Euro wrap-up

Overview

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- While Germany's traffic-light coalition deal was unveiled with few surprises, Bunds largely made modest gains as the ifo business survey reported weakening sentiment and ECB Board member Panetta suggested that the Governing Council should not respond to the current jump in inflation.
- Gilts made modest losses as a UK manufacturing survey reported a surge in orders and historically high price pressures.
- Thursday will bring the account of the ECB's October policy meeting while new data includes the latest German consumer confidence indices.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.761	-0.017
OBL 0 10/26	-0.561	-0.010
DBR 0 08/31	-0.226	-0.002
UKT 0 1/8 01/24	0.573	+0.002
UKT 0 3/8 10/26	0.750	+0.015
UKT 0¼ 07/31	1.007	+0.013

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

Euro area

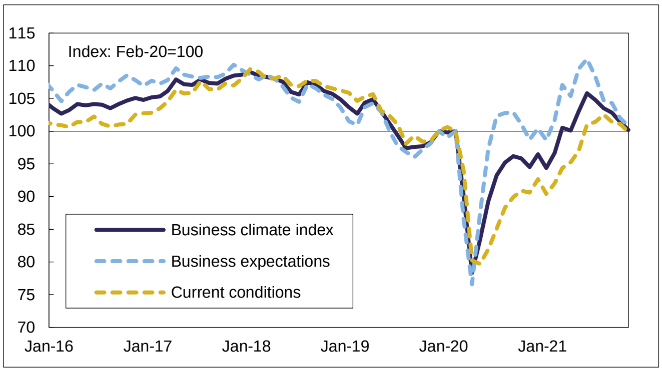
Traffic-light coalition deal finally agreed with no major surprises

Almost two months after Germany's federal election, the traffic-light coalition deal – between the centre-left SPD, Greens and liberal FDP – was unveiled today. That marked the swiftest post-election coalition agreement since 2009. Subject to confirmation by the party members, the new government, and new Chancellor Olaf Scholz, will be sworn in by the Bundestag early next month. At the time of writing, there appeared to be no major surprises arising from the agreement. As the largest party in parliament, the SPD looked set to get six ministries, as well as the Chancellery. The Greens were set to get five, including the foreign ministry under its Chancellor candidate Annalena Baerbock, as well as a new economy and climate protection super-ministry to be headed by the party's co-leader Robert Habeck. And the FDP looked set to get four, including the Ministry of Finance under its leader Christian Lindner. As such, the agreement also appeared to abide with key FDP red-lines of no tax hikes and respect of Germany's constitutional debt limits from 2023, albeit with the government to review scope within the framework for supporting growth. Given the electoral success of the Greens, the environment will play a central role in policy. Consistent with the goal of becoming carbon neutral by 2045, the parties aim to phase out use of coal-fired power stations "ideally" by 2030, eight years earlier than currently scheduled, and accelerate the transition to electric vehicles. The coalition also inevitably commits to facilitate large-scale investments in green (as well as digital) projects, with railways set to be prioritized and development bank KfW tasked to play an active role. The parties are also open to revising the euro area's fiscal rules to allow for greater green investment while it does not preclude the establishment of EU-wide fiscal policy instruments as a potential follow-up to the current NGEU recovery funds. Meanwhile, more interventionist policies aimed at the SPD rank-and-file include an increased minimum wage, the extension of the residential rent cap, and extra home-building. Of course, the devil will be in the detail of the agreement, much of which still appears vague.

Dovish Panetta makes clear that ECB policy decisions next month remain open

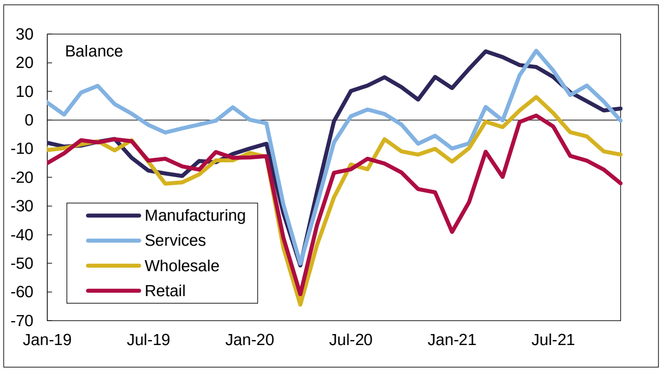
Yesterday's relatively hawkish comments from ECB Executive Board member Isabel Schnabel – who judged the risks to the inflation outlook now to be skewed to the upside, thought it probable that net PEPP purchases would stop in March, and also doubted whether the flexibility of the PEPP purchases should be transferred to the regular APP purchases – prompted a sell-off in euro area government bonds. But today brought some highly dovish comments from fellow Executive Board member Fabio Panetta, who challenged much of Schnabel's analysis and policy conclusions. Among other things, Panetta stated that high inflation in the euro area was largely driven by supply shocks not demand, and predominantly reflected disturbances generated abroad. He cautioned that the pandemic wasn't over and judged that the downside risks to economic activity might be growing. And noting continued subdued growth in negotiated wages, he doubted that upside risks to medium-term

Germany: ifo business climate indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: ifo expectations indices by sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

inflation were crystallising. He reminded that the ECB's strategy review had committed to be "forceful and persistent" in monetary policy to achieve the medium-term inflation target on a sustained basis, even if it required a moderate transitory overshoot. And he thought that the conditions for raising rates specified in the ECB's forward guidance were "not close to being met". So, he insisted that the ECB should continue to look through the current inflation spike. He judged that "an inappropriate, sharp reduction of purchases would be tantamount to a tightening of the policy stance" and that net asset purchases should be "an essential ingredient of our monetary policy stance even if the PEPP comes to an end." And he emphasised that the flexibility of the PEPP programme "should become an integral element of our asset purchases". While the bond markets failed to react today, his comments made clear that the decisions to be taken at next month's Governing Council meeting about the pace of asset purchase in Q1 and the nature of purchases thereafter remain in the balance.

Contrary to flash PMIs, ifo indices flag hit to German growth as pandemic and bottlenecks bite

Yesterday's flash PMIs surprised on the upside, providing some reassurance that the combination of ongoing supply bottlenecks and sharp increases in new coronavirus cases in several member states should not stop the recovery in its tracks this quarter. Today's business sentiment survey results from Germany and France, however, provided mixed messages. In particular, the ifo institute's headline business climate index fell for a fifth successive month, and a touch further than had been expected before the release of the flash PMIs, to 96.5, the lowest level since April. The survey measure of current conditions dropped for a third successive month and by the most since January to a six-month low (99.0). And the index of expectations for the coming six months dropped by the same margin to 94.2, the lowest since January and below the long-run average.

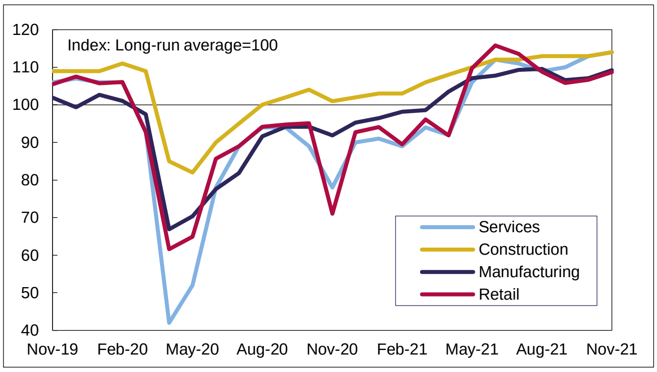
Survey signals higher prices but weaker growth

According to the ifo survey, the deterioration in German business sentiment from October was widespread but most marked in services. Seemingly reflecting concerns about the pandemic and the prospect of further tightening of restrictions to come, services expectations turned negative for the first time in seven months with the drop in the respective index the sharpest in a year. Expectations in wholesale and retail trade were also much weaker, and very low by historical standards, with the respective indices plunging to the lowest since last winter's wave of Covid-19. And retailers also reportedly bemoaned continued supply shortages and expected prices to continue to rise over coming months. With expectations deteriorating in the construction sector too, it was only in manufacturing sector where German firms were a touch more upbeat about the outlook. But those firms judged current conditions to be significantly worse due to persistent shortages in the supply of inputs and expectations of higher prices to come. Overall, therefore, the ifo survey points to an uncomfortable mix of ongoing price pressures and slowing growth. While German consumer price inflation will likely rise above 5.5%Y/Y this month, we expect GDP growth to slow to 0.5%Q/Q or below in Q4.

INSEE survey optimism points to ongoing firm economic recovery in France

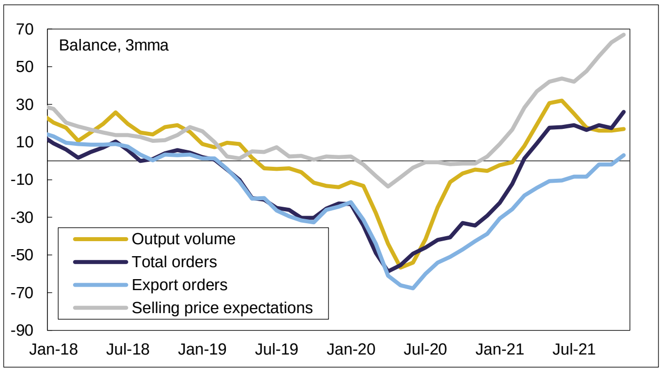
While the ifo survey suggested that the improvement recorded in the German flash PMIs might be misguided, the INSEE survey was entirely consistent with the pickup in activity implied by the French flash PMIs. Indeed, the INSEE survey's headline business climate indicator rose 2pts to 114, matching the highest level in two decades and some 8pts above the pre-pandemic level at the start of 2020. The improvement in French conditions appeared broad-based too, with all main sectors more optimistic on the month and reporting conditions more favourable than the long-run average. The largest upgrade to the assessment of conditions was reported in wholesale trade, with an increase in deliveries from abroad hinting at a welcome easing of supply constraints. Not troubled by any tightening of pandemic restrictions as seen in Germany, the Netherlands and Austria, French services firms reported the most favourable conditions since the year 2000, amid increased sales expectations. In retail, where sentiment rose to a three-month high, firms' optimism about the outlook was buoyed by increased orders. Manufacturers, who were similarly the most upbeat for three months, also reported a notable increase in new orders, particularly from abroad. And, with the exception of autos where supply bottlenecks continue to act as a significant restraint, manufacturers flagged increased production expectations. Strikingly, however, manufacturers also

France: INSEE business confidence indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

reported a marked upward revision in sales price expectations to a series high. And thanks not least to stronger hiring in services, the employment climate was judged to have improved again, with the respective survey index up to its highest since June 2011. All in all, therefore, a very bullish survey, which is consistent with our French GDP forecast of at least 0.8%Q/Q in Q4.

The day ahead in the euro area

The focus tomorrow will be on the ECB's account from the 28 October Governing Council meeting, after which President Lagarde tried to push back on market pricing of a rate hike in 2022 but also suggested that the PEPP programme was likely to conclude in March. The account will be watched closely for any insights into what might be announced at December's policy-setting meeting regarding the future path of asset purchases. Meanwhile, various Governing Council members, including President Lagarde and influential Executive Board member Schnabel, are due to speak publicly.

Datawise, tomorrow brings updated German GDP figures for Q3, which will include the first official expenditure breakdown. The initial release suggested that Germany's economy grew by 1.8%Q/Q, seemingly driven principally by household expenditure. Tomorrow also sees the release of the German GfK consumer confidence survey for December, which is expected to report a fall in the headline sentiment index, to about -1.0, albeit still a way off the low of -23.1 recorded in May last year. But with record numbers of daily Covid cases in Germany and across neighboring countries, and German policymakers considering a full lockdown and mandatory vaccines, the risks to consumer confidence must be skewed significantly to the downside. Elsewhere, Spain will publish its latest producer price figures, which are expected to reveal that prices at the factory gate remained elevated in October, after the headline PPI inflation rate accelerated to a high of 23.6%Y/Y in September.

UK

CBI survey points to strong goods demand amid rising price expectations

Yesterday's flash manufacturing PMIs suggested that output and new orders in the sector were up by the most in three months in November, albeit still at rates down from the Q3 average. Today's CBI industrial trends survey was also broadly upbeat. The survey measure of output growth in the three months to November edged up (by 2pts to +17%) to be well above the long-run average but similarly below the range from May to August Twelve out of seventeen sub-sectors reported growth in output, led by food, drink & tobacco, as well as the electronic engineering and chemicals sub-sectors. Manufacturers expect output growth to accelerate in the next three months, albeit marginally less than was the case last month. But total order books reportedly grew at the strongest pace on the series dating back to 1977 (the survey's net balance jumped 17ppts to +26%, well above the long-run average of -14%). Moreover, export orders grew for the first time since March 2019. With supply bottlenecks persisting, however, stock adequacy reportedly declined to a series low. And with cost pressures continuing to mount, manufacturers' output price expectations for the coming three months were the strongest since May 1977.

The day ahead in the UK

Tomorrow is set to be a quiet day on the UK economic data front with no releases scheduled. We will, however, hear from BoE Governor Bailey and MPC member Haskel who are both due to speak publicly during the afternoon.

European calendar

Today's results

Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		Ifo business climate	Nov	**96.5**	96.7	97.7	**-**
		Ifo current assessment balance (expectations)	Nov	**99.0 (94.2)**	99.0 (94.6)	100.1 (95.4)	**100.2 (-)**
France		INSEE business confidence	Nov	**114**	112	113	**112**
		INSEE manufacturing confidence (production outlook)	Nov	**109 (20)**	106 (-)	107 (21)	**-**
UK		CBI industrial trends survey, total orders (selling prices)	Nov	**26 (67)**	8 (57)	9 (59)	**-**
Auctions							
Country		Auction					
Germany		Auction: €980mn of 0% 2036 bonds at an average yield of -0.006%					

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	Final GDP Q/Q% (Y/Y%)	Q3	1.8 (2.5)	1.6 (9.8)
		07.00	GfK consumer confidence	Dec	-1.0	0.9
Spain		08.00	PPI Y/Y%	Oct	-	23.6
Auctions and events						
Euro area		08.00	ECB's Villeroy scheduled to speak			
		09.00	ECB's Schnabel scheduled to speak			
		12.30	ECB publishes account of October policy meeting			
		13.30	ECB President Lagarde gives opening remarks at the ECB's Legal conference			
Italy		10.00	Auction: €1bn of 0.4% 2030 inflation-linked bonds			
		10.00	Auction: €2.25bn of0% 2024 bonds			
UK		14.30	BoE's Haskel to give introductory remarks at a BoE/NIESR event			
		17.00	BoE Governor Bailey scheduled to speak at a Cambridge Union event			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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