Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest gains at the longer end of the curve as Italian and Spanish IP data were significantly weaker than expected.
- Gilts made losses and sterling rose on reports that Brexit will likely be postponed beyond end-March and UK GDP data beat expectations.
- The coming week brings data on euro area IP and inflation, German GDP, and UK inflation and retail sales, as well as the House of Commons meaningful vote on Brexit.

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.584	+0.005
OBL 0 10/23	-0.351	-0.003
DBR 0¼ 02/29	0.237	-0.018
UKT 2 07/20	0.804	+0.031
UKT 0¾ 07/23	0.947	+0.030
UKT 1⅝ 10/28	1.288	+0.014

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

Euro area

More IP woes from Italy and Spain

The November industrial production figures from Germany and France released earlier this week were dire, with declines in manufacturing output well in excess of 1.0%M/M leaving the annual rates for both countries at their weakest for more than five years. And today's figures from Italy and Spain were similarly weak. In Italy, industrial production fell 1.6%M/M, the most since July, to leave the October-November average down 0.2% from the Q3 average. And in Spain it fell 1.5%M/M, the most since April, to leave the average for Q4 so far little changed from the previous quarter. In both countries, production fell 2.6%Y/Y, the biggest annual declines since 2013. Given these results and the data from Germany and France, euro area industrial production (for which the figures are due on Monday) looks set to have declined in November by 1½%M/M or more, which would represent the biggest drop since February 2016. While fundamentals in the sector have doubtless deteriorated, the extent of that decline looks to have been exacerbated by special factors, not least calendar effects including the timing of the All Saints Day holiday. And so, we fully expect a rebound in December. But with the euro area manufacturing PMI having declined last month to its lowest level since February 2016 and new orders reportedly declining, the extent of the bounce back might well prove limited. Therefore, the euro area industrial sector looks firmly on track to post a decline over Q4 as a whole.

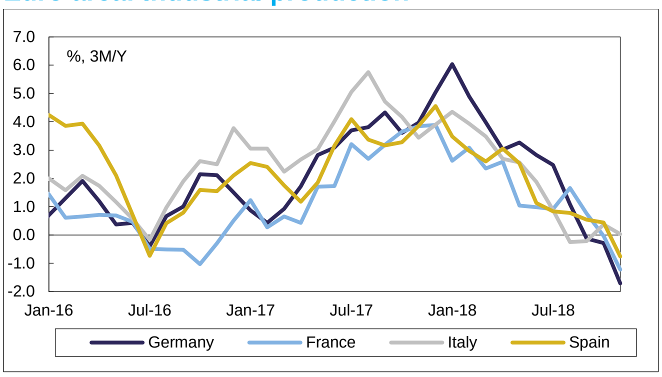
A better French business survey

Most recent French economic confidence indicators have been very downbeat, with the composite PMI in contraction territory and consumer confidence plunging in December. However, the Bank of France's business sentiment survey for December, released today, pointed to an improvement in the industrial sector towards year-end, with the respective index rising 2pts to a three-month high of 103 in the final month of last year. That tallies with our expectation of a rebound in output last month after the steep drop in November. But while today's survey suggested that new orders in the sector picked up too, it also pointed to weaker output in January. The Bank of France report also suggested that services sector sentiment remained firm, with the respective index unchanged at 102 for a sixth consecutive month, despite weakness in hospitality no doubt related to the Gilets Jaunes unrest. And construction firms were reportedly still upbeat, with the respective index stable at 105 in line with its average in 2018. Overall, therefore, the Bank of France judged that its survey was consistent with French GDP growth in Q4 of 0.2%Q/Q – bang in line with our own forecast.

The week ahead in the euro area and US

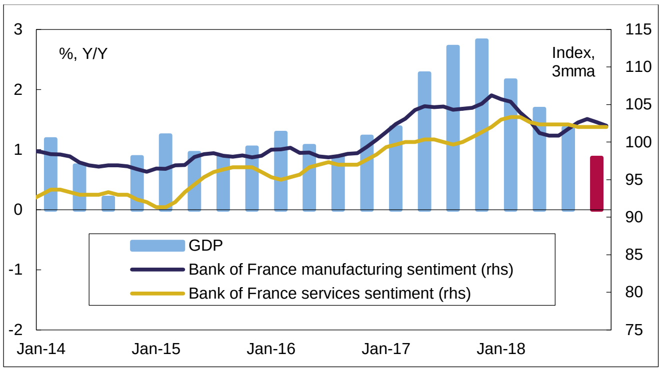
The coming week brings a handful of top-tier economic data from the euro area kicking off with November's industrial production figures. In light of the weak readings from the four largest member states, euro area IP is set to post a decline of

Euro area: Industrial production*



*Excluding construction. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

France: Business sentiment and GDP*



*GDP forecast for Q418. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

about 1½%M/M leaving it on track for a drop over the fourth quarter as a whole. A preliminary full-year German GDP growth figure for 2018 is due on Tuesday along with an estimate of the government budget surplus – consistent with our forecast of subdued activity in Q4, we expect the figures to show full-year GDP growth of 1.5% down from 2.2% in 2017. November's euro area goods trade data are also due on Tuesday along with final French and Spanish inflation numbers for December. The equivalent German and Italian CPI figures are due Wednesday and the euro area numbers due Thursday – the flash euro area estimates of 1.6%Y/Y for headline inflation and 1.0%Y/Y for core inflation seem likely to be confirmed. Euro area car registrations figures for December are also due on Wednesday and, with German registrations down 7%Y/Y, seem bound to confirm a weak end to the year. Construction output figures are due Thursday with ECB balance of payments figures out Friday. Meanwhile, ECB President Draghi will speak at the European Parliament on Tuesday. In the bond markets, Germany will sell 30Y bonds on Wednesday while Spain will sell bonds on Thursday.

In the US, despite the ongoing government shutdown, the coming week looks set to bring a handful of economic data, starting on Tuesday with the Empire Manufacturing survey for January and December PPI figures. Wednesday will bring the Fed's latest Beige Book, capital inflows data and the NAHB housing index, with weekly jobless claims and the Philly Fed index due the following day. Friday, meanwhile, will bring December's industrial production report and the preliminary University of Michigan consumer sentiment survey for January. December's retail sales and business inventories data (Wednesday), as well as housing starts figures (Thursday) risk postponement due to the government shutdown. In the markets, the Treasury will sell 10Y TIPS on Thursday.

UK

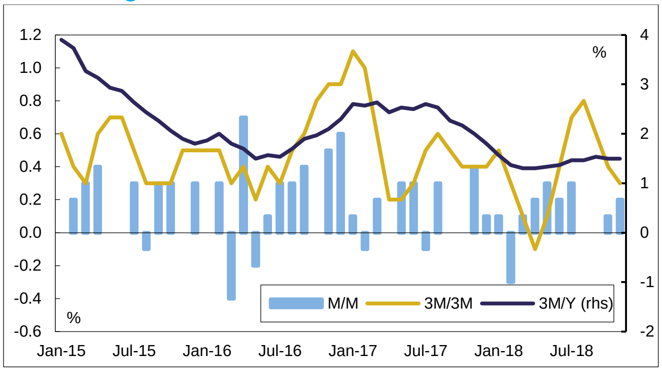
GDP growth on a downward trend

The end of what was a relatively quiet week for major UK economic data releases brought the announcement of November's monthly GDP. The figures showed an increase in economic output of 0.2%M/M, the strongest in four months and 0.1ppt above the expected rate. The increase was driven mainly by services – despite a notable deterioration in some business sentiment indicators, activity was up by 0.3%M/M, a rate at the top of the range of the past two years. Wholesale, retail and motor trade accounted for half of that growth mainly thanks to retailers who were highly active with Black Friday promotions. Construction output also contributed positively rising 0.6%M/M, but industrial production disappointed echoing the similar data releases from the large euro area member states. Indeed, manufacturing output declined for a fifth consecutive month, this time by 0.2%M/M, while production in mining, quarrying and energy fell in excess of 1.0%M/M. Looking through the monthly volatility, the figures once again highlighted the loss of economic momentum in the UK. Having peaked at 0.8%3M/3M in August, GDP growth eased to 0.3%3M/3M in November, and we expect a further step down in December. Reports suggest that retail sector activity went into reverse in December, while manufacturers appear unlikely to have seen a strong pick-up in output. Therefore, we maintain our forecast that UK GDP rose by only 0.2%Q/Q in the final quarter of the year.

Net exports likely to be neutral in Q4

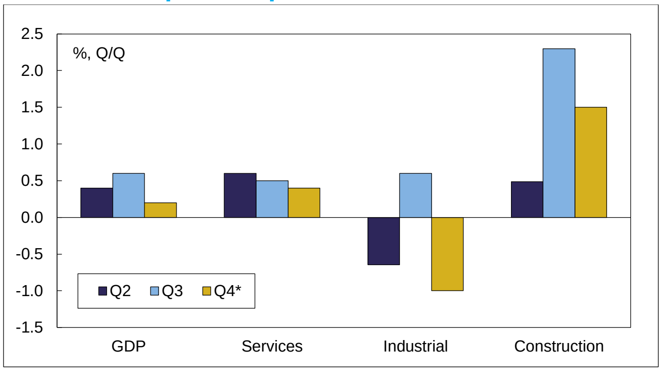
The trade figures were a brighter spot among today's UK data releases. The headline trade deficit shrunk slightly to below £3bn, a level still around £0.5bn higher than its average over the last twelve months. The goods trade deficit widened but that mainly reflected a deterioration in the oil trade balance, while the services trade balance showed a small improvement. Meanwhile, adjusted for price effects, total exports were up by 1.3%M/M while imports declined slightly. However, on a three-month basis, growth was very similar on both sides of the ledger, suggesting that net exports might be broadly neutral in Q4, having provided a 0.1ppt contribution to GDP growth in Q3.

UK: GDP growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP output components



**October-November average. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

The week ahead in the UK

Brexit is set to dominate the coming week in the UK, with all eyes on Parliament's 'meaningful vote' on Tuesday and Theresa May's response to the result. Commission President Juncker is expected on Monday to write to Theresa May to offer reassurances that, if the Irish backstop is triggered, the UK would be kept in a customs union with the EU only temporarily. But that seems highly unlikely to change the result on Tuesday. The Prime Minister looks set to suffer defeat, with the main question seemingly being the magnitude of the loss. Reports of MPs' intentions currently suggest the defeat will be the largest ever endured by a Government in the modern House of Commons (the current record being a defeat by a margin of 166 votes suffered by the Labour Government in 1924). Belated efforts by Theresa May to reach out to certain Labour MPs – specifically by endorsing an amendment specifying that the UK should commit in the Political Declaration on the future relationship not to lower its standards on workers' rights and environmental standards – might limit the size of the defeat somewhat. But it will not prevent a rejection of May's Brexit deal.

It is still highly uncertain what May's strategy will be in the event of defeat on Tuesday. She will be pressed to give an early indication of her planned next steps, perhaps as soon as Tuesday evening or at Prime Ministers' Questions in the House of Commons the following day. And the Government's loss in a vote earlier this week specifies that, in the event of defeat on Tuesday, May will have to submit a statement to Parliament on her intended next steps within three sitting days, i.e. by Monday 21 January. But her strategy up to now has appeared to be to run down the clock, using the threat of a disorderly no-deal Brexit to try to persuade MPs to back her Brexit deal in the absence of alternatives. And if the size of defeat is not too extreme, she might maintain that strategy, being vague about her precise intentions while upping efforts to try to build broader support, particularly among Labour MPs sympathetic to the Leave cause, in favour of a version of her deal (or at least giving MPs cause to consider abstaining rather voting against if and when she presents an amended proposal).

Alternatively, May might give her consent for Parliament to hold a set of 'indicative' votes on a range of different options to try to see whether a majority might exist on any particular path forward for Brexit. And we cannot exclude the possibility that May will call Labour's bluff and propose a new General Election or second referendum. Whatever path she chooses, however, there is very little chance of Parliament endorsing a Brexit deal and adopting all of the necessary legislation in time for the UK to leave the EU by end-March. As such, even though May's spokesperson subsequently tried to rule it out, we were not surprised by today's reports of senior UK Ministers, and certain European governments, suggesting that Brexit will be delayed beyond end-March. That news gave a boost to sterling. And it matches our expectation that extra time will ensue and a 'no deal' Brexit will be avoided. And so we continue to attach roughly equal probabilities to the likelihoods of eventual (i) endorsement of a variant of May's deal (perhaps whereby the door is left open to the so-called Norway-plus arrangement) or (ii) revocation of the Article 50 notice, with a second referendum or general election possible before then too.

Data-wise, the coming week brings December inflation and retail sales figures. We expect that the core CPI rate remained unchanged at 1.8%Y/Y, the lowest rate since Q117. But with energy prices having fallen very significantly, the headline CPI rate should come in below the 2.3%Y/Y rate seen in November – we forecast a decline to 2.1%Y/Y, which would also be the slowest pace since the start of 2017. Meanwhile, the retail sales data will probably be very weak. The growth rate in November, when many retailers offered attractive deals during Black Friday promotions, was flattered as many shoppers brought their spending forward. So, we expect payback in December, which might see sales falling by around 1.0%M/M or even more. Among other data announcements, UK Finance lending data (on Tuesday), the RICS Residential Market survey and the BoE Credit Conditions survey (both due on Thursday) will be worth following too.

Daiwa economic forecasts

	2018				2019				2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP forecasts %, Q/Q											
Euro area	0.4	0.4	0.2	0.2	0.3	0.3	0.3	0.3	1.8	1.0	1.0
Germany	0.4	0.5	-0.2	0.2	0.3	0.3	0.3	0.3	1.5	1.0	1.2
France	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	1.5	1.0	0.9
Italy	0.3	0.2	-0.1	0.0	0.1	0.2	0.1	0.2	0.9	0.3	0.5
Spain	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.4	2.5	1.9	1.7
UK	0.1	0.4	0.6	0.2	0.1	0.1	0.4	0.3	1.4	1.0	1.1
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.3	1.7	2.1	1.9	1.2	1.1	0.8	0.9	1.7	1.0	1.4
Core CPI	1.0	0.9	1.0	1.0	1.0	1.0	1.1	1.1	1.0	1.1	1.3
UK											
Headline CPI	2.7	2.4	2.5	2.3	1.9	1.9	1.7	1.7	2.5	1.8	1.9
Core CPI	2.5	2.0	2.0	1.8	1.8	2.0	1.9	2.0	2.1	1.9	2.0
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*	30	30	30	15	0	0	0	0	15	0	0
BoE											
Bank Rate %	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
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/ *Daiwa forecast*	Previous	Revised
France	Bank of France industrial sentiment indicator	Dec	**103**	100	101	-
Italy	Industrial production M/M% (Y/Y%)	Nov	**-1.6 (-2.6)**	-0.3 (0.4)	0.1 (1.0)	**-0.1 (-)**
Spain	Industrial production M/M% (Y/Y%)	Nov	**-1.5 (-2.6)**	0.4 (0.3)	1.2 (0.8)	**1.1 (0.7)**
UK	Monthly GDP estimate M/M% (3M/3M%)	Nov	**0.2 (0.3)**	*0.1 (0.3)*	0.1 (0.4)	-
	Industrial production M/M% (Y/Y%)	Nov	**-0.4 (-1.5)**	0.2 (-0.7)	-0.6 (-0.8)	**-0.5 (-0.9)**
	Manufacturing production M/M% (Y/Y%)	Nov	**-0.3 (-1.1)**	0.4 (-0.7)	-0.9 (-1.0)	**-0.6 (-0.7)**
	Construction output M/M% (Y/Y%)	Nov	**0.6 (3.0)**	0.2 (2.6)	-0.2 (3.8)	**0.0 (4.1)**
	Services activity M/M% (3M/3M%)	Nov	**0.3 (0.3)**	0.1 (0.2)	0.2 (0.3)	-
	Trade balance (goods trade balance) £bn	Nov	**-2.9 (-12.0)**	-2.8 (-11.4)	-3.3 (-11.9)	**-3.0 (-12.0)**

Country	Auction
Italy sold	€3bn of 2.3% 2021 bonds (15-Oct-2021) at an average yield of 1.07%
	€2.25bn of 2.5% 2025 bonds (15-Nov-2025) at an average yield of 2.35%
	€1.25bn of 3.45% 2048 bonds (01-Mar-2048) at an average yield of 3.68%

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 14 January 2019			
EMU		10:00	Industrial production M/M% (Y/Y%)	Nov	*-1.6 (-2.4)*	0.2 (1.2)
			Tuesday 15 January 2019			
EMU		10:00	Trade balance €bn	Nov	12.6	12.5
Germany		09:00	Full year GDP Y/Y%	2018	*1.5*	2.2
		09:00	Budget balance % of GDP	2018	-	1.0
France		07:45	Final EU-harmonised CPI Y/Y%	Dec	*1.9*	2.2
Spain		08:00	Final EU-harmonised CPI Y/Y%	Dec	*1.2*	1.7
			Wednesday 16 January 2019			
EMU		10:00	EU27 new car registrations Y/Y%	Dec	-	-8.0
Germany		07:00	Final EU-harmonised CPI Y/Y%	Dec	*1.7*	2.2
Italy		10:00	Final EU-harmonised CPI Y/Y%	Dec	*1.2*	1.6
UK		09:30	CPI (core CPI) Y/Y%	Dec	*2.1 (1.8)*	2.3 (1.8)
		09:30	Input (output) PPI Y/Y%	Dec	3.5 (2.9)	5.6 (3.1))
		09:30	UK House Price Index Y/Y%	Dec	3.0	2.7
		09:30	UK Finance mortgage approvals '000	Dec	38.9	39.4
			Thursday 17 January 2019			
EMU		10:00	Construction output M/M% (Y/Y%)	Nov	-	-1.6 (1.8)
		10:00	Final CPI (core CPI) Y/Y%	Dec	*1.6 (1.0)*	1.9 (1.0)
Italy		09:00	Trade balance €bn	Nov	-	3.8
UK		00:01	RICS house price balance %	Dec	-13	-11
			Friday 18 January 2019			
EMU		09:00	Current account balance €bn	Nov	-	23.0
Italy		09:00	Current account balance €bn	Nov	-	6.1
UK		09:30	Retail sales excluding auto fuel M/M% (Y/Y%)	Dec	-0.6 (3.9)	1.2 (3.8)
		09:30	Retail sales including auto fuel M/M% (Y/Y%)	Dec	-0.8 (3.6)	1.4 (3.6)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions			
Country		GMT	Event / Auction
			Monday 14 January 2019
			- Nothing scheduled -
			Tuesday 15 January 2019
EMU		15:00	Draghi presents ECB 2017 Annual Report
UK		-	UK Parliament holds the 'meaningful vote' on the Brexit deal
			Wednesday 16 January 2019
Germany		10:30	Auction: to sell €1.5bn of1.25% 2048 bonds (15-Aug-2048)
UK		09:15	BoE's Carney and other FPC members testify before the Treasury Select Committee
			Thursday 17 January 2019
Spain		09:30	Auction: to sell bonds
UK		09:30	BoE releases Credit Conditions and Bank Liabilities surveys
		10:30	Auction: to sell £2.5bn of 1% 2024 bonds (22-Apr-2024)
			Friday 18 January 2019
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.