

Euro wrap-up

Overview

- Bunds made modest losses as Germany's ZEW survey signalled a notable improvement in investor sentiment about the outlook.
- Gilts made losses despite some softer than expected UK GDP data.
- After tomorrow's Fed announcement, Thursday will bring key European events with Lagarde's first ECB policy-meeting press conference and the UK General Election.

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Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.651	+0.001
OBL 0 10/24	-0.564	+0.006
DBR 0 08/29	-0.299	+0.012
UKT 3% 09/21	0.586	+0.013
UKT 1 04/24	0.599	+0.027
UKT 0% 10/29	0.793	+0.030

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

Source: Bloomberg

Euro area

German investor sentiment takes a turn for the better

Following yesterday's data revealing a more [positive export](#) performance at the start of Q4, today's German ZEW survey of financial market professionals – the first guide to economic sentiment in December – suggested renewed optimism about the outlook. In particular, the survey's expectations index jumped 12.8pts to 10.7, the highest level since February 2018 and a whopping 55pts higher than August's trough. Unfortunately, however, the expectations balance rarely provides a reliable guide to the growth outlook in the euro area's largest member state. The survey's current conditions index, however, provides a guide to the more closely watched ifo business survey (due 18 December). And while there was a second successive monthly increase in December – and by a sizeable 4.8pts, the most since the start of 2018 – this index remained firmly in negative territory at -19.9. That was still 65pts below the level a year ago and 115pts below its peak at the start of 2018. So, perceptions of current economic conditions remain very subdued and consistent with still weak GDP growth.

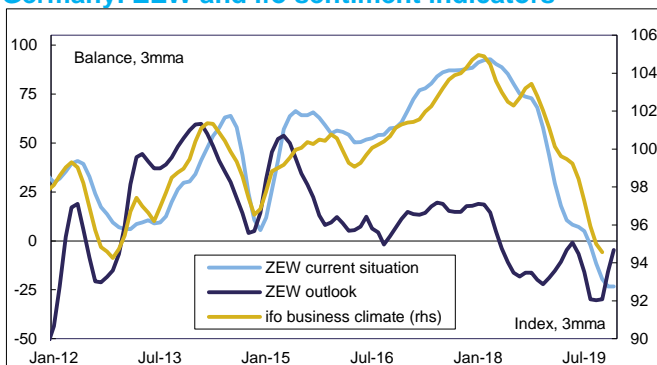
Positive start to Q4 for French IP

Contrasting with the weakness seen in [German production](#) in October, but consistent with the more upbeat Bank of France sentiment survey for that month, today's French industrial production data showed a second successive monthly increase in October of 0.4%M/M. With construction and energy production having slipped back, this growth was more than fully accounted for by manufacturing, where output rose 0.5%M/M. And this growth principally reflected an increase in production of 'other manufactured' goods (+1.7%M/M) on the back of a marked acceleration in output from the pharmaceuticals subsector (+8.3%M/M). Vehicle production (+3.4%M/M) reversed the decline in September. In aggregate, production of consumer and intermediate goods rose but capital goods production slipped back. And overall, while the level of total French industrial output remains below the peak seen in May, and still down compared with a year earlier (-0.2%Y/Y), the recent profile does suggest a return to positive growth over the fourth quarter as a whole, following the near-1%Q/Q decline in Q3.

Italian IP maintains downward trend

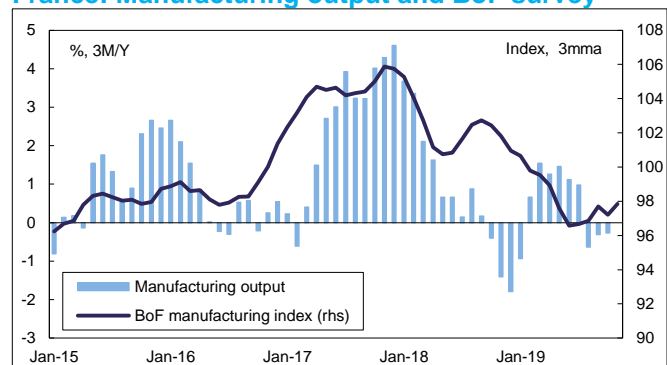
In contrast to France, Italy's production figures for October disappointed. In particular, total industrial output fell 0.3%M/M, the fourth monthly decline out of the past five, to be down 2.4%Y/Y, the steepest annual drop since last December. With the exception of consumer non-durables – in part thanks to increased production of pharmaceuticals and clothing – the weakness was broad based. So, overall manufacturing output was also down 0.3%M/M, more than reversing the increase seen in September and leaving it down 0.7%3M/3M, the sixth consecutive decline on a three-month basis. Looking ahead, the latest PMIs currently signal a slightly steeper pace of contraction in the sector in Q4 than in Q2 and Q3.

Germany: ZEW and ifo sentiment indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

France: Manufacturing output and BoF survey



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



The coming two days in the euro area and US

The main event in the euro area over the coming two days will be the conclusion on Thursday of the latest ECB Governing Council meeting, the first under the new Presidency of Christine Lagarde. The meeting will coincide with publication of the ECB's updated macroeconomic projections, although 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 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 post-meeting press conference might offer detail on its scope, direction and timeline.

In terms of data, after a day bereft of releases tomorrow, Thursday will also bring euro area industrial production figures for October. Notwithstanding the improvement in France, falls in production in Germany, Italy and Spain suggest that aggregate euro area output declined around ½%M/M at the start of Q4, leaving it almost 2½% lower than a year earlier. Final November inflation estimates from Germany and France are also due that day.

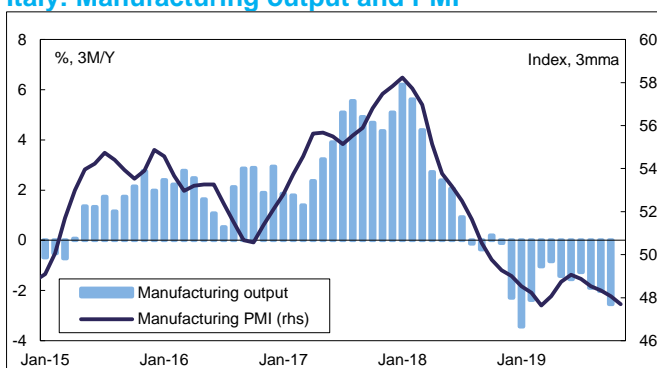
It will be a more eventful day in the US tomorrow, with the conclusion of the latest FOMC meeting, updated Fed forecasts and November's CPI estimate due. No change to policy is expected, with the target range for the Fed Funds Rate to be maintained at 1.50-1.75%. And there seems little reason for Fed Chair 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. With respect to the data, both the headline and core CPI indices are expected to have risen 0.2%M/M last month, 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. These data will be followed on Thursday by PPI figures for the same on month, as well as weekly jobless claims numbers and the Fed's flow of funds data for Q3. In the markets, the Treasury will sell 30Y bonds on Thursday.

UK

GDP fell short of expectations in October

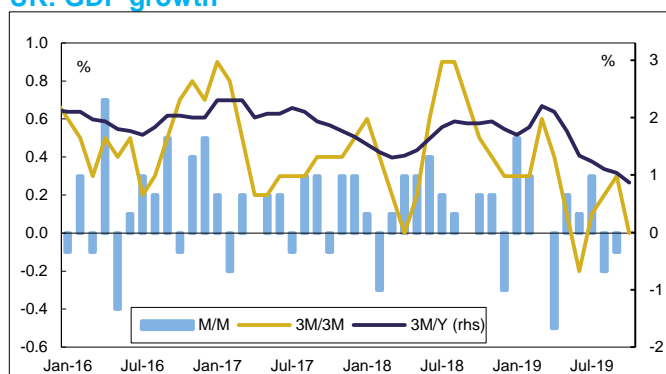
As the UK gears up to head to the polls on Thursday, today's GDP data for October further illustrated the ongoing negative economic impact of persistent political and Brexit uncertainty. Indeed, contrasting with the anticipated modest increase, total output flat-lined in October, marking the third consecutive month the economy has failed to grow. While the monthly series is notoriously volatile, GDP growth on a three-month basis also slowed to zero. And compared with a year earlier, output was just 0.7% higher, the weakest annual pace since mid-2012. Within the detail, there was a return to modest growth in services and manufacturing activity in October (+0.2%M/M a piece). But construction output fell sharply (-2.3%M/M) to its lowest level for eighteen months. And on a three-month basis, services slowed (down 0.2ppt to 0.2%3M/3M) while manufacturing – with the exception of transport equipment and food – went into reverse (down 0.7ppt to -0.7%3M/3M).

Italy: Manufacturing output and PMI



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

UK: GDP growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Looking ahead, with the three-month extension of the Article 50 deadline through to the end of January having removed the imminent threat of a no-deal Brexit, we might well see a pick up production before year-end, while Black Friday discounting and the Festive shopping period are likely to see consumer spending receive support. Nevertheless, with the PMIs signalling contraction and following today's figures for October, we continue to forecast negative GDP growth (-0.1%Q/Q) over the fourth quarter as a whole, which would leave the annual pace of expansion in Q4 at just 0.6%Y/Y, a rate that in the past would have sufficed to justify a rate cut from the BoE.

Imports surged as Brexit deadline approached

Given the distortions generated by the Article 50 deadlines as firms frontloaded shipments and built up inventories in case of a no-deal Brexit, monthly trade figures have been particularly volatile over the past year. This was again evident in October's trade report, with a sharp widening of the deficit (by £3.0bn to £14.5bn) as a surge in imports more than offset a rise in exports. In particular, imported goods jumped 9.8%M/M, the most since January, with import volumes from the EU up 5½%M/M and those from elsewhere up more than 14½%M/M. There was also an acceleration in goods exports to the EU (7.0%M/M). But with exports to non-EU countries down for the third consecutive month, this left total shipments of UK goods up just 1.9%M/M.

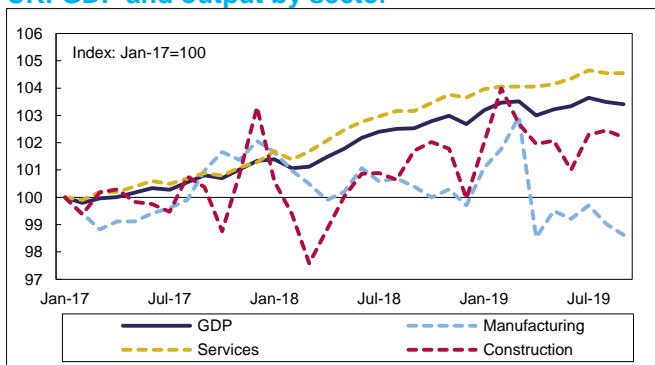
The coming two days in the UK

Of course, all eyes in the UK will be firmly on 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. Investors have firmed up their expectation of a Parliamentary majority for PM Johnson's Conservatives, as, on average, 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 growth to remain very subdued, meriting an easing of monetary policy. Therefore, while a Conservative majority would likely 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.

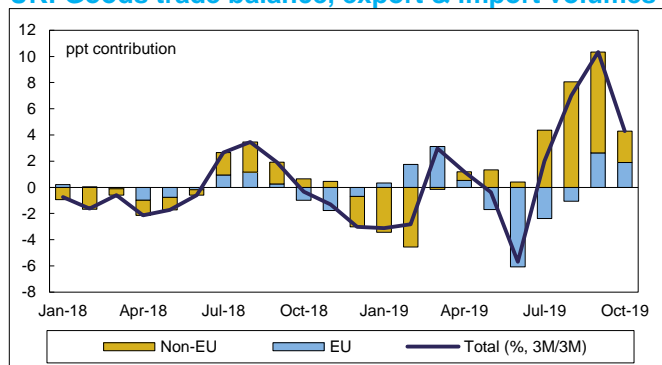
If there is a minority Labour administration, the new Government would need to seek a further extension of the Article 50 deadline beyond end-January to accommodate a second Brexit referendum around mid-year. It would also try to rapidly negotiate an alternative softer Brexit deal to be subjected to that referendum. The near-term impact on sterling and Gilt yields would be negative, all the more so given Labour's pledges to significantly increase both public current spending and taxes and its aggressive plans for renationalisation of utilities. The near-term economic outlook would also likely be no better than under the Conservatives as uncertainty persists. However, the possibility that Brexit might eventually be cancelled would represent upside future potential for sterling and economic growth.

UK: GDP and output by sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Goods trade balance, export & import volumes












Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.


European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany	 ZEW current situation (expectations) balance	Dec	-19.9 (10.7)	-22.0 (0.0)	-24.7 (-2.1)	-
France	 Industrial production M/M% (Y/Y%)	Oct	0.4 (-0.2)	0.2 (-0.4)	0.3 (0.1)	0.4 (0.2)
Italy	 Industrial production M/M% (Y/Y%)	Oct	-0.3 (-2.4)	-0.2 (-2.0)	-0.4 (-2.1)	- (-2.2)
UK	 Monthly GDP estimate M/M% (3M/3M%)	Oct	0.0 (0.0)	0.1 (0.0)	-0.1 (0.3)	-
	 Industrial production M/M% (Y/Y%)	Oct	0.1 (-1.3)	0.2 (-1.2)	-0.3 (-1.4)	-
	 Manufacturing production M/M% (Y/Y%)	Oct	0.2 (-1.2)	0.0 (-1.4)	-0.4 (-1.8)	-
	 Construction output M/M% (Y/Y%)	Oct	-2.3 (-2.1)	-0.2 (-0.1)	-0.2 (0.5)	-
	 Services activity M/M% (3M/3M%)	Oct	0.2 (0.2)	0.1 (0.2)	0.0 (0.4)	-
	 Trade balance (goods trade balance) £bn	Oct	-5.2 (-14.5)	-2.8 (-11.7)	-3.4 (-12.5)	-1.9 (-11.5)

Auctions

Country	Auction
Germany	 Auction: sold €3.2bn of 0% 2021 bonds at an average yield of -1.64%


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
- Nothing scheduled -					








Auctions and events

Country	GMT	Auction / Event
UK	 10.30	Auction: £0.5bn of 0.125% 2048 index-linked bonds





Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
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 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

Auctions and events

Country	GMT	Auction / Event
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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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