Euro wrap-up

Overview

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- Bunds made gains as euro area manufacturing output and export figures disappointed and data confirmed the softest full-year GDP growth in Germany for six years.
- Gilts made significant gains as UK inflation fell well short of expectations.
- Thursday will bring the ECB's account from its 12 December Governing Council meeting, euro area new car registrations figures and the BoE's credit conditions survey.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.604	-0.009
OBL 0 10/24	-0.514	-0.024
DBR 0 02/30	-0.206	-0.032
UKT 3¾ 09/21	0.458	-0.041
UKT 1 04/24	0.435	-0.072
UKT 0⅞ 10/29	0.648	-0.073

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

Euro area

IP falls short of expectations

After some positive German figures last week and sentiment surveys having implied some recovery in manufacturing conditions in November, today's euro area industrial production release for that month fell slightly short of expectations. In particular, total output rose a paltry 0.2%M/M in November, following a steeper pace of decline in October (revised by 0.4ppt to -0.9%M/M). So, output was still 1½% lower compared with its level a year earlier, nevertheless the softest annual rate of decline for six months. With production having risen in Germany (0.9%M/M), France (0.3%M/M) and Spain (1.1%M/M), the weakness in part reflected sharp (but not unusual) drops in Ireland (-4.1%M/M) and Greece (-3.7%M/M). At the aggregate level, the detail was mixed. Energy production rose for the first month in two (0.8%M/M), while the increase in capital goods production (1.2%M/M) reversed half the drop in October. Meanwhile, drops in intermediate and consumer goods output (down 0.5%M/M apiece) followed modest growth the prior month. So, overall, manufacturing production rose 0.2%M/M in November, leaving it trending broadly sideways compared with the Q3 average, a marked improvement on the near-1%Q/Q declines seen in the previous two quarters.

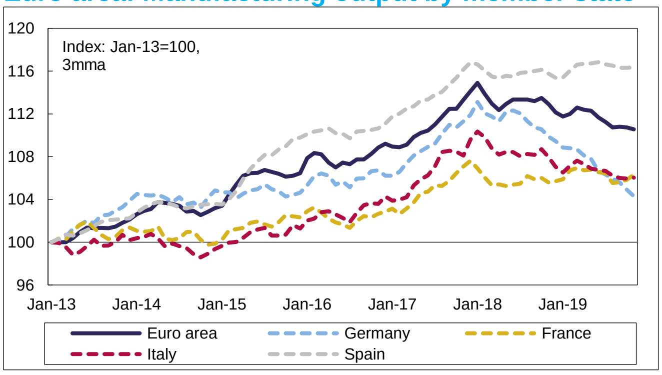
Exports disappoint, weakened by Brexit

At face value, today's euro area trade report also disappointed. In particular, the headline trade surplus fell €4.8bn to €19.2bn as the value of exports declined 2.8%M/M while the value of imports was down a smaller 0.5%M/M. Admittedly, the trade surplus narrowed from a more than two high in October. And the decline in exports followed a strong increase at the start of the quarter and was the first in four months. Moreover, the volatility was principally driven by movements in shipments to the UK, for which the 12%M/M drop in November was the steepest since April, when demand was also distorted by Brexit deadlines. But exports to the US were also weak, with the 4½%M/M drop the steepest for nineteen months, while shipments to Japan fell for the second successive month (1.0%M/M) and were also down to China (1½%M/M). Nevertheless, given the strength at the start of the fourth quarter, this still left exports over the first two months of Q4 trending more than 1% above the Q3 average. And with imports down a little less than ½% on the same basis, today's report offered cautious optimism that net trade provided a positive contribution to GDP growth in Q4 for the first quarter in three.

German growth predictably slow, while surplus again beats expectations

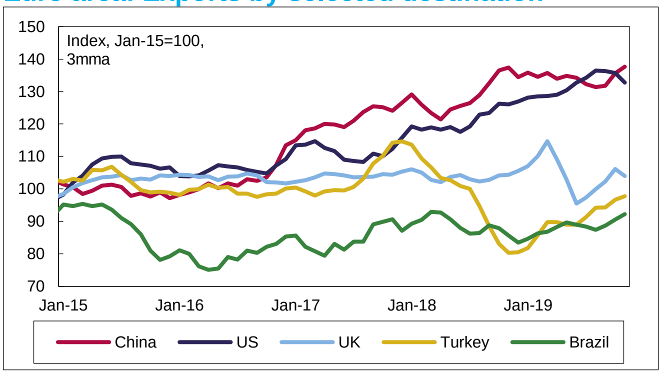
There was no surprise from the preliminary estimate of German GDP in 2019, which reported growth of just 0.6%Y/Y, down 0.9ppt from 2018 and the least since 2013. Within the detail, consumption of households (1.6%Y/Y) and government (2.5%Y/Y) accelerated at the fastest pace since 2016, as did construction investment (3.8%Y/Y). But investment in

Euro area: Manufacturing output by member state



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Exports by selected destination



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

machinery and equipment slowed sharply (down 4.0ppts to 0.4%Y/Y). And weak exports (0.9%Y/Y) meant that net trade, as well as inventories, subtracted from GDP growth. Despite the economic slowdown and strong increase in its spending, the government ran an eighth consecutive annual budget surplus. At 1.5% of GDP, this was larger than expected, twice as large as planned in the government's original Stability Programme for 2019, and 0.4ppt smaller than in 2018 despite the case for far more substantive support from fiscal policy. (The budget surpluses for each of the prior four years were revised higher too.) Today's data are consistent with our forecast of German growth of 0.1%Q/Q in Q4, preliminary data for which will not be published until Valentine's Day. And looking ahead, we expect economic growth to remain unchanged at 0.6%Y/Y in 2020, with the budget surplus remaining above 1.0% of GDP despite the increased scope to provide fiscal stimulus without increasing the government debt ratio.

The day ahead in the euro area and US

Thursday's most notable release will be the ECB's account from its 12 December Governing Council meeting, the first to be chaired by President Lagarde. On that occasion, policy was left unchanged, with the ECB's interest rates, monthly asset purchases and forward guidance all unamended. So, the Governing Council left open the door to further rate cuts. But the post-meeting press conference also suggested that Lagarde was keen not to preempt the findings of the ECB's scheduled strategic policy review, which is now underway and might not conclude before year-end. The account will no doubt be closely watched for any insight into the Governing Council's assessment of the economic outlook and how policy might evolve over coming quarters. But we might expect it to underscore expectations that policy is unlikely to change for a while yet.

Data-wise, new car registration figures for December are due along with final German inflation data for the same month, for which the headline rate on the EU-harmonised measure is likely to align with the flash estimate of 1.5%Y/Y. (Today's equivalent final estimates from France (1.6%Y/Y) and Spain (0.8%Y/Y) aligned with their respective preliminary figures.) In the evening, ECB President Lagarde will speak publicly in Frankfurt.

In the US, retail sales figures for December will be the highlight on a busy day for new economic data. Other releases include import and export price data for the same month, the Philly Fed and NAHB housing indices for January, and the usual weekly jobless claims numbers.

UK

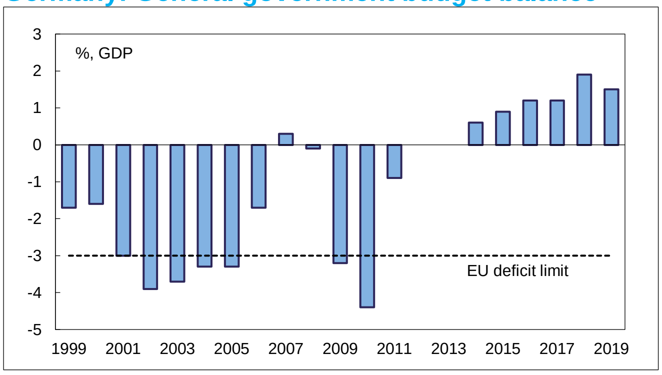
Inflation drops to three-year low

The case for a near-term rate cut increased further today as December's inflation data surprised on the downside. In particular, contrary to the consensus expectation of no change, the headline CPI rate dropped 0.2ppt to 1.3%Y/Y, the lowest since November 2016. Likewise, the core inflation rate fell 0.3ppt to 1.4%Y/Y, also the lowest in more than three years. Within the detail the weakness was widespread. Non-energy industrial goods inflation fell 0.2ppt to a seven-month low of 0.3%Y/Y, weighed particularly by prices of clothes on increased pre-Christmas discounting. And services prices rose the least for any December since 2000, pushing the respective inflation rate down 0.4ppt to 2.1%Y/Y, the lowest since April 2018. This, however, appears partly to have reflected special factors related to the timing of the data collection on inflation of airfares, which might point to a rebound in this component in January. Softness in another traditionally volatile component, restaurant and hotel prices (which fell for a third consecutive month to rise just 1.6%Y/Y, barely more than half the annual rate a year earlier) also contributed.

BoE expects a further dip in inflation in the spring

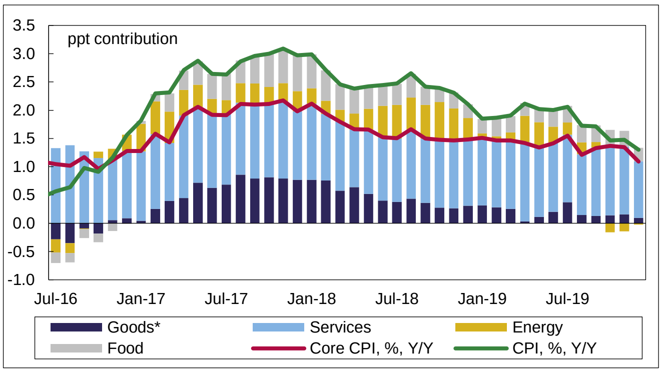
While today's data came in below expectations, headline inflation was only 0.1ppt lower than the rate implied by the BoE's November Monetary Policy Report forecast. And so, given also the special factors and weakness in the volatile components, they do not yet make an open-and-shut case for a rate cut. At last month's policy meeting, the MPC judged that the headline

Germany: General government budget balance



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation and contributions



**Non-energy industrial goods. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

inflation rate would pick up again in Q1 before falling to around 1¼%Y/Y in Q2 due to falls in regulated energy and water prices as well as the impact of recent appreciation of sterling. Thereafter, however, it was expected to pick up from the fourth quarter and rise above the 2.0%Y/Y target from the second half of 2021.

BoE risks significantly undershooting its target

Nevertheless, currently there appears little cost pressure in the pipeline. Core output producer price inflation fell further in December to 0.9%Y/Y, the lowest since June 2016. With economic output having slowed significantly, wage and job growth has moderated since the summer to suggest an easing of labour cost growth ahead. And so, while we also anticipate a pickup in inflation at the end of this year and into 2021 not least due to the costs generated by Brexit, there is a non-negligible risk that the headline CPI rate will fall around mid-year to below 1.0%Y/Y. That would require a letter explaining the substantive miss of the inflation target to be sent to the Chancellor of the Exchequer by the next BoE Governor, Andrew Bailey, who will take up his new role in March. And the risks of a sustained undershoot of the BoE's target led external member Michael Saunders today to restate his case for the rate cut, which he voted for at the last two MPC meetings.

The day ahead in the UK

Thursday's economic data are likely to have less impact on the judgement of the MPC at this month's monetary policy meeting. Nevertheless, after ONS data today showed average house price inflation rising 0.7ppt to 2.2%Y/Y in November, the firmest annual rate for a year, the RICS residential survey for December might suggest somewhat greater optimism about the likelihood of a pick-up in activity in the housing market over the coming year. The BoE's latest credit conditions survey, meanwhile, will likely report relatively little change to credit availability and loan demand in the final quarter.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Industrial production M/M% (Y/Y%)	Nov	**0.2 (-1.5)**	0.3 (-1.0)	-0.5 (-2.2)	**-0.9 (-2.6)**
	Trade balance €bn	Nov	**19.2**	22.0	24.5	**24.0**
Germany	GDP Y/Y%	2019	**0.6**	0.6	1.5	-
France	Final CPI (EU-harmonised CPI) Y/Y%	Dec	**1.5 (1.6)**	1.4 (1.6)	1.0 (1.2)	-
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Dec	**0.8 (0.8)**	0.8 (0.8)	0.4 (0.5)	-
UK	CPI (core CPI) Y/Y%	Dec	**1.3 (1.4)**	1.5 (1.7)	1.5 (1.7)	-
	ONS house price index Y/Y%	Nov	**2.2**	1.0	0.7	**1.3**

Auctions

Country	Auction
Germany	sold €1.1bn of 0% 2050 bonds at an average yield of 0.31%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's data releases

Economic data

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

Auctions

Country	Auction
Italy	sold €3.0bn of 0.05% 2023 bonds at an average yield of 0.18%
	sold €2.5bn of 0.85% 2027 bonds at an average yield of 0.94%
	sold €1.25bn of 3.1% 2040 bonds at an average yield of 2.14%
UK	sold £3.25bn of 0.625% 2025 bonds at an average yield of 0.536%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		07.00	EU27 new car registrations	Dec	-	4.9
Germany		07.00	Final CPI (EU-harmonised CPI) Y/Y%	Dec	1.5 (1.5)	1.1 (1.2)
UK		00.01	RICS house price balance	Dec	-8	-12

Auctions and events

Country		GMT	Auction / Event
ECB		12.30	ECB account of 12 December Governing Council meeting
		18.00	ECB President Lagarde scheduled to speak in Frankfurt
UK		09.30	BoE publishes its credit conditions survey

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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