Daiwa Capital Markets

Euro wrap-up

Overview

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- Despite some adequate economic data from the euro area, Bunds made big gains, BTPs made further losses and stocks tumbled as the spread of the COVID-19 coronavirus continued to spook markets.
- Gilts also rallied and sterling depreciated as the UK government set out its plans for the imminent negotiations on the future relationship with the EU.
- Friday brings the flash estimates of February inflation in Germany, France and Italy, as well as German labour market figures and UK economic sentiment surveys.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.748	-0.039
OBL 0 04/25	-0.734	-0.038
DBR 0 02/30	-0.552	-0.044
UKT 0½ 07/22	0.320	-0.049
UKT 0⅝ 06/25	0.342	-0.045
UKT 4¾ 12/30	0.458	-0.046

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

Euro area

Coronavirus fears continue to shake euro markets

The ongoing spread of the COVID-19 coronavirus inevitably continues to dictate the investor mood in the euro area. With the number of cases in Italy reportedly up by more than 260 (more than 60%) to 650, and further countries (Denmark and Estonia) affected, national authorities in Germany and France have both signalled the likelihood that they will succumb to the epidemic. Anecdotal evidence points to a meaningful impact already on Italian economic activity and a growing if more modest impact so far elsewhere. And while no hard data to quantify the impact will be available for some time, the case for additional macroeconomic stimulus looks set to rise.

Extent of new fiscal boost from Germany questionable

Yesterday's suggestion by German Finance Minister Scholz (from the centre-left SPD) that he might propose relaxing the country's debt brake constraints on local government budgets – which account for about 18% of overall general government expenditure – was therefore welcome. But the plan might struggle to find parliamentary approval, not least from MPs from the senior ruling coalition partners, the conservative CDU and CSU. And ultimately, unless there is additional stimulus at the central government level, we would doubt that the boost to German economic growth would be significant. Indeed, today's comments from Economy Minister Altmaier, that the measures he was preparing to help to improve business conditions did not represent a stimulus package "in the classical sense", suggest that we should not hold our breath for a major new impetus from the German government.

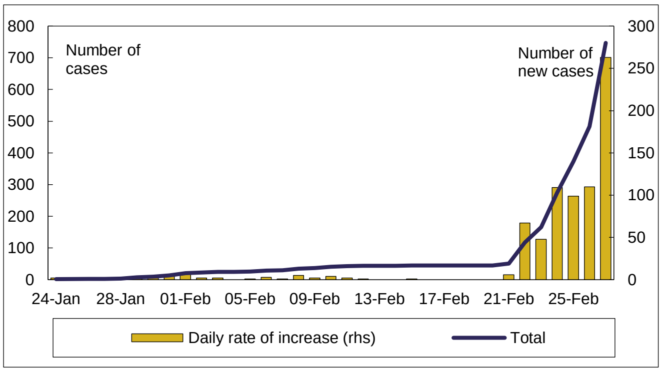
Eventual ECB response possible, but not imminent

ECB President Lagarde this afternoon added that, in her view, the economic impact of the coronavirus did not yet merit a monetary policy response. But, earlier in the day, her Executive Board colleague Schnabel asserted that the euro area's 'reversal rate' – beyond which further rate cuts might be considered contractionary – had not yet been reached. That underscored the message of its current forward guidance that the ECB still sees scope to reduce rates further if necessary. And, with investors seemingly sharing our scepticism that forthcoming German fiscal measures will provide much of a boost to growth, that is consistent with developments in money markets, which today fully priced in the expectation of a 10bp cut in the deposit rate by December.

Euro area sentiment rises to nine-month high

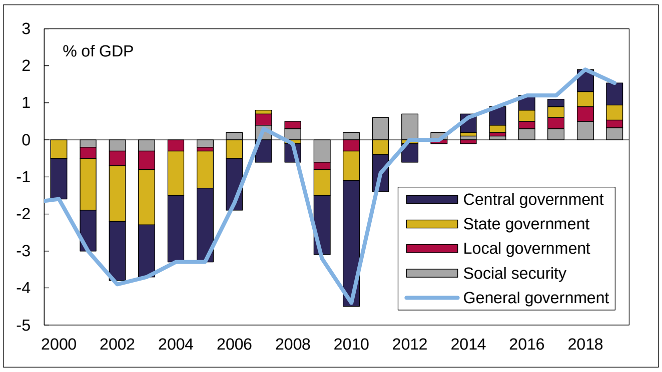
The most noteworthy economic release today was the European Commission's business and consumer sentiment survey

Europe: Number of COVID-19 coronavirus cases*



Figures for 27-February at time of publishing. Source: WHO and Daiwa Capital Markets Europe Ltd.

Germany: General government fiscal balance



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

results for February, which often provide the most reliable guide to euro area economic activity. However, the responses to this month's survey were all submitted before the escalation of the coronavirus outbreak in Europe and therefore are unlikely to provide an adequate representation of current sentiment. Nevertheless, like the flash PMIs, the Commission's indicators pointed to a further improvement in economic conditions in the euro area since the start of the year. In particular, the headline Economic Sentiment Index (ESI) rose for the fourth consecutive month in February and by a stronger-than-expected 0.9pt to 103.5, a nine-month high. Within the detail, the sizeable improvement in consumer confidence reported in last week's flash release was confirmed (up 1.5pts to -6.6) as households were notably more optimistic about the general economic outlook. The equivalent index for industrial firms had signalled ongoing recovery too (up 0.9pt to an eight-month high) as order books reportedly increased by the largest margin for 2½ years. Meanwhile, sentiment in services (up 0.2pt to 11.2) and construction (down 0.5pt to 5.3) was little changed.

Italian sentiment little changed before the coronavirus outbreak

At the country level, the French and Spanish ESI's were most improved in February, with the former rising 1.9pts to 105.8, the highest since mid-2018, while the latter reversed the 1.2pts decline recorded in January to 102.7. Germany's ESI also ticked higher in February (up 0.6pt to 101.8, an eight-month high) as households, services and manufacturers were the most upbeat for several months, perhaps surprisingly so given that more than 7% of German exports are shipped to China, which account for almost 3% of German GDP. And even before the lockdown of the industrialised regions in Northern Italy, that country's ESI (unchanged at 101.3) signalled no improvement in economic sentiment in February. Of course, with the coronavirus outbreak across Europe intensifying and increasingly affecting economic activity, we would expect to see a widespread deterioration in confidence in next month's sentiment surveys.

Bank lending stronger at start of 2020

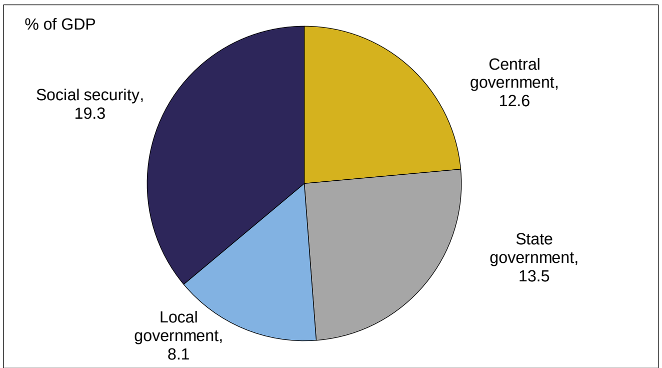
Having slowed towards the end of 2019, bank lending to non-financial corporations was somewhat stronger in January, with the flow of new loans (adjusted for sales and securitisations) of €7.7bn the strongest for four months. That, however, was still below the average for the second half of 2019, left the year-on-year rate unchanged at December's two-year low of 3.2%Y/Y, and was consistent with a continued negative credit impulse to GDP growth. At the country level, growth in business loans in Germany was most notable, moderating to a 21-month low (down 0.8ppt to 5.0%Y/Y). Meanwhile, despite a further increase in lending for house purchase, total new loans to households slowed by almost €3bn from December's near-twelve-year high to €19.5bn, just shy of the average of the second half of 2019. That, however, was sufficient to nudge the year-on-year growth rate up by almost 0.1ppt to an eleven-year high of 3.7%Y/Y. The ECB's most recent quarterly bank lending survey suggested that the flow of new loans to business might well slow further over the near term due to weaker demand related not least to downwardly revised capex plans. But reflecting the continued favourable conditions in the housing market, mortgage demand was likely to increase further, supporting the continued uptrend in growth in that lending to households.

The day ahead in the euro area and US

Tomorrow will bring flash CPI estimates for February from the largest three member states. Like today's Spanish figures – of which the EU-harmonised rate fell 0.2ppt to 0.9%Y/Y – these are expected to show that headline inflation in each country eased back this month or moved sideways as energy price inflation moderated. The German and French inflation figures on the EU-harmonised measure are expected to have declined 0.1ppt to 1.5%Y/Y and 1.6%Y/Y respectively, while the Italian rate is forecast to remain unchanged at a very weak 0.4%Y/Y. Friday will also bring the latest German unemployment figures for January, and French consumer spending data for the same month. Final French Q4 GDP numbers are also due.

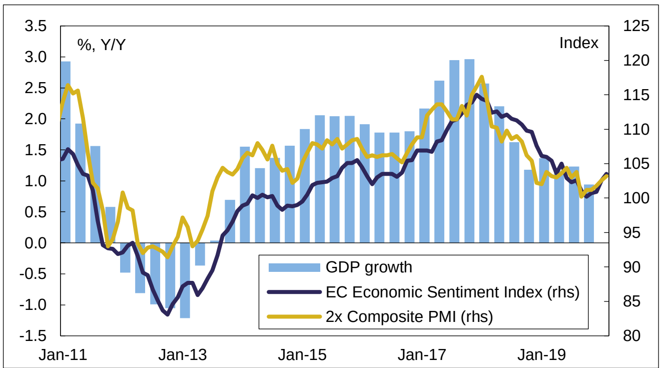
In the US, tomorrow will bring advance goods trade and wholesale inventories figures for January, as well as personal income and spending data, including the closely-watched deflators, for the same month. The updated University of Michigan consumer sentiment survey for February is also due. Elsewhere, the Fed's Bullard will discuss the US economy and monetary policy.

Germany: General government expenditure*



**2018 data. Source: Eurostat and Daiwa Capital Markets Europe Ltd.*

Euro area: GDP and survey indicators



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

UK

Government sets out priorities for EU negotiations

Ahead of the launch on Monday of the first round of negotiations between the UK and EU on their future relationship, today saw the UK government publish its priorities. Unsurprisingly, there was plenty of bluster, which weakened sterling and will likely have increased concerns among UK businesses that rely on trade with the EU. Among other things, the government restated that it would not seek an extension of the current Brexit transition period beyond the start of 2021. It also repeated that it would aim for a Comprehensive Free Trade Agreement (FTA) to provide for tariff-free access. And it reiterated that the FTA should be on similar lines to those that the EU has already reached with Canada, Japan and South Korea, so that the UK would have legal autonomy. As such, the UK insisted that it will not align itself with EU rules or accept the jurisdiction of the ECJ. In terms of timing, the UK government suggested that a broad outline of an agreement should be in place by June and capable of being rapidly finalised by September. And if that is not the case, it suggested that it would be prepared to walk away from the talks in the second half of the year and prepare to trade on WTO rules, i.e. with significant new tariffs imposed.

Significant gap between UK and EU positions

Today's announcements from the UK followed agreement earlier this week by the EU member states on the European Commission's mandate for the talks. That called for the UK to continue to apply EU state aid rules as they evolve over time (i.e. dynamic alignment). And EU standards on other matters, e.g. environmental and labour laws, would need to be considered the principal "reference point" for UK future regulation. The extent of dynamic alignment required on such matters – as opposed to the necessity merely to avoid regressing from current standards – was less clear, however. On sectoral matters, the EU identified early agreement on its access to UK fishing waters as a priority, while the UK government asserted today that agreement on equivalence assessments for rules on financial services should be possible by end-June.

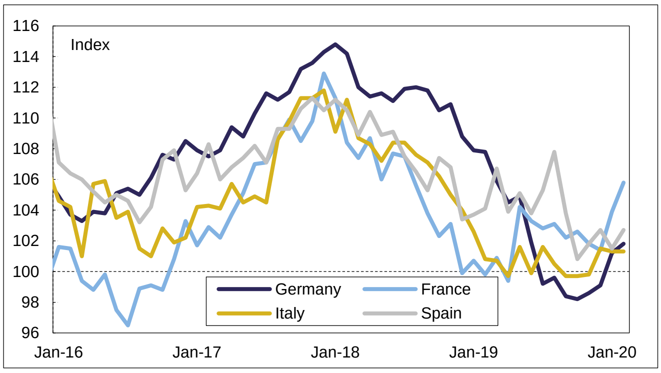
Scope for FTA, but outcome likely to be harmful regardless

So, there is a significant gap between the UK and EU positions. And it seems hard to believe that the gap can be largely bridged by June, raising the risk of a breakdown in the negotiations at that point. Nevertheless, there probably is still some scope for an eventual deal on an FTA, perhaps by early in the fourth quarter to allow time for the necessary parliamentary ratifications before year-end. Nevertheless, if there is no agreement reached, such that the UK-EU trading relationship from the start of 2021 will be governed by WTO rules, the economic harm from the resulting tariffs and non-tariff barriers would be high. A report by the UK government published fifteen months ago suggested that a WTO Brexit could lead to a loss of GDP relative to current arrangements of up to 9% over fifteen years. Even if an FTA is reached, to avoid tariffs and perhaps also allow for a gradual phasing-in of divergence in rules to reduce the immediate economic costs, the government's own analysis suggested that GDP might still be more than 6.0% lower over an equivalent timeframe. And with little constructive to emerge from the negotiations probably for a number of months to come, we continue to expect UK business investment to remain very subdued for the foreseeable future.

Car production remained in reverse in January

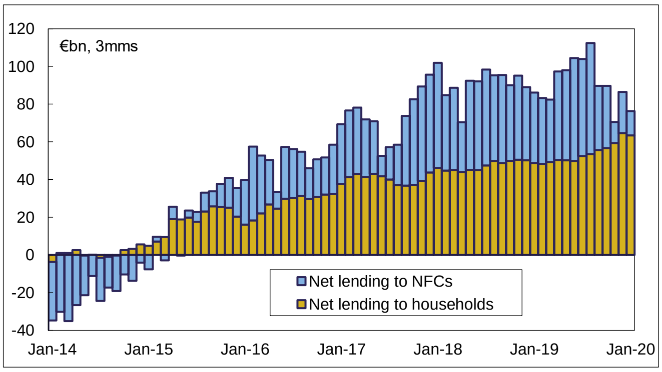
While business surveys had suggested a marked improvement in manufacturing activity since the start of the year, today's UK car production figures showed that growth in the sector remained in reverse gear at the start of 2020, with output falling on a year-on-year basis for the nineteenth month out of the past twenty. In particular, total production was down 2.1%Y/Y in January to the lowest level for the month since 2011. Production for export, which accounts for more than 80% of the total, rose 4.1%Y/Y. However, output for the home market was down a whopping 23.9%Y/Y. Against such a gloomy backdrop, car producers will hardly be impressed that the UK government again today underscored its readiness to accept non-tariff

Euro area: Economic sentiment by country



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

Euro area: Bank lending



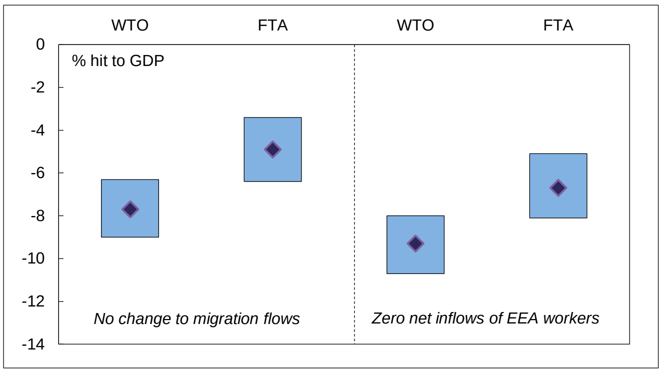
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

barriers and tariffs on trade with the EU. Indeed, the average EU tariff on finished vehicles is 10.0% while those on most auto parts typically amount to about 3.0-4.5%.

The day ahead in the UK

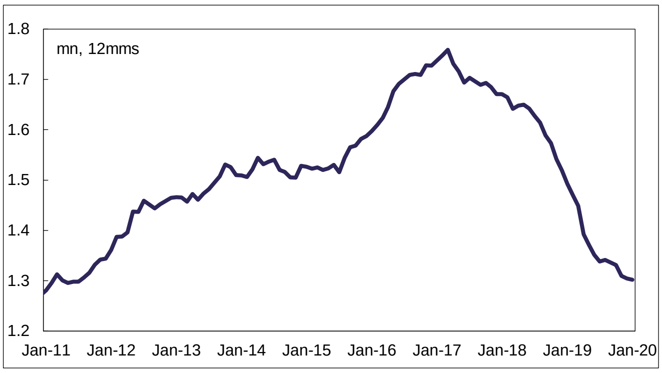
Today's data would be consistent with relatively subdued consumer confidence, which tomorrow's GfK survey is likely to illustrate – indeed, the headline sentiment index for February is expected to have fallen back from January's level of -9, which admittedly was a seventeen-month high. The latest Lloyds business barometer is also due.

UK: Impact on GDP of FTA/WTO rules with EU*



*Cumulative impact compared to current arrangements after fifteen years. Source: HM Government "EU Exit: Long-term economic analysis" (November 2018) and Daiwa Capital Markets Europe Ltd.

UK: Car production



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	M3 money supply Y/Y%	Jan	**5.2**	5.3	5.0	**4.9**
	Economic confidence indicator	Feb	**103.5**	102.8	102.8	**102.6**
	Industrial confidence (services)	Feb	**-6.1 (11.2)**	-7.3 (11.0)	-7.3 (11.0)	**-7.0 (-)**
	Final consumer confidence	Feb	**-6.6**	-6.6	-8.1	**-**
Italy	Consumer confidence indicator (manufacturing)	Feb	**111.4 (100.6)**	111.4 (99.4)	111.8 (99.9)	**- (100.0)**
Spain	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	**0.8 (0.9)**	0.8 (0.8)	1.1 (1.1)	**-**
UK	SMMT car production Y/Y%	Jan	**-2.1**	-	-6.4	**-**

Auctions

Country	Auction
Italy	sold €1.0bn of 2025 floating-rate bonds at an average yield of 0.47%
	sold €2.5bn of 0.35% 2025 bonds at an average yield of 0.36%
	sold €4.0bn of 0.95% 2030 bonds at an average yield of 1%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Consumer confidence indicator	Feb	**104**	103	104	-
UK	BRC shop price index Y/Y%	Feb	**-0.6**	-0.3	-0.3	-

Auctions

Country	Auction
Germany	sold €3.2bn of 0% 2025 bonds at an average yield of -0.69%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	08.55	Unemployment rate % (change '000s)	Feb	5.0 (4.5)	5.0 (-2.0)
	13.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	1.7 (1.5)	1.7 (1.6)
France	07.45	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	1.5 (1.6)	1.5 (1.7)
	07.45	Consumer spending M/M% (Y/Y%)	Jan	0.0 (0.3)	-0.3 (2.0)
	07.45	Final GDP Q/Q% (Y/Y%)	Q4	-0.1 (0.8)	0.3 (1.4)
Italy	10.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	0.6 (0.4)	0.5 (0.4)
UK	00.01	GfK consumer confidence indicator	Feb	-8	-9
	00.01	Lloyds business barometer	Feb	-	23
	07.00	Nationwide house price index M/M% (Y/Y%)	Feb	0.4 (2.3)	0.5 (1.9)

Auctions

Country	GMT	Auction / Event
Germany	10.00	Bundesbank President Weidmann scheduled to speak
UK	11.15	BoE Chief Economist Haldane scheduled to speak
	16:15	BoE's Cunliffe scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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