Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds made modest losses, while a French business survey signalled a further deterioration in conditions in manufacturing and services.
- Gilts also made modest losses despite a marked slowdown in UK GDP in Q4.
- Tomorrow will see Theresa May update the House of Commons on Brexit, while Wednesday will bring euro area IP and UK CPI data.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.576	-
OBL 0 04/24	-0.358	+0.009
DBR 0¼ 02/29	0.115	+0.028
UKT 2 07/20	0.727	+0.017
UKT 0¾ 07/23	0.822	+0.025
UKT 1⅝ 10/28	1.177	+0.026

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

Euro area

French business sentiment dips in January

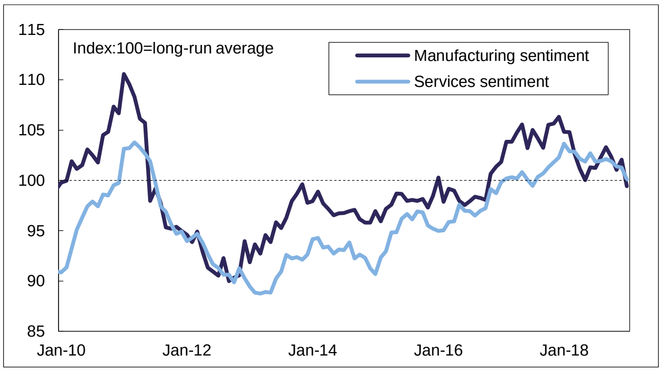
Today's most notable new data from the euro area came in the shape of the latest business survey from the Bank of France. In contrast to the modest improvement reported in the French PMIs, these indices suggested a weaker start to the year. In particular, the headline manufacturing index declined 3pts in January to 99, its lowest reading since October 2016 and just below the long-run average, as production reportedly fell and orders remained subdued. Sentiment in the services sector also dipped slightly, with the respective index down 1pt to 100, its lowest level since August 2017. In contrast, construction firms remained broadly upbeat about conditions at the start of the year, with the relevant index unchanged at an above-average 105. So, despite the downbeat tone among manufacturing and services firms – no doubt in part reflecting ongoing disruptions from the Gilet Jaunes protests – the Bank of France assessed today's survey to be consistent with GDP growth of 0.4%Q/Q in Q119, an improvement of 0.1ppt from the surprisingly stable growth of 0.3%Q/Q in Q418.

The coming two days in the euro area and US

After a day bereft of notable euro area data tomorrow, focus on Wednesday will turn to the aggregate industrial production figures for December. We expect euro area industrial output to have dropped a little less than ½%M/M in December, which would leave production down around 1% over the quarter as a whole, the third quarterly contraction out of the past four and the steepest since 2012. Meanwhile, in the markets, after Friday saw 10Y Bund yields slip below 0.1%, and the 10Y spread of BTPs over Bunds briefly touch 300bps, the bond auctions from Germany and Italy, scheduled for Wednesday, will be watched.

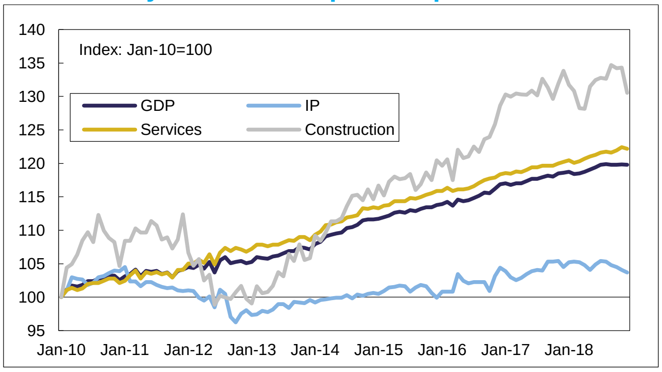
In the US, tomorrow will bring the NFIB small business survey for January and JOLTS survey for December. Likely of more interest will be the January CPI report on Wednesday, which Daiwa America's US economist Mike Moran expects to show prices falling for the second successive month on the back of lower energy prices. That should leave the annual rate of headline CPI down at least 0.4ppt to 1.5%Y/Y or less, which would be the lowest since at least September 2016. The core CPI, however, is expected to rise 0.2%M/M once again to leave the drop in the core inflation rate limited to just 0.1ppt to 2.1%Y/Y. A number of FOMC members are due to speak publicly over the coming two days on the topic of the US economy, including Mester (tomorrow) and Harker (Wednesday).

France: Bank of France sentiment indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Monthly GDP and output components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK

GDP slowed markedly in Q4

Focus in the UK today was on the first estimate of Q4 GDP, which, perhaps predictably, provided a further reminder of the damaging impact ongoing Brexit uncertainty is having on the economy. Indeed, aligning with our expectations, GDP slowed notably at the end of last year, by 0.4ppt to just 0.2%Q/Q, 0.1ppt below the BoE's assumption in its latest economic forecasts. To two decimal places, growth was just a whisker above 0.1%Q/Q. As a result, output in Q4 was just 1.3% higher than a year earlier, while full-year growth of 1.4% was down 0.4ppt from 2017 and last lower in 2009. Within the expenditure breakdown, growth was again supported by household and government spending, up 0.4%Q/Q and 1.4%Q/Q respectively with the latter the strongest increase since Q112, to cumulatively boost GDP growth by 0.5ppt. While exports were also firmer in Q4 (0.9%Q/Q) thanks to an improved showing from services, a stronger increase in imports left net trade subtracting from growth for the third quarter out of the past four and by 0.1ppt. But although inventory accumulation supported growth, the continued weakness in private investment was most striking in today's report. Business fixed investment posted a fourth consecutive quarterly decline in Q4 (1.4%Q/Q) to leave it a whopping 3.7% lower than a year earlier, the steepest such drop since Q110.

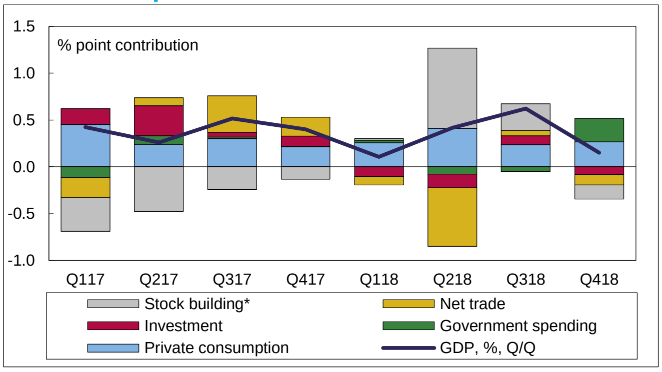
Services, manufacturing and construction end 2018 weaker

While the monthly GDP figures are notoriously volatile, the 0.4%M/M decline in December was nevertheless the steepest since March 2016 and bodes ill for a rebound in output in the current quarter. Indeed, the weakness was broad based that month, with output from services (-0.2%M/M), production (-0.5%M/M) and construction (-2.8%M/M) all down on the month for the first time since September 2012. Looking through the monthly volatility, services output continued to hold up relatively well in Q4 (0.4%Q/Q) supported in part by the health sector, management consultants (in no small amount advising on Brexit) and IT. In marked contrast, however, manufacturers continued to struggle, with production posting the sixth consecutive monthly fall in December – the longest negative run since 2008-9 – to leave it more than 2% lower than a year earlier and almost 1% lower in Q4, the steepest quarterly drop for six years. The weakness in Q4 in part reflected a 2.7%Q/Q drop in production of transport equipment, although this was attributed in part to the impact of factory shutdowns last quarter. Nevertheless, overseas demand for British goods continued to wane over recent months. As goods export volumes fell 0.9%3M/3M, while goods imports were up 1.7%3M/3M, the price-adjusted goods trade deficit widened slightly in December to £11.4bn. When including services and price effects, the overall trade deficit (£3.2bn) also maintained the widening trend seen over the past year. Recent surveys suggest that new orders from abroad have declined further at the start of this year so we expect little support from net trade over the near term. And with domestic demand also seemingly having lost significant momentum against the backdrop of persistent Brexit uncertainty, there seems little prospect of a notable rebound in GDP growth in the current quarter.

May hints at willingness to make a deal with Labour

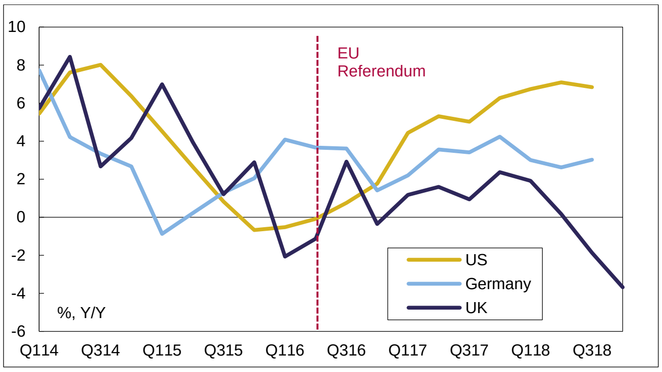
At face value, this week might be a notable one for Brexit, with Theresa May now set to make a statement to Parliament tomorrow (one day earlier than previously planned) ahead of a debate in the House of Commons on Thursday. And with May hoping to win new (perhaps at-best cosmetic) concessions on the Irish backstop that might persuade Brexiter Tory MPs and the Northern Irish DUP to back her approach to Brexit, another meeting between UK Brexit Minister Steve Barclay and EU chief negotiator Michel Barnier was set to take place this evening, while discussions between UK and EU officials were set to continue. Those talks, however, seem unlikely to bear fruit, at least not this week. Nevertheless, May's letter to Labour leader Corbyn, published last night, hinted at her readiness to turn her back on her right-wing backbenchers and instead strike a cross-party deal if they fail in due course to support her whatever the EU eventually offers.

GDP and expenditure contributions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Business investment



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Letter targeted at backbenchers not Corbyn

To some extent, May's letter offered Corbyn little more than further talks on Brexit. But in a sop to Labour demands, she repeated her pledge to protect existing commitments on workers' rights and environmental protections, while proposing a new mechanism for Parliament to consider upgrades to those arrangements in line with any future changes in EU rules, albeit reserving the right of her Party to oppose such changes. She also confirmed that the Government was examining ways to provide further financial support to 'communities that feel left behind', many of which can be assumed to be Brexit-voting constituencies of Labour MPs. At the same time, May continued to resist Corbyn's call for a permanent customs union, insisting that it would curtail the UK's ability to strike new trade deals. And that suggests that she is still not prepared to strike a grand bargain with the opposition front bench to ensure that some form of Brexit can be agreed before Brexit day on 29 March. Instead, she appears to hope to persuade just about enough Labour and Tory backbenchers to shift the support in favour of her preferred deal. And as the Eurosceptic Corbyn still seems likely to be content to cast a blind eye towards those Labour MPs voting for May's deal in such circumstances, that Brexit scenario remains the one to which we attach by some margin the greatest probability.

Little progress expected this week

When she updates Parliament tomorrow, May will likely continue to argue that she needs more time to try to strike a deal with the EU. So, on Thursday, MPs are set to debate the continued lack of progress and vote on proposed amendments to a 'neutral' government motion on the state of play, just as they did on 29 January. As on that occasion, theoretically those votes could establish new Parliamentary processes to allow MPs to influence more substantively the future course of Brexit policy. But the failure of MPs to agree anything last month suggests that they will likely similarly fail to take greater control of the process this week. Instead, in line with Government's latest proposal on the timetable, if no new decal with the EU has been reached by then, Parliament will come back again at the end of February to discuss progress and vote on next steps, with a meaningful vote then most likely to be held next month.

The coming two days in the UK

Focus in the UK tomorrow will be on Theresa May's statement to the House of Commons. Data-wise, the main release will be January inflation figures due Wednesday, with a fall in the headline CPI rate expected, possibly by 0.2ppt to 1.9%Y/Y. The core rate might edge lower too, from 1.9%Y/Y in December. Wednesday will also bring the latest official house price figures for December. Beyond the data, BoE Governor Carney is due to speak in London on Tuesday on the global economy and the risks to the outlook.

In the absence of significant news, the next edition of the Euro wrap-up will be published on 13 February 2019.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
France	Bank of France industrial sentiment	Jan	**99**	103	103	**102**
UK	GDP – first estimate Q/Q% (Y/Y%)	Q4	**0.2 (1.3)**	*0.2 (1.3)*	0.6 (1.5)	**-**
	Monthly GDP estimate M/M%	Dec	**-0.4**	*-0.1*	0.2	**-**
	Industrial production M/M% (Y/Y%)	Dec	**-0.5 (-0.9)**	0.1 (-0.5)	-0.4 (-1.5)	**-0.3 (-1.3)**
	Manufacturing production M/M% (Y/Y%)	Dec	**-0.7 (-2.1)**	0.2 (-1.1)	-0.3 (-1.1)	**-0.1 (-1.2)**
	Construction output M/M% (Y/Y%)	Dec	**-2.8 (-2.4)**	0.1 (1.5)	0.6 (3.0)	**0.1 (1.8)**
	Services activity M/M% (3M/3M%)	Dec	**-0.2 (0.4)**	*-0.1 (0.4)*	0.3 (0.3)	**- (0.4)**
	Trade balance (goods trade balance) £bn	Dec	**-3.2 (-12.1)**	-3.0 (-11.9)	-2.9 (12.0)	**-3.6 (-12.4)**

Auctions and events

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
- Nothing scheduled -						

Auctions and events

Country		GMT	Auction / Event
UK		13:00	BoE's Carney scheduled to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Wednesday's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		10:00	Industrial production M/M% (Y/Y%)	Dec	-0.4 (-3.2)	-1.7 (-3.3)
UK		09:30	CPI (core CPI) Y/Y%	Jan	*1.9 (1.8)*	2.1 (1.9)
		09:30	Input (output) PPI Y/Y%	Jan	3.8 (2.2)	3.7 (2.5)
		09:30	House Price Index Y/Y%	Jan	2.5	2.8

Auctions and events

Country		GMT	Auction / Event
Germany		10:30	Auction: to sell €1.5bn of 2.5% 2046 index-linked bonds (15-Aug-2046)
Italy		10:00	Auction: to sell up to €2.25bn of 2.3% 2021 bonds (15-Oct-2021)
		10:00	Auction: to sell up to €2.25bn of 2.5% 2025 bonds (15-Nov-2025)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

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