a prospect that – as Draghi acknowledged – has become increasingly reflected in market pricing.

Capital key revisions to have little effect, work to start on liquidity operations

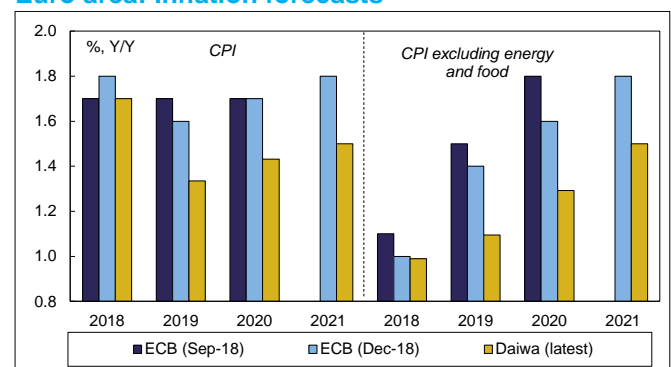
In addition to the enhanced forward guidance, the ECB also today confirmed new guidelines governing its reinvestments. In particular, it agreed that as "a rule... redemptions will be reinvested in the jurisdiction in which principal repayments are made, but the portfolio allocation across jurisdictions will continue to be adjusted with a view to bringing the share of the PSPP

Euro area: GDP growth forecasts*



*NB: ECB forecasts for 2021 were published for the first time in December 2018. Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts*



*NB: ECB forecasts for 2021 were published for the first time in December 2018. Source: ECB and Daiwa Capital Markets Europe Ltd.



portfolio into closer alignment with the ... [recently revised] ECB capital key". Those adjustments will be gradual and calibrated "to safeguard orderly market conditions". As such, we expect little significant market impact although note that the decision should over time support at the margin a modest and gradual reallocation of holdings away from BTPs (and to a lesser extent Bonos) for which the ECB's holdings currently exceed the amounts implied by the capital key, towards Portuguese government bonds where the opposite is true. Finally from a policy perspective, as we expected, the Governing Council tasked the relevant ECB committees with reviewing policy 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 programme.

The day ahead in the euro area and US

Data-wise, Friday will bring the most notable euro area releases of the week with the December flash PMIs. If, as we expected, the euro area composite PMI comes in close to November's reading of 52.7, the Q4 average will be the weakest since 2014 strongly suggestive of another subdued quarter of GDP growth. Q3 labour cost figures will also be watched by the ECB. Euro area new car registration data for November are also due. And after today's final November inflation figures from Germany and France matched the flash estimates, both 2.2%Y/Y on the EU harmonised measure, tomorrow will also bring the final estimates from Italy and Spain. Meanwhile, the Euro Summit will discuss measures to strengthen the policy framework of the euro area including banking union, reforms to the ESM bailout fund, and possible new budgetary instruments.

In the US, the retail sales and IP reports for November will cast further light on how activity is tracking during Q4. The headline retail figure is likely to come in on the soft side weighed by a slowing of new auto sales and lower prices of gasoline, although a decent showing around the Thanksgiving Holiday should provide some support. The IP data should reveal a sixth successive monthly increase in manufacturing output. October business inventory data and the little-followed flash December PMIs will also be released on Friday.

UK

EU reassurances unlikely to shift opinion in the Commons

Having survived yesterday evening's confidence vote with the backing of less than two thirds of her party's MPs, Theresa May flew to Brussels today safe in the knowledge that she now has a twelve-month window free of challenge from within her party, but with her authority further diminished. Having pulled Tuesday's meaningful vote in the face of significant defeat, she today sought help from other EU leaders in the hope that might swing the balance of opinion in Parliament in the New Year. But while the PM was hoping to gain legally-binding guarantees about the nature of the controversial 'backstop' arrangements, the draft conclusions prepared for the Summit suggested that the other leaders would only give her non-binding reassurances. Among other things, they looked set to note that implementation of the backstop would not be "a desirable outcome" for the EU but would be a necessary "insurance policy"; the backstop would only apply for a short period; and there would be "full determination" to replace the backstop by end-2020 with alternative trade arrangements. But, crucially, there was unanimous agreement among the member states not to reopen the Withdrawal Agreement for renegotiation. And so, the final conclusions to be agreed tonight looked highly unlikely to shift in a significant way the views of the large swathe of Tory MPs who voted against the PM yesterday or the Northern Irish DUP MPs upon whom May also relies for her Parliamentary majority. So, May seems highly likely to remain on track for defeat if and when the House of Commons eventually holds its meaningful vote in the New Year. (See our [comment](#) issued following last night's result for further discussion of the confidence vote.)

RICS housing survey adds to a weakening picture

On another quiet day for UK economic data, the only new report of note was the RICS residential market survey for November. And in keeping with the wide range of evidence of a loss of momentum right across the UK economy since the summer, the RICS survey suggested a continued softening trend in sales activity, with the indicator for newly agreed sales down 5pts to an eight-month low of -15%, the net balance for new buyer enquiries declining to a fourteen-month low of -21%, and the new instructions balance falling to a more than two-year low of -24%. Most regions reported subdued activity, with Brexit uncertainty cited as a cause, while the respective forward-looking indicators all pointed to further weakening over the near term too. Against that backdrop, it's no surprise that the headline price net balance also edged lower, to a six-year low of -11%, consistent with a modest fall in house prices at the national level and the steepest declines still in London. Near-term price expectations were more negative still (a net balance of -25%, the weakest since the Brexit referendum) although the outlook for prices twelve months ahead currently is assessed to be subdued but stable.







The day ahead in the UK

Friday in the UK will be dominated by political reaction to the outcome of today's EU summit discussion on Brexit. There are no notable data due for release.

European calendar

Today's results



Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 ECB Main Refinancing rate %	Dec	0.00	<u>0.00</u>	0.00	-
	 ECB Marginal Lending Facility rate %	Dec	0.25	<u>0.25</u>	0.25	-
	 ECB Main Deposit rate %	Dec	-0.40	<u>-0.40</u>	-0.40	-
Germany	 Final EU-harmonised CPI Y/Y%	Nov	2.2	2.2	2.4	-
France	 Final EU-harmonised CPI Y/Y%	Nov	2.2	2.2	2.5	-
UK	 RICS house price balance %	Nov	-11	-9	-10	-
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Industrial production M/M% (Y/Y%)	Oct	0.2 (1.2)	0.1 (0.7)	-0.3 (0.9)	-0.6 (0.8)
Country	Auction					
UK sold	 £500mn of 0.125% 2048 index-linked bonds (10-Aug-2048) at an average yield of -1.687%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
EMU	07:00	EU27 new car registrations Y/Y%	Nov	-	-7.3
	08:30	Preliminary manufacturing PMI	Dec	51.8	51.8
	08:30	Preliminary services PMI (preliminary composite PMI)	Dec	53.4 (52.8)	53.4 (52.7)
	10:00	Labour costs Y/Y%	Q3	-	2.2
Germany	08:30	Preliminary manufacturing PMI	Dec	51.7	51.8
	08:30	Preliminary services PMI (preliminary composite PMI)	Dec	53.5 (52.4)	53.3 (52.3)
France	08:15	Preliminary manufacturing PMI	Dec	50.7	50.8
	08:15	Preliminary services PMI (preliminary composite PMI)	Dec	54.8 (54.0)	55.1 (54.2)
Italy	10:00	Final EU-harmonised CPI Y/Y%	Nov	1.7	1.7
Spain	08:00	Final EU-harmonised CPI Y/Y%	Nov	1.7	2.3
Country	GMT	Auction / Event			
EMU	08:15	ECB's Guindos scheduled to speak in Frankfurt			
	09:30	ECB's Lautenschlaeger scheduled to speak in Frankfurt			
	-	Two-day European Council summit concludes with the Euro summit			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

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