Euro wrap-up

Overview

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- While the ECB response to the coronavirus appeared sluggish compared to the Fed, Bunds made modest gains and BTPs rallied.
- Gilts also rallied as Carney stated that the BoE stands ready to take "all necessary steps" to support the UK economy.
- Wednesday will see the final services PMIs for February, euro area retail sales data for January, and BoE Governor-designate Bailey speak publicly.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.837	-
OBL 0 04/25	-0.826	-0.017
DBR 0 02/30	-0.645	-0.016
UKT 0½ 07/22	0.224	-0.060
UKT 0⅝ 06/25	0.249	-0.041
UKT 4¾ 12/30	0.376	-0.031

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

Euro area

ECB reluctant to act in face of the coronavirus

The reluctance of the ECB to respond swiftly to the risks posed by the coronavirus was highlighted today as the Governing Council sat on its hands while the Fed delivered an emergency 50bp rate cut. Of course, Christine Lagarde's statement on the spread of the coronavirus issued several hours after Monday's European market close had already come well after the equivalent press releases published by the Fed, BoJ and BoE either side of the weekend. Nevertheless, Lagarde's statement still ticked many of the right boxes for investors. And so, while it was late, it was better than nothing. In particular, Lagarde noted that the situation was "fast developing". By acknowledging risks for both the economic outlook and the functioning of financial markets, she hinted that a range of different measures – rate cuts, asset purchases, or special liquidity operations – might eventually be utilised. And insisting that "the ECB is closely monitoring developments", Lagarde signalled that a policy change could possibly come as soon as next week's scheduled policy meeting.

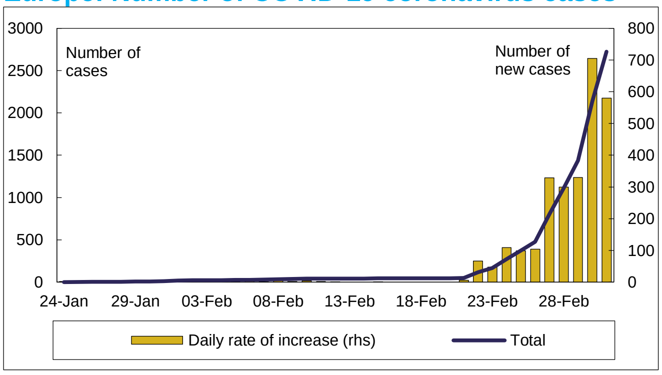
New liquidity scheme a likely response

Most notably, however, Lagarde's statement added that measures would be "targeted… and commensurate with the underlying risks". Consistent with that form of words, a Reuters report today suggested that the ECB is now working up new measures "to provide liquidity to businesses hit by the economic fallout of the coronavirus outbreak". One of the measures would reportedly be a new targeted longer-term refinancing operation (TLTRO) directed at small- and medium-sized enterprises, who may be most severely impacted from the epidemic. Austrian national bank governor Holzmann subsequently said that such a measure would indeed be under consideration by the ECB, although he saw no urgency in this respect. Perhaps unsurprisingly given his well-established views, he added that he would not support a rate cut.

Rate cut highly unlikely before Q2

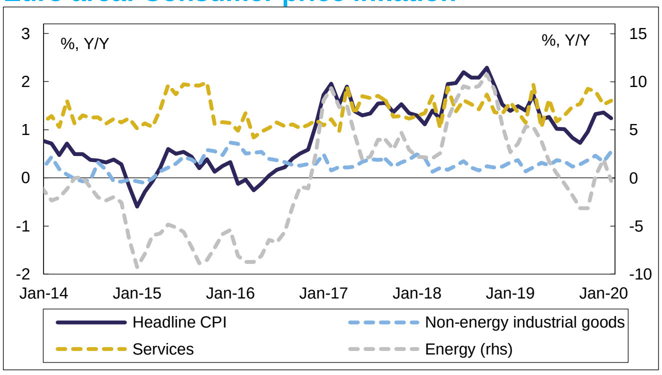
Certainly, for the time being, the ECB's initial response does seem likely to be aimed merely at relieving financial stresses caused by the coronavirus rather than countering any wider economic slowdown. So, the conclusion of the Governing Council's scheduled meeting next week might well see Lagarde confirm the ECB's intention to develop a new special liquidity scheme to support SMEs. It could also announce an explicit increase in purchases of corporate bonds. However, we still think that a rate cut would be more likely to come in the second quarter when the economic impact, and any fiscal policy response, should be clearer.

Europe: Number of COVID-19 coronavirus cases



Source: WHO and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

No surprises from flash inflation data

Fully in line with expectations, the flash euro area estimate of inflation in February fell 0.2ppt from the prior month's nine-month high to a three-month low of 1.2%Y/Y. The drop was entirely due to energy inflation, which fell 2.2ppts to -0.3%Y/Y. Other major components increased. For example, food inflation also edged up slightly (2.2%Y/Y). Inflation of non-energy industrial goods rose 0.2ppt to 0.5%Y/Y. And services inflation rose 0.1ppt to 1.6%Y/Y, in line with the average of the preceding six months. As such, core inflation rose 0.1ppt to 1.2%Y/Y. Looking ahead, the recent fall in the oil price is likely to subtract further from energy inflation. And the appreciation of the trade-weighted euro to the strongest levels since last summer, will also weigh on prices of non-energy industrialised goods. So, while the supply- and demand-side impacts of the coronavirus will only become clear over time, we currently expect headline and core inflation to remain at their February levels or below over the remainder of the year.

Unemployment flat-lined at the start of the year

Also in line with expectations, the euro area's unemployment rate remained unchanged in January at 7.4% for a fourth successive month. Being just 0.1ppt below the level last June, the labour market clearly lost significant momentum as GDP slowed. Indeed, the level of unemployment rose in January for the first time since September, albeit by 1k. The unemployment rates in each of the four largest member states remained unchanged. And the youth unemployment rate also remained steady for a fourth successive month too, at 15.6%. While the two main sources of recent job creation in the euro area – Germany and Spain – continued to increase employment at the start of the year, the number of Italians in work fell. And with Italian economic activity having weakened further due to the coronavirus, we expect the remainder of the first quarter to be relatively subdued for overall job creation in the euro area, despite the biggest jump in Spanish employment in February (56k) in fifteen months.

The day ahead in the euro area and US

Tomorrow will bring final services and composite PMIs for February from the euro area and selected member states. These typically have a slightly longer collection period than the equivalent manufacturing survey and therefore might have seen a modest share of firms respond after the surge in Italian coronavirus cases. But overall, we expect to see only modest downward revisions to the services and composite indices, from the four-month high of 52.8 and six-month high of 51.6 reported in the respective flash estimates. Wednesday will also bring euro area retail sales figures for January, which seem bound to have picked up at the start of the year following weakness at the end of 2019. The 1.6%M/M decline reported in December is also likely to be revised given that the drop in Germany is now estimated to have been 2.0%M/M rather than the steeper plunge of 3.3%M/M originally published. But to some extent these data will offer little guide to the outlook for consumption growth in Q1 with the recent surge in coronavirus cases across Europe likely to significantly hit household spending on services.

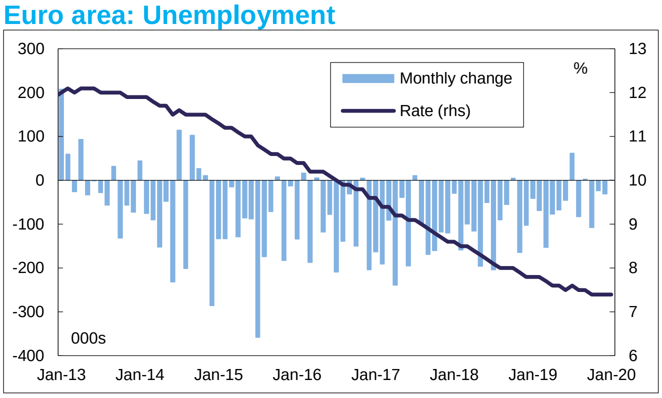
In the US, tomorrow will bring the non-manufacturing ISM and final Markit services PMIs for February. While the ISM is expected to point to ongoing steady expansion, risks to this forecast are skewed to the downside following yesterday's weak manufacturing ISM. Certainly, the flash services PMI fell sharply to 49.4, the first contractionary reading for four years and the weakest since October 2013. Meanwhile, ahead of Friday's BLS payrolls report, tomorrow will also bring the ADP employment survey, expected to report an increase of 170k following the surge of 291k in January. The Fed's latest Beige Book is also due.

UK

BoE stands ready to take "all necessary steps"

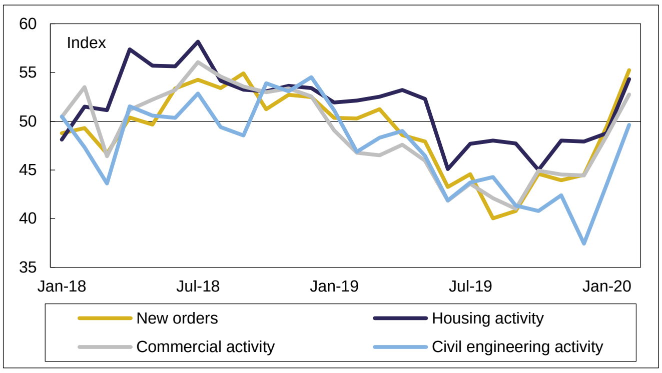
Yesterday's statement from the BoE suggested that its priority for the time being would be to mitigate any financial risks arising from the coronavirus epidemic rather than offset any economic slowdown. But, at his last formal appearance before

Euro area: Unemployment



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Construction PMI



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

the Treasury Select Committee, outgoing Governor Carney today insisted that the Bank stood ready to take “all necessary steps” to support the UK economy as it faced a shock that “could prove large but will ultimately be temporary”. Indeed, he suggested that all of the BoE’s available tools would be on the table for discussion at the next MPC meeting on 26 March. Carney also reiterated that, as it could restart unconventional measures, the BoE had roughly 200-250bps of policy space left to deploy if necessary, while still avoiding the use of negative rates. He also promised that action taken collectively by the G7 would be “powerful and timely”. That sentiment was not matched by the statement issued shortly thereafter by the G7 finance ministers and central bank governors. But it certainly did tally with the subsequent emergency 50bp rate cut announced by the Fed.

Rate cut likely this month

Of course, unless the BoE follows the Fed with an emergency rate cut, the decision whether or not to ease policy on 26 March will not be Carney’s to facilitate, as he will hand over to incoming BoE Governor Andrew Bailey on 16 March. Before making their minds up, MPC members will likely want to scrutinise next week’s Budget for indications of the extent of near-term fiscal stimulus. They might also want to study incoming data. In that context, the number of coronavirus cases in the UK is still relatively modest by European standards, at 51 at the time of writing. And the flash PMIs on 24 March will provide a better guide to the evolving impact of the virus on the UK economy. But with two members having already been voting for a rate cut at recent meetings, Carney today added that his own vote last month had been “finely balanced”. And external member Tenreyro wrote today that a further reduction in uncertainty would be required and a stronger rebound than assumed in the Bank’s February Inflation Report needed to remove the case for near-term stimulus. As such, there seems good reason to believe that a majority in favour of a 25bps cut in Bank Rate will be found at the scheduled meeting later this month, if not beforehand.

Construction PMI jumps in February

Of secondary importance, today’s construction PMI illustrated the marked improvement in conditions in the sector since political uncertainties diminished after the December general election. In particular, the headline activity index jumped a stronger-than-expected 4.2pts in February to 52.6, the highest reading since 2018. The report suggested that the recovery might have been even stronger had there not been disruption from severe weather conditions. Consistent with certain other relevant indicators of late, the housing activity PMI jumped 5½pts to 54.3, a nineteen-month high. The survey suggested a return to positive growth in commercial activity too (up 4.2pts to 52.8) and only modest contraction in civil engineering (the relevant PMI stood at 49.6, more than 12pts higher than the November trough). Furthermore, a surge in new orders – the relevant component rose by the most for almost a decade (5.8pts) to 55.2 – bodes well for near-term output too. Of course, the construction sector accounts for just 6% of the economy. And so, much more emphasis should be placed on tomorrow’s services PMI.

The day ahead in the UK

The main UK economic release tomorrow will be the aforementioned services PMI. After the equivalent manufacturing survey brought a modest downwards revision on the back of heightened coronavirus concerns, the longer survey data collection period might trigger a more notable downwards revision to the services PMI (which already fell 0.6pt in the flash estimate to 53.3). As such, we might well see the composite output PMI revised down from the 53.3 level recorded in both January and the flash February release. More importantly perhaps, Wednesday’s appointment hearing for incoming BoE Governor Andrew Bailey before the Treasury Select Committee will be watched closely for any hints into his preference for near-term policy action ahead of his first MPC meeting at the helm on 26 March. Deputy Governor Ben Broadbent is also scheduled to speak in London tomorrow evening. And in the markets, the DMO will sell 5Y Gilts.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Preliminary CPI (core CPI) Y/Y%	Feb	**1.2 (1.2)**	1.3 (1.2)	1.4 (1.1)	-
		Unemployment rate %	Jan	**7.4**	7.4	7.4	-
		PPI Y/Y%	Jan	**-0.5**	-0.4	-0.7	**-0.6**
Italy		Unemployment rate %	Jan	**9.8**	9.8	9.8	-
Spain		Unemployment change, 000s	Feb	**-7.8**	5.8	90.2	-
UK		Construction PMI	Feb	**52.6**	49.0	48.4	-

Auctions

Country		Auction
Germany		sold €184mn of 0.1% 2026 index-linked bonds at an average yield of -1.40%
		sold €182mn of 0.5% 2030 index-linked bonds at an average yield of -1.41%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Final services (composite) PMI	Feb	52.8 (51.6)	52.5 (51.3)
		10.00	Retail sales M/M% (Y/Y%)	Jan	0.6 (0.8)	-1.6 (1.3)
Germany		07.00	Retail sales M/M% (Y/Y%)	Jan	0.8 (1.5)	-2.0 (1.7)
		08.55	Final services (composite) PMI	Feb	53.3 (51.1)	54.2 (51.2)
France		08.50	Final services (composite) PMI	Feb	52.6 (51.9)	51.0 (51.1)
Italy		08.45	Services (composite) PMI	Feb	51.5 (50.2)	51.4 (50.4)
		09.00	Final GDP Q/Q% (Y/Y%)	Q4	-0.3 (0.0)	0.1 (0.3)
Spain		08.15	Services (composite) PMI	Feb	52.5 (51.7)	52.3 (51.5)
UK		09.30	Final services (composite) PMI	Feb	53.3 (53.3)	53.9 (53.3)

Auctions and events

Country		GMT	Auction / Event
UK		10.30	Auction: £3.5bn of 0.625% 2025 bonds
		14.15	Incoming BoE Governor Andrew Bailey to appear before the Treasury Select Committee
		18.00	BoE Deputy Governor Ben Broadbent to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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