Daiwa Capital Markets

Euro wrap-up

Overview

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- With USTs selling off on trade-war headlines, Bunds also moved lower as the ECB left its policy and forward guidance unchanged but Lagarde suggested that downside risks to the outlook had become less pronounced.
- Gilts also made losses as the UK went to vote in its General Election.
- Friday will see markets respond to the UK election result, while Italian industrial sales and orders data are due.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.640	+0.012
OBL 0 10/24	-0.535	+0.045
DBR 0 08/29	-0.269	+0.056
UKT 3¾ 09/21	0.585	+0.013
UKT 1 04/24	0.615	+0.034
UKT 0⅞ 10/29	0.823	+0.048

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

Euro area

No change to policy as Lagarde takes over

Despite the handover of the Presidency from Mario Draghi to Christine Lagarde at the start of last month, nothing significant appears to have changed so far at the ECB. Following the first policy meeting chaired by Lagarde, the Governing Council today inevitably left unamended its main interest rates and €20bn monthly asset purchase target. It also left the precise wording of its forward policy guidance fully intact. So, it kept open the possibility of a further rate cut, restating that it expects "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%". And it reiterated that the QE programme is open-ended, with net asset purchases still set to run "for as long as necessary" and only "to end shortly before it starts raising the key ECB interest rates".

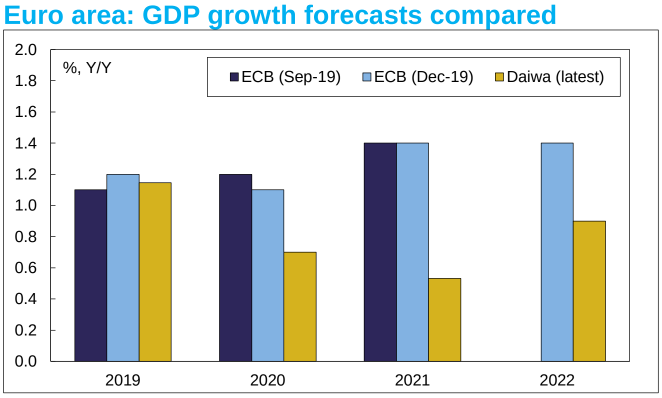
Lagarde judges rates to be clearly above the reversal rate

In the course of her press conference, Lagarde insisted that she was neither hawk nor dove. And she was keen not to preempt the findings of the ECB's strategic review on policy, which will kick off next month and conclude towards the end of 2020. Nevertheless, her comments suggested that her views are well aligned with those of Chief Economist Philip Lane, the architect of the September easing package. In particular, she judged that every one of the adjustments made by the ECB to its various policy tools in September – including both the rate cut and the recommencement of QE – would help to support economic growth and inflation in a complementary manner. And, as implied by the ECB's forward guidance, she would appear to believe that there is significant scope to cut rates further, citing the recent acceleration of bank lending as evidence that current levels are above the so-called "reversal rate" below which rate cuts would be contractionary.

Inflation to remain sub-target, but downside risks not so pronounced

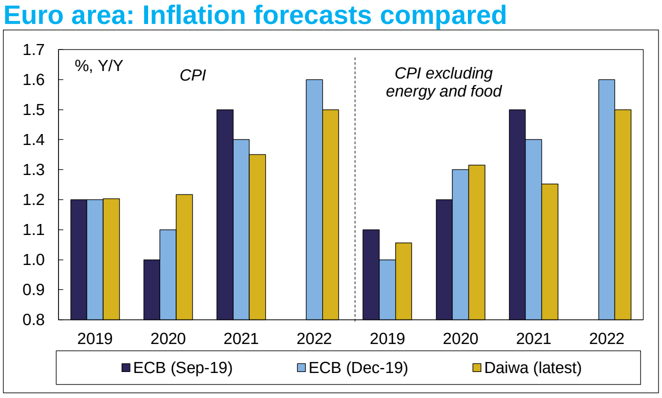
Nevertheless, we should not expect ECB policy to be adjusted for quite a while yet. The ECB's economic projections were little changed from the previous set published in September. So, it still expects economic growth to pick up gradually, from 0.2%Q/Q in the current quarter to 0.3%Q/Q in each quarter of next year, and 0.4%Q/Q in each quarter of 2021. That profile is only slightly softer than presented in the previous set of forecasts. So, full-year growth in 2020 is now predicted to be 1.1%Y/Y, just 0.1ppt lower than was anticipated in September, and no change was made to the full-year forecast for 2021 (1.4%Y/Y). Likewise, the ECB's inflation projection also saw minimal amendment, being nudged up very slightly in 2020 (to 1.1%Y/Y) but nudged down in 2021 (to 1.4%Y/Y), principally due to an amended profile for energy prices. The projections for 2022 – published for the first time – foresaw inflation continuing to rise gradually to 1.7%Y/Y in the fourth quarter of that year, a level that Lagarde judged still to fall slightly short of the ECB's target of "close to 2%". She also considered that the risks to

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.

the outlook remain tilted to the downside. But echoing yesterday's judgement by the Fed, Lagarde stated that the extent of the downwards skew was now less pronounced than previously thought. That is true. However, we still consider the ECB's projections to be overoptimistic. And if and when those forecasts will need to be revised down, the Governing Council will be forced to discuss the case for further easing. So, for now, we maintain our forecast of another 10bp cut to the deposit rate and a €10bn increase in the rate of net asset purchases in September 2020.

Euro area IP weakens further

In her press conference, Lagarde acknowledged that the ongoing weakness of international trade and persistent global uncertainties continued to weigh on business investment and, more generally, activity in the euro area manufacturing sector. And this impact was illustrated by today's economic data. Euro area industrial production fell for a second successive month in October and by 0.5%M/M, leaving it down more than 2% compared with a year earlier and at its lowest level for more than 2½ years. This was hardly surprising given the significant weakness already reported in Germany (-1.5%M/M), with output also lower in Italy and Spain. Production of autos in the euro area was down a sizeable 5.6%M/M in October, while aggregate capital goods output fell 2.0%M/M. The increase in intermediate goods output (+0.6%M/M) also failed to fully reverse the decline in September. And while consumer goods output (+0.6%M/M) was also boosted by pharmaceuticals, overall manufacturing production fell ½%M/M in October. Despite a modest improvement in industrial confidence indicators in November, they remained weak – the European Commission's industrial sentiment index was the second-lowest since mid-2013, while the headline manufacturing PMI (46.9) was still consistent with significant ongoing contraction in the sector. And we do not expect a marked rebound in production for a while to come.

The day ahead in the euro area and US

It should be a quieter end to the week for economic news from the euro area, with just final Spanish inflation numbers for November due, along with Italian industrial orders and sales data for October. In the US, meanwhile, tomorrow will bring retail sales figures for November. A reportedly strong start to the holiday shopping period and a pickup in sales of new vehicles is expected to have boosted overall retail sales. Friday will also bring export and import price indices for the same month, as well as business inventories figures for October.

UK

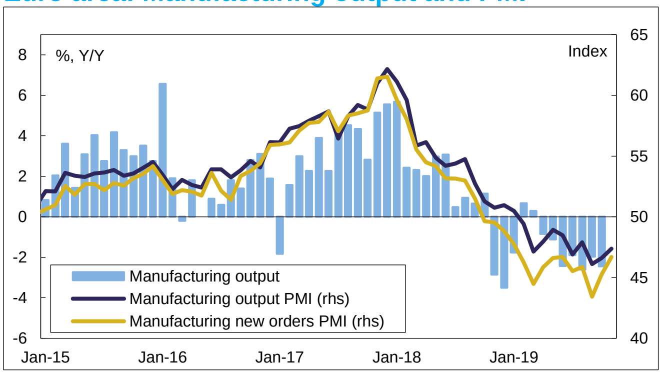
Political uncertainty weighing on housing market

As the UK headed to the polls in what will likely be a pivotal General Election for Brexit, today was a quiet day for domestic economic news with just the RICS Residential Market Survey results for November published. Unsurprisingly given heightened political uncertainty, new buyer enquiries and selling instructions fell again to suggest weakness on both the demand and supply sides of the market. But conditions are expected to improve gradually. The net balance for expected sales in three months' time edged up to 11%. And average twelve-months sales expectations rose for a third month in a row, suggesting that a net 35% of survey respondents (the most since February 2017) expect sales to increase this time next year. In terms of prices, following three broadly flat readings, the headline price balance fell to -12%, a level suggestive of a modest decline in average house prices at the national level albeit once again led by London and the South East. Near-term price expectations are relatively flat. But a net balance of 33% of respondents expect UK house prices to pick up over the coming twelve months.

The day ahead in the UK

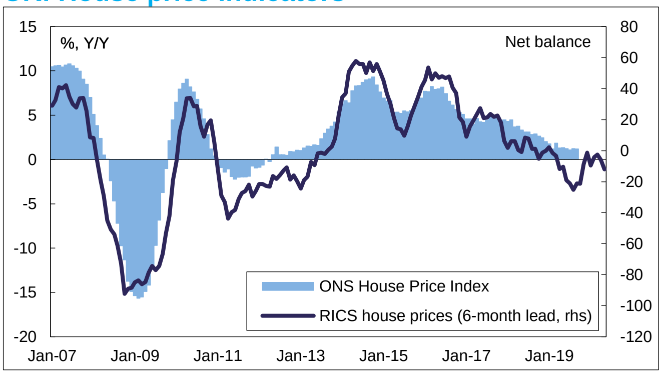
Of course, all eyes in the UK will be firmly on the outcome of today's General Election, with the exit polls to be published as soon as polling stations close at 10pm GMT. The results from individual constituencies will be published throughout the night, however, so that the overall result will likely to be clear well before European markets reopen tomorrow morning. Over the

Euro area: Manufacturing output and PMI



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

UK: House price indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

past week or so, 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 is still as much as 9ppts. 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 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 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 might well 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, a minority Labour administration would not be able to implement the most radical measures within the Party's manifesto. And the possibility that Brexit might eventually be cancelled would represent upside future potential for sterling and economic growth.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Industrial production M/M% (Y/Y%)	Oct	**-0.5 (-2.2)**	-0.5 (-2.0)	0.1 (-1.7)	**-0.1 (-1.8)**
	ECB main refinancing rate %	Dec	**0.00**	0.00	0.00	**-**
	ECB marginal lending rate %	Dec	**0.25**	0.25	0.25	**-**
	ECB deposit rate %	Dec	**-0.50**	-0.50	-0.50	**-**
Germany	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**1.1 (1.2)**	1.1 (1.2)	1.1 (0.9)	**-**
France	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**1.0 (1.2)**	1.0 (1.2)	0.8 (0.9)	**-**
UK	RICS house price balance	Nov	**-12**	-5	-5	**-6**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
	- Nothing to report -					

Auctions

Country	Auction
UK	sold £0.5bn of 0.125% 2048 index-linked bonds at an average yield of -1.825%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	0.4 (0.5)	0.1 (0.2)

Auctions and events

Country	BST	Auction / Event
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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