Euro wrap-up

Overview

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- Following yesterday's dovish remarks from ECB President Lagarde, Bunds made gains and BTP spreads narrowed further as data confirmed a drop in euro area industrial production in September.
- Gilts also made significant gains as Q3 GDP data confirmed that the UK economic recovery continues to lag that of the other major economies and reports suggested a continued lack of progress in the EU-UK negotiations.
- Friday will bring data updates on euro area goods trade, employment and GDP.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.732	-0.005
OBL 0 10/25	-0.732	-0.018
DBR 0 08/30	-0.537	-0.028
UKT 1¾ 09/22	-0.047	-0.034
UKT 0⅝ 06/25	0.013	-0.041
UKT 4¾ 12/30	0.350	-0.061

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

Euro area

Lagarde unambiguously dovish on second-wave concerns

Yesterday's introductory speech by President Lagarde to the ECB's Forum on Central Banking was unambiguously dovish. She refused to get carried away by Pfizer's news of a possible breakthrough on the Covid-19 vaccine, which was broadly in line with the ECB's baseline expectation already. Nor was she over-enthused by the stronger-than-expected GDP rebound in Q3, which she simply saw as demonstrating that the ECB's policy response had been appropriate. Most notably, she expressed fears that the economic damage from the current second wave of pandemic might be longer-lasting and more troubling than that from the first wave. And so she saw the need for ECB policy to remain highly supportive at least until a vaccine programme had been successfully rolled out. So, she signalled the likelihood that the current deadlines governing the ECB's existing policy tools will need to be extended. And, as we previously suggested, she was explicit that the PEPP purchases and TLTROs are likely to remain the main tools for adjusting ECB policy. At the time of writing, Lagarde had yet to make her contribution to today's policy panel at the ECB's Forum. Nevertheless, we certainly maintain our view that the asset purchase and TLTRO programmes will be extended and augmented at the 10 December Governing Council meeting.

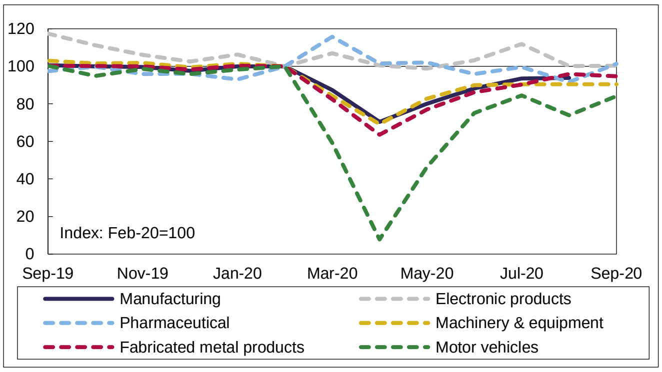
Drop in industrial production in September marks the start of a bumpier period of recovery

Among other things, Lagarde noted her concern that the recovery could be "bumpy". She emphasised that, until vaccine programmes have been implemented, output in the services sector might be unlikely to fully recover. Moreover, while she judged that – unlike regular recessions, or indeed the aftermath of the global financial crisis – manufacturing had so far been far more resilient than services, she saw a significant risk that industrial production might slow significantly once order backlogs have been exhausted and output becomes better aligned with demand. With that in mind, while it was not a surprise in light of the data from the member states, today's confirmation of a drop of 0.4%M/M in euro area industrial production in September, following four successive monthly increases was a little disconcerting.

Autos and capex still lagging recovery in other manufacturing sub-sectors

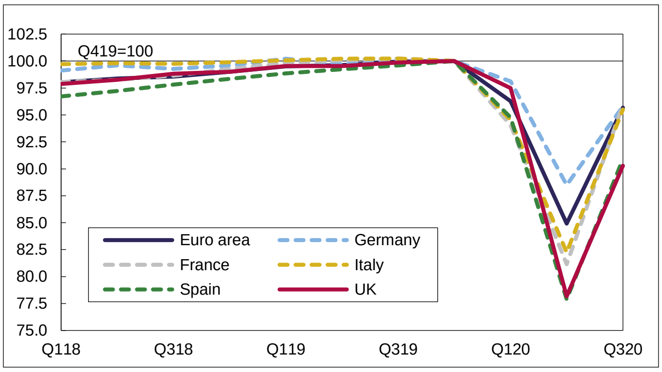
Despite the drop in September, euro area industrial production rose a record 16.3%Q/Q in Q3. But it was still down 5.9% from February's pre-lockdown level, with manufacturing output 6.4% lower on the same basis, and significant variation between sub-sectors. Growth in autos (13.7%M/M) was particularly vigorous after a steep drop in August. But it was still down almost 12% from the pre-lockdown level. And with minimal growth in the latest month, production of machinery and equipment was also still down more than 10% from February. In contrast, chemicals output was down just 3% from the pre-lockdown level, while production of pharmaceuticals and electronic items rose above February's level. Among the member

Euro area: Industrial production by sub-sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area countries and UK: GDP



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

states, Germany, France and Spain posted ongoing growth but Italy and several smaller member states saw steep declines. Looking ahead, surveys point to a resumption of the uptrend in production in October, but growth from now on seems likely to be unsteady, with the uncertain outlook for business investment likely to see continued weakness in production of machinery and equipment even if consumer demand for goods continues to benefit from the rotation away from services.

The day ahead in the euro area

The week will conclude with the preliminary estimate of Q3 employment in the euro area as well as an updated estimate of GDP growth for the same quarter. Following a modest decline of 0.3%Q/Q in Q1, employment fell a record 2.9%Q/Q in Q2 as the coronavirus and associated restrictions on activity took their toll. Q3 will have brought a return to positive job growth on the quarter, but insufficient to prevent the level of employment remaining well down on a year earlier. Meanwhile, the initial estimate of GDP growth beat expectations at 12.7%Q/Q, to be down just 4.3% from the pre-Covid peak in Q419. In addition, September goods trade data for the euro area are also scheduled for release. And, from the member states, final estimates of October inflation from France and Spain are due. According to the flash estimates on the EU-harmonised measure, French inflation was unchanged at 0.0%Y/Y while the Spanish rate dropped 0.4ppt to -1.0%Y/Y. Today's final estimates from Germany aligned with the preliminary figures, with the EU-harmonised rate dropping 0.1ppt to -0.5%Y/Y, the lowest since January 2015 and core inflation seemingly softening too.

UK

Recovery continues to lag other major economies despite record growth in Q3

Having been hit harder by the pandemic than all other G7 economies in the first half of the year, the UK recovery continues to lag well behind that of its peers despite record growth in Q3. GDP last quarter rose 15.5%Q/Q – slightly weaker than the BoE's updated forecast (16.1%Q/Q) but bang in line with our own. That, however, left output still 9.6% down on a year earlier, and a similar 9.7% below the pre-Covid level in Q419 – more than double the equivalent shortfall in the euro area (4.3%) and each of the three largest member states, and almost three times that in the US (3.5%). Moreover, following the initial rebound, the monthly pace of growth steadily slowed over the course of Q3, with growth of 1.1%M/M in September down from 2.1%M/M in August and the softest since the recovery started.

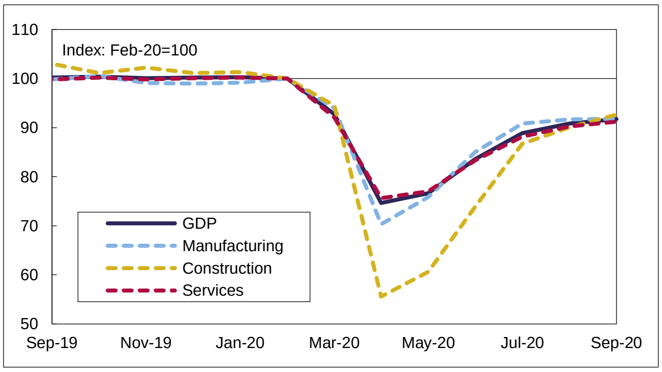
A highly uneven recovery across the various sub-sectors

All major sectors posted record growth in Q3 as lockdown restrictions eased. Following a drop of 19.2%Q/Q in Q2, services output jumped 14.2%Q/Q in Q3. But that still left the level around 10% below where it was in Q419. And, importantly, there remained huge differences among the various sub-sectors, underscoring the unevenness of the recovery. Despite the support provided by the government's incentives to spend, accommodation and food services output was still about 29% below Q419 level, with arts, entertainment and recreation little better (down more than 26% on the same basis). In contrast, wholesale, retail and motor vehicle repair activity was back above the Q4 level, as was public administration and defence. And the shortfalls in real estate (-1.7%) and finance and insurance (-2.5%) were relatively modest. Beyond services, production rose 14.3%Q/Q in Q3 to be 6.3% below the Q419 level. Output of chemicals, pharmaceuticals and electrical equipment rose above the pre-Covid level. But production of machinery and equipment (-18%) and transport goods (-25%) remained far below the Q419 levels. Meanwhile, construction output rose 41.7%Q/Q but was still down 11.5% from the pre-lockdown level.

Business investment and imports recovering more slowly than other expenditure components

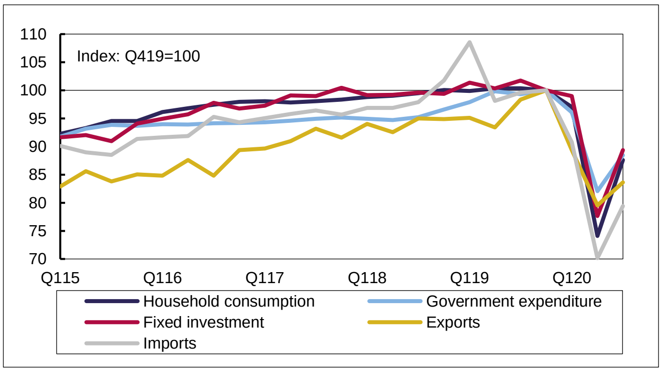
On the expenditure side, there was also inevitably rapid growth in all major components. But reflecting significant uncertainty about the outlook – perhaps related to the end of the Brexit transition period as well as the pandemic – the recovery in business investment continued to lag behind, with the level in Q3 still 20.5% below where it was in Q419. In contrast, household consumption was down 12.4% on the same basis while general government spending was down a similar 11.6%.

UK: Monthly GDP by sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Meanwhile, the trade surplus narrowed in Q3 to 0.9% of GDP (2.5% excluding precious metals) as imports outpaced exports. However, while exports were still down 16.4% from end-2019, imports were still down 20.6% on the same basis.

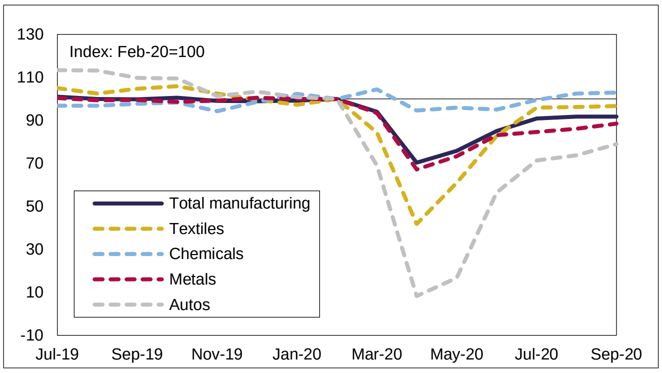
Failure to agree EU-UK FTA could trigger more BoE stimulus

Unfortunately, as the second wave of pandemic intensified and several regions imposed new selective restrictions on activity, economic output appears to have slowed further last month. And with England under a more substantive lockdown – with the closure of all non-essential retailing, hospitality, and leisure and other face-to-face services – throughout November and quite possibly well into December too, GDP will decline in Q4. When the Covid-related restrictions on activity are lifted, consumer spending should see further steady growth, not least as employee compensation rose back above the Q419 level in Q3. But economic output in Q121 is also set to be impeded by disruption caused by the end to the Brexit transition, whether or not the UK government secures an FTA with the EU. So, the UK recovery seems bound to continue to lag that of the other major economies well into 2021. Of course, in light of the downbeat outlook, last week the BoE increased its Gilt purchase target by a further £150bn to extend throughout much of next year. However, since the BoE's forecast currently assumes that an agreement will be reached, BoE Governor Bailey today did not rule out adding extra stimulus at the 17 December MPC meeting (or further ahead) if no deal is agreed between the EU and UK and the economic outlook thus deteriorates even further.

The day ahead in the UK

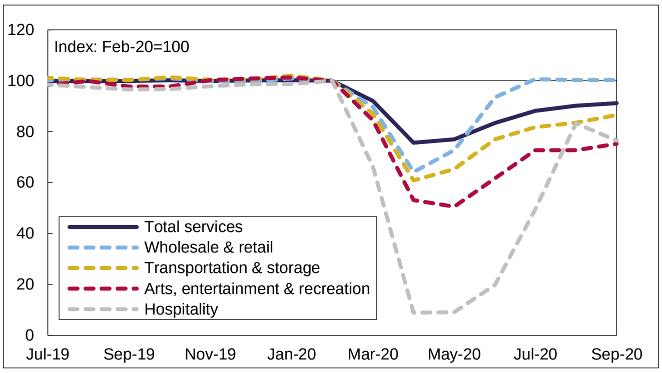
With no new economic data from the UK due on Friday, attention will likely be on the negotiations between the EU and UK on the post-transition arrangements. However, agreement by the self-imposed deadline of 15 November now looks extremely unlikely. EU leaders will hold a teleconference on 19 November, suggesting that the days ahead of that discussion might be key to determine the outcome of the negotiations one way or the other.

UK: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services sector output



Source: 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	Industrial production M/M% (Y/Y%)	Sep	**-0.4 (-6.8)**	1.0 (-5.6)	0.7 (-7.2)	**0.6 (-6.7)**
Germany	Final CPI (EU-harmonised CPI) Y/Y%	Oct	**-0.2 (-0.5)**	-0.2 (-0.5)	-0.2 (-0.4)	-
UK	RICS house price balance %	Oct	**68**	55	61	**62**
	Preliminary GDP Q/Q% (Y/Y%)	Q3	**15.5 (-9.6)**	15.6 (-9.5)	-19.8 (-21.5)	-
	Monthly GDP M/M%	Sep	**1.1**	0.9	2.1	**2.2**
	Industrial production M/M% (Y/Y%)	Sep	**0.5 (-6.3)**	0.5 (-6.0)	0.3 (-6.4)	-
	Manufacturing production M/M% (Y/Y%)	Sep	**0.2 (-7.9)**	0.6 (-7.7)	0.7 (-8.4)	**0.9 (-8.3)**
	Construction output M/M% (Y/Y%)	Sep	**2.9 (-10.0)**	3.1 (-10.9)	3.0 (-13.0)	**3.8 (-12.2)**
	Index of services M/M% (3M/3M%)	Sep	**1.0 (14.2)**	1.0 (14.4)	2.4 (7.1)	**- (6.9)**
	Total trade balance (goods trade balance) £bn	Sep	**0.6 (-9.3)**	0.8 (-9.3)	1.4 (-9.0)	**2.8 (-6.8)**

Auctions

Country	Auction
Italy	sold €3bn of 0% 2024 bonds at an average yield of -0.19%
	sold €1.75bn of 0.95% 2027 bonds at an average yield of 0.35%
	sold €1.25bn of 1.45% 2036 bonds at an average yield of 1.05%
UK	sold £3bn of 0.25% 2031 bonds at an average yield of 0.496%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
			- Nothing to report -			

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	Preliminary GDP Q/Q% (Y/Y%)	Q3	12.7 (-4.3)	-11.8 (-14.8)
	10.00	Preliminary employment Q/Q% (Y/Y%)	Q3	-	-2.9 (-3.1)
	10.00	Trade balance €bn	Sep	22.5	21.9
France	07.45	Final CPI (EU-harmonised CPI) Y/Y%	Oct	0.0 (0.0)	0.0 (0.0)
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Oct	-0.9 (-1.0)	-0.4 (-0.6)

Auctions and events

Country	GMT	Event
EMU	10.00	ECB's Weidmann scheduled to speak
France	-	French sovereign debt rated by Fitch

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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