Europe | Economic Research | 13 December 2019

Euro wrap-up

Overview

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- While Gilts opened lower on the Conservatives' landslide election win, they subsequently rose in line with the global trend to close up on the day.
- On a day bereft of euro area data, Bunds followed a similar path to Gilts.
- The BoE's MPC meeting on Thursday will leave policy unchanged, while the flash December PMIs and UK figures for inflation, employment and retail sales are due.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.637	+0.005
OBL 0 10/24	-0.547	-0.007
DBR 0 08/29	-0.298	-0.025
UKT 3¾ 09/21	0.541	-0.043
UKT 1 04/24	0.586	-0.028
UKT 0⅞ 10/29	0.789	-0.032

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

UK

Johnson wins a landslide

Boris Johnson romped to a landslide victory in Thursday's General Election to ensure that the UK will leave the EU on 31 January. With echoes of Trump in 2016, Johnson's Conservatives won large swathes of seats in the traditional 'red wall' of the Labour heartlands in Northern England, Wales and the Midlands. The party achieved a House of Commons majority of 80 (out of 650 seats), its best result since Margaret Thatcher. The Conservatives were not the only party to perform well – the Scottish National Party won most seats North of the Border to intensify doubts about the future of Scotland within the UK. However, the pressures for a Scottish referendum are unlikely to crystallise before the next Scottish Parliament election in 2021. And undeniably, the main message from the General Election is that, for the foreseeable future, Johnson has carte blanche to set policy as he wishes, without having to worry about how Parliament might respond.

Passage of Withdrawal Agreement Bill should now be smooth

First and foremost, the large Conservative majority means that Parliament will likely pass the legislation required to ensure that the UK leaves the EU on 31 January without a great deal of fuss. A second reading of the Withdrawal Agreement Bill is likely to be held on 20 or 23 December, while the House of Lords could sit to consider the legislation shortly after Christmas. In the New Year, the Bill should be able to enter the parliamentary committee and report stages, before a final reading is held and the Withdrawal Agreement eventually completes a (probably smooth) passage into UK law. Of course, the European Parliament will similarly have to pass the necessary EU legislation, but that process is also likely to be a *fait accompli*.

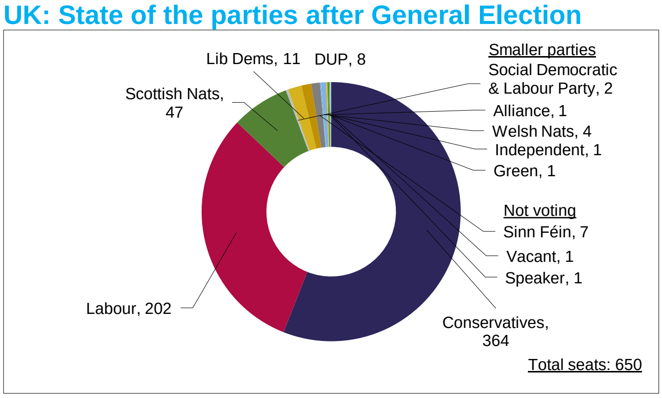
UK to enter transition period from end-January

Once the UK has left the EU on 31 January, it will enter a transition/implementation phase during which nothing will change in the country's trading and financial relationship with the EU, apart from the removal of the UK's say in decision-making. According to the Withdrawal Agreement, the transition period could be extended for one or two years, but only if that extension is agreed before July next year. During his election campaign, Johnson insisted that it would not be extended.

Negotiations on FTA to be the difficult

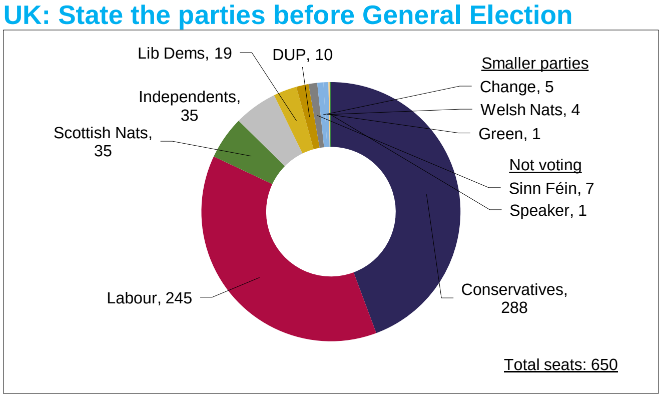
Negotiations to determine the longer-term future relationship should commence in the early spring, with a desire on both

UK: State of the parties after General Election



Source: UK Parliament and Daiwa Capital Markets Europe Ltd.

UK: State the parties before General Election



Source: UK Parliament and Daiwa Capital Markets Europe Ltd.

sides to put in place a new Free Trade Agreement as soon as possible. But this will be complicated and time-consuming. Johnson has repeatedly insisted that the UK should diverge significantly from EU rules on matters such as labour standards and environmental rights, and state aid rules. Should Johnson wish to secure a future FTA with the US, significant divergence would also be required from EU rules in several areas, including food standards. But wherever the UK seeks to diverge from EU rules, the EU will insist on the imposition of barriers to trade to protect the integrity of the Single Market and defend itself from what might otherwise be a greater threat of competition. Meanwhile, a simple 'off-the-peg' FTA such as was agreed between the EU and Canada would still fail to provide access to EU markets for services, the UK's strongest sector. So, unless Johnson gave up his plans to diverge in any meaningful way from EU rules, it is hard to believe that a new UK-EU Free Trade Agreement could be negotiated and ratified by the end of next year, and certainly not without damaging the UK economy.

Risk of a WTO trade relationship at end-2020

So, the Conservative victory would appear to bring with it a significant risk that the UK ends its transition period at end-2020 with the disruptive imposition of tariffs and non-tariff barriers to trade. Johnson's large majority, however, means that he should be less reliant in Parliament on the support of his party's hardline nationalist ERG grouping. As such, to secure a quick deal, he could choose to pivot towards a very soft form of Brexit, with a very high level of alignment with EU rules. Additionally, just as he reversed his earlier pledge to avoid a hard border down the Irish Sea under Brexit, he might in due course renege on his commitment not to extend the transition period beyond the end of next year. We suspect that he has yet to decide his strategy in terms of what the future trade arrangements should look like and in terms of how he might deliver them without causing collateral economic damage.

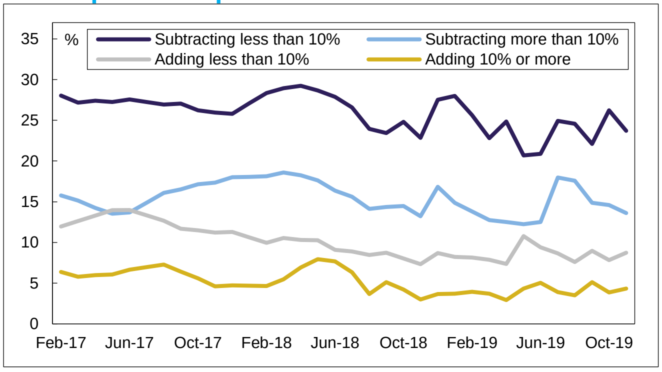
Transition uncertainty to weigh on capex

From a near-term economic perspective, the persisting uncertainty surrounding the transition and the risk of new barriers to trade being imposed at end-2020 would seem likely to continue to weigh on business investment in the UK, which has flat-lined since the 2016 referendum. A recent poll conducted by the Bank of England suggested that more than 40% of firms expected Brexit uncertainty to be unresolved until 2021 at the earliest. And even when that uncertainty lifts, a majority of firms expect the future arrangement between the UK and EU to affect sales negatively (see charts). So, although the new Government will pass a slightly stimulative Budget early next year offering households a small cut in National Insurance contributions and providing for extra public investment over the coming five years, we expect UK GDP growth to remain very subdued over coming quarters. That will also ensure that inflation remains sub-target, meriting an easing of monetary policy. So, we expect sterling in due course to give up some of its recent appreciation gain, and Gilt yields to fall back in the first half of next year.

The week ahead in the UK

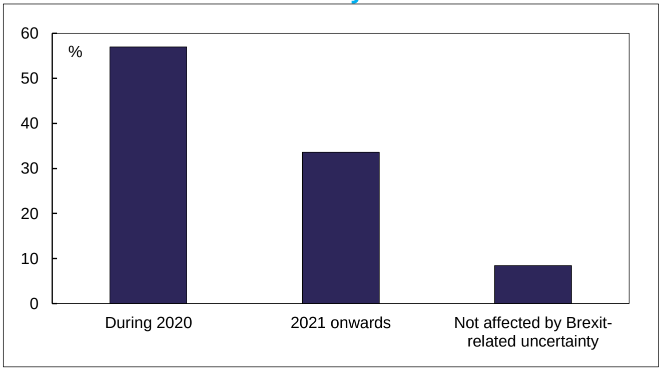
Politics aside, the main event in the UK in the coming week will be the BoE policy announcement on Thursday. The MPC adopted a more downbeat assessment of the economic outlook at November's meeting and two Committee members (Haskel and Saunders) voted for a 25bps rate cut – the first split decision since June 2018. This meeting seems likely to be largely uneventful, with Bank Rate again left unchanged at 0.75% and the same two members voting for monetary easing. The policy statement will, however, be closely watched for the Bank's judgement on recent developments. Near-term political uncertainties – both domestic and external – have diminished somewhat. But GDP has failed to rise in any month since August, and sentiment indicators remain consistent with contraction in Q4, compared to the BoE's previous expectation of growth of 0.2%Q/Q. Certainly, the flash December PMIs on Monday are expected to show that, despite a modest improvement on the month, the headline manufacturing and services indices remain below the key 50-level.

UK: Expected impact of Brexit on sales*



*Average probability of how firms anticipate sales will be impacted once the UK has left the EU. Source: BoE DMP survey

UK: When Brexit uncertainty will be resolved?*



*Share of respondents signalling expectation of when Brexit-related uncertainty facing their business will be resolved. Source: BoE DMP survey

The remainder of the week will be a busy one for top-tier releases too, with labour market, inflation and retail sales figures due Tuesday, Wednesday and Thursday respectively. With employment expected to have fallen for the third consecutive month in October, the unemployment rate is likely to tick slightly higher to 3.9%. Wage growth is also forecast to have fallen back. Against this backdrop, Wednesday's inflation release is likely to confirm that price pressures remain relatively subdued – indeed, we expect headline inflation to decline 0.1ppt to 1.4%Y/Y, which would be the weakest rate for three years. Finally, the retail sales figures for November are likely to be somewhat misleading, with the annual rate likely to be negatively impacted by the timing of the Black Friday sales – the ONS will incorporate this discounting period this year in the data for December rather than November. This release will also be accompanied by the CBI's distributive trades survey for December, which might shed more light on conditions in the retail sector over the fourth quarter as a whole. In the markets, finally, the DMO will sell 5Y Gilts on Tuesday.

Euro area

The week ahead in the euro area and US

After a quiet end to this week for euro area economic data, the coming week's calendar kicks off with arguably the most noteworthy release in the form of December's flash PMIs. While the headline manufacturing index is expected to post a modest improvement for the third consecutive month, it will still remain firmly in contractionary territory. And with the equivalent services index set to remain at a relatively subdued level, overall the composite PMI will be little improved from the 50.6 reading of November, which itself was the joint second-lowest since mid-2013. Indeed, the composite PMI for Q4 is likely to be roughly ½pt lower than the Q3 average and consistent with a softer pace of GDP growth. The Commission's flash consumer confidence indicator – due Friday – also seems unlikely to break out of the sideways trend seen since the start of the year. National sentiment indicators due include the German ifo (Wednesday) and French INSEE business indices (Thursday) and German GfK consumer and Italian ISTAT economic surveys (Friday).

With respect to price pressures, Monday's euro area labour costs figures for Q3 will be watched, while Wednesday will bring revised euro area inflation figures for November. These are likely to confirm that headline and core inflation ticked higher last month, by 0.3ppt to 1.0%Y/Y and 0.2ppt to 1.3%Y/Y respectively. Other euro area releases include November new car registrations and October trade figures (Tuesday), and October construction output data (Wednesday). Elsewhere, ECB Chief Economist Philip Lane will chair a panel at an ECB conference on fiscal policy and EMU governance on Thursday.

In the US, following the release of the Empire Manufacturing and flash Markit PMI indices on Monday, the first of the coming week's top-tier releases will come on Tuesday with November's IP data. These are expected to show that manufacturing output fully reversed the 0.6%M/M decline in October. Aside from the weekly jobless claims figures, Thursday will bring balance of payments data for Q3 as well as the latest Philly Fed and Conference Board's leading indices. Of most interest on Friday will be the monthly personal income and spending figures for November, which will include the closely watched deflators. That day will also bring revised Q3 GDP data and University of Michigan's consumer sentiment survey. Meanwhile, housing market indicators due include the NAHB house price index (Monday), housing starts (Tuesday) and existing home sales (Thursday). In terms of Fed speak, Williams, Kaplan and Rosengren will speak publicly on Tuesday, while Brainard speak at the ECB's conference on Thursday. In the markets, the US Treasury will sell 5Y TIPS on Thursday.

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	1.3	1.3	1.3	1.5	1.2	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	-0.50	-0.50	-0.60	-0.60	-0.50	-0.60	-0.60
Net asset purchases*	0	0	0	20	20	20	30	30	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
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**0.4 (0.5)**	0.4 (0.5)	0.1 (0.2)	-
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 16 December 2019			
EMU		09.00	Preliminary manufacturing (services) PMI	Dec	47.4 (52.0)	46.9 (51.9)
		09.00	Preliminary composite PMI	Dec	50.8	50.6
		10.00	Labour costs Y/Y%	Q3	-	2.7
Germany		08.30	Preliminary manufacturing (services) PMI	Dec	45.0 (52.0)	44.1 (51.7)
		08.30	Preliminary composite PMI	Dec	49.9	49.4
France		08.00	Preliminary manufacturing (services) PMI	Dec	51.5 (52.0)	51.7 (52.2)
		08.00	Preliminary composite PMI	Dec	52.0	52.1
Italy		09.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	0.4 (0.4)	0.2 (0.2)
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Dec	-	-1.3 (0.3)
		09.30	Preliminary manufacturing (services) PMI	Dec	49.2 (49.5)	48.9 (49.3)
		09.30	Preliminary composite PMI	Dec	49.6	49.3
			Tuesday 17 December 2019			
EMU		07.00	EU27 new car registrations Y/Y%	Nov	-	8.7
		10.00	Trade balance €bn	Oct	-	18.3
Italy		09.00	Trade balance €bn	Oct	-	2.8
UK		09.30	ILO unemployment rate 3M%	Oct	3.9	3.8
		09.30	Employment 3M/3M, '000s	Oct	-17	-58
		09.30	Claimant count rate % (change '000s)	Nov	-	3.4 (33.0)
		09.30	Average earnings (excluding bonuses) 3M/Y%	Oct	3.3 (3.4)	3.6 (3.6)
		11.00	CBI industrial trends survey, total orders	Dec	-25	-26
			Wednesday 18 December 2019			
EMU		10.00	Construction output M/M% (Y/Y%)	Oct	-	0.7 (-0.7)
		10.00	Final CPI (core CPI) Y/Y%	Nov	1.0 (1.3)	0.7 (1.1)
Germany		09.00	Ifo business climate index	Dec	95.5	95.0
		09.00	Ifo current assessment balance (expectations)	Dec	98.1 (92.9)	97.9 (92.1)
UK		09.30	CPI (core CPI) Y/Y%	Nov	1.4 (1.7)	1.5 (1.7)
		09.30	PPI input prices (output prices) Y/Y%	Nov	-1.9 (0.8)	-5.1 (0.8)
		09.30	House price index Y/Y%	Oct	-	1.3
			Thursday 19 December 2019			
France		07.45	Business confidence indicator	Dec	-	105
		07.45	Manufacturing confidence (production outlook) indicator	Dec	99 (-)	100 (-3)
UK		09.30	Retail sales including fuel M/M% (Y/Y%)	Nov	0.5 (2.6)	-0.1 (3.1)
		09.30	Retail sales excluding fuel M/M% (Y/Y%)	Nov	0.5 (2.1)	-0.3 (2.7)
		11.00	CBI distributiives trades survey, reported sales	Dec	-4	-3
		12.00	BoE Bank Rate %	Dec	0.75	0.75
			Friday 20 December 2019			
EMU		15.00	Consumer confidence indicator	Dec	-7.6	-7.2
Germany		07.00	GfK consumer confidence indicator	Dec	9.8	9.7
France		07.45	Consumer spending M/M% (Y/Y%)	Nov	0.2 (0.1)	0.2 (-0.2)
Italy		09.00	Consumer confidence (manufacturing) indicator	Dec	108.5 (99.0)	108.5 (98.9)
		09.00	Economic sentiment indicator	Dec	-	99.1
UK		00.01	GfK consumer confidence indicator	Dec	-14	-14
		00.01	Lloyds business barometer	Dec	-	9
		09.30	Final GDP Q/Q% (Y/Y%)	Q3	0.3 (1.0)	-0.2 (1.3)
		09.30	Current account balance £bn	Q3	-15.5	-25.2
		09.30	Public sector net borrowing £bn	Nov	5.5	10.5

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 16 December 2019
EMU		13.00	ECB Vice President Guindos scheduled to speak
UK		16.00	BoE publishes its Financial Stability Report
			Tuesday 17 December 2019
UK		10.30	Auction: to sell £2.75bn of 2% 2025 bonds
			Wednesday 18 December 2019
			- Nothing scheduled -
			Thursday 19 December 2019
EMU		15.30	ECB Chief Economist Lane scheduled to speak
UK		12.00	BoE MPC policy decision, statement and minutes published
			Friday 20 December 2019
UK		11.00	BoE's Haskel scheduled to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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