Daiwa Capital Markets

Euro wrap-up

Overview

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- As the ECB cut rates, introduced a tiering framework and launched a new open-ended QE programme, euro area govvies made losses at the shorter end of the curve but longer-dated periphery bonds made gains.
- Gilts were little changed despite a more downbeat UK housing survey.
- Tomorrow will bring euro area trade figures for July and labour costs data for Q2.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.745	+0.108
OBL 0 10/24	-00765	+0.078
DBR 0 08/29	-0.539	+0.027
UKT 3¾ 09/21	0.524	+0.027
UKT 1 04/24	0.478	+0.027
UKT 0⅞ 10/29	0.652	+0.013

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

ECB easing package beats expectations

All eyes today were on Frankfurt, as Mario Draghi announced the ECB's latest monetary easing package. While some measures were in line with the consensus view, others went beyond expectations. As a result, following the announcement, short-dated government bonds made significant losses but longer-dated periphery bonds, particularly BTPs, rallied. In particular:

I. The cut of 10bps in the deposit rate to -0.50% was in line with expectations. However, the ECB revised its forward guidance significantly, to keep open the door to further rate cuts only until the inflation outlook "robustly" converges to target and such convergence has been "consistently reflected in underlying inflation". So, core CPI will need to pick up significantly on a sustained basis before rate cuts will be taken off the table.

II. Despite well-known differences of opinion on the Governing Council, the decision to relaunch QE was expected. But the detail of the package was not. The monthly net purchase amount of €20bn, to commence from 1 November, might have appeared on the low side and meant that the 'issue' and 'issuer' limits will not need to be increased until late next year at the earliest. However, the fact that this programme will be open-ended and will continue "as long as necessary" until just before rates start to go up, went well beyond expectations – hence the rally in longer-dated periphery bonds.

III. In a further surprise, the ECB also made the conditions on its forthcoming TLTRO-III operations (the first of which will be held next week) more generous for participating banks. In particular, it removed the 10bps premium on such borrowing. So, e.g., it reduced the base-case interest rate to the average refi rate over the life of the respective TLTRO. And for participating banks that increase lending above a pre-specified benchmark, the rate will be as low as the average deposit rate over the life of the respective TLTRO. It also increased the maturity of the TLTRO-III operations from two to three years (although banks will still have the option to repay after two years). These measures should benefit banks from the euro area's periphery disproportionately.

IV. As an additional step to support banks, but as expected, the ECB announced its intention to introduce a tiering rate framework on reserve remuneration, to exempt a share of bank deposits lodged at the central bank from the negative rate. In particular, the volume of reserve holdings in excess of minimum reserve requirements that will be exempt from the -0.50% deposit facility rate will be a multiple of an institution's minimum reserve requirements, initially set at 6. (For reference, required reserves over the most recent maintenance period amounted to about €131bn.) This measure will disproportionately benefit banks from Germany, France, the Netherlands and Luxembourg, which account for the lion's share of excess reserves. As it reduced the relative attractiveness of bonds relative to excess funds deposited at the ECB, shorter-dated government bonds sold off sharply.

Economic forecasts revised down (but probably not by enough)

To justify the new policy package, Draghi pointed to the ECB's updated economic forecasts, which revised down the outlooks for euro area GDP growth and inflation. In particular, it now expects GDP growth to be weaker than previously thought in 2019 and 2020, at 1.1% and 1.2% respectively, but still thinks that growth will pick up to 1.4% in 2021. And it is more pessimistic about inflation than before, revising down its forecast inflation over the horizon. Most notable, its CPI forecast for next year was revised down by 0.4ppt to just 1.0%Y/Y, while the key forecast for inflation at the end of the horizon, in 2021, was revised down 0.1ppt to 1.5%Y/Y, well below target. Draghi also continued to emphasise the downward skew in the balance of risks to the outlook. With market- and survey-based inflation expectations recently having fallen to record lows, he underscored again the need to act to counter concerns about the ECB's lack of credibility. And in recognition of this fact, while support on the Governing Council for new QE in particular was not unanimous, the policy package was agreed by consensus.

ECB likely to keep buying assets for the foreseeable future

Draghi stated, however, that there was unanimity on the Governing Council that fiscal policy, not monetary policy, should now become the main policy instrument for demand management. Indeed, while the Governing Council stands ready to ease further if necessary by adjusting all of its tools, the sense is that monetary policy in the euro area (as in Japan, perhaps) is close to the limits of its effectiveness. And so, the ECB called explicitly for governments with fiscal space (most notably Germany's) to "act in an effective and timely manner". Unfortunately, given the nature of the national political debate, we doubt very much that we will see any effective fiscal stimulus emerge from Germany anytime soon. We also remain downbeat about the outlook for global demand as well as the resilience of euro area domestic demand. And we are still pessimistic about the ability of the euro area to generate a sustained upwards trend in underlying inflation. As such, our forecasts for GDP and core inflation are much more pessimistic than the ECB. And while, like the BoJ, the ECB might now be reluctant to cut rates further, in light of its current guidance the ECB is likely to have to keep buying assets, most likely still at €20bn per month, for the foreseeable future.

Euro area IP falls again

The recent flow of downbeat economic data easily justifies the downwards revisions to the ECB's forecasts. Certainly, today's euro area industrial production release further illustrated the persistent challenges facing manufacturers, with output declining in July (-0.4%M/M) for the fourth month out of the past five. This left output down 2% compared with a year earlier, at the lowest level since April 2017 and more than 1% lower than the average in Q2. While there was a notable increase in production of capital goods in July (1.8%M/M), this reversed just half the decline seen in June to leave output almost ½% lower than the average in Q2 and therefore suggestive of a continued downward trend at the start of Q3. Production of consumer durables was more positive, with the 1.2%M/M increase almost fully reversing June's decline to leave it more than 1% higher than the average in Q2. In contrast, however, production of non-durable consumer goods fell for the second successive month. And with output of intermediate goods down for the fifth consecutive month to the lowest level since the start of 2017, manufacturing output fell a further 0.3%M/M in July. While the manufacturing PMI implied a modest improvement in sentiment in August, the headline index was still the second-lowest since April 2013 and consistent with ongoing contraction in the sector.

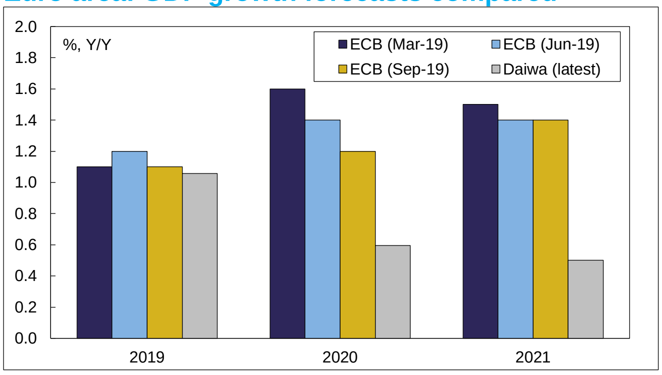
German and French inflation remains subdued

As today's final August inflation figures from Germany and France brought no major surprises, they further emphasised the subdued inflationary environment. In particular, Germany's headline EU-harmonised rate confirmed the 0.1ppt drop reported in the flash estimate to 1.0%Y/Y, the lowest since November 2016. But while the equivalent French figure was revised higher from the flash release by 0.1ppt to 1.3%Y/Y (leaving it unchanged from July) this was merely cosmetic. To two decimal places the annual rate was nudged only 0.01ppt higher to 1.26%Y/Y. As such, notwithstanding a significant surprise to the Italian (due Monday) and Spanish (due tomorrow) figures, final euro area inflation data, due to be published next Wednesday, are likely to confirm that the headline CPI rate moved sideways in August at 1.0%Y/Y, the lowest since November 2016. While the national CPI measures in Germany and France have differed somewhat from the harmonised series over the summer, today's release showed that core inflation (on the national measures) eased in both countries in August – both down 0.2ppt to 1.4%Y/Y and 0.7%Y/Y respectively.

The day ahead in the euro area and US

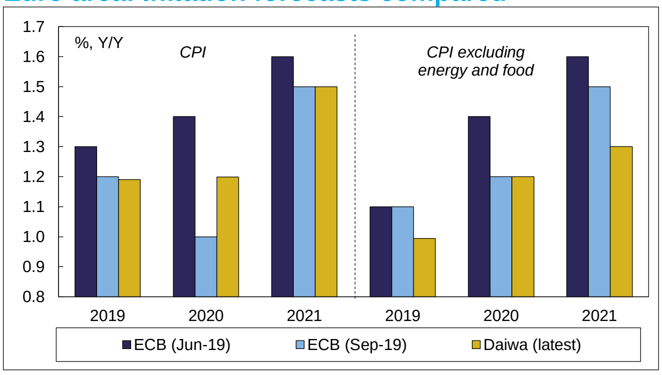
The end of the week will bring several euro area releases of note, including labour costs figures for Q2 and July's trade report. With German figures earlier in the week having reported a step up in labour costs growth last quarter to the strongest annual rate for two years, we should see a modest increase in the euro area aggregate number from growth of 2.4%Y/Y in Q1. Some slightly stronger German exports figures, as well as a decline in imports, should also feed through to an improved

Euro area: GDP growth forecasts compared



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts compared



Source: ECB and Daiwa Capital Markets Europe Ltd.

trade position for the euro area as a whole at the start of Q3. Final Spanish CPI figures for August are also due and likely to confirm that the EU-harmonised rate fell 0.2ppt to 0.6%Y/Y, the lowest since November 2016.

Tomorrow will bring a number of top-tier economic releases from the US too, with most notably retail sales figures for August. These are expected to show only modest growth last month after a strong increase in July. The preliminary University of Michigan consumer confidence survey for September will also be closely watched, with the headline index having previously fallen to the lowest since October 2016. Friday will also bring import and export price numbers for August and business inventories figures for July.

UK

UK moving closer to a constitutional crisis

Despite Parliament's five-week shutdown, political noise related to Brexit continues to increase. After Scotland's highest court yesterday judged the Prime Minister's advice to the Queen and the prorogation of Parliament to be unlawful, today the Government won a separate ruling on a related matter in a more junior Northern Irish court. While that case will be heard again tomorrow in a court of appeal in Belfast, the outcome should be of only passing interest. Instead, most relevant will be the judgement of the UK's Supreme Court following its review of the relevant cases in a hearing starting next Tuesday. If it backs the Scottish court's judgement while the Government continues to refuse to restart Parliament, the political crisis will have morphed into a constitutional crisis. And calls for Boris Johnson's resignation, for misleading the Queen, would also mount. Meanwhile, the case for Parliament to remain in operation ahead of the end-October Article 50 cliff edge was highlighted yesterday evening as the Government grudgingly published – in response to MPs' demands – a short summary of its own dire assessment of the potential impact of a no-deal Brexit prepared under its so-called "Operation Yellowhammer" plans.

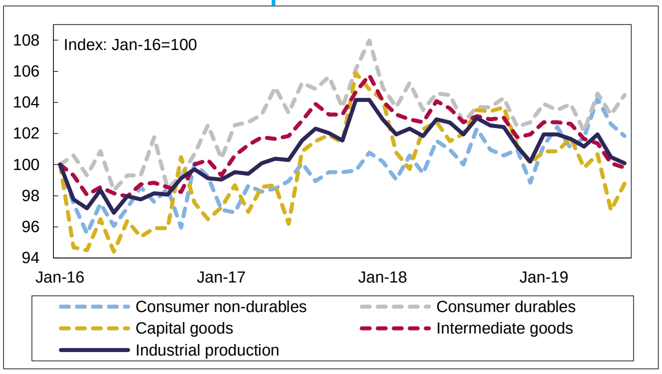
Government lays bare potential no-deal impact

Under the Government's illustrative "worst-case" (or "base") scenario, disruption to trade flows across the English Channel would be severe. The flow of freight traffic might fall to 40-60% of current levels, with heavy goods vehicles facing delays of 1.5-2.5 days before being able to cross the border into the EU. Disruption of that magnitude might persist for three months before it eases somewhat. The impact on supply of goods to UK markets would be acute. The supply of medicines, of which about 75% enter the UK via this route, would be particularly severely impacted, as would that of some types of food. Prices of such items, and fuel, would be expected to rise. Public disorder and community tensions might increase. In Northern Ireland in particular, criminal and dissident activity would be expected to rise. And some cross-border UK financial services would also be disrupted. Of course, the anti-no-deal legislation, which was given royal assent at the start of the week, significantly reduces the probability of such a harmful event at end-October. However, the probability of it occurring at a later date – particularly if Johnson's Conservatives were to win a majority (with or without the Brexit party) after a new general election – is non-negligible. Indeed, overall, we still attach a probability of between one quarter and one third to it occurring. If and when it did occur, given the large adverse shock to demand that might outweigh the shock to supply, we would expect the BoE to respond to a no-deal Brexit with rate cuts and, in due course, QE.

RICS survey suggests still subdued housing market

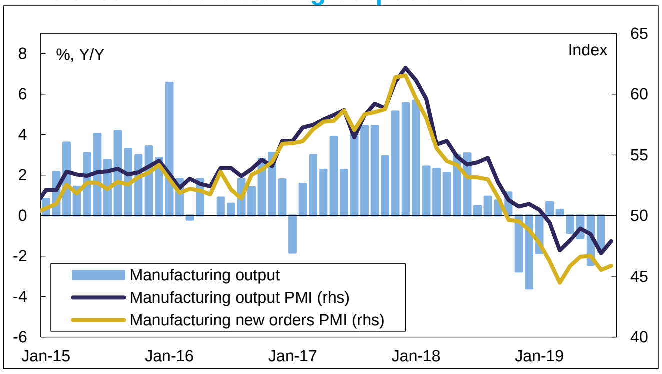
At face value, today's RICS house price survey for August indicated a modest improvement in housing market conditions, with the headline price indicator unexpectedly rising 5pts to -4%, the second-highest reading for the past year. On this basis today's survey suggested that the steady downward trend seen in the official ONS measure of house price growth should come to an end around the turn of the year, albeit stabilising at a rate significantly lower than the average over the past six years. But many other details of the survey were more downbeat. For example, there was a further notable decline in price

Euro area: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output and PMI



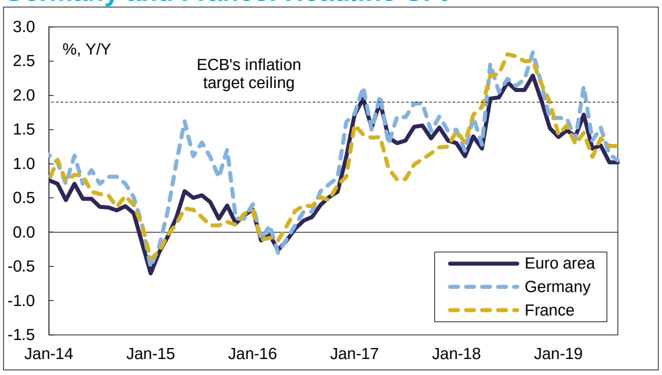
Source: Thomson Reuters, Markit and Daiwa Capital Markets Europe Ltd.

expectations over the coming three months, while near-term sales expectations fell to the lowest since February too, with weakening reported in most UK regions. Of course, Brexit, as well as the outcome of the next general election, will be all-important in determining the path of house prices into next year and beyond.

The day ahead in the UK

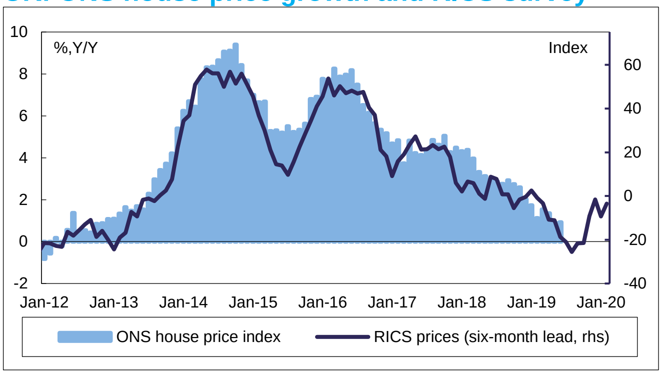
It should be a quiet end to the week in the UK with no economic releases due for release.

Germany and France: Headline CPI



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: ONS house price growth and RICS survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Industrial production M/M% (Y/Y%)	Jul	**-0.4 (-2.0)**	-0.1 (-1.3)	-1.6 (-2.6)	-1.4 (-2.4)
		ECB main refinancing rate %	Sep	**0.00**	0.00	0.00	-
		ECB marginal lending facility %	Sep	**0.25**	0.25	0.25	-
		ECB deposit facility rate %	Sep	**-0.50**	*-0.60*	-0.40	-
Germany		Final CPI (EU-harmonised CPI) Y/Y%	Aug	**1.4 (1.0)**	1.4 (1.0)	1.7 (1.1)	-
France		Final CPI (EU-harmonised CPI) Y/Y%	Aug	**1.0 (1.3)**	1.1 (1.2)	1.1 (1.3)	-
UK		RICS house price balance	Aug	**-4**	-10	-9	-

Auctions

Country		Auction
Italy		sold €4bn of 2023 bonds at an average yield of -0.01%
		sold €2.25bn of 2026 bonds at an average yield of 0.56%
		sold €1.5bn of 2049 bonds at an average yield of 2.06%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain		Industrial production M/M% (Y/Y%)	Jul	**-0.4 (0.8)**	-0.3 (1.5)	-0.2 (1.8)	- (1.6)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		10.00	Trade balance €bn	Jul	17.5	17.9
		10.00	Labour costs Y/Y%	Q2	-	2.4
Spain		08.00	Final CPI (EU-harmonised CPI) Y/Y%	Aug	0.3 (0.4)	0.5 (0.6)

Auctions

Country	BST	Auction/Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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