Euro wrap-up

Overview

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- Bunds and other euro area government bonds made gains as a French survey suggested a softening of business sentiment and Italian political uncertainty intensified.
- Gilts made losses as a survey suggested a marked improvement in optimism in the UK's manufacturing sector.
- Thursday will bring the conclusion of the latest ECB monetary policy meeting and an update on euro area consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.598	-0.006
OBL 0 10/24	-0.543	-0.009
DBR 0 02/30	-0.265	-0.013
UKT 3¾ 09/21	0.444	+0.017
UKT 1 04/24	0.436	+0.009
UKT 0⅞ 10/29	0.635	+0.005

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

Euro area

French business sentiment slips back at start of 2020

While yesterday's ZEW survey suggested a significant rebound in optimism among market analysts about the euro area outlook at the start of the year, business surveys usually offer a more reliable guide to economic activity. And the latest French business confidence survey – the first guide to the economic climate in January in the euro area's second largest member state – suggested a slight softening of sentiment at the start of the year. In particular, the headline business climate index fell 1pt from a downwardly-revised reading for December to an eleven-month low of 104.0, suggestive of continued albeit relatively tepid economic growth. The deterioration was principally associated with retail and wholesale activity, while the business climate in services and construction was judged to be stable. And although conditions in manufacturing were assessed to have improved, this partly reflected the fact that the survey's assessment of conditions in the sector in December was revised down to suggest a soft end to 2019. Meanwhile, the INSEE employment climate index deteriorated to an eight-month low, but at 105.2 this was still consistent with job growth.

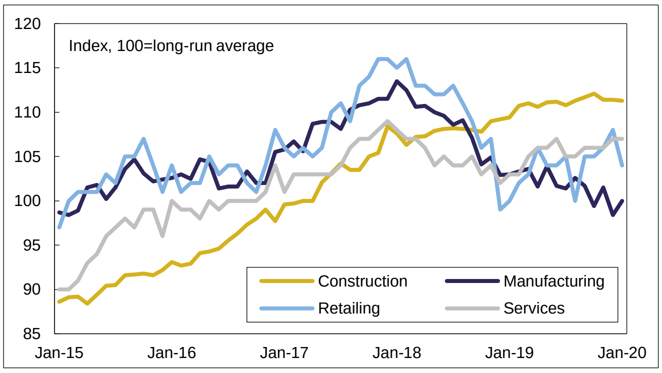
Industrial unrest to weigh on sentiment for a while

Overall, the slight weakening in the INSEE business climate indicators should not come as a surprise in light of the ongoing dispute between unions and government over Macron's pension reform proposals. Indeed, while public transport workers returned to work at the start of this week after six weeks of strikes, energy workers yesterday cut electricity supplies to parts of the Paris suburbs. And with the Council of Ministers set to discuss the final legal text of the reforms on Friday, the CGT union federation called for protests across the country over the remainder of this week. Disruption looks set to continue for a while yet.

Italian political uncertainty intensifies

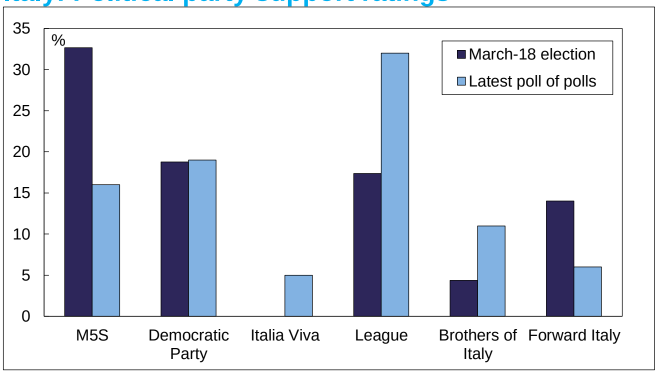
Italian political uncertainty has intensified further after former Deputy Prime Minister Luigi Di Maio today announced his intention to resign as leader of the populist Five Star Movement (M5S), the largest party in the governing coalition. Di Maio's decision follows the recent deepening of divisions within M5S and the coalition, which have prompted dozens of defections of its legislators to put at risk the government's majority in the upper house. It also reflects the ongoing downward trend in the M5S party's ratings, with opinion polls suggesting that support among the public has roughly halved since it won 33% share of the vote in the 2018 general election. Moreover, it came in anticipation of a bad showing for M5S and Democratic Party (PD) in Sunday's elections in the Emilia Romagna region, where Salvini's right-wing League could bring to an end 75 years of uninterrupted PD rule. With the current ratings for M5S and PD so poor, however, neither party has the incentive

France: INSEE business climate indices



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Italy: Political party support ratings



Source: Politico and Daiwa Capital Markets Europe Ltd.

to terminate the coalition and facilitate an early General Election. Indeed, Di Maio intends to retain his current role as Foreign Affairs Minister. And we continue to expect the government to continue to muddle through despite likely continued turbulence with the ruling parties.

Italian manufacturing bottoming out

At face value, today's Italian industrial orders data made for disappointing reading, with orders down 0.3%M/M in November to leave them more than 4% lower than a year earlier, the ninth year-on-year decline of the past eleven months and the third steepest. But the weakness principally reflected calendar effects. Moreover, the monthly drop followed three months of steady increase, suggesting that, like in Germany, Italy's manufacturing sector might have reached a turning point, or at least stopped deteriorating. Indeed, while manufacturing production appears to have moved broadly sideways in the first two months of Q4 compared with Q3, orders were on track to rise more than 1% in Q4, underpinned by a more notable rebound in foreign orders (up almost 2½% on the same basis). Admittedly, the improvement in domestic orders was more modest. And overall, the level of orders remains well below the peak at the start of 2018.

The day ahead in the euro area and US

The main event tomorrow will be ECB's latest Governing Council policy announcement and press conference, only the second for new President Christine Lagarde. But this seems likely to be relatively uneventful. There seems no reason whatsoever for a change of monetary policy or forward guidance. And with no new economic forecasts to be published, the Governing Council's overall assessment of economic conditions will not change substantively either. We would expect Lagarde again to take comfort from signs of stabilisation in the growth slowdown and note a mild increase in underlying inflation in line with previous expectations. And, as in December, she might judge the risks to the economic outlook from events abroad to have become even less skewed to the downside.

Most notable might be what Lagarde has to say about the ECB's strategic policy review. But with the work barely underway she will certainly not preempt its findings. Instead, she will likely merely announce how the work will be organised. According to Bloomberg, the review will be split into two parts. The first would revisit the monetary policy framework, instruments and inflation target. The second would consider broader issues such as financial stability, climate change and communication.

Thursday will also bring the European Commission's flash consumer confidence indicator for January. In December, the index fell to its lowest level since early 2017, with the deterioration led by French consumers, likely reflecting the impact of the strikes among workers in transport and certain other sectors. And only modest improvement is anticipated at the start of the New Year.

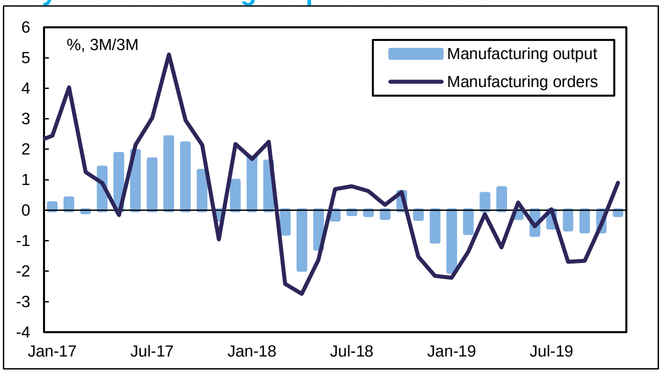
In the US, Thursday will bring the Conference Board's Leading Index for December, the Kansas Fed manufacturing activity indicator for January and the latest weekly jobless claims figures.

UK

Manufacturers seemingly much more upbeat…

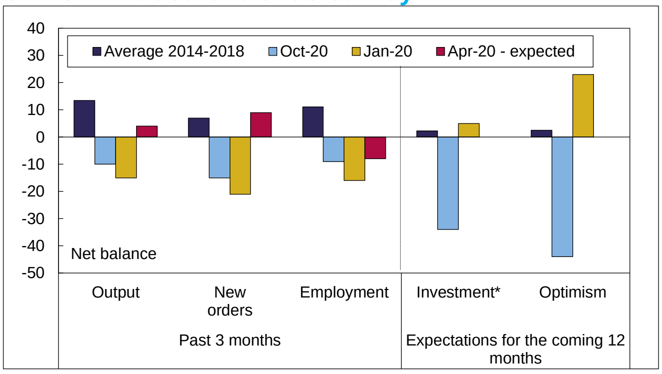
As the Bank of England considers the case for a rate cut at next week's MPC meeting, today's CBI industrial trends survey grabbed attention with its headline message that UK manufacturers were significantly more upbeat about business conditions at the start of the New Year. Indeed, the relevant index jumped a huge 67pts to +23 in the three months to January, suggesting that firms were the most optimistic for almost six years. As a result, firms reportedly revised up their investment intentions, with a record number planning to expand capacity. This notwithstanding, with manufacturers having

Italy: Manufacturing output and orders



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends survey



**Intentions for the coming twelve months relative to the actual spending in the previous twelve months. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

cut back their workforces over the past three months by the most since the Global Financial Crisis, one third of firms was also concerned that labour shortages would be a restraint.

…but output likely to remain subdued…

The improvement in optimism overshadowed a dire quarter for production, with the CBI survey's relevant component – down 5pts to -15 – implying the steepest contraction for more than a decade. While this principally reflected weakness in the autos sector, only 5 of 17 subsectors reported growth over the past three months. Orders declined by the most for more than 10½ years, with manufacturers expecting only a modest recovery over the coming three months too. So perhaps inevitably, today's survey suggested that production is likely to remain subdued over the near term, with the relevant index below the long-run trend and well down on the average of the five years to the start of 2019.

…and Brexit uncertainty to continue to weigh on capex

In addition, we fear that hostile comments from UK Finance Minister Javid after the CBI survey was conducted, emphasising that the government still intends to diverge significantly from EU single market regulations after Brexit, will weigh significantly on investment despite the suggestion of greater optimism in today's results. Indeed, earlier this week, a much larger cross-sectoral survey conducted by the IoD, with a sample size three times that of the CBI's, suggested that more than half of firms will only be able to make planning and investment decisions with certainty when the UK's future relationship with the EU has been fully clarified.

On track for higher borrowing in FY19/20

Public sector net borrowing excluding banks (PSNB ex) in December came in below expectations at £4.8bn, marginally less than in the same month of 2018. Increased government spending, partially on health and social care, was more than fully offset by higher tax receipts. Nevertheless, income tax and corporation tax revenues, which are most closely aligned with economic activity, were weaker. Despite the lower deficit in December, cumulative government borrowing over the first nine months of FY19/20 reached £54.6bn, still £4.0bn more than in the same period of the previous fiscal year. Of that, a little more than £30bn was accounted for by net investment, leaving the current budget deficit at £24.4bn. However, with nominal GDP rising faster than borrowing, public sector net debt excluding public sector banks (PSND ex) still fell almost 1ppt from a year earlier to 80.8% of GDP.

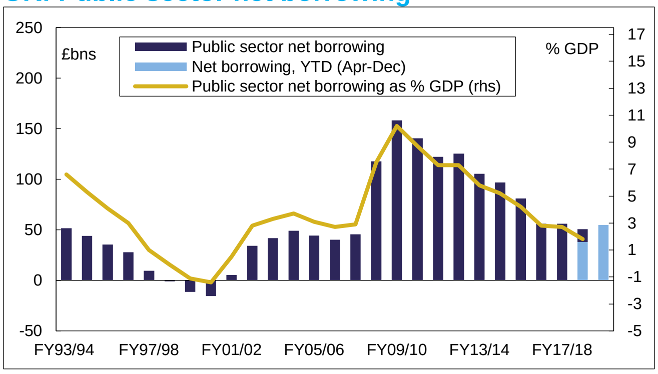
Spending pressures to require tax rises or a bigger deficit

Looking ahead, the government is committed to reducing the current budget deficit to zero while boosting net public investment from 2% of GDP steadily to a limit of 3%. That would be consistent with a broadly stable stock of public debt as a share of GDP. But with the exception of the healthcare budget, its current plans will require further significant cuts to current expenditure over the coming parliament. The government might well decide that such spending restraint is undeliverable. If so, and if it also unwilling to stomach a renewed uptrend in borrowing, the Budget announcement on 11 March might well bring proposals for tax increases. However, the government will still press ahead with the modest reduction in National Insurance Contributions pledged ahead of the General Election, and has also boxed itself in with commitments not raise the rates of income tax and VAT.

The day ahead in the UK

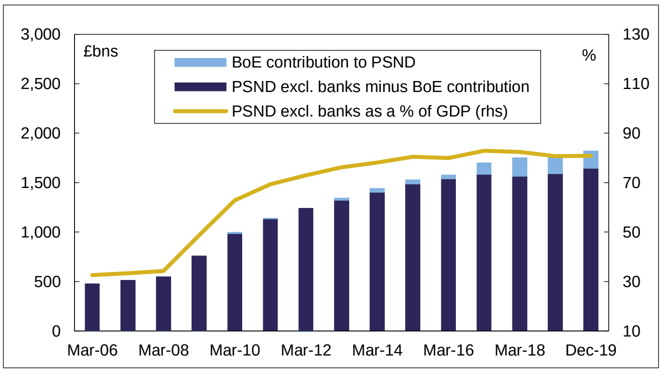
Thursday should be a quiet day for UK economic news with no top-tier data due for release.

UK: Public sector net borrowing*



*OBR forecast of PSNB ex for FY19/20. Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt



Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Business confidence indicator	Jan	**104**	105	106	**105**
	Manufacturing confidence indicator (production outlook)	Jan	**100 (-5)**	101 (-5)	102 (-6)	**98 (-5)**
Italy	Industrial sales M/M% (Y/Y%)	Nov	**0.0 (0.1)**	-	0.6 (-0.2)	**-**
	Industrial orders M/M% (Y/Y%)	Nov	**-0.3 (-4.3)**	-	0.6 (-1.5)	**- (-1.6)**
UK	Public sector net borrowing, excluding public sector banks £bn	Dec	**4.8**	5.3	5.6	**4.9**
	CBI industrial trends survey, total orders (business optimism)	Jan	**-22 (23)**	-25 (-20)	-28 (-44)	**-**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	12:45	ECB main refinancing rate %	Jan	0.00	0.00
	12.45	ECB marginal lending facility %	Jan	0.25	0.25
	12.45	ECB deposit facility rate %	Jan	-0.50	-0.50
	15.00	Preliminary consumer confidence	Jan	-7.6	-8.1

Auctions and events

Country	GMT	Auction / Event
EMU	13.30	ECB Governing Council press conference
France	09.50	Auction: to sell 0.0% 2023 bonds
	09.50	Auction: to sell 0% 2025 bonds
	09.50	Auction: to sell 1% 2027 bonds
	10.50	Auction: to sell 0.1% 2028 index-linked bonds
	10.50	Auction: to sell 0.1% 2029 index-linked bonds
	10.50	Auction: to sell 0.1% 2047 index-linked bonds
Spain	09.45	Auction: to sell 0.0% 2023 bonds
	09.45	Auction: to sell 2.15% 2025 bonds
	09.45	Auction: to sell 2.7% 2048 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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