Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- The euro strengthened and Bunds made modest losses as the ECB's policy announcements failed to exceed market expectations.
- While UK GDP posted another month of growth in October, sterling depreciated and Gilts rallied again after last night's dinner between von der Leyen and Johnson set Sunday as the new deadline for a deal.
- On Friday, the focus will remain on Brexit, while the outcome of the summit discussions on the EU budget and recovery fund will also be watched.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.777	+0.007
OBL 0 10/25	-0.791	+0.007
DBR 0 08/30	-0.605	+0.002
UKT 1¾ 09/22	-0.132	-0.039
UKT 0⅝ 06/25	-0.086	-0.042
UKT 4¾ 12/30	0.201	-0.058

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

Euro area

ECB fails to exceed market expectations with policy announcements

Given the significant strengthening of the euro since the ECB signalled at end-October its plans to ease policy at its December meeting, there was a good case for it to exceed market expectations today. However, the Governing Council failed to provide any significant surprises with its policy announcements, and so the euro appreciated further in response. In particular, as was fully expected, the ECB left its main interest rates, including the -0.5% deposit rate and 0.0% refi rate, unchanged. So, its policy adjustments measures related to its QE and liquidity programmes, specifically:

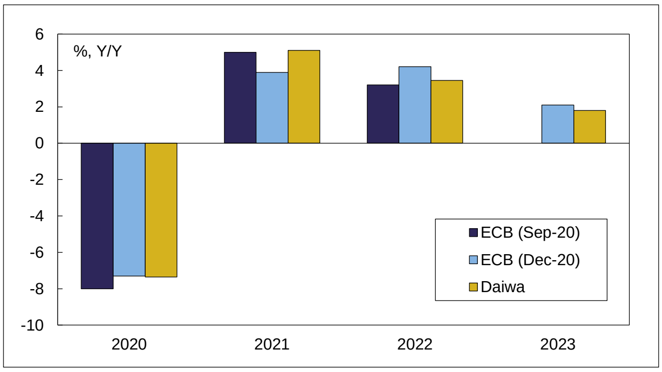
- In terms of QE, the ECB increased its PEPP asset purchase envelope by €500bn to €1.85trn, no more than the consensus expectation. Admittedly, it extended the horizon of the purchases by nine months to at least March 2022, three months longer than the consensus view, or until it judges the coronavirus crisis to be over. It also pledged to extend the reinvestment of principal payments from maturing securities purchased under the PEPP until at least the end of 2023. In addition, net purchases under the regular APP will continue at the standard monthly pace of €20bn. And the ECB will continue to reinvest maturing proceeds of that programme until after the first rate hike. But that was all widely expected too.

- In terms of liquidity, the ECB announced more generous conditions on the TLTRO loans with extra operations too. The period over which more favourable terms will apply was extended by twelve months, to June 2022, although the conditions for qualifying for the -1.0% interest rate were tightened. Three additional operations will also be conducted between June and December 2021. And the total amount that counterparties will be entitled to borrow in TLTRO III operations was raised by 5ppts to 55% of their stock of eligible loans. The ECB also announced four additional PELTRO operations. It extended to June 2022 the duration of the set of collateral easing measures adopted in April. And it also extended to March 2022 temporary swap and repo lines with non-euro area central banks.

Inflation forecast revised down, remaining well below target over the horizon

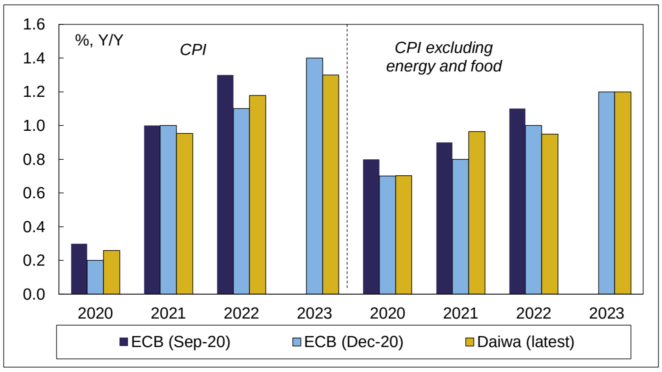
The ECB's justification for today's extension to its monetary easing measures was, of course, the deterioration in the economic outlook on account of the second wave of Covid-19. Certainly, due not least to pandemic containment measures, the near-term growth outlook was revised down, with GDP now expected to fall 2.2%Q/Q in the current and rise just 0.6%Q/Q in Q121 and a moderate 3.9%Y/Y in 2021 as a whole, compared to 5.0%Y/Y previously. But as vaccine programmes are gradually rolled out, the ECB expects a degree of normality to return by end-2021, to allow a return to the GDP path previously expected in 2022, when it now forecasts growth of 4.2%Y/Y, 1ppt more than previously. Meanwhile, in

Euro area: GDP forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

terms of inflation, the headline CPI rate is expected to return to positive territory in the New Year. But thereafter, weak demand, soft wage growth and the recent appreciation of the euro will all conspire to keep inflation low. Indeed, the ECB revised down its forecasts for headline and core inflation across the horizon. And even by the end of the projection period in 2023, headline inflation is expected to average just 1.4%Y/Y with core inflation a paltry 1.2%Y/Y – clearly well below the ECB's inflation aim of close to 2.0%Y/Y.

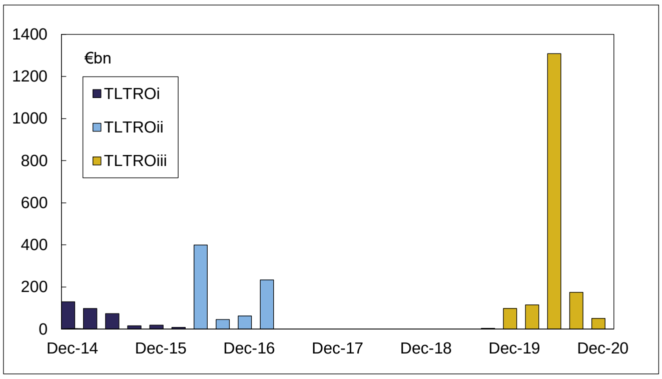
Has the ECB done enough today?

Given such a weak inflation outlook the question is whether the ECB eased policy sufficiently today. Unfortunately, based on the ECB's ready reckoners, the extra €500bn of PEPP purchases, plus €20bn per month of APP purchases, would on its own be unlikely to be enough to get core inflation back to 2%. Yet it also retained the option not to buy the full amount if it saw fit. So, the ECB will be keeping its fingers crossed that its TLTRO operations will do the trick. However, recent evidence of a tightening of financial conditions, coupled with concerns about a premature withdrawal of government support for both the banking sector and real economy might suggest otherwise. Indeed, some of the detail of today's measures might also suggest that the extra TLTROs won't suffice. In particular, the decision to adjust the reference period used to determine whether banks would qualify for the lowest rate to become (in the words of Lagarde) "more challenging" was baffling. And the decision to offer an extra 5ppt of borrowing entitlement seems like a mere token gesture, which will have little impact.

Doves and hawks settled for compromise

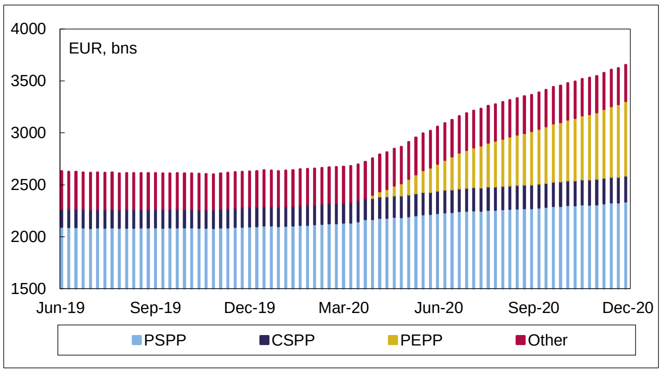
Indeed, just as the TLTRO package appeared to reflect a compromise between those on the Governing Council who wanted to do everything possible to support bank lending, and those who are concerned about unintended consequences, so too did the agreement on the duration of the extension of the PEPP purchases. Lagarde's justification for extending by a further 9 months to March 2022, until just after vaccination programmes have allowed some return to normality to people's lives after the pandemic, just about sounds credible. But it also smacks of compromise, with reports suggesting that the Governing Council was split into camps of those wanting to extend by one year and those wanting to extend by just six months. Indeed, since the Governing Council also retained the option not to buy the full PEPP envelope, there would have been little cost to extending the possible purchase period to June 2022. By the same token, in her press conference, Lagarde insisted that the ECB continues to monitor the euro exchange rate "very carefully". But, it's hard to see what the ECB is going to do about it, particularly having missed a chance today to prove its determination to the markets. Indeed, in this respect, her words sound like a hollow threat. And while the ECB's forward guidance still leaves the door open to extra action, in terms of rates and asset purchases, it's now highly likely to sit on its hands for the foreseeable future.

Euro area: TLTRO uptake



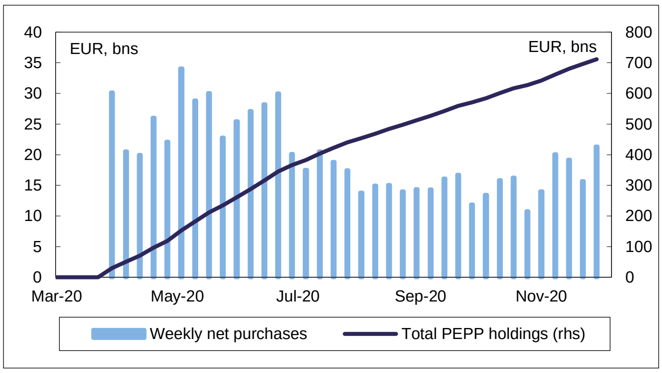
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Asset purchases



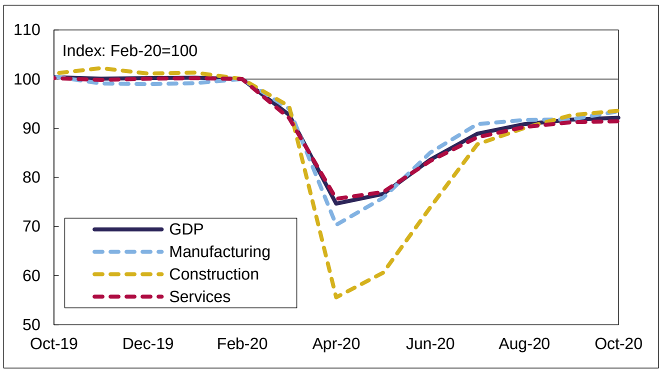
Source: ECB and Daiwa Capital Markets Europe Ltd.

ECB: PEPP asset purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

UK: GDP by sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Focus tomorrow will be on the European Council meeting, which got underway this afternoon, and subsequent euro area leaders' summit. Most notably, investors will be looking for resolution of the impasse over the €1.074trn EU Budget for 2021-2027 and €672.5bn Recovery and Resilience Facility. But unless Hungary and Poland lift their vetoes, the other member states might decide to proceed with the Recovery and Resilience Facility with an alternative mechanism without the involvement of the two dissenting central European member states. Data-wise, a quiet day will bring Italian industrial production data for October, which – like Germany and France – are expected to show positive growth in the sector at the start of Q4. In addition, final November inflation data from Germany and Spain are due. According to the flash estimates, the EU-harmonised inflation fell 0.2ppt to a series low of -0.7%Y/Y in Germany, but was unchanged at -0.9%Y/Y in Spain.

UK

Sterling and gilt yields fall as EU and UK leaders set Sunday deadline for a deal

Sterling weakened and Gilts made further gains today after last night's Brussels dinner between Commission President von der Leyen and UK PM Johnson concluded with no evidence of progress. While, according to von der Leyen, they had "a lively and interesting discussion" and "gained a clear understanding of each other´s positions", they acknowledged that they "remain far apart". So, the two leaders agreed that the negotiation teams should immediately reconvene, and set a new target to "come to a decision by the end of the weekend". That would leave businesses with little more than a fortnight to prepare for the substantive but as yet still unclear changes that will govern roughly half of all UK trade from the start of January.

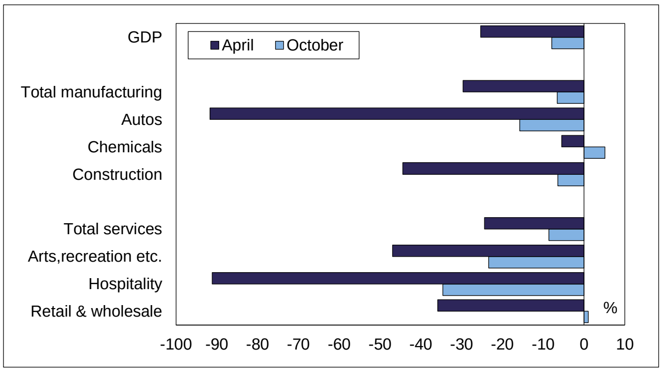
Commission proposes limited no-deal mitigation measures

An agreement – that would likely see the EU make concessions on the economically unimportant but politically sensitive issue of fish, to allow Johnson to give ground on the more technical but also more economically substantive issues related to the level playing field – is still possible. But while the negotiations might yet pass beyond Sunday's new deadline in an attempt to find a compromise, it remains to be seen whether the politics will allow such a deal to happen. And if they don't – a scenario which Johnson previously rejected as it would reflect a failure of statesmanship – sterling and gilt yields will have plenty further to fall, while the UK economy will face a further adverse shock. At the end of last month, the OBR estimated that no deal would knock a further 2% off GDP in Q1 and add 1ppt or more inflation by the end of next year. Given the likelihood of severe disruption to activity in that scenario, the European Commission today proposed no-deal contingency measures – related to maintaining aviation services, facilitating road freight and passenger transport for six months, and (perhaps provocatively) maintaining mutual access to fisheries for up to a year – that would aim to mitigate certain impacts, as long as the UK also took reciprocal legal action. However, those would do nothing to offset the damage from the imposition of tariffs and non-tariff barriers that would have a highly damaging impact on trade and investment in such circumstances.

UK GDP slowed in October to softest pace since recovery began

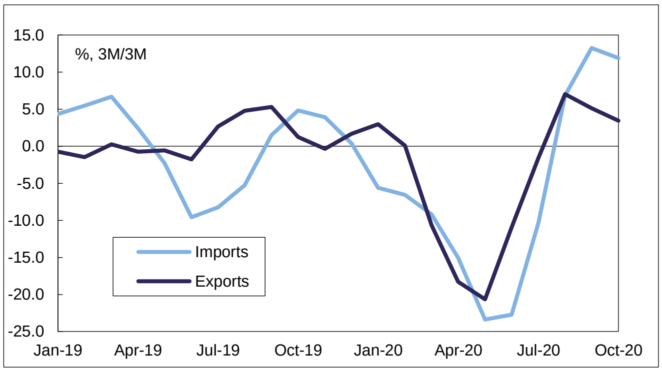
Given the major uncertainties posed to the near-term economic outlook by the Brexit negotiations, today's UK GDP data for October were arguably of academic interest. Nevertheless, despite the burgeoning second wave of Covid-19 and gradual tightening of localised containment measures that month, UK GDP grew for a sixth successive month but by just 0.4%M/M, the softest pace since the recovery began. While that left it 23.4% above its April low, GDP was still 7.9% below the pre-pandemic level in February. Thanks in particular to a rebound in the autos subsector (up 6.7%M/M), manufacturing production (up 1.7%M/M) made the largest contribution to growth in October, but was still 4.4% below February's level. Construction output rose 1.0%M/M to be 6.4% below February's level. And despite a renewed sharp fall in activity in hospitality (down 14.4%M/M to subtract 0.4ppt from GDP growth), services output rose 0.2%M/M to be 8.6% below the pre-pandemic level, supported not least by a revival in activity in the healthcare sector.

UK: Output deviations from February 2020 level



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Trade volumes*



**Includes both goods and services.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK imports outpacing exports as firms intensify Brexit-related stock-building

In terms of trade, due to weaker shipments of goods, total UK exports fell 1.1%M/M in October. But imports rose 0.8%M/M, due not least to increase demand for chemicals and clothing, to increase the trade deficit (ex non-monetary gold) by £0.9bn to £1.6bn. Looking through the monthly volatility, the total trade surplus, excluding non-monetary gold and other precious metals, decreased by £6.5bn to £0.8bn in the three months to October 2020, as imports (up £14.3bn due to a range of items including autos, capital goods and other miscellaneous items) outpaced exports (up £7.8bn, due largely to increased shipments of machinery and transport equipment) a reversal of the trend in the euro area, where exports continue to outpace imports. Given the Brexit uncertainties, we expect imports to accelerate further over the remainder of Q4 as firms try to accumulate inventories. Indeed, the additional complication of Brexit-related stock-building, on top of Covid-related strains in global container shipping, is now causing acute bottlenecks at UK ports.

The day ahead in the UK

It will be a quiet end to the week for economic data, with no new releases to distract from the Brexit negotiations, which are supposed to (but still might not) conclude on Sunday. However, the BoE will publish its latest Financial Stability Report and Financial Policy Committee Record, which are likely to address the issue of risks related to a failure to secure an agreement between the UK and EU.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	ECB main refinancing rate %	Dec	**0.00**	*0.00*	0.00	-
	ECB marginal lending facility %	Dec	**0.25**	*0.25*	0.25	-
	ECB deposit facility rate %	Dec	**-0.50**	*-0.50*	-0.50	-
France	Industrial production M/M% (Y/Y%)	Oct	**1.6 (-4.2)**	0.4 (-5.5)	1.4 (-6.0)	**1.6 (-5.9)**
	Manufacturing production M/M% (Y/Y%)	Oct	**0.5 (-5.7)**	0.5 (-5.5)	2.2 (-6.3)	**2.3 (-6.2)**
UK	RICS house price balance	Nov	**66**	63	68	**67**
	Monthly GDP M/M% (3M/3M%)	Oct	**0.4 (10.2)**	*-0.5 (9.9)*	1.1 (8.0)	-
	Industrial production M/M% (Y/Y%)	Oct	**1.3 (-5.5)**	0.3 (-6.4)	0.5 (-6.3)	-
	Manufacturing production M/M% (Y/Y%)	Oct	**1.7 (-7.1)**	0.3 (-8.4)	0.2 (-7.9)	-
	Construction output M/M% (Y/Y%)	Oct	**1.0 (-7.1)**	1.1 (-7.4)	2.9 (-10.0)	-
	Index of services M/M% (Y/Y%)	Oct	**0.2 (9.7)**	0.3 (9.7)	1.0 (14.2)	-
	Trade balance £bn	Oct	**-1.7**	-0.2	0.6	-

Auctions

Country	Auction
Italy	sold €2.75bn of 0% 2024 bonds at an average yield of -0.3%
	sold €3bn of 0.95% 2027 bonds at an average yield of 0.19%
Spain	sold €921mn of 1.25% 2030 bonds at an average yield of -0.027%
	sold €482mn of 0.65% 2027 index-linked bonds at an average yield of -1.147%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Tomorrow's releases

Economic data					
Country	**GMT**	**Release**	**Period**	**Market consensus/ *Daiwa forecast***	**Previous**
Germany	07.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	-0.3 (-0.7)	-0.2 (-0.5)
Italy	09.00	Industrial production M/M% (Y/Y%)	Oct	1.0 (-4.3)	-5.6 (-5.1)
	10.00	Unemployment rate %	Q3	9.8	8.3
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Nov	-0.8 (-0.9)	-0.8 (-0.9)
Auctions and events					
EMU	-	ECB President Lagarde takes part in Euro Summit			
	-	European Council meeting			
France	07.45	French labour office publishes final wages data			
Spain	-	Spanish sovereign debt rated by Fitch			
UK	07.00	BoE publishes Financial Stability Report			
	09.30	BoE/Kantar Inflation Attitudes Survey			
	-	UK sovereign debt rated by DBRS			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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