Daiwa Capital Markets

Euro wrap-up

Overview

Emily Nicol
+44 20 7597 8331

- Bunds followed the global trend lower on increased optimism surrounding a US-China trade agreement, despite Germany's IP data confirming the fifth consecutive quarterly contraction in Q3.
- Longer-dated Gilts also made losses, despite a dovish BoE Monetary Policy Report and two MPC members having voted for a 25bps rate cut.
- Tomorrow will bring September trade reports from Germany and France, as well as IP data from the latter. A UK labour market survey is also due.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.621	+0.028
OBL 0 10/24	-0.522	+0.068
DBR 0 08/29	-0.251	+0.093
UKT 3¾ 09/21	0.516	-0.022
UKT 1 04/24	0.506	+0.004
UKT 0⅞ 10/29	0.767	+0.052

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

Euro area

German IP continues to contract

Attention in the euro area today was firmly on the latest German IP release. But while yesterday's factory orders provided a rare upside surprise, the output figures broadly aligned with downbeat expectations. In particular, total production fell 0.6%M/M in September, more than reversing the upwardly revised increase in August and marked the third monthly drop out of the past four. As such, output was still almost 4½% lower than a year earlier. Moreover, when excluding construction – the index consistent with the headline euro area measure of IP – the decline was even steeper at 1.0%M/M (-5.3%Y/Y). Within the detail, like construction (1.8%M/M), energy production provided a boost in September (2.0%M/M) albeit for only the second month out of the past eight. In marked contrast, the weakness in manufacturing in September (-1.3%M/M) was broad based – e.g. production of capital goods fell by 1½%M/M, intermediate goods by 1.3%M/M and consumer goods by ½%M/M. So, over the third quarter as a whole, manufacturing production declined 1%Q/Q, while total industrial output was down 1.1%Q/Q, both smaller drops than in Q2, but still representing the fifth consecutive quarterly contraction. Although manufacturing orders increased at the end of Q3, it's far too soon to judge that they have finally turned the corner for the better. Indeed, while car production looks set for a better fourth quarter, with various business surveys suggesting ongoing weakness elsewhere – e.g. the manufacturing PMI implied further steep declines in output and new orders in October – the outlook for the sector remains far from favourable heading into year-end.

The day ahead in the euro area and US

Tomorrow will bring the latest industrial production figures from France, which in contrast to Germany, are expected to report a modest increase in output in September, albeit the forecast rise of 0.4%M/M would reverse only half the decline seen in August and still leave production almost 1% lower over the third quarter as a whole. Friday will also bring September's goods trade reports from Germany and France.

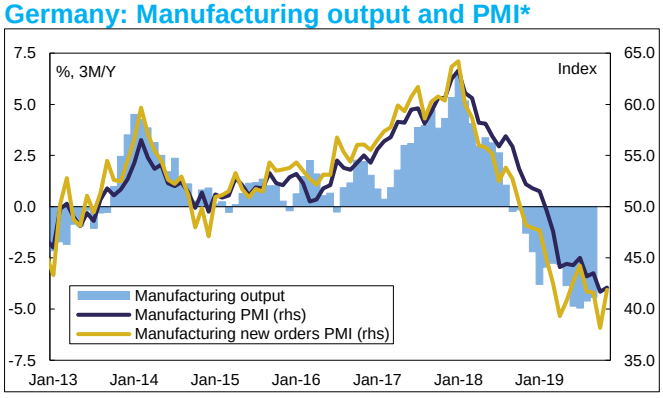
In the US, the end of the week will bring the University of Michigan's latest consumer sentiment survey for November, along with wholesale inventories and trade sales figures for September. Elsewhere, the Fed's Daly and Bostic are due to speak publicly.

UK

Bank Rate unchanged, but two vote for cut

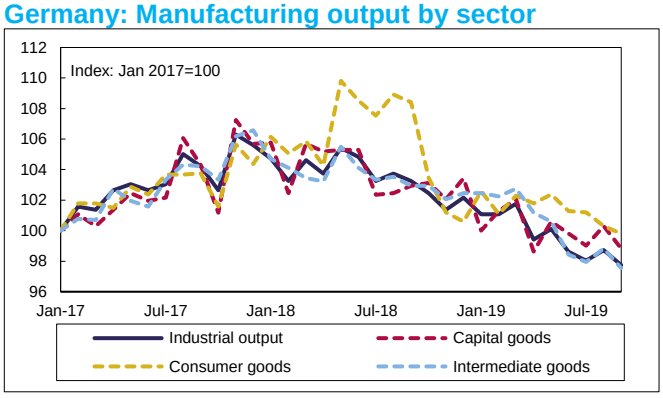
As predicted, the BoE today kept Bank Rate unchanged at 0.75%. But the meeting was not completely uneventful, with two Committee members – Michael Saunders and Jonathan Haskel – voting for a 25bps rate cut, the first split decision since June 2018. The accompanying newly rebranded Monetary Policy Report was also decidedly more downbeat about the economic outlook

Germany: Manufacturing output and PMI*



PMIs have one-month lead. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output by sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

further along the forecast horizon than it had been three months ago. And despite the Government's negotiation of a Brexit Withdrawal Agreement and the Article 50 extension having reduced expectations for a no-deal Brexit, the BoE still assessed risks to its downwardly revised GDP forecast to be skewed to the downside.

Growth forecasts revised down

Admittedly, the Bank's expectation for GDP growth in the second half of 2019 was nudged slightly higher, to 0.4%Q/Q in Q3 and 0.2%Q/Q in Q4. But Carney flagged that this differed somewhat from the message from recent surveys – certainly we see a non-negligible probability of negative growth in the final quarter of the year. Moreover, the Bank acknowledged that underlying growth had slowed materially over the past year, with average quarterly growth just half that seen in the previous three years. Looking ahead, reflecting not least an appropriately weaker assessment for the global outlook, the Bank maintained its expectation for sub-potential growth this year and next (1.3%), and also revised notably lower its GDP growth forecast further out. Indeed, despite an anticipated boost to growth from fiscal policy, with the Government's recent spending review assessed to add 0.4% to the level of GDP by the end of the forecast horizon, the Bank's GDP growth projections for Q421 and Q422 on a like-for-like basis (i.e. adjusted for the changes in asset prices and world economic outlook since the August Inflation Report to reduce the inconsistencies in its previous forecasts) were cut by 0.4ppt to 1.8%Y/Y and 0.2ppt to 2.1%Y/Y respectively. And given that these projections are based on the unlikely assumption of an orderly transition to a deep free trade agreement between the UK and EU, we suspect they will need to be revised lower in due course.

Inflation set to fall further over near term

Against the backdrop of softer economic growth and a less tight labour market, the Bank anticipated a further fall in headline inflation over the near term due principally to developments in regulated prices. And while it forecast a gradual increase through the second half of its projection horizon, not least as previous energy price declines drop out, the Bank pushed back its central expectation that headline inflation will rise back to its 2% target by almost one year to Q321. Moreover, based on the assumption that rates follow the path implied by the markets (i.e. with a near-term 25bp rate cut and policy unchanged thereafter), headline CPI was expected to rise to only slightly above the target (2.2%) by end-2022. While the BoE judged risks to its inflation forecast to be broadly balanced, it also acknowledged the impact of the exchange rate will remain key, which in turn will remain sensitive to developments with Brexit.

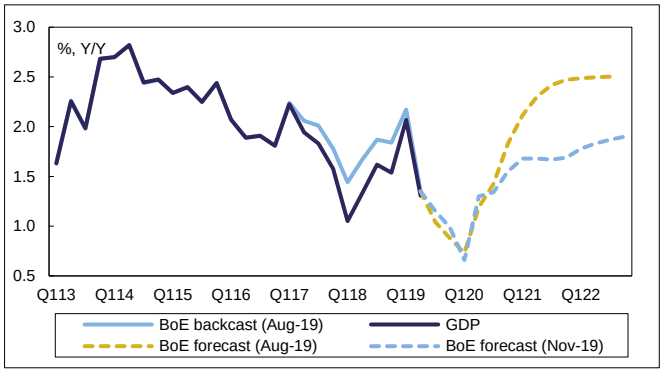
Rate cut on the cards

Of course, the unpredictable outcome of next month's General Election represents a crucial additional source of uncertainty with respect to the economic outlook, not least due to the wide range of economic policies being proposed by the various parties. However, there is a significant risk that lack of clarity with respect to Brexit will drag on regardless of the outcome. Yet even if Johnson's Withdrawal Agreement Bill is adopted before the end-January 2020 deadline, we would not expect a sudden improvement in business sentiment, with still significant ambiguities likely to persist surrounding the UK's future trading agreements. Indeed, Johnson is currently insisting that the UK would not extend its transition period beyond the end of 2020, raising the risk that UK exporters will face major tariff and non-tariff barriers when trading with the EU if – as would seem highly likely – an FTA with the EU had still not been agreed by the middle of next year. So, despite the BoE policy statement having noted that, should the "economy recover broadly in line with the MPC's latest projections, some modest tightening of policy, at a gradual pace and to a limited extent, may be needed", we think GDP and inflation will be significantly weaker than those forecasts imply. And so, we expect the MPC's next policy move to be an easing rather than a tightening. Our central expectation is for a 25bps rate cut in January.

The day ahead in the UK

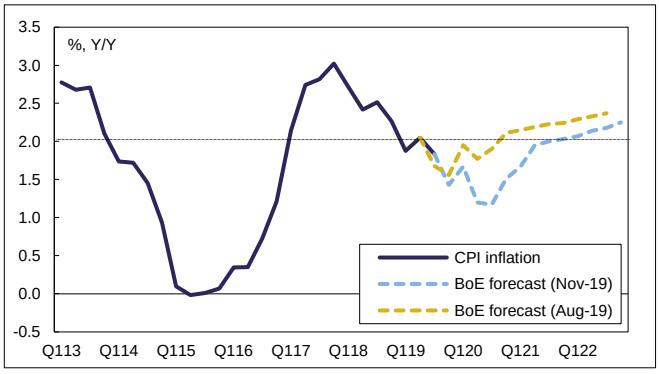
A relatively quiet end to the week will bring the REC/KPMG Report on Jobs, which will provide an update on labour market conditions at the start of Q4.

UK: BoE GDP forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE CPI forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Industrial production M/M% (Y/Y%)	Sep	**-0.6 (-4.3)**	-0.3 (-4.4)	0.3 (-4.0)	**0.4 (-3.9)**
	Construction PMI	Oct	**51.5**	-	50.1	**-**
Italy	Retail sales M/M% (Y/Y%)	Sep	**0.7 (0.9)**	-	-0.6 (0.7)	**-0.5 (0.8)**
UK	BoE Bank Rate %	Nov	**0.75**	0.75	0.75	**-**

Auctions

Country	Auction
France	sold €5.2bn of 0% 2029 bonds at an average yield of -0.03%
	sold €1.2bn of 1.25% 2034 bonds at an average yield of 0.24%
	sold €2.5bn of 1.5% 2050 bonds at an average yield of 0.79%
	sold €1.13bn of 1.75% 2066 bonds at an average yield of 0.95%
Spain	sold €970mn of 0.25% 2024 bonds at an average yield of -0.199%
	sold €1.0bn of 0.6% 2029 bonds at an average yield of 0.295%
	sold €1.0bn of 1.85% 2035 bonds at an average yield of 0.699%
	sold €568mn of 0.15% 2023 index-linked bonds at an average yield of -1.064%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Trade balance €bn	Sep	18.8	16.4
	07.00	Exports (imports) M/M%	Sep	0.4 (0.0)	-1.5 (0.6)
France	07.45	Trade balance €bn	Sep	-4.9	-5.0
	07.45	Industrial production M/M% (Y/Y%)	Sep	0.3 (0.4)	-0.9 (-1.4)
	07.45	Manufacturing production M/M% (Y/Y%)	Sep	0.2 (0.1)	-0.8 (-1.6)

Auctions and events

Country	BST	Auction / Event
UK	-	UK's sovereign credit rating review by Moody's
	00.01	REC/KPMG Report on Jobs for October

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.