Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest losses after take-up of the ECB's first TLTRO-III operation fell well short of expectations.
- Shorter-dated Gilts also made modest losses despite a more dovish feel to the BoE's latest policy statement.
- Tomorrow's data highlight will be the Commission's flash consumer confidence indicator for September.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.731	+0.014
OBL 0 10/24	-0.716	+0.016
DBR 0 08/29	-0.507	+0.070
UKT 3¾ 09/21	0.521	+0.014
UKT 1 04/24	0.461	+0.006
UKT 0⅞ 10/29	0.641	-0.001

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

Euro area

First TLTRO-III operation is a damp squib

Today saw the ECB announce the allotment of funds under the first of its seven quarterly TLTRO-III operations. And take up was strikingly low, with just €3.4bn disbursed. Just 28 banks participated in the round, compared to the 360 that participated on average in the four auctions of the previous TLTRO-II operations. Last week, the Governing Council increased the relative attractiveness of borrowing under the TLTRO-III programme, removing the 10bps interest rate premium charged on the funds relative to the TLTRO-II operations, and also increasing the average maturity of the loans from two to three years (with the option still of repayment after two years). It is possible that the announcement of the change to conditions came too late to influence banks' decision-making at these operations. Moreover, with several further operations to come, and still some €690bn of funds borrowed under the TLTRO-II programme outstanding, most banks simply saw no need to participate this time around, particularly as economic uncertainty remains high. Of course, from the middle of next year, we would strongly expect to see the outstanding TLTRO-II loans, which are set to mature every three months from June 2020 to March 2021, to be rolled over into new TLTRO-III disbursements.

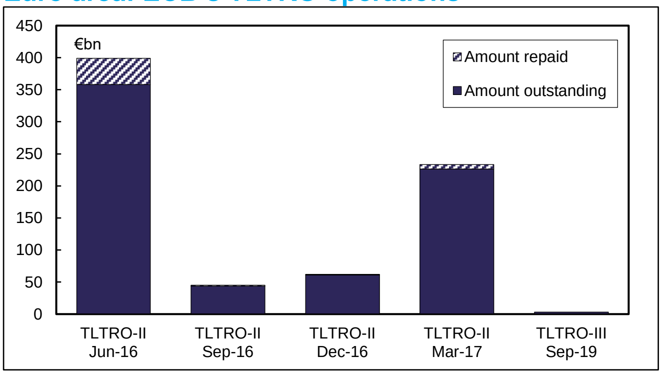
Current account surplus on gradual narrowing trend…

On a quiet day for economic news from the euro area, the sole data release of note was the balance of payments for July. In particular, with increased surpluses on goods trade and primary income more than offsetting a smaller surplus on services, the current account surplus rose €2.1bn from June to €20.6bn. Looking through the month-to-month volatility, however, the narrowing trend in the current account seen since late 2017 remains intact. Indeed, the cumulative current account surplus in the twelve months to July came in at €317bn (2.7% of GDP), down €66bn (or 0.6% of GDP) from the twelve months to July 2018. That, of course, reflects the narrowing of the surpluses in goods and services trade due to weaker external demand.

…but remains historically high

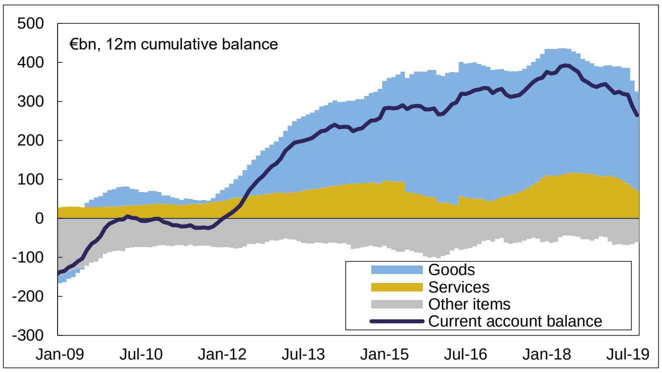
By historical standards, however, the current account surplus remains very large, and a function of excessive savings relative to investment in the euro area. In part, that reflects the elevated household savings rate, which among other things relates to the region's poor demographics. But although their contribution to aggregate net saving diminished last year as fixed investment picked up, non-financial corporations (NFCs) have also been net savers since the euro crisis. In addition, the steady decline of government borrowing over recent years meant that the euro area's current account surplus was larger than otherwise would have been.

Euro area: ECB's TLTRO operations



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Current account balance & contributions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Limited fiscal loosening to leave current account surpluses large in the core

We expect the aggregate fiscal stance of the euro area to loosen somewhat next year not least due to changes to policy in Germany, Italy and the Netherlands. But despite the ECB's ever-louder calls for certain governments in Northern Europe to provide effective and timely support to demand, the aggregate relaxation of the fiscal stance is likely to be relatively modest. Indeed, despite ongoing economic weakness, governments in Germany and the Netherlands are likely again to run budget surpluses, albeit somewhat smaller than in recent years. As a result, both countries will both continue to run exceptionally large current account surpluses, of about 7% and 9% of GDP respectively. And while the euro area's general government budget deficit might be expected to rise from about 1.0% of GDP this year, this increase will be modest, perhaps of the order of about ½% of GDP for a second successive year. Therefore, with household and NFC net savings unlikely to fall significantly in the face of increased economic uncertainty, we expect the euro area's current account surplus to remain close to 2½% of GDP in 2020, and indeed remain in that vicinity beyond.

The day ahead in the euro area and US

The main data focus in the euro area tomorrow will be on the Commission's flash consumer confidence indicator for September. The headline indicator has effectively trended sideways over the past six months. And while it fell a larger-than-expected 0.5pt in August to -7.1, that left it broadly in line with the average since the start of the year. Tomorrow will also bring German PPI figures for August. Meanwhile, a quieter end to the week for US releases will see the Fed publish the latest financial accounts figures for Q2.

UK

BoE keeps Bank Rate unchanged

There were no surprises from today's BoE monetary policy announcement, with Bank Rate left unchanged at 0.75%. But while the Committee's guidance on future policy was also little changed, there appeared to be a further loss of confidence on the MPC about the Brexit process. Indeed, the statement noted that, perhaps only "*in the event of greater clarity that the economy is on a path to a smooth Brexit*, and assuming some recovery in global growth…the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate". Although the MPC acknowledged that the Government's recent spending announcement could raise GDP by around 0.4% over the Bank's forecast horizon, it also noted that, due to the highly adverse impact on private investment, the longer Brexit uncertainties persisted the more likely that UK GDP growth would remain below potential. By the same token, therefore, the longer Brexit uncertainties persisted the more domestically-generated inflationary pressures would decline.

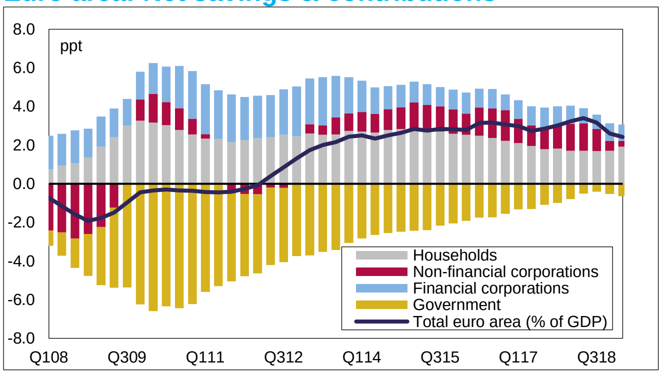
MPC more downbeat about GDP

Indeed, with global economic growth having also weakened, the Committee was more downbeat about the near-term outlook. In particular, after growth in Q2 turned out significantly weaker than it had previously expected, the Bank staff also revised down its expectation for Q3 GDP growth by 0.1ppt to 0.2%Q/Q. This principally reflected a smaller than previously anticipated contribution to growth from car production, as – contrary to earlier expectations – some manufacturers held their usual summer shutdown in addition to the earlier special shutdown in April as part of the initial Brexit deadline preparations. Moreover, with some car firms having indicated a further shutdown following the current end-October deadline, the MPC flagged additional downside risks to Q4 GDP.

Employment expected to slow further

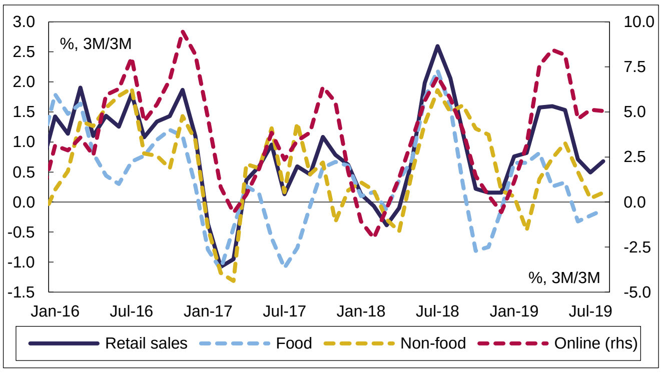
While the recent pickup in wage growth was slightly stronger than the Bank had expected and above the range judged to be consistent with the 2% inflation target, the MPC also noted that employment had slowed this year and was expected to

Euro area: Net savings & contributions



Source: Eurostat and Daiwa Capital Markets Europe Ltd.

UK: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

weaken further, raising uncertainties about the outlook for spare capacity in the labour market. So, while the BoE continued to state that the appropriate policy response in future would depend on the balance of the effects of Brexit on demand, supply and the sterling exchange rate, today's minutes had a more dovish feel than of late. And with our expectation for GDP growth and inflation more downbeat that the BoE over the forecast horizon, further policy easing in due course seems likely, with our current expectation for a 25bps cut in Bank Rate in February.

Retail sales still trending higher despite drop in August

Despite persistent Brexit uncertainty, household consumption has held up relatively well over recent quarters. But while retail surveys implied a notable turn for the worse over recent months, today's retail sales figures were consistent with positive growth in the third quarter. Admittedly, retail sales declined for the first month in three in August. But the drop of 0.3%M/M followed upwardly revised growth (0.4%M/M) in July. The weakness in August principally reflected non-store retailing, with the 3.3%M/M decline reversing some of the strength seen in July. But, on average in the first two months of Q3, sales at non-store retailers (i.e. principally online sales) were still almost 6½% higher than the average in Q2. And while there was a fall in spending at department stores (-1.3%M/M) in August, this category was also still trending higher than in Q2. In contrast, despite posting a notable increase last month, sales of household goods were on average in July and August more than 2% lower than in Q2. And sales of clothing failed to rise for the second successive month despite discounting as unseasonably wet weather in the first half of the month hit demand. Overall, retail sales were on average in July and August 0.7% higher than the average in Q2. So, while retailing accounts for roughly one third of private consumption, today's figures still suggest another solid positive contribution from household spending to GDP growth in the current quarter.

The day ahead in the UK

It should be a quiet end to the week in the UK with no data due for release. (The Supreme Court hearing judgement on whether PM Johnson's suspension of Parliament was lawful will not come until next week.)

European calendar

Today's results

Economic data							
Country	**Release**	**Period**	**Actual**	**Market consensus/ *Daiwa forecast***	**Previous**	**Revised**
EMU	Current account balance €bn	Jul	**20.5**	-	18.4	-
Italy	Current account balance €bn	Jul	**8.4**	-	5.0	-
UK	Retail sales including fuel M/M% (Y/Y%)	Jul	**-0.2 (2.7)**	0.0 (2.8)	0.2 (3.3)	0.4 (3.4)
	Retail sales excluding fuel M/M% (Y/Y%)	Jul	**-0.3 (2.2)**	-0.3 (2.3)	0.2 (2.9)	0.4 (3.1)
	BoE Bank Rate %	Sep	**0.75**	0.75	0.75	-

Auctions

Country	Auction
France	Auction: sold €3.6bn of 1.75% 2023 bonds at an average yield of -0.66%
	Auction: sold €3.9bn of 0% 2025 bonds at an average yield of -0.5%
	Auction: sold €1.5bn of 3.5% 2026 bonds at an average yield of -0.48%
	Auction: sold €0.4bn of 0.1% 2028 index-linked bonds at an average yield of -1.07%
	Auction: sold €0.9bn of 0.1% 2029 index-linked bonds at an average yield of -1.16%
	Auction: sold €0.4bn of 0.1% 2036 index-linked bonds at an average yield of -0.9%
Spain	Auction: sold €1.2bn of 0.05% 2021 bonds at an average yield of -0.477%
	Auction: sold €1.1bn of 0.6% 2029 bonds at an average yield of 0.211%
	Auction: sold €0.9bn of 5.75% 2032 bonds at an average yield of 0.358%
	Auction: sold €0.8bn of 1.85% 2035 bonds at an average yield of 0.649%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	15.00	Flash consumer confidence indicator	Sep	-7.0	-7.1
Germany	07.00	PPI Y/Y%	Aug	0.6	1.1
France	07.45	Final wages Q/Q%	Q2	0.5	0.8

Auctions

Country	BST	Auction/Event
UK	12.00	BoE publishes its Q319 Quarterly bulletin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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