Euro wrap-up

Overview

- Bunds made losses as the drop in euro area inflation in December was confirmed but German manufacturing orders data gave some comfort.
- Gilts also largely made losses as Theresa May consulted selected politicians from outside Government to try to find a new way forward on Brexit.
- Friday will bring new data on UK retail sales and the euro area balance of payments.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.591	+0.013
OBL 0 10/23	-0.355	+0.018
DBR 0¼ 02/29	0.241	+0.019
UKT 2 07/20	0.819	-0.005
UKT 0¾ 07/23	0.972	+0.005
UKT 1⅝ 10/28	1.332	+0.023

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

Euro area

Drop in inflation at end-2018 confirmed

With the final estimates of December inflation in each of the four largest member states having aligned with their preliminary figures, there was no surprise today that the final estimates of euro area inflation last month did likewise. There were also only minimal amendments made to the various main components. So, in particular, the headline CPI rate fell 0.3ppt to 1.6%Y/Y, with the principal cause being the step down in energy inflation, which fell 3.7ppts to 5.4%Y/Y. Food inflation was only marginally lower on the month at 1.8%Y/Y. And with inflation of services (1.3%Y/Y) and non-energy industrial goods (0.4%Y/Y) unchanged from November, core inflation was also unchanged at a subdued 1.0%Y/Y, the average rate of the past two years and hence inconsistent with the ECB's aim of achieving a self-sustainable rise in underlying price pressures. Given the continued loss of economic momentum of recent quarters – acknowledged earlier this week by Mario Draghi – we expect core inflation to remain close to 1.0%Y/Y over the coming couple of quarters. And with oil prices now below their levels a year ago, headline inflation looks set to take another step down in January and remain lower throughout 2019. We forecast a further drop in the annual CPI rate to 1.2%Y/Y this month and an average inflation rate of just 1.0%Y/Y this year. That's well below the ECB's 2019 projection of 1.6%Y/Y, and in our view too low to allow the Governing Council to start raising rates, particularly as GDP growth looks likely to be somewhat weaker than its most recent projection too.

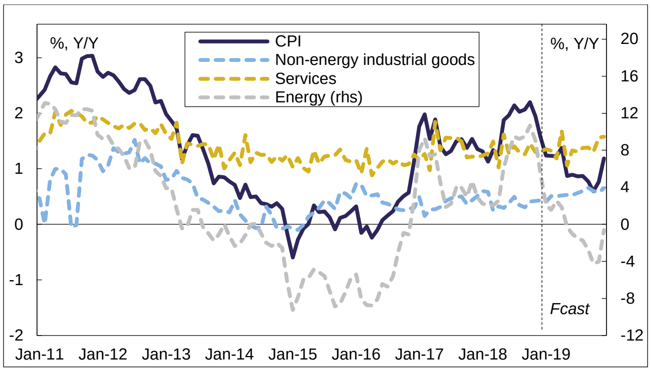
Construction output sluggish in Q4

After a weak start to the fourth quarter, euro area construction output edged a touch lower in November, slipping back 0.1%M/M, with building work up 0.1%M/M but civil engineering down 0.2%M/M. At the country level, weakness was most notable in Germany (down for the second successive month and by 1.7%M/M) while output in France posted a modest rebound (up 1.4%M/M) from a steep drop in October. With construction output in the euro area having dropped 1.6%M/M in October, the average level for the first two months of Q4 was 0.1% below that of Q3. But we expect to see a rebound in output in December, led by Germany, where construction orders continue to trend higher, sentiment in the sector remains elevated and fundamentals – including historically low interest rates, easy lending standards and rising prices – remain supportive. So, construction seems likely to have grown, albeit minimally, over the fourth quarter as a whole.

German backlogs suggest soft patch is temporary

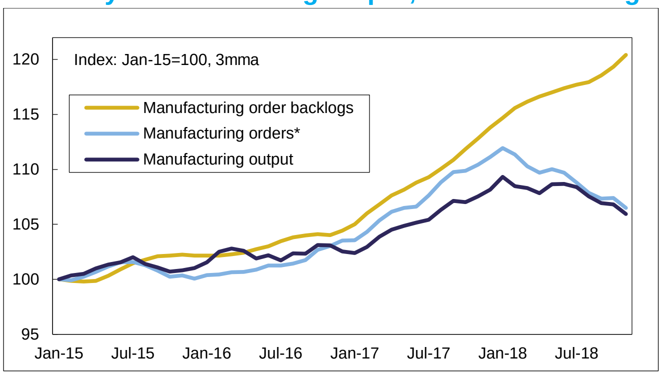
A key recent trend has been the weakness of manufacturing production, particularly in Germany where output fell in five of the six months since May to a twenty-month low in November. New orders in the sector have also fallen in Germany, down in

Euro area: CPI inflation and forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output, orders & backlogs



**Manufacturing orders excludes major orders. Source: Destatis, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

November to the lowest level since January 2017. And surveys suggest ongoing weakness in the sector too, with the German manufacturing new orders PMI dropping in December to a contractionary four-year low of 47.7. Many reasons for the weakness come from the demand side, including softer external demand not least from emerging market countries and a fall in demand for new cars in the euro area related to new emissions standards and diesel's fall from favour. Production in November was also likely hit by calendar effects, notably the timing of the All Saints Day holiday. But while most leading indicators suggest that sluggishness will persist over the near term, today's figures for the stock of unfilled orders point to a resumption of growth before too long. In particular, the stock of manufacturing orders rose for a fifth consecutive month and by 1.1%M/M in November to a new series high, maintaining the clear uptrend of recent years, with increases in unfilled domestic and foreign orders alike. The mismatch between the high level of order backlogs and the low level of production and new orders in part reflects supply-side constraints, including disruption to freight transport on the Rhine caused by unusually low water levels. Impaired shipments of chemicals and basic commodities, in particular, disrupted production in a range of sub-sectors. With water levels having picked up towards year end, this particular constraint should ease, allowing firms to boost production and make inroads into their order backlogs over coming months. So, we still expect manufacturing output to contribute positively to German GDP growth in Q1.

The day ahead in the euro area and US

The week in the euro area is set to end on a quiet note with the ECB's balance of payments data for November. In the US, Friday will bring December's industrial production report and the preliminary University of Michigan consumer sentiment survey for January while New York Fed President John Williams will speak on the economic outlook and monetary policy.

UK

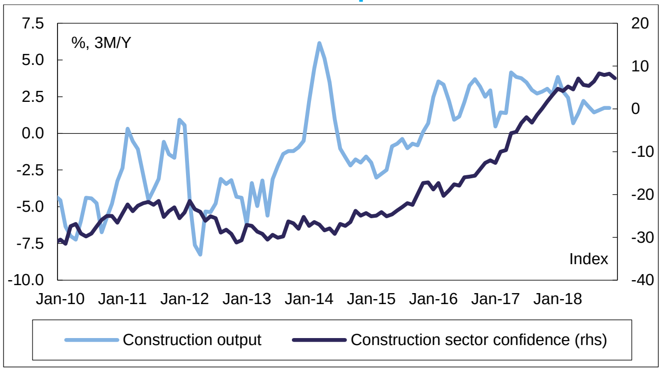
Limited room for manoeuvre for May to find a new deal

Theresa May predictably survived yesterday evening's confidence vote in the House of Commons. But the narrow result (325-306) highlighted the PM's dependence on the backing of the Northern Irish DUP for her survival (without the votes from the Province she'd have lost), as well as her vulnerability to mutiny within her own party, which obviously remains divided. So, as she resumed discussions today with MPs from various political groupings – but not Labour leader Corbyn who refused to participate unless a no-deal Brexit is ruled out – May appeared to have limited room for manoeuvre in her attempt to find a Parliamentary majority in favour of one form of Brexit or another. Against that backdrop, May's reluctance to even hint at flexibility on her red lines – in particular her determination to bring an end to freedom of movement which precludes Single Market membership, and to provide scope for the UK to negotiate its own trade deals, which largely precludes a permanent customs union – might be understandable, but, when coupled with her limited political skill-set, bodes ill for a near-term breakthrough. The next important dates are Monday, when May must submit a new plan to Parliament, while a full debate and key vote is scheduled for 29 January, when MPs might attempt to wrest control of the Brexit process from May. Given the lack of time available for Parliament to discover and endorse an alternative Brexit deal, and adopt all of the necessary legislation to allow the UK to leave the EU in an orderly manner by end-March, we continue to expect the Article 50 notice to be extended. For the EU to agree to that, however, the UK will need first to agree a deliverable new proposal for a way forward.

Credit conditions tightened in Q4

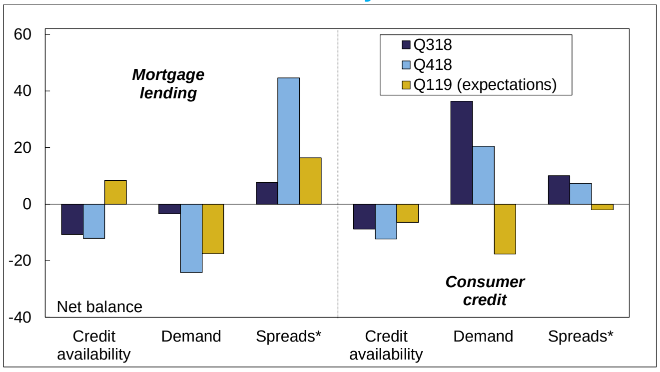
Credit conditions in the UK tightened at the end of last year, according the Credit Conditions Survey released by the BoE today. The new figures showed that lenders were less eager to provide loans to households with the availability of credit falling in both secured and unsecured lending. The weaker economic outlook, reduced appetite for risk, and deteriorating outlook in the housing market appear to have been the major factors prompting them to be more cautious. With regard to demand, lenders reported a sharp decline in secured lending for house purchases, which reinforced the message of many other indicators (see below for an example) suggesting that momentum in the UK housing market has declined in recent months. In contrast,

Euro area: Construction output and confidence



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

UK: Credit Conditions Survey



**A positive balance indicates narrowing. Source: BoE and Daiwa Capital Markets Europe Ltd.*

households wanted to borrow more unsecured funds in the form of credit-card borrowing, however lenders expected that demand to fall in the current quarter. The survey also highlighted that spreads on loans to households in Q4 were unchanged or narrower. However, it is worth noting that these data were collected in late November and early December, and therefore did not capture the deterioration in sentiment in global financial markets later that month. With concerns about the economic outlook in most advanced economies having become more prominent, we would not be surprised to see that major lenders have now become even more reluctant to add more risk to their balance sheets.

Housing market sentiment eased further in December

Brexit uncertainty continues to take its toll on the UK economy. The latest example came from today's RICS Residential Market Survey, which pointed to intensifying downward pressures on house prices at the end of last year, with a net balance of 19% of survey respondents reporting falling prices in December and prices in decline in all regions bar the North-West. The weakness persisted on both sides of the market with indicators for new buyer enquiries and new vendor instructions remaining firmly in negative territory, at -17% and -21% respectively. Against this backdrop, transaction levels maintained a downward trend, and the survey signalled a further decline in activity ahead. Indeed, the near-term sales expectations indicator dropped to the lowest level since the survey began in 1999. The equivalent indicator for expected price growth was also weaker – at -27% this was below the level seen immediately after the Brexit vote and the lowest since 2011. We certainly do not expect a significant recovery in price growth unless and until Brexit uncertainty lifts and real wages accelerate.

The day ahead in the UK

The end of the week brings the latest retail sales figures. Some major retailers reported relatively decent festive period sales, but, with consumer confidence having taken a turn for the worse towards the end of the year, overall High Street momentum appears to be weak. So, consistent with the subdued results of the latest retail sector surveys, tomorrow's figures will probably show a drop in sales – expectations are for a decline of nearly 1%M/M, which would leave sales in Q4 only slightly higher compared to Q3.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		Construction output M/M% (Y/Y%)	Nov	**-0.1 (0.9)**	-	-1.6 (1.8)	**- (0.6)**
		Final CPI (core CPI) Y/Y%	Dec	**1.6 (1.0)**	*1.6 (1.0)*	1.9 (1.0)	-
Italy		Trade balance €bn	Nov	**3.8**	-	3.8	-
UK		RICS house price balance %	Dec	**-19**	-13	-11	-
Country		Auction					
Spain sold		€811mn of 1.5% 2027 bonds(30-Apr-2027) at an average yield of 1.137%					
		€726mn of 2.75% 2024 bonds (31-Oct-2024) at an average yield of 0.565%					
		€1.7bn of 0.35% 2023 bonds (30- Jul-2023) at an average yield of 0.289%					
		€1.4bn of 0.05% 2021 bonds (31-Oct-2021) at an average yield of -0.047%					
UK sold		£2.1bn of 1% 2024 bonds (22-Apr-2024) at an average yield of 1.018%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tomorrow's data releases						
Economic data						
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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	-0.8 (3.8)	1.2 (3.8)
		09:30	Retail sales including auto fuel M/M% (Y/Y%)	Dec	-0.8 (3.6)	1.4 (3.6)
Auctions and events						
Country		GMT	Auction / Event			
- Nothing scheduled -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

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