Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest losses despite softer-than-expected growth in euro area retail sales in December while BTPs made further gains as former PM Conte suggested he might support a new Draghi-led Italian government.
- While the MPC continued its preparatory work on negative rates, Gilts made sizeable losses as the BoE was sanguine about the UK economic outlook as it left the current policy stance unchanged.
- Friday will bring new data for German factory orders.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.722	+0.001
OBL 0 10/26	-0.691	+0.006
DBR 0 02/31	-0.458	+0.009
UKT 1¾ 09/22	-0.040	+0.053
UKT 0⅝ 06/25	0.053	+0.055
UKT 4¾ 12/30	0.436	+0.067

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

Euro area

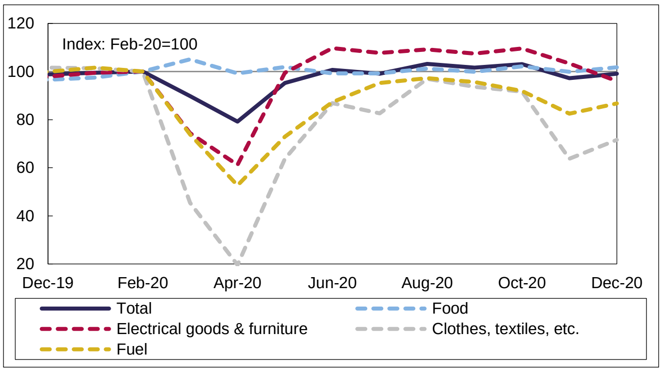
Retail sales rebound in December insufficient to prevent drop in Q4

Following a revised drop of 5.7%M/M in November, euro area retail sales rose 2.0%M/M in December, slightly less than expected, to be up 0.6%Y/Y but 0.9% below February's pre-pandemic level. The headline euro area figure masked massive variation between the member states, reflecting the significant differences in the timing and stringency of pandemic containment measures. Strikingly, following steep drops in November, sales rebounded vigorously in France (22.3%M/M), Belgium (15.9%M/M) and Ireland (11.4%M/M) as containment measures were eased. In marked contrast, the tightening of restrictions on non-essential stores saw sales in Germany (-9.6%M/M) and the Netherlands (-10.9%M/M) fall sharply. Likewise, there remained significant variation in sales by type of store at the aggregate euro area level. Sales at clothing and textile stores rebounded 12.4%M/M following a drop of 30.5%M/M the prior month, but were still down more than one quarter from the pre-pandemic level. Sales of electrical goods and furniture fell for a second successive month and by 7.0%M/M to 3.9% below last February's level and the lowest since April. But food sales rose 1.9%M/M, not quite reversing the previous month's decline but still rising back above the pre-pandemic level. Overall, having leapt 10.4%Q/Q in Q320, euro area retail sales fell 1.5%Q/Q in Q420, underscoring the strong likelihood that household consumption fell sharply too. And given the extension of pandemic containment measures, we expect sales and household consumption to decline again in Q121.

Construction PMIs suggest weakening in the sector at the start of 2021

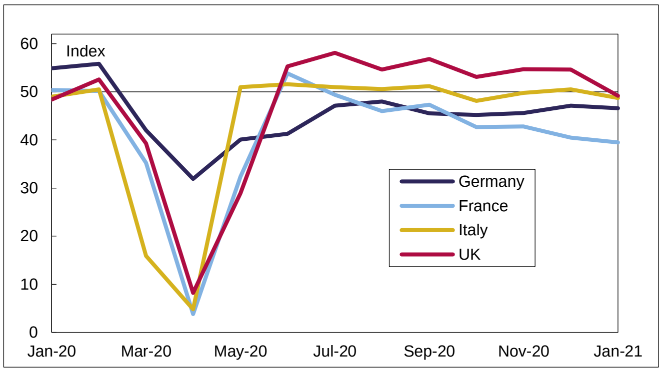
The January construction PMIs suggested that momentum in the sector has weakened further in the face of the intensified pandemic. The headline euro area total activity index dropped for a second successive month and by 1.4pts to 44.1. That was the lowest since May and a level clearly consistent with contraction in the sector, albeit still far superior to those recorded between March and June last year. The headline activity indices also fell in each of the three largest member states in January. All dropped back below the key 50 level with the French PMI weakest at just 39.5, also an eight-month low. At the sectoral level, there was at least a modest easing in the pace of decline reported in euro area housing activity, for which the respective PMI rose 0.7pt from December to 47.7. Nevertheless, additional weakness in France largely offset an improvement in such building work in Germany and Italy. In addition, the equivalent indices for commercial activity (42.3) and civil engineering (41.9) fell to their lowest levels since May. Discouragingly, the PMIs also suggested a subdued near-term outlook, with new business down for an eleventh successive month in January and at a faster pace, with Markit suggesting that pandemic containment measures had further weighed on demand and led to delays in the sign-off of projects. Given such a downbeat backdrop, the survey also reported a further decline in employment in the sector, with job-shedding reportedly the quickest for three months. There was at least a glimmer of light at the end of the tunnel. Buoyed by progress

Euro area: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Construction PMIs



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

with vaccine development (if not implementation), the PMI for expectations twelve months ahead rose more than 5pts to 52.9, the first net positive reading since July and the best in eleven months.

The day ahead in the euro area

Friday will bring German factory orders data for December. Following seven months of positive growth, orders are expected to drop slightly in December by about 1%M/M. That, however, would still leave them up about 6½%Y/Y. December figures for French goods trade and Italian retail sales are also due tomorrow.

UK

BoE leaves policy stance and guidance unchanged, continues work on negative rates

The conclusion of the BoE's first monetary policy meeting of the year brought no major surprises, but was nonetheless noteworthy. Most predictably, the Bank's interest rates and QE were left unchanged while its forward guidance was also unchanged. So, the MPC still does not intend to tighten policy until there is clear evidence that significant progress is being made to eliminate spare capacity and achieve the 2% inflation target on a sustainable basis. And it also remains ready to take "whatever additional action is necessary to achieve its remit" if the inflation outlook weakens. The MPC's summary statement had no further discussion of options to ease policy if required. However, the meeting minutes revealed that the MPC had discussed issues related to a possible future move to negative interest rates. And following that discussion, the MPC agreed – albeit with some members evidently having reservations – to start new work to ensure that it would have the option of moving to a negative Bank Rate at some point in future.

Preparations to be made for a negative Bank Rate with tiering, but no intention yet to implement it

The meeting minutes noted the PRA's judgement that implementation of a cut in Bank Rate to negative territory over a shorter timeframe than six months would be inadvisable given operational risks. So, the MPC concluded that, for precautionary purposes, it would now start preparations with banks "to provide the capability to implement a negative rate at some point if necessary" in more than six months' time. It also asked BoE staff to commence internal technical preparations on a possible tiered system of reserve remuneration that might possibly accompany a move to negative rates. But the MPC was also "clear that it did not wish to send any signal that it intended to set a negative Bank Rate at some point in the future". Indeed, "some" members of the MPC did not want to start this precautionary work at all, not least as it was considered to be "not warranted by the current conjuncture and the outlook described in the MPC's latest economic projections".

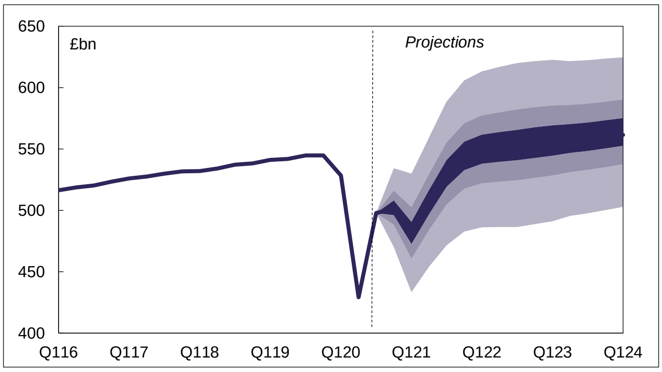
BoE also to reconsider tightening strategy

The recognition that, at some point in the future, Bank Rate might be cut to negative territory, however, led the MPC also to decide that it would be appropriate now also to reconsider its previous guidance on the appropriate strategy for any eventual tightening of monetary policy. The previous guidance stated that the stock of purchased assets would likely be maintained until Bank Rate reached a level from which it could be cut materially. In June 2018, the MPC agreed that it intended not to reduce the stock of purchased assets until Bank Rate reached around 1.5%. But if and when the BoE decided that it had secured the technical ability to cut rates below zero at some point in future, the MPC might well at some point decide to reduce the stock of purchased assets when Bank Rate is some way below 1.5%. The strategy will now be reconsidered by Bank staff.

BoE expects economy to "recover rapidly" as the year goes on

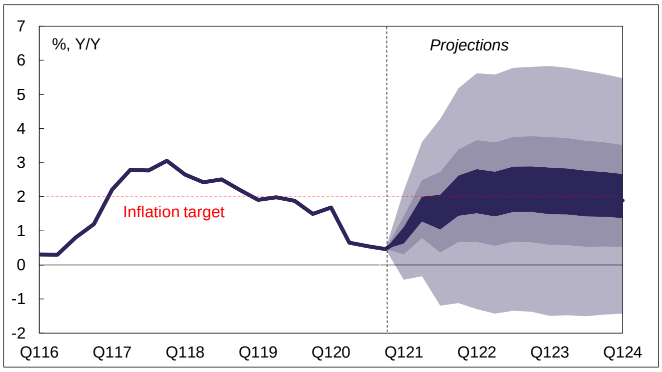
Despite the decision to continue preparatory work, it is now clear that a negative (or zero) Bank Rate will definitely not be implemented in the first half of 2021. And if the economy follows the path set out in the BoE's updated economic projections, negative rates will not be implemented at all this cycle. Indeed, the BoE's baseline forecast continues to suggest that inflation will return to the BoE's 2% target around the end of this year, and remain thereabouts thereafter, suggesting no need for any

Bank of England: GDP outlook*



*Based on Bank Rate constant at 0.10%. Source: BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.

Bank of England: Inflation outlook*



*Based on Bank Rate constant at 0.10%. Source: BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.

extra monetary easing at all over the horizon. And overall, the BoE is sanguine about the UK economic outlook. Admittedly, while it fared better than the MPC expected last quarter, GDP is now expected to drop about 4.2%Q/Q and 9.2%Y/Y this quarter (compared to a previously forecast drop of 6.5%Y/Y). The BoE also expects the unemployment rate to jump to 7¾% by mid-year. Moreover, the BoE estimates that the new trading arrangements with the EU mean that, over the long run, UK trade will be about 10½% lower than it otherwise would have been and GDP will be around 3¼% lower. But not least given the good progress implementing the vaccine programme, which should enable the steady easing of containment restrictions from next quarter on, the MPC expects the UK economy subsequently to "recover rapidly" over 2021 and into 2022. According to the baseline projection, it expects GDP to be up a whopping 14.2%Y/Y and close to the pre-Covid level in the first quarter of 2022, with risks no longer skewed to the downside. And given its dim view of the UK's growth potential, the MPC expects spare capacity in the economy by then to have been exhausted.

The day ahead in the UK

It is set to be a quiet end to the week for economic news from the UK with no top-tier data due.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Retail sales M/M% (Y/Y%)	Dec	**2.0 (0.6)**	2.5 (0.4)	-6.1 (-2.9)	**-5.7 (-2.2)**
Germany	Construction PMI	Jan	**46.6**	-	47.1	-
France	Construction PMI	Jan	**39.5**	-	40.5	-
Italy	Construction PMI	Jan	**48.7**	-	50.5	-
UK	New car registrations Y/Y%	Jan	**-39.5**	-	-10.9	-
	Construction PMI	Jan	**49.2**	52.8	54.6	-
	BoE Bank Rate %	Feb	**0.10**	*0.10*	0.10	-
	BoE Gilt purchase target £bn	Feb	**875**	*875*	875	-

Auctions

Country	Auction
France	sold €6.154bn of 0% 2030 bonds at an average yield of -0.25%
	sold €1.587bn of 1.25% 2036 bonds at an average yield of 0.05%
	sold €1.499bn of 1.75% 2039 bonds at an average yield of 0.14%
	sold €1.756bn of 0.75% 2052 bonds at an average yield of 0.5%
Spain	sold €2.289bn of 0% 2024 bonds at an average yield of -0.458%
	sold €1.309bn of 0% 2026 bonds at an average yield of -0.36%
	sold €2.025bn of 0.1% 2031 bonds at an average yield of 0.162%
	sold €492.3mn of 0.7% 2033 index-linked bonds at an average yield of -0.906%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Factory orders M/M% (Y/Y%)	Dec	-1.0 (6.7)	2.3 (6.3)
France	07.45	Total trade balance €bn	Dec	-	-3.6
	07.45	Preliminary private sector payrolls Q/Q%	Q4	-0.7	1.6
Italy	09.00	Retail sales M/M% (Y/Y%)	Dec	1.6 (-4.8)	-6.9 (-8.1)

Auctions and events

Country	GMT	Event
EMU/UK	13.30	BoE's Bailey and ECB's Guindos scheduled to speak on Post-covid recovery

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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