Euro wrap-up

Overview

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- Gilts made losses today despite the BoE's emergency easing measures, including a 50bps cut in Bank Rate to 0.25%, while the government's budget confirmed fiscal stimulus.
- Bunds also made losses even as a report suggested that the ECB is considering deploying all of its policy tools.
- The ECB will disappoint markets tomorrow if it fails to deliver at least a rate cut and a new lending facility.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.973	+0.007
OBL 0 04/25	-0.926	+0.024
DBR 0 02/30	-0.756	+0.043
UKT 0½ 07/22	0.136	-0.003
UKT 0⅝ 06/25	0.184	+0.017
UKT 4¾ 12/30	0.274	+0.033

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

UK

BoE announces emergency easing package

In an unscheduled announcement issued before UK markets opened today, the BoE unveiled what it considered to be a "big package" of new easing measures to address the economic hit from the coronavirus. In particular:

- The MPC cut Bank Rate by 50bps to 0.25%, matching its record low, but still 15bps above the level that the BoE judges to be its effective floor.

- The MPC also introduced a new Term Funding Scheme to support the pass-through of the rate cut to borrowers and provide incentives for banks to lend to SMEs (TFSME). Under the scheme, which is similar to that introduced in 2016, over the next twelve months the BoE will offer four-year funding of at least 5% of participants' stock of real economy lending at interest rates at, or very close to, Bank Rate. Additional funding will be available for banks that increase lending, especially to small and medium-sized enterprises (SMEs). The BoE reckons that this could provide more than £100bn in term funding to the economy.

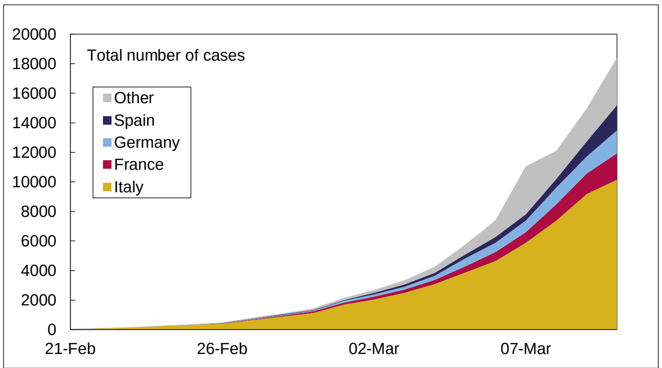
- To give further support to bank lending, the FPC cut the UK countercyclical capital buffer (CCyB) rate to 0% of banks' exposures to UK borrowers for at least one year. The buffer rate had been 1% and had been due to rise to 2% by December 2020. The BoE reckons release of the CCyB will support up to £190 billion of bank lending to businesses, equivalent to 13 times banks' net lending to businesses in 2019.

- However, the MPC left its targeted stock of asset holdings unchanged.

Some monetary ammunition left, but BoE likely to be on hold for a while to come

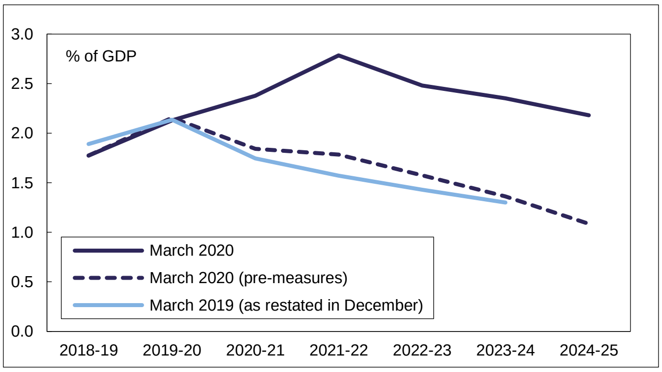
In his press conference, departing Governor Carney suggested that the package in its entirety should be considered to deliver the equivalent of 100bps or more of regular easing. It thus effectively exhausts a little less than half of the BoE's remaining room for maneuver. So, whether or not the MPC decides to cut Bank Rate further to 0.10%, strengthen its forward rate guidance, and/or restart net asset purchases, remains to be seen. Carney judged that the economic impact of the coronavirus would be sharp but temporary. And the future path of policy will depend on quite how severe and long-lasting the impact – on demand, supply chains, the flow of credit to firms and households, and the inflation outlook – is likely to be. Not least also given the substantive loosening of fiscal policy announced this afternoon, as well as the limited further boost that would be delivered by additional easing, for the time being we expect BoE policy to be left on hold.

Europe: Coronavirus cases*



*EEA countries and UK. Source: WHO and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing*



*Forecast incorporates budget measures but based on assumptions made before the coronavirus intensified. Source: OBR

Government confirms fiscal stimulus

The timing of the BoE's announcement reflected the certainty given to the path of fiscal policy, which was revealed in the government's Budget statement this afternoon. In particular, Chancellor Sunak announced new temporary support measures, worth about £12bn (about 0.5% of GDP) to tackle the impact of the coronavirus, including extra funds for the National Health Service and other public services, an extension of Statutory Sick Pay and welfare benefits for individuals affected, and support for businesses, including a new loan scheme. He also announced £18bn of extra public spending on wider measures consistent with December's Conservative manifesto, to take the total package to about 1.3% of GDP in FY20/21 (broadly as expected). That represents the first meaningful loosening of UK fiscal policy in a decade. As a result, the DMO's net financing requirement is planned to rise by £14bn in the coming fiscal year (and £24bn above the original plan for FY19/20 following last year's Budget) to £156.1bn. And the profile of borrowing in future years will be far higher than previously planned (see chart) as public expenditure increases further. Most notably, real public sector net investment will rise by 0.8ppt over the coming three years to 3.0% of GDP as the government seeks to upgrade the UK's infrastructure.

Government set to miss two of its fiscal rules

Given the unfolding impact of the coronavirus on the economy, the OBR's forecasts were out of date before they were published. Nevertheless, the broad profile of borrowing forecast for the coming few years gives a clear guide as to the impact of the Budget on the main public finance aggregates. Of the government's four fiscal rules, the OBR forecasts suggest that only the loosest two will now be met, i.e. the target to reduce net debt as a share of GDP in FY20/21, and the so-called 'welfare cap' that aims to reduce spending on certain benefits by FY22/23. To allow for the government's sudden switch from austerity to fiscal largesse, the legislated mandate to reduce the structural deficit below 2% of GDP in FY20/21, and the objective to balance the budget by the middle of the decade, have been put on ice ahead of a review of all fiscal objectives to report later in the year.

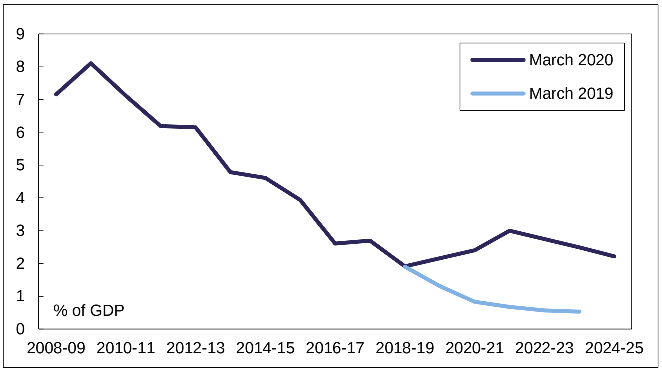
UK economy moved sideways in January

Today's monthly output figures suggested that, even before the COVID-19 outbreak took hold in Europe, the UK's economy was still struggling to grow. Indeed, GDP was unchanged in January from the prior month. This left growth on a three-month basis also at 0.0%, unchanged from Q4, and the year-on-year rate (0.5%) at its second-lowest since mid-2012. Within the sectoral breakdown, services remained disappointingly subdued, up just 0.1%M/M and trending sideways on a three-month basis. While there was a rebound in wholesale, retail and motor trade in January, activity in these subsectors continued to trend lower. The main drag on growth in January was motion pictures, a trend that seems likely to continue for as long as coronavirus concerns continue. Meanwhile, despite a modest increase in manufacturing output (0.2%M/M), this was principally due to production of chemical and pharmaceutical products. Indeed, less than half of the thirteen manufacturing subsectors posted growth in January, with notable weakness in electrical and machinery equipment production. Overall, manufacturing output was still down 1.2%3M/3M. And with output from utilities down more than 4%M/M, total IP rose just 0.1%M/M, leaving it down 1.0%3M/3M. So, despite a drop in January (-0.8%M/M), construction output was the only source of growth on a three-month basis. But due to the small size of the sector, the near-1½%3M/3M increase in construction merely added 0.1ppt to GDP growth.

The day ahead in the UK

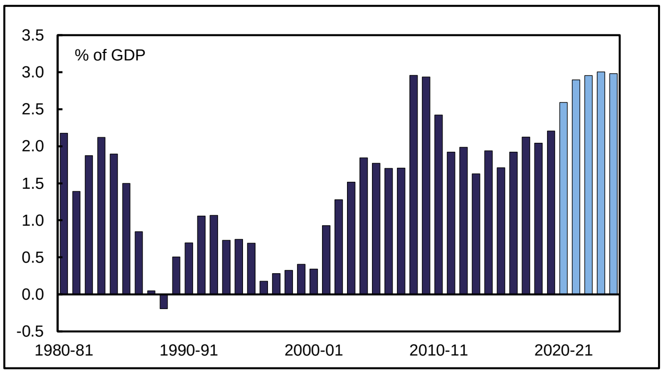
Thursday should be a much quieter day for UK economic news, with just the RICS residential market survey for February due for release.

UK: Cyclically-adjusted net borrowing*



Forecast incorporates budget measures but based on assumptions made before the coronavirus intensified. Source: OBR

UK: Public sector net investment*



Forecast incorporates budget measures but based on assumptions made before the coronavirus intensified. Source: OBR

Euro area

ECB to deploy all available tools?

Following today's emergency BoE policy announcement, it would be absurd, and economically harmful, if the ECB provided only modest new stimulus tomorrow. But a Bloomberg report today suggested that Christine Lagarde will be arguing for substantive easing. Among other things, the report suggested that Lagarde had yesterday warned EU leaders of risks of "a 2008-style crisis" and "the collapse of part of your economies". And it also claimed that ECB policy makers are considering deploying all of its available tools tomorrow, including "measures to provide 'super-cheap' funding and ensure liquidity and credit don't dry up."

Expect a package of measures tomorrow

At a minimum, we should expect the Governing Council tomorrow to provide a meaningful rate cut on the TLTROs and/or a new lending facility with a lower interest rate. But the recent moves by the Fed and BoE, the associated appreciation of the euro close to its strongest levels in trade-weighted terms for ten years, the marked deterioration in the inflation outlook and the severe harm to Italy's economy already underway, all call for more substantive action. A cut of at least 10bps in the deposit rate to -0.60% or below, offset by an increase in the tiering ratio, would seem likely. Likewise, an increase in corporate bond purchases would be justified. And a decision to increase the issue and issuer limits on the public sector asset purchases as a precursor to a possible future in buying of such securities might also be in order. Certainly, while several Governing Council members might be opposed, a substantive package of measures, rather than a token gesture, would now seem more likely than not.

Commission set to allow greater fiscal flexibility to fight the coronavirus

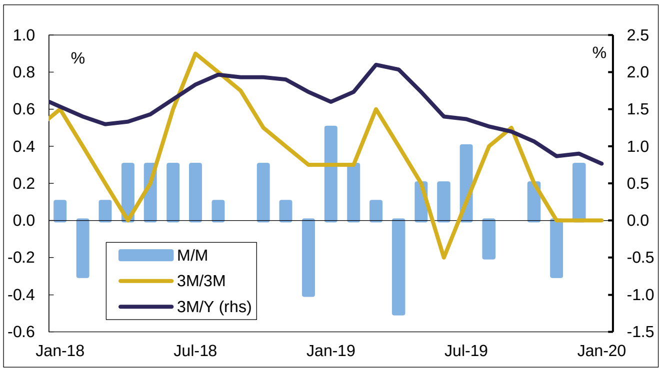
As in the UK, monetary easing in the euro area will be supplemented by fiscal support, which will be all the more necessary given the limited potency of the options available to the ECB. The European Commission agreed yesterday to clarify by the end of the week how new public sector initiatives to tackle the impact of the coronavirus will be accommodated within the EU's fiscal rules. We expect the approach to be lenient, providing significant flexibility for countries to loosen policy. Meanwhile, the Italian government's first package worth about €12bn (about 0.6% of GDP) – and to include support for healthcare, assistance for workers facing temporary layoffs, and a guarantee fund for loans to SMEs affected by the virus – is set to be confirmed by the end of the week. Additional Italian support of roughly the same magnitude looks likely to come in due course. And given the likely deep recession set to result from the nationwide restrictions on movement and economic activity, we expect Italy's budget deficit to rise above 3.0% of GDP this year. At a minimum, we expect France and Spain – which currently appear most at risk of following Italy's profile of coronavirus cases – to step up to the plate with proposals for new fiscal support soon, with the 3% of GDP deficit limit also at significant risk of being breached in both countries.

The day ahead in the euro area and US

The ECB's announcements will obviously be the main event in the euro area tomorrow. In terms of economic data, however, tomorrow will bring euro area industrial production figures for January. With output having jumped in four of the five largest member states (Germany +3.0%M/M, France +1.2%, Italy +3.7%M/M, Spain +0.2%M/M, Netherlands +3.1%M/M), the euro area figures are likely to report production growth of more than 2%M/M in January, reversing the decline seen in December but nevertheless leaving output still lower on a three-month basis and also lower compared with a year ago. In the markets, Italy will sell 7Y, 10Y and 20Y bonds.

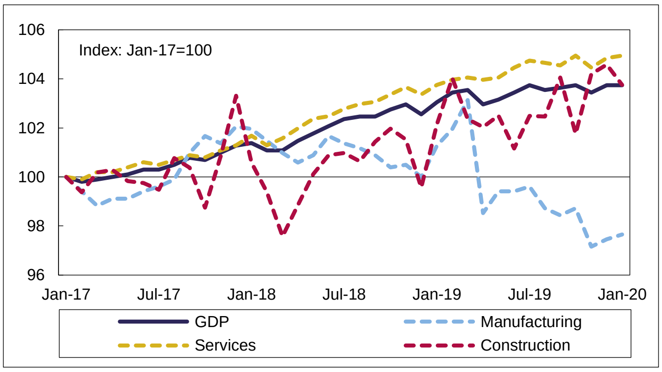
In the US, Thursday will bring PPI figures for February, which are likely to flag a notable weakening in pipeline pressures on the back of the weaker oil price. Tomorrow will also bring flow of funds figures for Q4. In the markets, the Treasury will sell 30Y bonds.

UK: GDP growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP and output components



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
Spain	Retail sales Y/Y%	Jan	**1.7**	1.6	1.7	**1.8**
UK	Bank Rate %	Mar	**0.25**	-	0.75	-
	Monthly GDP estimate M/M% (3M/3M%)	Jan	**0.0 (0.0)**	0.2 (0.1)	0.3 (0.1)	-
	Services activity M/M% (3M/3M)	Jan	**0.1 (0.0)**	0.2 (0.1)	0.3 (0.1)	-
	Industrial production M/M% (Y/Y%)	Jan	**-0.1 (-2.9)**	0.3 (-2.6)	0.1 (-1.8)	-
	Manufacturing production M/M% (Y/Y%)	Jan	**0.2 (-3.6)**	0.3 (-3.5)	0.3 (-2.5)	-
	Construction output M/M% (Y/Y%)	Jan	**-0.8 (1.6)**	0.0 (2.4)	0.4 (5.0)	-
	Trade balance (goods trade balance), £bn	Jan	**4.2 (-3.7)**	-0.4 (-7.0)	7.7 (0.8)	**6.3 (-1.4)**

Auctions

Country	Auction
Germany	sold €2.8bn of 0% 2030 bonds at an average yield of -0.77%

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	Industrial production M/M% (Y/Y%)	Jan	2.0 (-2.5)	-2.1 (-4.1)
	12.45	ECB main refinancing rate %	Mar	0.00	0.00
	12.45	ECB marginal lending rate %	Mar	0.25	0.25
	12.45	ECB deposit facility rate %	Mar	-0.60	-0.50
UK	00.01	RICS house price balance %	Feb	20	17

Auctions and events

Country	GMT	Auction / Event
EMU	13.30	ECB President Largarge speaks at post-meeting press conference
Italy	10.00	Auction: €3.5bn of 0.6% 2023 bonds
	10.00	Auction: 0.85% 2027 bonds
	10.00	Auction: 1.35% 2030 bonds
	10.00	Auction: €1.5bn of 3.1% 2040 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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