Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses despite weaker-than-expected data for euro area retail sales and German factory orders.
- Gilts also made losses even as the BoE increased QE by more than expected while the Government extended its support for the labour market.
- Friday will bring new data for German industrial production and French private sector payrolls.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.797	+0.007
OBL 0 10/25	-0.814	+0.009
DBR 0 08/30	-0.637	+0.003
UKT 1¾ 09/22	-0.059	+0.024
UKT 0⅝ 06/25	-0.056	+0.022
UKT 4¾ 12/30	0.230	+0.026

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

Euro area

Retail sales took a step back in September, outlook complicated by lockdowns

Following a surge in August, partly related to summer discounting in France and Italy but also a pullback in Germany, euro area retail sales fell back in September by 2.0%M/M, a little more than expected. That, however, still left sales up 2.2%Y/Y following revised growth of 4.4%Y/Y in August, and 1.1% above February's pre-lockdown level. Within the detail, spending on clothing and shoes dropped a steep 7.6%M/M in September back well below February's level following a jump of 15.9%M/M the previous month. Online sales dropped 5.5%M/M following growth similarly more than double the rate the prior month. And sales of all core (i.e. non-food and non-energy) items fell 2.6%M/M, while sales of food and drink dropped 1.4%M/M. Sales of fuel were little worse than flat but thus remained about 3% below the pre-lockdown level. Despite the soft showing in September, euro area retail sales jumped 10.2%Q/Q in Q3 following the drop of 5.0%Q/Q in Q2. Looking ahead, the closure of non-essential retailing in France, and restrictions on activity elsewhere, seem bound to hit retail sales this month. However, online sales seem bound to see renewed strength. And the continued shift of spending away from services to goods could well see the uptrend in retail sales resume as soon as restrictions are lifted.

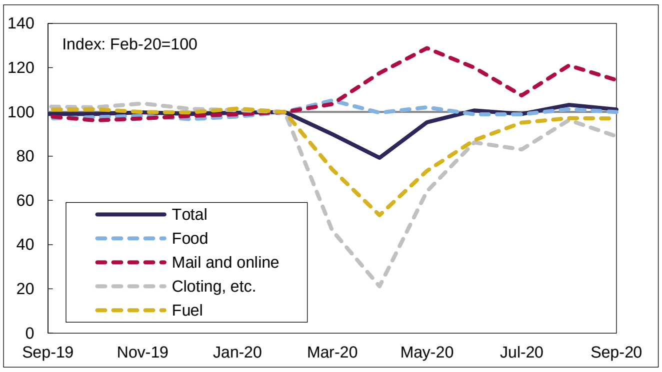
German factory orders disappoint but uptrend remains

Germany's factory orders data for September also came in softer than expected, with growth of just 0.5%M/M. While orders in August were revised higher (up 4.9%M/M), orders in September were still down 1.9%Y/Y and 2.6% below February's pre-lockdown level. The downside surprise for September was the result of a sharp drop of 6.0%M/M in orders from the rest of the euro area, seemingly as payback for strength in August, while growth at home and beyond the euro area was firm. By sector, orders for many capital and intermediate goods were also strong, with autos rising 5.1%M/M to be 5.8% above the pre-lockdown level. However, orders of machinery and equipment dropped 3.7%M/M to be 8.2% below February's level. Excluding large orders, factory orders were up a stronger 4.5%M/M, with orders from the rest of the euro area up 2.8%M/M, giving confidence that the softer-than-expected headline figure was principally due to volatility related to exceptional items rather than a sudden weakening of the recent positive trend.

Construction PMIs suggest sector is firmly in reverse gear

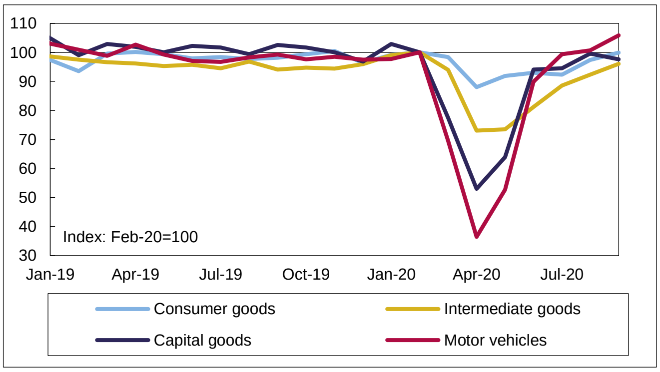
If the latest construction PMIs are anything to go by, conditions in that sector continue to weaken. The headline euro area construction PMI fell 2.6pts in October to a highly contractionary 44.9, the lowest since May when firms were still struggling to operate due to the impact of lockdown measures in several member states. The deterioration was seen in the headline measures for each of the three largest member states, all of which now stand firmly below the key 50 level. And the same is

Euro area: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

true for each of the sub-sectoral PMIs, as the measures for housing, commercial and civil engineering work also suggested a clear reversal of momentum. With new orders reportedly falling, expectations for the future were the weakest since April and firms in the sector cut jobs at the fastest pace since the spring too. While construction firms are currently able to continue working through the various national lockdown restrictions, rising unemployment, downwards pressure on wages and tighter financial conditions are likely to weigh on demand for housing. And commercial work will be deterred by pandemic-related uncertainty about future demand for offices and city-centre retail, hospitality and leisure space.

The day ahead in the euro area

The euro area dataflow this week will come to an end with German industrial production figures for September. In light of strong recent survey results and an increase of 1.1%M/M in manufacturing turnover reported today, manufacturing output seems likely to have posted firm growth, perhaps upwards of 1%M/M. That, however, would leave it still more than 10% below February's pre-lockdown level. And construction activity – which fell back in each of the prior two months – represents a downside risk to total production. French private sector payroll and wage data for Q3 are also due for release.

UK

BoE increases QE by a larger-than-expected £150bn

The BoE announced an increase its Gilt purchase target by a larger-than-expected £150bn to take the respective total to £875bn. With the £20bn total for purchases of private sector securities left unchanged, the total amount of QE now stands at £895bn. Unlike the previous time the asset purchase target was increased in June, when Chief Economist Haldane voted against, the decision on the MPC to increase QE at this meeting was unanimous. The MPC expects the extra Gilt purchases to be completed around the end of 2021, with the pace initially expected to remain around its current level before slowing later in the year. At the same time, the BoE is ready to accelerate the pace over the near term if financial market conditions demand it – say, if the UK government fails to reach an agreement with the EU on a new FTA and market turbulence ensues.

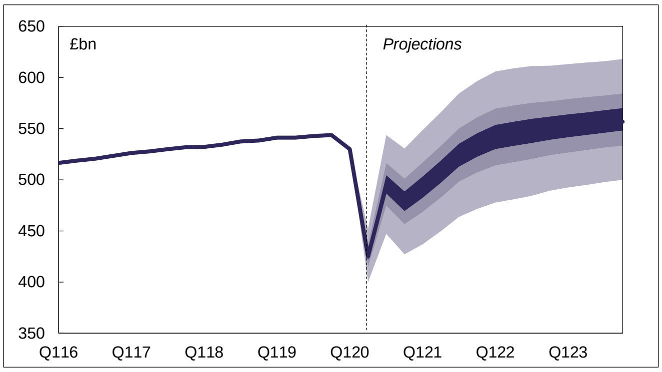
Rate cuts were discussed, but remain an option for 2021 if the outlook deteriorates

In terms of the BoE's other policy tools, the MPC's statement and minutes made no mention of possible rate cuts, let alone a possible move to negative rates. But Governor Bailey subsequently noted again in his press conference that negative rates were one a number of policy tools to be considered for possible future use, and that discussions with stakeholders – including banks and the other regulators – on technical preparations to allow such a move were ongoing. And while the BoE's revised forward guidance did not explicitly flag the possibility of a rate cut, it stated that "If the outlook for inflation weakens, the Committee stands ready to take whatever additional action is necessary to achieve its remit", thus leaving the door open to such a move if the outlook worsens materially. In addition, and unsurprisingly, the MPC still doesn't intend to tighten monetary policy at least until there is clear evidence that "significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably".

BoE expects GDP to decline in Q4 before return to growth from Q1 on

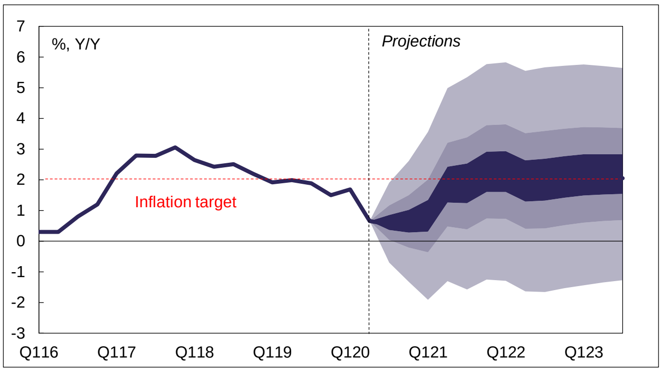
Given the new English lockdown, which started today, more stimulus was hardly a surprise. And to reflect the new restrictions, as well as a third quarter that looks to have been weaker than it previously thought, the BoE's updated economic forecasts revised down significantly the near-term profile for output, with a renewed drop in GDP of 2%Q/Q in Q4 resulting in a skewed W-shaped profile. On an annual basis, economic output is now expected to be down 11.0%Y/Y in the current quarter, more than twice as sharp as the drop envisaged in the BoE's previous forecast (- 5.4%Y/Y). But on the assumption that the restrictions are eased, and also that an EU-UK FTA is reached before the end of the year to avoid the imposition of new tariffs on trade between the blocs, GDP is expected to return to positive growth from Q121. But the new trade arrangements will nevertheless mean that GDP in Q1 is expected to be 1% lower than it otherwise would be, while the lasting hit to the UK's potential level of GDP means that the output gap is expected to close as soon as end-2021. The

UK: Bank of England GDP projection



Source: Bank of England and Daiwa Capital Markets Europe Ltd.

UK: Bank of England inflation projection



Source: Bank of England and Daiwa Capital Markets Europe Ltd.

unemployment rate is expected to rise to 6.3% by the end of this year, and continue rising to about 7.75% by mid-2021 before falling back thereafter. Meanwhile, given recent higher-than-expected CPI data, the BoE's near-term inflation outlook was nudged up slightly. And, despite the near-term hit to output, the forecast for two years' time was pushed down by only 0.1ppt to 2.0%Y/Y – bang on target, suggesting little need to change policy for several quarters to come. But, of course, the risks to the forecasts remain skewed significantly to the downside given uncertainty surrounding the path of the pandemic (and the length of the current lockdown measures) and the outcome of the EU-UK negotiations. And should such downside risks crystallise, the MPC will eventually have to pull the trigger on yet more stimulus.

Job Retention Scheme extended to end-March

The BoE's announcement of more QE came ahead of confirmation by the Chancellor later in the day of more generous fiscal support for business and employees. In particular, having previously sought to end the programme at the end of last month, in yet another policy U-turn the Government announced an extension of the Job Retention Scheme, whereby an initial 80% of wages of staff unable to work due to the pandemic will be subsidised through March 2021 in regions affected by the strictest lockdown restrictions. While the level of contribution from employers to the scheme will be reviewed in January, the extension of the policy – which by mid-October had already cost more than £40bn – will represent a further shock to the public finances. On 25 November, the Chancellor will announce his updated spending plans for next year, which will be published along with the OBR's revised forecasts for government borrowing and an updated Gilt issuance remit for the DMO.

UK car registrations still subdued, construction activity slowing

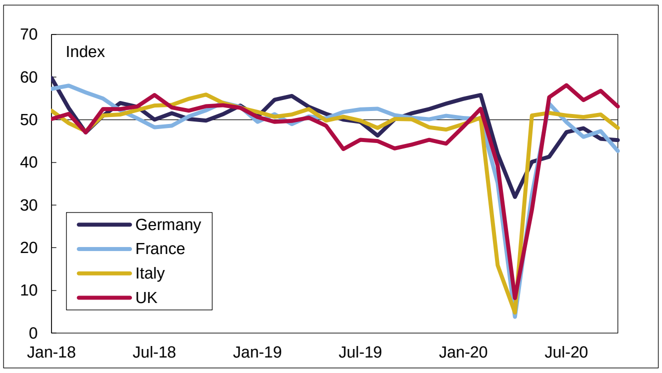
The latest economic data, which were consistent with an economic recovery that has struggled to gain traction, were not without interest. Private new car registrations rose above their level a year earlier in October, albeit increasing by just 0.4%Y/Y to be still down a steep 27.0%YTD/Y over the first ten months of the year. And including business and fleet vehicles, total new car registrations fell 1.6%Y/Y in October to be down 31.0%YTD/Y. The somewhat improved showing for private registrations appears to reflect pent-up demand from the first lockdown as well as a desire of some travellers to avoid using public transport due to the pandemic. But the outlook appears soft. Under the new English lockdown rules, car showrooms are now closed until early December at the earliest. And with consumer confidence weakening again amid rising unemployment, we do not expect a marked pickup over coming months, even if an EU-UK FTA is signed.

Separately, the construction PMI fell a larger-than-expected 3.7pts to 53.1 in October, due principally to a sharp decline in output reported in the civil engineering sector. In contrast, the housing activity and commercial activity indices slipped back moderately to remain consistent with positive growth. And new work across the construction sector reportedly rose at the strongest pace since end- 2015. Nevertheless, construction firms continued to cut jobs. And a recent tightening in credit conditions – which the BoE's extra QE might seek to address – as well as higher unemployment points to a softer housing market outlook. At the same time, just as in the euro area, uncertainty about long-term demand for offices and city-centre retail, hospitality and leisure space will likely weigh on commercial activity in the sector for some time.

The day ahead in the UK

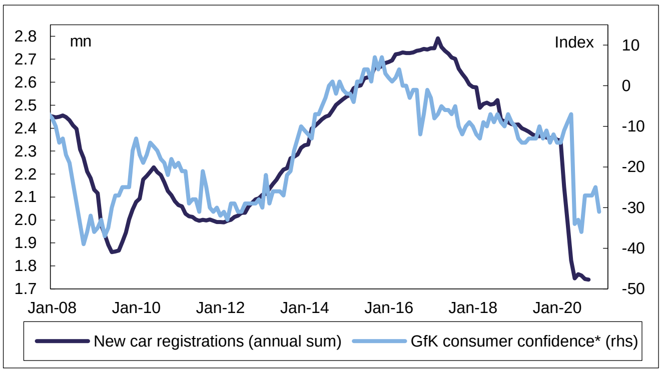
It should be an uneventful end to the week for UK economic news, with no top-tier data due for release.

Euro area & UK: Construction PMIs



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

UK: New car registrations & consumer confidence



**Confidence has three-month lead.*
Source: SMMT, GfK, Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Construction PMI	Oct	**44.9**	-	47.5	-
	Retail sales M/M% (Y/Y%)	Sep	**-2.0 (2.2)**	-1.5 (2.8)	4.4 (3.7)	**4.2 (4.4)**
Germany	Factory orders M/M% (Y/Y%)	Sep	**0.5 (-1.9)**	2.0 (-1.2)	4.5 (-2.2)	**4.9 (-1.7)**
	Construction PMI	Oct	**45.2**	-	45.5	-
France	Construction PMI	Oct	**42.7**	-	47.3	-
Italy	Construction PMI	Oct	**48.1**	-	51.2	-
UK	BoE Bank Rate %	Nov	**0.10**	*0.10*	0.10	-
	BoE asset purchase target £bn	Nov	**895**	*845*	745	-
	New car registrations Y/Y%	Oct	**-1.6**	-	-4.4	-
	Construction PMI	Oct	**53.1**	55.0	56.8	-

Auctions

Country	Auction
France	sold €3.497bn of 0.5% 2029 bonds at an average yield of -0.5%
	sold €3.49bn of 0% 2030 bonds at an average yield of -0.38%
	sold €2.52bn of 1.5% 2050 bonds at an average yield of 0.27%
	sold €1.47bn of 4% 2055 bonds at an average yield of 0.32%
Spain	sold €1.35bn of 1.2% 2040 bonds at an average yield of 0.602%
	sold €470mn of 0.15% 2023 index-linked bonds at an average yield of -0.995%

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	Industrial production M/M% (Y/Y%)	Sep	2.5 (-6.5)	-0.2 (-9.6)
France	07.45	Trade balance €bn	Sep	-6.8	-7.7
	07.45	Private sector payrolls	Q3	0.7	-0.8
Itay	09.00	Retail sales M/M% (Y/Y%)	Sep	-1.5 (1.2)	8.2 (0.8)
Spain	08.00	Industrial production M/M% (Y/Y%)	Sep	1.3 (-3.8)	0.4 (-5.7)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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