Euro wrap-up

Overview

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- With risk appetite having evaporated, euro area stocks fell sharply and Bund yields plunged to record lows as Italy implemented controls on movement and activity in Lombardy and neighbouring provinces.
- Gilt yields also registered new lows, for a while falling into negative territory out to 7Y maturities.
- On Tuesday EU leaders will hold a teleconference to discuss a possible coordinated response to the coronavirus.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-1.033	-0.156
OBL 0 04/25	-1.004	-0.136
DBR 0 02/30	-0.853	-0.139
UKT 0½ 07/22	0.097	+0.011
UKT 0⅝ 06/25	0.121	-0.025
UKT 4¾ 12/30	0.169	-0.065

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

Euro area

Italian recession inevitable as North goes into lockdown

With the number of Italian deaths from the coronavirus continuing to surge (up more than 133 yesterday to 366, second worldwide only to China), the authorities today implemented new severe restrictions on movement and activity in the region of Lombardy – which alone accounts for more than one fifth of Italian GDP – and more than a dozen other provinces in neighbouring regions. The controls, which will be in place at least until 3 April, make it certain that Italy's economy will contract again in Q1. Given the inevitable hit to transport, tourism, hospitality, retail and recreational services – which collectively account for almost one quarter of Italian economic activity – that will likely extend throughout the first half of the year, Italy's GDP would seem unlikely to rebound before Q3, despite the authorities' plans for a €7.5bn fiscal stimulus. And with about two-thirds of all Italian employment and about half of all Italian output being generated by 'micro' and small firms, the Italian economy appears all the more vulnerable to the economic and financial shock from the coronavirus, and reliant on the ability of the ECB and banking sector to keep funds flowing.

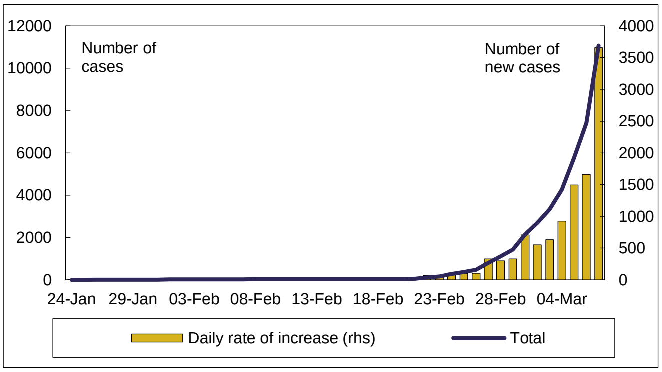
French calls for fiscal stimulus to come to little?

The Bank of France today predicted that its country's GDP would grow just 0.1%Q/Q in Q1. However, with the number of cases yesterday up above 1100 and rising on trajectory similar to Italy, the risks to that estimate and the French outlook more generally seem skewed significantly to the downside too. At tomorrow's teleconference of EU leaders to discuss the handling of the coronavirus, France is likely to be at the forefront of calls for a coordinated fiscal stimulus. But several member states, including Germany, are likely to take a more cautious approach despite the sharp drop in core government yields and limited room for manoeuvre for monetary policy. So, while recognition will likely be given to the existing flexibility in the EU's rules to boost borrowing in exceptional circumstances, we doubt that the additional support to be provided by governments will be sufficient to prevent recession in the euro area as a whole. And nor will it prevent the steep drop in inflation that now seems bound to ensue over the remainder of the year due to softer demand, the plunge in oil prices, and marked appreciation in the euro near its strongest levels in trade-weighted terms for a decade.

Sentix survey signals significant souring of sentiment

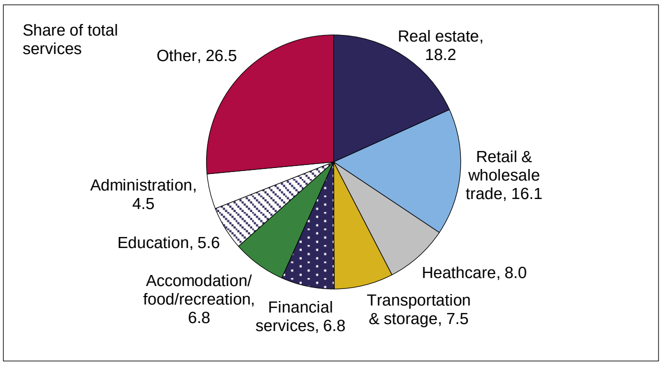
Against the backdrop of the spread of the coronavirus and the associated financial market turmoil, this week's data releases should have relatively little influence on the ECB's forthcoming policy decision. Nevertheless, today's Sentix investor confidence survey illustrated the recent marked deterioration in sentiment over recent weeks. The headline Sentix index dropped more than 20pts – the most on the series – to a near-seven-year low of -17.1. And the index for six-month

Europe: Coronavirus cases



Source: WHO and Daiwa Capital Markets Europe Ltd.

Italy: Services activity as share of services output



Source: ISTAT and Daiwa Capital Markets Europe Ltd.

expectations similarly dropped by a record margin, of more than 25bps, to -20.0. If past relationships hold, this suggests that the euro area's March composite PMI will fall back below 50 when it is released in a fortnight's time.

German IP rebounded, but so what?

In marked contrast, today's German industrial production figures for January comfortably beat expectations, suggesting that growth in Q1 might have been much improved had the coronavirus not caught hold. Total IP rose a whopping 3.0%M/M, the most since November 2017, following a revised drop of 2.2%M/M in December to be down just 0.2%3M/3M, the least since April. Within the detail, construction output rose more than 4½%M/M, the most in eleven months. Production of intermediate goods also surged by the most for more than two decades (5.1%M/M), with output of chemicals up 4.1%M/M. And while production of consumer goods was weak (-3.2%M/M), and output of motor vehicles dropped again to the lowest level since August 2010 (-0.9%M/M), output of machinery rose 5.5%M/M, the most in nine years. So, total manufacturing production rose 2.8%M/M. Alas, while order books were also much improved at the start of the year, the marked deterioration in the outlook over recent days suggests that the improvement in January will not be sustained.

The day ahead in the euro area and US

EU leaders will hold a teleconference on Tuesday to discuss the handling of the coronavirus, including a possible economic policy response. The ECB's monetary policy decision, however, still seems highly unlikely to come before Thursday. Data-wise, Tuesday will bring French and Italian industrial production data for January, which, like today's German figures, will show a rebound at the start of the year. In addition, updated euro area national accounts figures for Q4, which will provide the first official expenditure breakdown, are also due. While GDP growth is expected to be unrevised at 0.1%Q/Q, we expect household consumption growth to have slowed to its weakest rate since Q114 to provide only minimal support. And a boost from net trade will likely be more than offset by a drag from inventories. Tomorrow will also bring updated figures for euro area employment and German labour costs for Q4. In the US, the latest NFIB small business survey will be watched for indications of initial concerns about the impact of the spread of the coronavirus.

UK

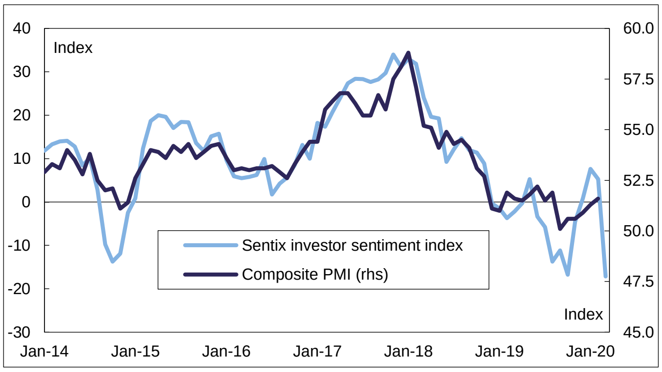
Negative Gilt yields reinforce case for increased government borrowing

As elsewhere, today's financial market moves in the UK were extraordinary. While stocks plunged, for the first time Gilt yields chalked up negative yields on all maturities up to 7Y before moving higher in the afternoon session. And for a while, 10Y yields fell below the 0.10% level that the BoE appears to consider the floor on Bank Rate. So, investors appeared to be preparing themselves for a BoE rate cut of at least 50bps this month, and an eventual move to QE. We continue to think that an emergency rate cut could be announced by the BoE as soon as Wednesday following the Chancellor's Budget announcement. Certainly, the Government appears set to take advantage of super-low yields to relax its fiscal rules to allow for a significant increase in borrowing over the coming three years. That will be used to fund a big increase in public investment, and probably also higher current expenditure and a modest reduction in certain tax rates. As a result, fiscal policy will be set to make its first significantly positive contribution to UK GDP growth in more than a decade. The Government will also probably announce a new loan guarantee scheme, which could work in tandem with a new BoE special funding facility, to assist firms affected by the coronavirus. In the meantime, following Friday's announcement by UK Finance that the major High Street banks will consider new support to customers affected by the coronavirus, today brought announcement from NatWest (in which the Government is the majority shareholder) of a £5bn Working Capital Support programme for SMEs affected by the epidemic.

The day ahead in the UK

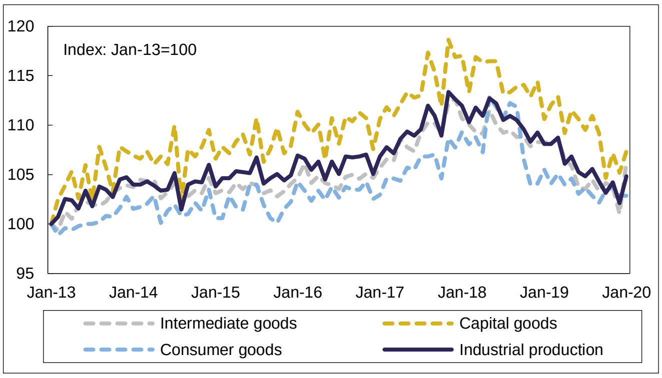
Data-wise, ahead of the January monthly GDP report on Wednesday, tomorrow will bring just the BRC retail sales monitor for February.

Euro area: Survey indicators



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

Germany: Industrial 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
Germany		Industrial production M/M% (Y/Y%)	Jan	**3.0 (-1.3)**	1.7 (-3.9)	-3.5 (-6.8)	**-2.2 (-5.3)**
		Trade balance, €bn	Jan	**13.9**	15.3	15.2	-
France		Bank of France industrial sentiment indicator	Feb	**96**	95	96	-
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		10.00	Final GDP Q/Q% (Y/Y%)	Q4	0.1 (0.9)	0.3 (1.2)
		10.00	Final employment Q/Q% (Y/Y%)	Q4	0.3 (1.0)	0.1 (0.9)
Germany		07.00	Labour costs Q/Q% (Y/Y%)	Q4	-	0.9 (3.1)
France		07.45	Industrial production M/M% (Y/Y%)	Jan	1.8 (-1.9)	-2.8 (-3.0)
		07.45	Manufacturing production M/M% (Y/Y%)	Jan	1.7 (-1.7)	-2.6 (-3.2)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jan	1.5 (-3.7)	-2.7 (-4.3)
UK		00.01	BRC retail sales monitor, like-for-like retail sales Y/Y%	Feb	0.5	0.0
Auctions and events						
Country		GMT	Auction / Event			
UK		10.30	Auction: £2.25bn of 4.75% 2030 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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