Euro wrap-up

Overview

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- Bunds followed Treasuries lower as German IP data exceeded expectations and exports maintained an upward trend.
- Shorter-dated Gilts made notable gains on the back of dovish comments from BoE Governor Carney and a disappointing UK retail survey.
- Friday will bring November IP data from France, Italy and Spain, as well as French business and UK labour market surveys.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.612	+0.011
OBL 0 10/24	-0.504	+0.023
DBR 0 02/30	-0.190	+0.023
UKT 3¾ 09/21	0.584	-0.045
UKT 1 04/24	0.612	-0.021
UKT 0⅞ 10/29	0.816	-0.001

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

Euro area

German industrial production data beat expectations

After yesterday's disappointing factory orders figures, today's German industrial production report provided better news. Overall IP rose a slightly larger-than-expected 1.1%M/M in November, while the extent of the drop in October was revised down to 1.0%M/M (compared to the fall of 1.7%M/M previously estimated). As such, production was down 2.6%Y/Y, the softest annual pace of decline since March. Within the detail, manufacturing output rose for the first month in three, up 1.0%M/M (albeit still down 3.9%Y/Y), boosted by a rebound in production of capital goods (2.4%M/M), with output of autos and machinery both higher. Meanwhile, production of consumer items rose for a second successive month (0.5%M/M). The headline IP figure got an extra boost from a leap in construction sector output, up 2.6%M/M and 5.4%Y/Y. But energy production slipped back 0.8%M/M (to be down 5.7%Y/Y) after exceptionally strong growth in October.

Manufacturing output to trough in Q4

Today's figures left construction and energy production in the first two months of Q4 trending more than 2% and 3% respectively above their Q3 averages. However, despite the rebound in November, on an equivalent basis manufacturing output was still down about 2% with total IP thus trending down 0.6% on the prior quarter. And with the VDA having reported a steep decline in auto production in December, manufacturing output seems bound to have fallen back again in December, and declined over the fourth quarter as a whole, extending the downturn in the sector for an eighth quarter. However, with factory orders having broadly levelled off, that should represent the trough, and we expect manufacturing production to cease being a drag on German (and euro area) GDP growth from the current quarter on.

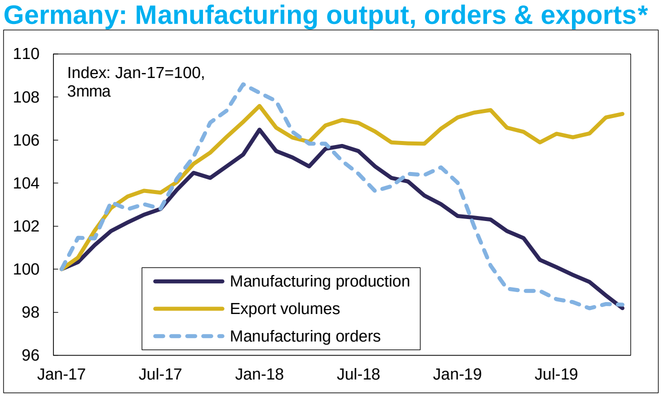
Exports on track for growth in Q4

Germany's November trade data were, unfortunately, significantly softer than expected, with export values down 2.3%M/M while imports fell just 0.5%M/M. As a result, the trade surplus fell more than €2bn to €18.3bn, the smallest since June. Adjusting for prices, export volumes fell 2.3%M/M in November. However, the weaker showing followed two months of solid export growth. So, on average over the first two months of Q4 export volumes were still trending 1.0% above the Q3 norm, and the bottom in exports appears to have passed. In addition, with import volumes about 0.8% higher on an equivalent basis, net trade might well have provided support to German GDP growth in Q4 for the third quarter in the past four.

Euro area unemployment drifts sideways

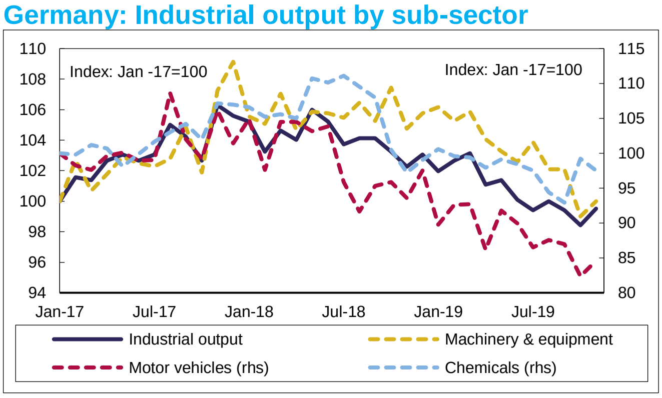
There were no surprises from the euro area's latest labour market figures, which saw the unemployment rate move sideways

Germany: Manufacturing output, orders & exports*



*Goods export volumes. Source: Bundesbank, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Industrial output by sub-sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

in November, remaining at 7.5% for the fourth month out of the past six. This was nevertheless the joint-lowest rate since the Global Financial Crisis, down 0.4ppt from a year ago and more than 4½ppts below the post-crisis peak. Among the larger member states, the unemployment rates were similarly unchanged in Germany (3.1%) and Italy (9.7%) where economic growth has been more sluggish over recent quarters. In contrast, there was a further modest improvement in France and Spain where economic momentum has remained steady, with the respective jobless rates down 0.1ppt a piece to 8.4%, the lowest since the start of 2009, and 14.1%, matching the more-than-decade low hit in three of the past eight months. Overall, the number of people out of work fell just 10k, with the 38k decline in the three months to November the smallest since November 2014. The latest national figures from Spain suggest only a further modest decline in unemployment at the end of 2019. And Germany reported the second monthly rise in three in December, with a further notable drop in vacancies to their lowest since early 2017, suggesting a renewed slowdown in the rate of job growth over the near term after a pickup in Q4. And, in aggregate, the pace of decline in the euro area unemployment rate will continue to slow this year, with our expectation of a drop to 7.3% by year-end broadly in line with the ECB's most recent projection.

The day ahead in the euro area and US

Friday will bring November industrial production reports from France, Italy and Spain, which with the exception of Italy are expected to report modest growth, albeit at a likely softer pace than that seen in Germany. Tomorrow will also bring the Bank of France's business sentiment survey for December, which is expected to show no improvement or deterioration in conditions at the end of 2019.

Of course, a key focus tomorrow will be the December labour market report out of the US, with non-farm payrolls expected to have risen by somewhat less than the 180k average for the first eleven months of the year, having leapt 266k in November partly thanks to returning GM strikers. While revisions to the Household Survey will also be published, the unemployment rate is expected to remain unchanged at 3.5%. And growth in average hourly labour earnings is expected to move sideways at 3.1%Y/Y.

UK

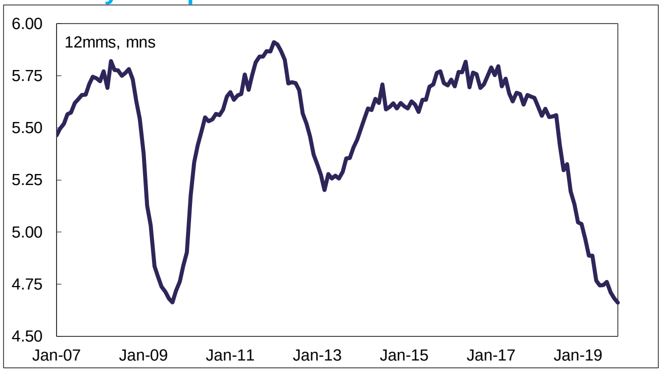
Dovish Carney comments give short-dated Gilts a boost

Gilts rallied at the shorter end of the curve and sterling weakened as outgoing BoE Governor Carney acknowledged the possibility of a near-term rate cut. The main focus of his speech was the evolution of the Bank's monetary policy framework, including possible options, such as an amended inflation target, to address the challenges posed by a world of persistently low global equilibrium interest rates. However, referring to the economic outlook, he noted that the BoE's most recent projections saw UK GDP growth picking up from current below-potential rates thanks to the reduction of Brexit-related uncertainties, fiscal easing and a modest recovery in global growth. But he also acknowledged that such a rebound in activity is not assured, with much hinging on the speed with which domestic economic confidence returns. He added that "If evidence builds that the weakness in activity could persist, risk management considerations would favour a relatively prompt response".

Rate cut likely if surveys fail to improve

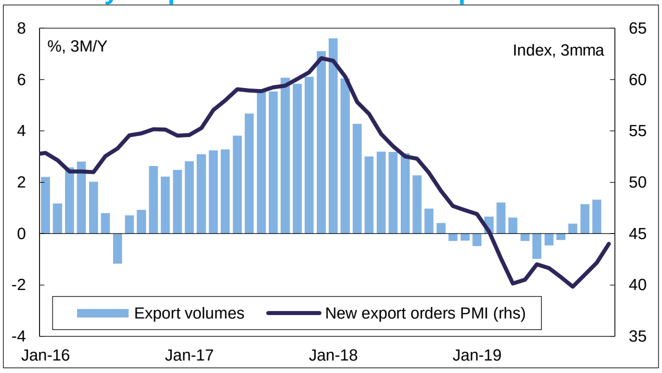
Carney's comments should not have come as a surprise. After all, two MPC members voted for a 25bp rate cut at the past two policy meetings. And given the weakness of economic growth over the past few quarters and the prospect that inflation will remain sub-target throughout the coming year, we have long seen a strong possibility that rates would be cut in H120. However, we would also emphasise that Carney's comments suggest that a rate cut is certainly not a done deal. The final December PMIs suggested that UK business confidence improved in the aftermath of the UK general election as near-term

Germany: Car production



Source: VDA, Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Export volumes & new export orders PMI



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

no-deal Brexit risk was effectively eliminated, while recent global economic data and financial market developments have also suggested no immediate cause for the BoE to shift its view. Moreover, of course, Carney has only one more policy meeting to chair before he is replaced by FCA Chair Andrew Bailey, who we suspect will take a relatively conservative approach to policy making. So, unless the flash January PMIs suggest that there will be no material recovery in growth this quarter, we would expect Bank Rate to be left unchanged when the MPC meets on 30 January. And as a near-term improvement in growth is our latest baseline, despite Carney's comments, we now think that a rate cut might not come along until next year when the economic hit from Brexit is likely to be more substantive.

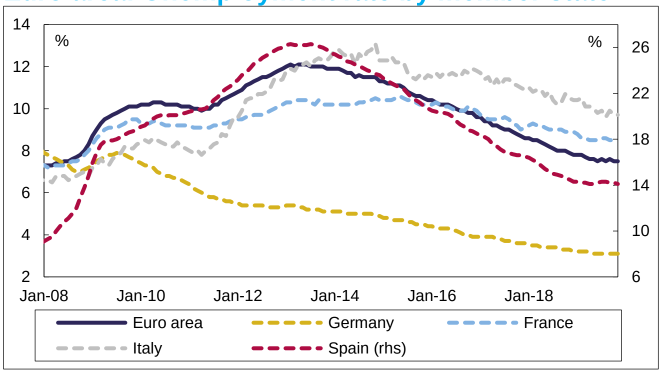
BRC suggests worst year on the High Street since early 1990s

Nevertheless, the case for near-term BoE easing was illustrated by the BRC retail sales monitor for the end of 2019, whose weakness was admittedly unsurprising. While there was a bounce back in the survey measure of sales growth in December, with total sales up 6.3ppts to 1.9%Y/Y and like-for-like sales growth at 1.7%Y/Y, to some extent this likely reflected special factors related to the inclusion of the Black Friday discounting period that month compared with November in 2018. Certainly, when smoothing out monthly volatility, today's release implied continued underlying weakness in spending, with the measure of total sales down 0.4%3M/Y in Q4. Indeed, while food sales continued to rise (albeit at a softer pace of 0.7%3M/Y), sales growth at non-food stores remained firmly in negative territory (-1.4%3M/Y). And over the year as whole, 2019 saw the first annual decline in BRC sales since records began in 1995, highlighting the major structural challenges facing the High Street. We caution, however, that the BRC figures have not been a reliable guide to the official retail sales figures in 2019, and we expect private consumption growth to have remained positive in Q4 and be relatively well maintained over coming quarters too.

The day ahead in the UK

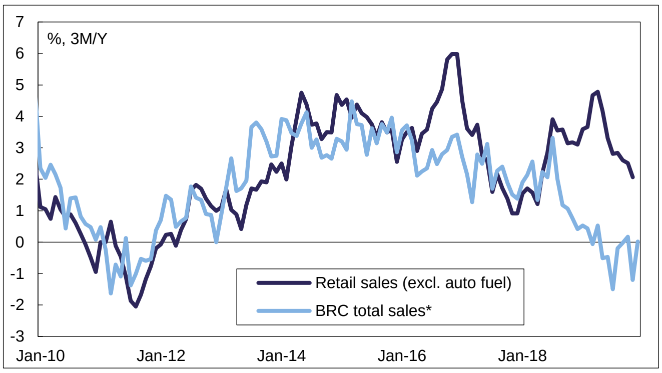
The end of the week will bring the latest REC/KMPG report on UK jobs for December. While this survey might show a modest pickup in the number of permanent staff placements at the end of 2019 as the outcome of the 12 December General Election provided some certainty on Brexit, it will likely remain consistent with a further slowdown in employment growth in the first half of 2020. In this respect, a speech by MPC member Tenreyro on the labour market outlook will also be of interest tomorrow.

Euro area: Unemployment rate by member state



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Retail sales and BRC retail monitor



**BRC sales adjusted using BRC shop price index. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Unemployment rate %	Nov	**7.5**	7.5	7.5	-
Germany		Industrial production M/M% (Y/Y%)	Nov	**1.1 (-2.6)**	0.8 (-3.7)	-1.7 (-5.3)	**-1.0 (-4.6)**
		Trade balance €bn	Nov	**18.3**	21.3	21.5	**21.3**
Italy		Unemployment rate %	Nov	**9.7**	9.7	9.7	-
UK		BRC like-for-like retail sales Y/Y%	Dec	**1.7**	-0.5	-4.9	-

Auctions

Country		Auction
France		sold €6.2bn of 0% 2029 bonds at an average yield of 0.04%
		sold €1.5bn of 1.25% 2036 bonds at an average yield of 0.44%
		sold €1.8bn of 1.50% 2050 bonds at an average yield of 0.87%
Spain		sold €2.0bn of 0.05% 2021 bonds at an average yield of -0.39%
		sold €1.4bn 0.25% 2024 bonds at an average yield of -0.10%
		sold €1.2bn of 1.85% 2035 bonds at an average yield of 0.85%
		sold €885mn of 0.7% 2033 index-linked bonds at an average yield of -0.44%
UK		sold £1.0bn of 0.125% 2028 index-linked bonds at an average yield of -2.44%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France		07.30	Bank of France industrial sentiment indicator	Dec	97	97
		07.45	Industrial production M/M% (Y/Y%)	Nov	0.1 (0.4)	0.4 (-0.2)
Italy		09.00	Industrial production M/M% (Y/Y%)	Nov	0.0 (-0.6)	-0.3 (-2.4)
Spain		08.00	Industrial production M/M% (Y/Y%)	Nov	0.2 (0.5)	-0.4 (-1.3)

Auctions and events

Country	GMT	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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