Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds made gains, BTPs rallied, and the euro exchange rate depreciated as the ECB sent a clear signal that further monetary easing is coming in December, with all policy tools being considered for recalibration.
- Gilts were little changed as UK car production hit a 25-year low, consumer credit fell, but new mortgage approvals reached their highest since 2007.
- Friday will bring first estimates of Q3 GDP from the euro area and largest member states, and the flash October inflation from the euro area, France and Italy.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.817	-0.018
OBL 0 10/25	-0.837	-0.018
DBR 0 08/30	-0.640	-0.012
UKT 1¾ 09/22	-0.068	+0.004
UKT 0⅝ 06/25	-0.072	+0.005
UKT 4¾ 12/30	0.218	+0.008

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

Euro area

ECB signals further easing in December

It was no surprise that the ECB did not announce any changes to policy today, nor that immediate policy changes were not even discussed by the Governing Council. And in light of the marked intensification of the pandemic over recent days, and yesterday's announcement by Merkel and Macron of significant new restrictions on economic activity, the ECB was suitably dovish. Indeed, it sent an unambiguous signal that further monetary easing is coming in December. In particular, the Governing Council stated that, on the basis of its updated economic projections to be presented to the next policy meeting, the ECB "will recalibrate its instruments…to respond to the unfolding situation and to ensure that financing conditions remain favourable to support the economic recovery and counteract the negative impact of the pandemic on the projected inflation path." With Lagarde asserting in her press conference that there had been a clear deterioration in the near-term economic outlook, she also left no doubt that the ECB's economic projections are bound to be revised down significantly. So, the recalibration of policy in December will certainly seek to add stimulus.

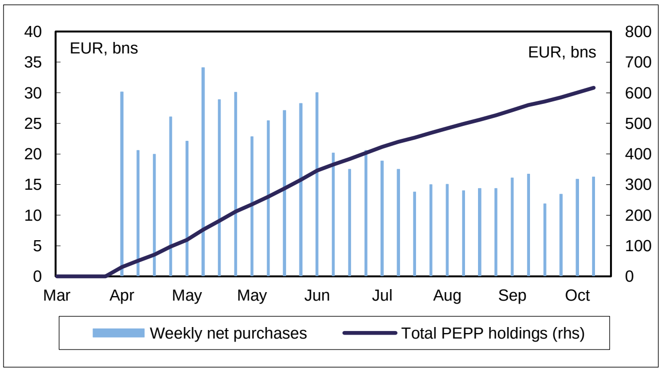
All policy tools up for discussion

Notably, however, Lagarde was at pains not to pre-commit to any specific policy change. Instead, she emphasised that all policy tools would be considered for recalibration. She also stated that the Governing Council would look at all dimensions of each of those tools, including duration, volume and attractiveness. That willingness to consider adjusting every aspect of every policy tool makes predicting the ECB's next steps tricky. Nevertheless, her comments revealed which tools she likely considers to be most effective in the current circumstance. In particular, she eulogized the significant strengths of the flexibility of the PEPP. And she also noted that the TLTRO-iii operations were proving effective in supporting bank lending to firms and households.

PEPP and TLTRO-iii operations to be augmented and extended?

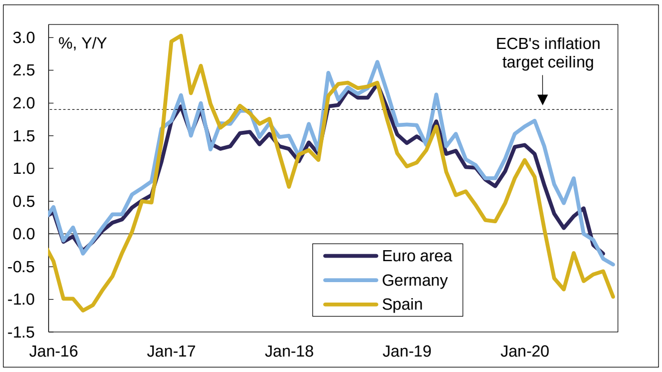
Given Lagarde's comments today, we maintain our expectation that the ECB will, at the December meeting, increase the PEPP envelope by between €500-650bn, and extend the duration of the programme at least to the end of 2021. We also anticipate a six-month extension, to June-2021, of the €20bn per month purchases under the regular Asset Purchase Programme. However, in addition, and in light of the evidence of a tightening of credit standards on new bank lending, we now also expect the Governing Council to enhance the stimulus provided by the TLTRO-iii loans by extending beyond June 2021 the end of the discount period during which the minimum interest rate of -1.0% is applied. And the ECB might also hold additional TLTRO-iii operations beyond the first quarter of next year. It is also possible – though perhaps less likely – that the

ECB: PEPP asset purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation*



**Flash estimates for Germany and Spain for October 2020.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

ECB will have a change of mind and increase the tiering multiple to reduce the cost to banks of the negative deposit rate. It might also tinker with its collateral rules. However, unless the euro exchange rate strengthens significantly, we maintain our expectation of no further interest rate cuts for the foreseeable future.

Near-term increase in PEPP purchases possible before December meeting

Of course, given the fast-moving situation in Europe, Lagarde made clear that the Governing Council could yet hold an emergency meeting before the scheduled meeting on 10 December if further easing would be appropriate. Moreover, she also reminded that, if necessary, the PEPP offers the ECB plenty of flexibility over the near term to adjust its asset purchases in terms of timing, asset classes and jurisdiction. And so, although today's auction saw the Italian government sell 10Y BTPs at a record-low yield, we would certainly not be surprised to see the ECB increase the current pace of its PEPP purchases from the recent average of about €15bn per week over coming weeks. Certainly, the ECB is well aware that the risks are now skewed very significantly to the downside and that economic and financial conditions could deteriorate significantly further over coming weeks.

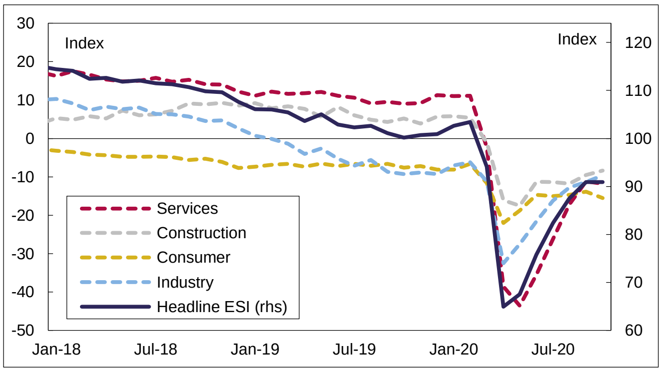
French GDP to decline significantly in Q4, euro area double-dip harder to avoid

Of course, all will depend on the path of the pandemic and the associated policy measures taken to contain its spread. With respect to the latter, there were similarities between the two sets of new restrictions announced yesterday by Merkel and Macron. Both will last at least a month. And, as in Belgium, the Netherlands and Ireland, restaurants, bars and leisure facilities will have to close. However, reflecting the severity of the situation in France, Macron's measures were much more stringent, involving the closure of non-essential shops, the sealing of the nation's borders to travelers from outside the Schengen area, and far greater limits on personal liberty. For example, anyone in France leaving their home will have to carry a special document justifying being out of doors, with time outside limited for reason other than work, school or essential shopping. With people encouraged to continue working wherever possible and schools still open, however, the hit to French economic output should be less marked than during the first-wave lockdown, which saw GDP drop a whopping 5.9%Q/Q in Q1 and a further 13.8%Q/Q in Q2. And it remains to be seen whether the new restrictions will have to last as long as during the first wave. Nevertheless, a substantive drop of French GDP in the fourth quarter now looks inevitable. The less stringent measures and current vigour in the manufacturing sector might help German GDP avoid such a fate. But there is a strong likelihood that further restrictions will be required elsewhere in the euro area – indeed Catalonia today extended for a further fortnight its shutdown of bars and restaurants and also tightened controls on its borders. And the severely impacted hospitality industry accounts for roughly 6% of economic activity. So, a contraction in euro area GDP in Q4, and further negative shock to inflation, is now looking very hard to avoid.

Commission sentiment survey flags turn for the worse in services

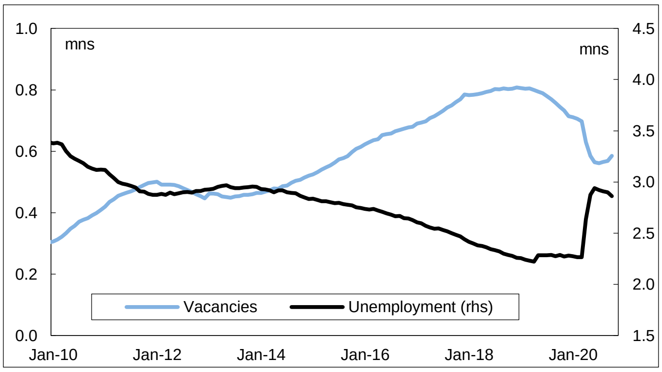
The ECB's statement asserted that there is clear evidence that the services sector is slowing materially. In this context, today's Commission sentiment survey tallied with the flash PMIs to flag the initial adverse impact of the revival in the pandemic on such activity. In particular, the index of euro area services sentiment dropped for the first time since May, with a relatively modest 0.6pt decline masking a larger deterioration in hard-hit France and the Netherlands, as well as a worsening in selling price expectations in the sector. In addition, the drop in euro area consumer confidence to a five-month low, suggested by the flash estimate, was confirmed. But, also consistent with the flash PMIs, the Commission survey suggested ongoing improvement in manufacturing, with the euro area industrial confidence index rising for a sixth month to the highest since February and notable gains in Germany and Italy. With confidence also firmer in retail and construction, the euro area Economic Sentiment Indicator (ESI) was unchanged at 90.9, the best reading since March. At the country level, the ESIs improved in Germany and Italy, dipped slightly in Spain, but fell back significantly in France and the Netherlands. Given the new restrictions and continued spread of pandemic, those declines might be expected to be widespread next month. Indeed, following five successive monthly improvements, the survey's index of employment expectations turned negative due to a marked decline in services. And consumers' fears about unemployment also deteriorated for the first time since April.

Euro area: Commission sentiment indices



Source: EC, Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Unemployment and vacancies



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Flash inflation data weaker, but German labour market continued to improve

Today's other economic data from the euro area were similarly a mixed bag. The first national flash estimates of inflation in October came in on the weak side. In particular, the EU-harmonised measure of German inflation fell 0.1ppt to a new five-year low of -0.5%Y/Y, with the softness seemingly emanating from core items. And Spanish inflation on the same measure dropped a steeper-than-expected 0.4ppt to a four-year low of -1.0%Y/Y due principally to lower prices of electricity and phone services. More happily, however, unemployment in Germany on the national measure fell a further 0.1ppt to 6.2% in October, with jobless claims down a much steeper-than-expected 35K following a revised 10K decline in September. In addition, job openings rose for a third month in a row, up a respectable 17K. These data suggest that the German labour was improving steadily ahead of the imposition of the new restrictions to control the pandemic. Admittedly, the government's kurzarbeit short-term working scheme continues to flatter the data, with an ifo institute survey suggesting that around 3 million workers are still being supported that way. And while that support will prevent a marked deterioration in the face of the new German 'lockdown light', the improving trend in the German labour market seems likely to be on hold over coming weeks.

The day ahead in the euro area

It will be a busy end to the week for top-tier euro area economic releases, with the first estimates for Q3 GDP and October inflation most notable. Despite a recent slowing in the pace of recovery, with activity having posted significant growth during the summer after lockdown measures were initially relaxed, euro area GDP – due for release on Friday – is expected to have risen at a historically rapid rate last quarter. We forecast GDP growth of 10.5%Q/Q, more than 2ppts stronger than the ECB's baseline projection. Nevertheless, this would mean that just 60% of the pandemic-related slump had been reversed, and would leave output still a little more than 6% below its Q419 level. The country releases – the largest four member states will also publish figures tomorrow – are similarly all are expected to show that GDP rebounded vigorously in Q3. We expect German GDP to have risen by around 7½%Q/Q, while data from France, Italy and Spain will reveal significantly stronger rates of growth following double-digit rates of decline in Q2.

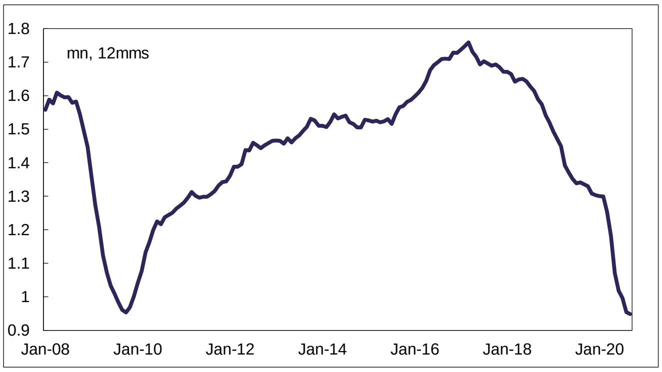
Meanwhile, given the still significant amounts of spare capacity, October's inflation release will continue to show that underlying price pressures remain subdued. Indeed, the first figures released by the member states today saw the EU-harmonised measures of German and Spanish inflation drop further into negative territory to new multi-year lows. However, we expect the euro area's headline and core CPI rates to rise slightly, perhaps ticking up 0.1ppt to -0.2%Y/Y and 0.3%Y/Y respectively, as the downside impact of delayed summer sales in France and Italy falls out of the arithmetic. Tomorrow also brings euro area labour market figures for September, which are expected to show a further uptick in the headline unemployment rate from 8.1% in August, although this will remain limited by the various government employment and wage-support schemes in place across the region. Figures for German retail sales and French consumer spending on goods are also due.

UK

Mortgage approvals highest since 2007, but consumer credit falls at a record annual rate

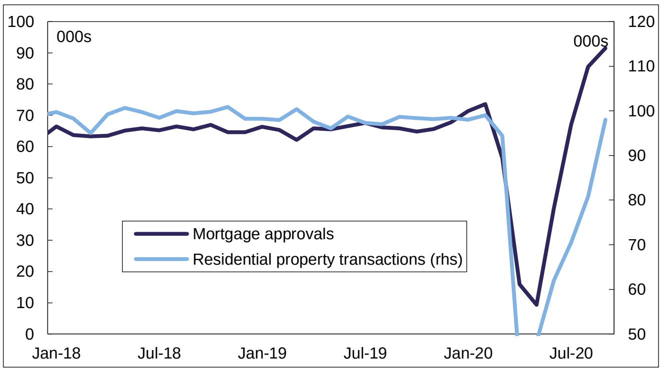
The BoE's lending figures continued to highlight diverging trends in the banking sector in September. Reflecting the rebound in housing market activity since lockdown, mortgage approvals for house purchase rose to 91.5k, the highest since September 2007 and 24% above the pre-lockdown level in February. Households borrowed an extra net £4.8bn secured against their homes, taking the level above the average in the six months before lockdown in March. Mortgage interest rates remained historically low and stable. But after a couple of months of net additional borrowing, consumer credit outstanding declined last month, with net repayments of £0.6bn, due to a net repayment on credit cards, pushing annual growth down to -4.6%Y/Y, the lowest on the series dating back to 1994. At the same time, the effective interest rate on interest-charging

UK: Car production



Source: SMMT, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Mortgage approvals and housing transactions



Source: HMRC, BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.

overdrafts rose to a record high (an eye-watering 22.52%). Private sector non-financial corporations repaid £0.5bn of loans in September, as net repayments by large firms more than offset continued net borrowing by SMEs. So, while borrowing by SMEs was up a series-high 22.8%Y/Y, borrowing by large firms was up just 0.7%Y/Y. The average cost of new business borrowing edged up slightly to 1.65%, but left it still 0.9ppt below the level prevailing in February before Covid-19 hit.

UK car production drops to 25-year low

UK car production maintained its terrible performance in September, with output dropping 5.0%Y/Y to 114.7k units, the lowest level for the month in 25 years. Perhaps as a taster for things to come under Brexit, production for exports, which account for more than three quarters of output, dropped 9.7%Y/Y to more than negate the 14.5%Y/Y increase in production for the domestic market. So far in the year to-date, total production is down 35.9%YTD/Y, with production for the home market down 38.7%YTD/Y and production for export down 35.2%YTD/Y.

The day ahead in the UK

Friday will bring the Lloyds Business Barometer and Nationwide house price indices, both for October.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	EC economic sentiment indicator	Oct	**90.9**	89.6	91.1	**90.9**
	EC industrial (services) confidence indicator	Oct	**-10.9 (-14.0)**	-10.9 (-14.2)	-11.1 (-11.1)	**-11.4 (-11.2)**
	Final EC consumer confidence indicator	Oct	**-15.5**	-15.5	-13.9	-
	ECB main refinancing rate %	Nov	**0.00**	*0.00*	0.00	-
	ECB marginal lending rate %	Nov	**0.25**	*0.25*	0.25	-
	ECB deposit rate %	Nov	**-0.50**	*-0.50*	-0.50	-
Germany	Unemployment claims rate % (change 000s)	Oct	**6.2 (-35.0)**	6.3 (-5.0)	6.3 (-8.0)	**- (-10.0)**
	Preliminary CPI (EU-harmonised CPI) Y/Y%	Oct	**-0.2 (-0.5)**	-0.3 (-0.4)	-0.2 (-0.4)	-
Italy	ISTAT consumer confidence indicator	Oct	**102.0**	102.0	103.4	**103.3**
	ISTAT business (manufacturing) confidence indicator	Oct	**92.9 (95.6)**	- (91.8)	91.1 (92.1)	**91.3 (92.6)**
Spain	Preliminary CPI (EU-harmonised CPI) Y/Y%	Oct	**-0.9 (-1.0)**	-0.4 (-0.7)	-0.4 (-0.6)	-
UK	SMMT auto production Y/Y%	Sep	**-5.0**	-	-44.6	-
	Net consumer credit £bn (Y/Y%)	Sep	**-0.6 (-4.6)**	-	0.3 (-3.9)	-
	Mortgage lending £bn (approvals 000s)	Sep	**4.8 (91.5)**	-	3.1 (84.7)	**3.0 (85.5)**

Auctions

Country	Auction
Italy	sold €3.0bn of 0.9% 2031 bonds at an average yield of 0.79%
	sold €2.5bn of 0.5% 2026 bonds at an average yield of 0.23%
	sold €1.0bn of 2023 floating-rate bonds at an average yield of 0.27%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
France	INSEE consumer confidence indicator	Oct	**94**	93	95	-
Spain	Retail sales Y/Y%	Sep	**-3.3**	-3.4	-2.4	**-2.9**
UK	BRC shop price index Y/Y%	Oct	**-1.2**	-	-1.6	-

Auctions

Country	Auction
Germany	sold €1.649bn of 0% 2035 bonds at an average yield of -0.46%
UK	sold £2.5bn of 0.375% 2030 bonds at an average yield of 0.244%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
EMU		10.00	Preliminary GDP Q/Q% (Y/Y%)	Q3	*10.5 (-6.1)*	-11.8 (-14.7)
		10.00	Preliminary CPI (core CPI) Y/Y%	Oct	*-0.2 (0.3)*	-0.3 (0.2)
		10.00	Unemployment rate %	Sep	*8.2*	8.1
Germany		07.00	Preliminary GDP Q/Q% (Y/Y%)	Q3	*7.5 (-4.9)*	-9.7 (-11.3)
		07.00	Retail sales M/M% (Y/Y%)	Sep	-0.6 (6.5)	1.8 (3.0)
France		06.30	Preliminary GDP Q/Q% (Y/Y%)	Q3	*16.0 (-6.1)*	-13.8 (-18.9)
		06.30	Consumer spending M/M% (Y/Y%)	Sep	-0.5 (2.2)	2.3 (2.4)
		07.45	Preliminary CPI (EU-harmonised CPI) Y/Y%	Oct	0.1 (0.1)	-0.5 (-0.6)
Italy		10.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Oct	-0.4 (-0.8)	-0.6 (-1.0)
		11.00	Preliminary GDP Q/Q% (Y/Y%)	Q3	*12.0 (-7.9)*	-12.8 (-17.7)
Spain		08.00	Preliminary GDP Q/Q% (Y/Y%)	Q3	*15.0 (-10.1)*	-17.8 (-21.5)
UK		00.01	Lloyds Business Barometer	Oct	-	-11
		07.00	Nationwide house price index M/M% (Y/Y%)	Oct	0.4 (5.2)	0.9 (5.0)
Auctions and events						
EMU		09.00	ECB to publish Survey of Professional Forecasters			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs