Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds followed USTs lower in the afternoon session to end little changed despite weak German IP data.
- Gilts made very modest gains as a UK labour market survey signalled further weakening in job and wage growth.
- Thursday will be an eventful day in the coming week, with the first ECB policy meeting under President Lagarde and the UK's General Election scheduled. Euro area IP and UK GDP figures for October are also due.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.638	-0.002
OBL 0 10/24	-0.548	+0.009
DBR 0 08/29	-0.292	+0.006
UKT 3¾ 09/21	0.584	-0.001
UKT 1 04/24	0.572	-0.007
UKT 0⅞ 10/29	0.764	-0.009

*Change from close as at 4:15pm GMT.
Source: Bloomberg

Euro area

German IP plunges at start of Q4

Hopes that Germany's manufacturing sector might be turning the corner were dashed by today's production data for October. Following yesterday's weak factory orders figures, and contrary to expectations of a sideways move, total industrial production fell 1.7%M/M, the most since April, following a decline of 0.6%M/M in September. That left it at the lowest level since November 2015, 1.9% below the Q3 average and a huge 8.0% below the peak reached two years ago. Within the detail, manufacturing production also fell 1.7%M/M to drop to a level 9.2% below its peak. Production of consumer and intermediate goods rose, with a welcome surge in the chemicals sub-sector (up 6.7%M/M). But output of capital goods was down 4.4%M/M. And strikingly, production of motor vehicles – so important for the German economy – fell a sharp 5.6%M/M to the lowest level since August 2014. Beyond the manufacturing sector, a second successive monthly rise in energy production (up 2.3%M/M) offset a steep drop in construction (down 2.8%M/M).

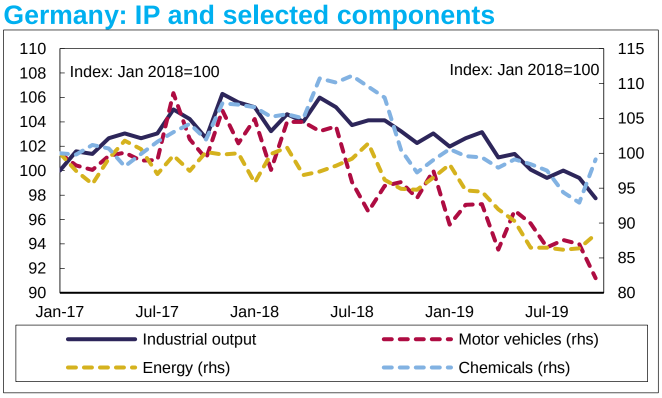
The weak IP and factory orders data also followed a very downbeat report on German retail sales (down 1.9%M/M, the most this year). Of course, special factors might have exacerbated the weakness (e.g. the timing of the German Unity Day holiday at the start of the month might have seen many workers take an extra day's leave). And it would not be a big surprise if the data were revised in due course. However, the drop in production tallies with the downbeat survey indicators for the sector. And looked at in the round, all recent data undeniably flag the likelihood of another very soft showing for German (and euro area) GDP in Q4, and indeed the risks of a second contraction in three quarters in the euro area's largest member state.

The week ahead in euro area and US

The main event of the coming week in the euro area will be Thursday's conclusion of the latest ECB Governing Council meeting, the first since Christine Lagarde succeeded Mario Draghi as President. The meeting will coincide with publication of the ECB's updated macroeconomic projections. But we do not expect significant amendments to be made to the previous projections, published in September, which anticipated a gradual pickup in GDP growth and inflation over coming quarters. At the October meeting, some Governing Council members cautioned that the expected improvements might not materialise. However, euro area GDP growth in Q3 (0.2%Q/Q) was a touch firmer than the ECB had expected and the near-term profile for inflation is likely to be slightly stronger than previously forecast.

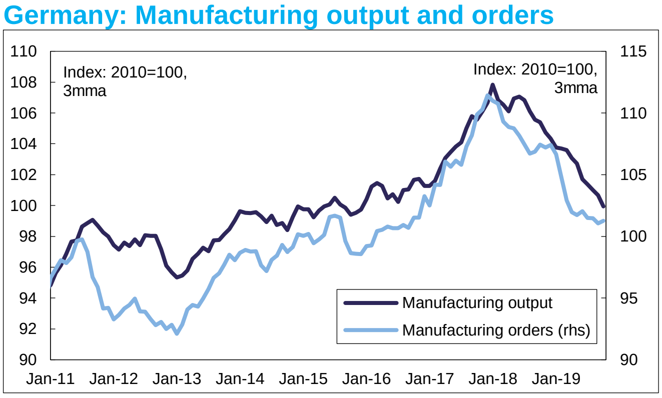
This time around, the ECB will for the first time publish projections for 2022, which we expect to show inflation below but close to 2.0%Y/Y, essentially consistent with its target, in that year. But Lagarde is likely to emphasise that the risks to the outlook remain skewed to the downside. So, there will be no reason whatsoever to amend policy, including the forward

Germany: IP and selected components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output and orders



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

guidance which currently states that "the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon and such convergence has been consistently reflected in underlying inflation dynamics". Of course, Lagarde has already indicated that the ECB will shortly commence a review of its monetary policy strategy, and her press conference on Thursday might offer detail on its scope, direction and timeline.

Data-wise, the coming week will maintain a focus on conditions in the manufacturing sector, with German goods trade figures due on Monday, French and Italian IP figures due the following day, and the equivalent euro area data due on Thursday. Given today's German numbers, euro area IP is expected to have declined at least ½%M/M at the start of Q4. Other data due in the coming week include German labour cost data for Q3 on Monday and the ZEW survey of investor sentiment in December on Tuesday. In the markets, Germany will sell 2Y Schatz on Tuesday, and Italy will sell 3Y and 7Y BTPs on Thursday.

In terms of politics, strains within the Italian government coalition will remain closely watched, with disagreements today having emerged over the 2020 Budget plan, which was criticised this week by European Commission Vice President Dombrovskis. Not least given the likelihood that any early election would be won comfortably by Salvini's League and its allies, we do not expect the government to fall apart over the near term, and certainly not before the regional elections due in late January. In Germany, meanwhile, investors will watch the ongoing SPD conference for clues about the future path of that country's coalition government. Delegates were expected today to approve a motion put forward by the new leadership team setting conditions for continued participation in the coalition, including a relaxation of the 'Black Zero' balanced-budget policy, a significant increase in public investment over ten years, a higher minimum wage, and a new anti-climate change agenda. As with Italy's ruling parties, however, we do not think that it is in the interests of the SPD to bring down the government at this point in time.

Like in the euro area, monetary policy will also be the focus in the US, where the Fed's latest policy meeting will conclude on Wednesday. No change to policy is expected, with the target range for the Fed Funds Rate to be maintained at 1.50-1.75%. And there seems little reason for Powell to change his recent message that rates are likely to be left unchanged for a while to come. Nevertheless, there will be scrutiny of FOMC members' updated economic projections and dot-plots of the expected path of rates, with the latter likely to highlight again the Committee's bi-directional split.

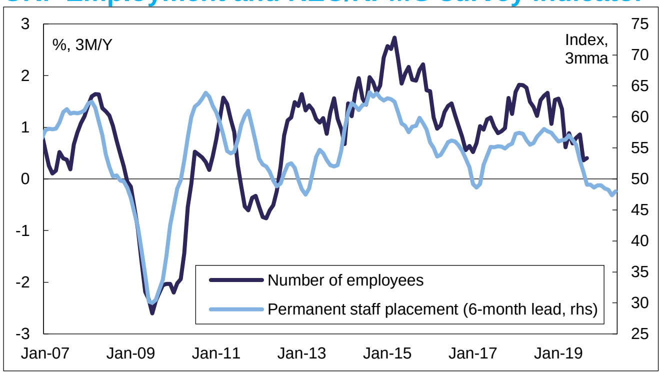
It will be a quiet start to the coming week for US economic data, with no releases scheduled on Monday and the NFIB small business survey for December and final Q3 unit labour cost and productivity data due on Tuesday. Thereafter, a key focus will be inflation, with November's figures for CPI, PPI and import/export prices due Wednesday, Thursday and Friday respectively. In terms of CPI, both the headline and core indices are expected to rise 0.2%M/M, which would see the headline annual rate rise 0.2ppt back to 2.0%Y/Y but the core rate unchanged at 2.3%Y/Y. The other top-tier release of the week will come on Friday with the advanced retail sales figures for November. In the markets, the Treasury will sell 3Y Notes on Monday, 10Y Notes on Tuesday and 30Y Bonds on Thursday.

UK

Labour market turning for the worse

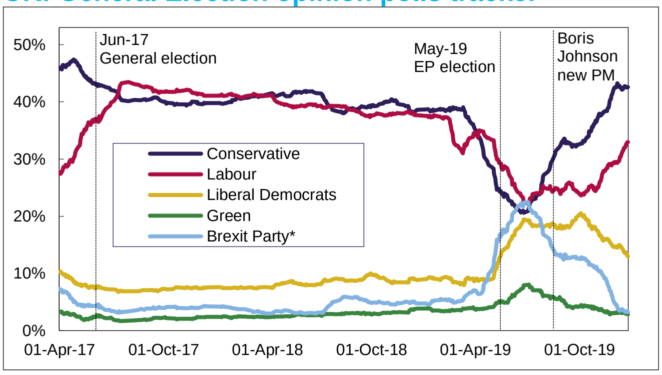
A quiet end to the week for UK economic data brought only the latest KPMG/REC report on jobs, which offered further evidence that conditions in the labour market have turned for the worse. In particular, recruitment consultants saw a further decline in permanent placements in November for the ninth consecutive month, with only a modest increase in temporary appointments too. And against the backdrop of persistent political uncertainty ahead of the 12 December election, consultants reported the slowest increase in job vacancies for more than a decade, while wages for both permanent and temporary staff rose at a softer pace – indeed, the relevant index for permanent salaries fell to the lowest since July 2016.

UK: Employment and REC/KPMG survey indicator



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

UK: General Election opinion polls tracker*



**15-poll moving average. Brexit Party shows UKIP data up to April 2019. Source Yougov, Ipsos Mori, Survation, Panelbase, ORB, ComRes, Opinium, Deltapoll, Kantar, ICM Research, BMG and Daiwa Capital Markets Europe Ltd.*

We expect the official average earnings data similarly to show a moderation in growth over coming months, suggesting that domestically generated price pressures are diminishing too.

The week ahead in the UK

The coming week in the UK will be dominated by Thursday's General Election, with markets likely to respond to the exit polls published as soon as polling stations close at 10pm. The results from individual constituencies will be published throughout the night, with the overall result likely to be clear well before European markets reopen on Friday morning. In the past week, investors have firmed up their expectation of a Parliamentary majority for PM Johnson's Conservatives, as opinion polls suggest that the party's lead over Labour has stabilised at around 10ppts. Given the margins of error on these polls, however, it remains within the bounds of possibility that the Conservatives will fall short of a majority, which would then open the door to a minority Labour administration. We currently attach a probability of 75% to a Conservative majority.

A majority for the Conservatives would mean that the UK would leave the EU at end-January and then enter a Brexit 'implementation' phase, which Johnson insists would conclude at the end of 2020. However, as it would be difficult for a new Free Trade Agreement between the UK and EU to be agreed and ratified before then, the risk of a highly costly WTO exit – implying the imposition of tariffs and non-tariff barriers to trade – at the end of next year would persist. The associated uncertainty would thus continue to weigh on business investment, which has flat-lined since the 2016 referendum. And so we would expect UK GDP to remain very subdued, meriting an easing of monetary policy. Therefore, while a Conservative majority would likely to see sterling appreciate further and Gilt yields rise too, we would expect those effects to reverse once again in the New Year as the continued weakness of economic activity became evident.

If there is a minority Labour administration, the new Government would need to seek a further extension of the Article 50 deadline beyond end-January to accommodate a second Brexit referendum around mid-year. It would also try to rapidly negotiate an alternative softer Brexit deal to be subjected to that referendum. The near-term impact on sterling and Gilt yields would be negative, and the near-term economic outlook would be no better as uncertainty persists. However, the possibility that Brexit might eventually be cancelled would represent upside future potential for sterling and economic growth. Finally, data-wise, all of the top-tier UK releases will come on Tuesday, with the October figures for GDP, production and trade due. The consensus forecast is for growth of 0.1%M/M, which would leave three-month growth at just 0.1%3M/3M. We see the risks to that view as skewed to the downside. Not least given the impact of uncertainty ahead of the end-month Article 50 deadline, manufacturing production seems likely to post a third successive monthly decline, while construction output is also likely to fall. Growth in services will likely be minimal. So, the difference between growth and stagnation might come down to the North Sea oil and gas sector.

The only other data release of note will come on Thursday with the November RICS residential market survey. In the markets, the DMO will sell 30Y linkers on Wednesday.

Daiwa economic forecasts

	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2019	2020	2021
GDP forecasts %, Q/Q											
Euro area	0.4	0.2	0.2	0.1	0.2	0.2	0.2	0.1	1.1	0.7	0.5
Germany	0.5	-0.2	0.1	0.1	0.1	0.2	0.1	0.1	0.6	0.5	0.4
France	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	1.3	1.2	0.8
Italy	0.1	0.1	0.1	0.0	0.0	0.1	-0.1	-0.1	0.2	0.1	0.0
Spain	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.3	2.0	1.6	1.1
UK	0.6	-0.2	0.3	-0.1	0.2	0.2	0.2	0.1	1.2	0.5	0.5
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.4	1.4	1.0	1.0	1.2	1.1	1.3	1.2	1.2	1.2	1.4
Core CPI	1.0	1.1	0.9	1.2	1.3	1.3	1.5	1.3	1.0	1.3	1.3
UK											
Headline CPI	1.9	2.0	1.8	1.5	1.7	1.1	0.9	1.0	1.8	1.3	1.5
Core CPI	1.9	1.7	1.7	1.7	1.6	1.4	1.2	1.1	1.7	1.3	1.3
Monetary policy											
ECB											
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.40	-0.40	-0.50	-0.50	-0.60	-0.60	-0.60	-0.60	-0.50	-0.60	-0.60
Net asset purchases*	0	0	0	20	20	20	20	20	20	30	30
BoE											
Bank Rate %	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.75	0.50	0.25
Net asset purchases**	0	0	0	0	0	0	0	0	0	0	0

**Monthly target €bn, end of period. **Monthly target £bn, end of period. Source: Bloomberg, ECB, 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%)	Oct	**-1.7 (-5.4)**	0.1 (-3.6)	-0.6 (-4.3)	- (-4.5)
France	Trade balance €bn	Oct	**-4.7**	-5.0	-5.6	-5.4
Italy	Retail sales M/M% (Y/Y%)	Oct	**-0.2 (1.0)**	- (1.1)	0.7 (0.9)	0.6 (0.8)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

The coming week's key data releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 9 December 2019			
Germany		07.00	Trade balance €bn	Oct	18.8	21.2
		07.00	Labour costs Q/Q% (Y/Y%)	Q3	-	0.8 (3.2)
France		07.30	Bank of France business sentiment indicator	Nov	99	98
			Tuesday 10 December 2019			
Germany		10.00	ZEW current situation (expectations) balance	Dec	-22.0 (3.5)	-24.7 (-2.1)
France		07.45	Industrial production M/M% (Y/Y%)	Oct	0.3 (-0.3)	0.3 (0.1)
Italy		09.00	Industrial production M/M% (Y/Y%)	Oct	0.2 (-2.0)	-0.4 (-2.1)
UK		09.30	Monthly GDP estimate M/M% (3M/3M%)	Oct	0.1 (0.0)	-0.1 (0.3)
		09.30	Industrial production M/M% (Y/Y%)	Oct	0.2 (-1.2)	-0.3 (-1.4)
		09.30	Manufacturing production M/M% (Y/Y%)	Oct	-0.1 (-1.3)	-0.4 (-1.8)
		09.30	Construction output M/M% (Y/Y%)	Oct	-0.4 (-0.2)	-0.2 (0.5)
		09.30	Services activity M/M% (3M/3M%)	Oct	0.1 (0.2)	0.0 (0.4)
		09.30	Trade balance (goods trade balance) £bn	Oct	-2.8 (-11.7)	-3.4 (-12.5)
			Wednesday 11 December 2019			
			- Nothing scheduled -			
			Thursday 12 December 2019			
EMU		10.00	Industrial production M/M% (Y/Y%)	Oct	-0.5 (-2.0)	0.1 (-1.7)
		12.45	ECB main refinancing rate %	Dec	0.00	0.00
		12.45	ECB marginal lending rate %	Dec	0.25	0.25
		12.45	ECB deposit facility rate %	Dec	-0.50	-0.50
Germany		07.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	1.1 (1.2)	1.1 (0.9)
France		07.45	Final CPI (EU-harmonised CPI) Y/Y%	Nov	1.0 (1.2)	0.8 (0.9)
UK		00.01	RICS house price balance	Nov	-5	-5
			Friday 13 December 2019			
Spain		08.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	0.4 (0.5)	0.1 (0.2)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 9 December 2019
			- Nothing scheduled -
			Tuesday 10 December 2019
Germany		10.30	Auction: €4bn of 0% 2021 bonds
			Wednesday 11 December 2019
UK		10.30	Auction: £0.5bn of 0.125% 2048 index-linked bonds
			Thursday 12 December 2019
EMU		13.30	ECB President Lagarde speaks after Governing Council policy decision
Italy		10.00	Auction: €2.5bn of 0. 3Y bonds
		10.00	Auction: €3.25bn of 7Y bonds
UK		-	UK General Election
			Friday 13 December 2019
France		-	French sovereign debt to be rated by Fitch
Spain		-	Spanish sovereign debt to be rated by Fitch
UK		-	UK sovereign debt to be rated by DBRS

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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