Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- With reports that the EU and UK are getting closer to a deal, and as the flash euro area PMIs beat expectations, Bunds made significant losses.
- Despite a downside surprise to UK inflation, the Brexit reports also pushed longer-dated Gilts lower while the flash PMIs suggested a stabilisation of UK output.
- Thursday will bring the latest BoE MPC announcement along with final euro area inflation figures for November.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.741	+0.035
OBL 0 10/25	-0.753	+0.043
DBR 0 08/30	-0.570	+0.044
UKT 1¾ 09/22	-0.090	-0.018
UKT 0⅝ 06/25	-0.035	-
UKT 4¾ 12/30	0.271	+0.013

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

Euro area

Flash PMIs point to near-stabilisation of output at end of Q4

Today's flash PMIs for December beat expectations across the board, suggesting that euro area economic activity was broadly stable at the end of Q4 following the inevitable contraction that followed the tightening of pandemic containment restrictions last month. In particular, the flash euro area composite PMI rose 4.5pts in December to 49.8. And that left the Q4 average at 48.4, down 4pts from Q3 but more than 16pts above the level in Q2, to suggest a relatively modest decline in GDP this quarter. Within the detail, the PMIs suggested a pickup in momentum in the manufacturing sector, for which the headline PMI rose 1.7pts to a respectable 55.5. And encouragingly, the services activity PMI rose a substantive 5.6pts to a three-month high of 47.3, to suggest a slowing in the pace of decline in the sector that has been the focus of containment restrictions. In addition, new orders reportedly rose slightly for the first time since September, boosted particularly by a significant acceleration in orders of goods from abroad, even as new foreign orders of services weakened.Looking forward to the year ahead, future output expectations jumped to their highest in almost three years boosted by vaccine news. And while employment reportedly continued to fall in December, it did so at the softest pace since the start of the pandemic began.

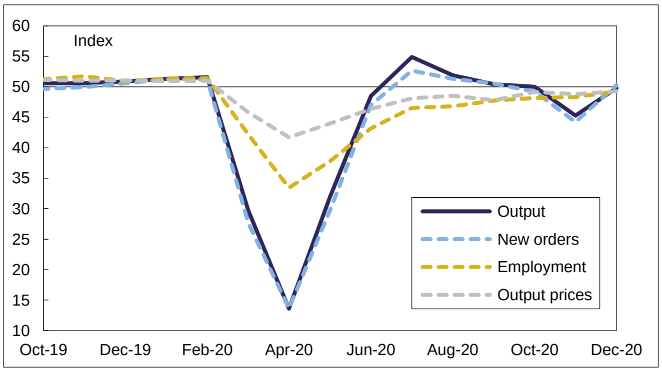
Country PMIs point to relatively widespread Improvement in December

At the country level, the flash PMIs continued to report significant differences in performance this month. However, improvement was widespread. Despite the adverse trend in the pandemic, Germany's flash composite PMI rose 0.8pt to 52.5 to suggest ongoing growth. Manufacturing output growth eased for a second month, but the respective PMI remained historically high at 61.4. And Germany's services PMI rose to 47.7, suggesting a moderation in the pace of contraction. We caution, however, that conditions in that sector will have deteriorated after the latest tightening of restrictions, which took effect from today, and so anticipate a downwards revision in the final estimates due on 4 January. Meanwhile, France's composite PMI leapt more than 9pts to 49.6 to indicate greater stability thanks not least to the relaxation of containment measures on services at the end of last month. While Markit reported that conditions were weaker in the rest of the euro area, the respective flash composite output PMI rose almost 5pts to 47.5, as renewed growth in manufacturing offset persistent services weakness.

French retail sales down by about one quarter last month due to lockdown

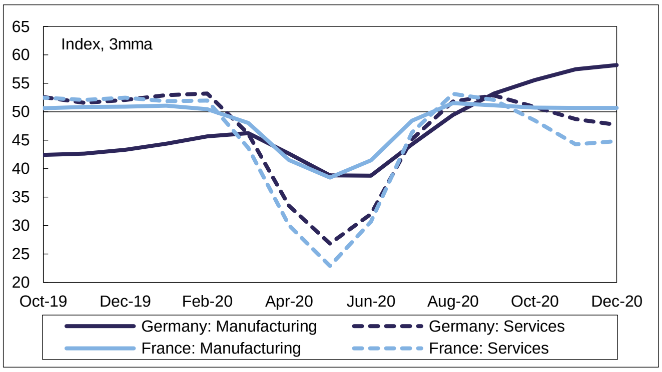
Having surged at the start of Q4, rising 6.2%Y/Y in October, French retail sales inevitably plunged in November as non-essential stores were closed until the 28th of the month. Indeed, according to the Bank of France survey results, retail sales fell by almost one quarter (down 24.5%Y/Y) last month. While steep, that was still some way short of the decline of

Euro area: Composite PMIs



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

Germany and France: Headline sectoral PMIs



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

39.1%Y/Y during the peak of the first wave in April, and was likely accentuated by the delay to Black Friday sales. Within the detail, the survey suggests that sales of manufactured goods were down 37.0%Y/Y while food products fell a more limited 6.4%Y/Y. Big falls were recorded in sales of watches and jewellery (down more than 75%Y/Y), sports equipment (similarly down 75%Y/Y), perfume and hygiene products and textiles and clothing (all down more than two thirds). The only two categories to see an increase in sales from a year earlier were DIY-related items and pharmaceuticals. Sales at small firms fell by almost one third but those at large firms were down by just 8.0%Y/Y.

Exports and construction output rise at start of Q4

Following recent decent figures for retail sales and industrial production, today's data for goods trade and construction confirmed that the start to the fourth quarter saw relatively broad-based growth across the euro area economy before the second wave of the pandemic took its toll. In particular, on a seasonally adjusted basis, the value of euro area exports increased by 2.1%M/M, for a sixth successive month outpacing imports, which rose 1.0%M/M. As a result, the trade surplus rose €2.2bn to €25.9bn, the second highest level on the series and just shy of March's record level. Exports increased again to most major markets. But while they were up compared to a year earlier to China, South Korea, Turkey and Norway, they remained down by more than 10%Y/Y to the US, UK and Japan. Compared to February's pre-pandemic level, exports were down 6.2% while imports were down 7.4%.

Meanwhile, construction output rose 0.5%M/M, admittedly a relatively modest increase following the drop of 2.7%M/M in September, which left the level still slightly below the Q3 average. Weakness in Spain and Portugal, in particular, partly offset continued growth in Germany and France. At the sectoral level, growth in building work offset weakness in civil engineering. Looking ahead, however, surveys and other leading indicators point to weakness in the sector. Recent solid gains in residential property prices look subject to downside risk in light of elevated unemployment, lower incomes due to ongoing containment measures, and a tightening of mortgage lending standards. The uncertain business outlook will also likely restrain building work associated with new capital expenditure. And commercial activity associated with city-centre retail, office and leisure space also seems bound to be weak in light of the existential threat to ways of work and lifestyles posed by the pandemic.

The day ahead in the euro area

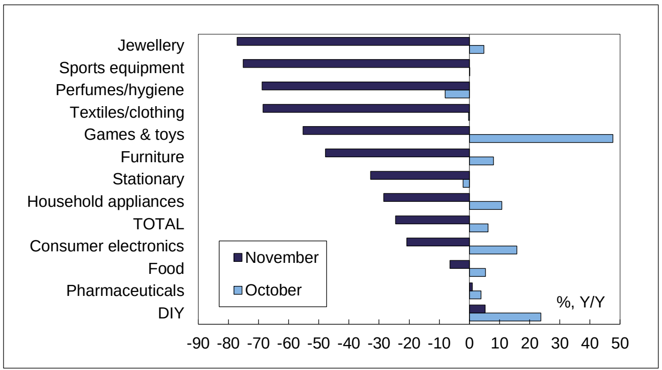
Looking ahead to Thursday, INSEE will publish the results of its own business sentiment survey for December, which are expected to tally with today's PMIs and point to a modest improvement in activity. Meanwhile, with data from the large member states already having reported steep declines, new car registrations figures for the euro area are bound to report a sharp fall in November as showrooms in many countries were forced to close. Additionally, final November inflation figures for the euro area are expected to align with the flash release which showed the headline and core rates steady for a third month, respectively at -0.3%Y/Y, the lowest level since January 2015, and 0.2%Y/Y, a record low.

UK

Inflation surprises on the downside in November

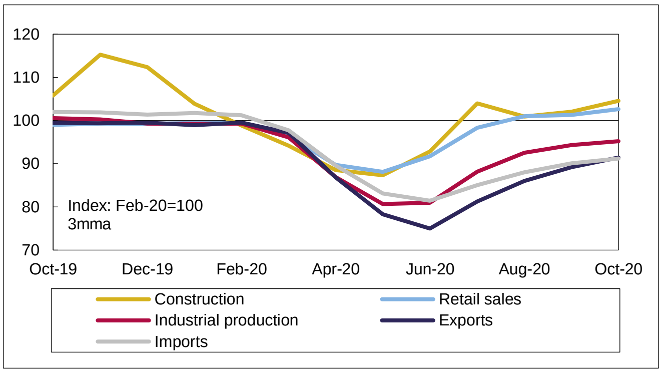
We had expected UK inflation to fall last month, but the data still surprised significantly on the downside. In particular, headline CPI inflation fell 0.4ppt in November – the most since August – to just 0.3%Y/Y, similarly the lowest in three months. Core inflation also fell 0.4ppt to 1.1%Y/Y, likewise the lowest since August. The drop was caused principally by discounted prices of clothing, which have been a significant source of volatility this year. Having been up 0.2%Y/Y in October, clothes prices fell 3.7%Y/Y last month against the backdrop of the closure of non-essential stores in England. However, prices of food and beverages also made a significant contribution to the fall in headline inflation, dropping 0.8ppt to just 0.2%Y/Y, the lowest since 2016. And prices of the other major categories of goods also fell, pushing inflation of non-industrial goods down 0.9ppt to 0.6%Y/Y. In contrast, inflation of services remained unchanged at 1.4%Y/Y, although we caution that prices of

France: Retail sales



Source: Bank of France, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Activity indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

many items were imputed by the statisticians. Indeed, prices of items accounting for almost 14% of the total basket were unavailable for collection. Meanwhile, energy inflation was unchanged at -9.4%Y/Y. But that component in particular will rise steadily over coming months, pushing headline inflation up to about 1½%Y/Y by the second quarter if, as we assume, a deal between the EU and UK is reached. If there is no deal, inflation could well be 3%Y/Y or more by then, pushed higher by new tariffs as well as the likely plunge in sterling. Thankfully, reports today suggested that an agreement could be reached by the end of the week, opening the path to ratification in the UK Parliament next week and providing scope for its application (perhaps provisional) from 1 January even if the European Parliament has no time for ratification.

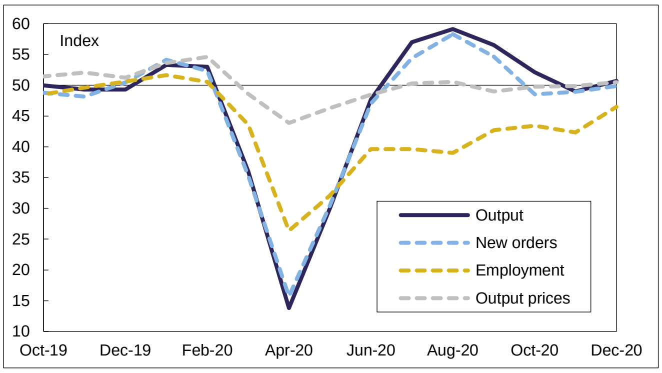
UK PMIs suggest stabilisation in services, concerns about manufacturing supply-chain disruption

Like in the euro area, the flash UK PMIs for December were arguably as strong as might have been hoped. The composite PMI rose 1.7pts to 50.7, above the key 50 level to suggest a modest increase in activity following the easing in pandemic containment restrictions at the end of last month. Of course, some restrictions continue across most of the country, hitting activity in hospitality, leisure and travel, and so the services PMI (49.9) pointed to stabilization rather than expansion. And while the manufacturing output PMI continued to suggest positive growth, at 55.3 it slipped back to a six-month low. Most notably, perhaps, the PMIs flagged increased strains on manufacturing supply chains related to freight delays at UK ports, with Markit reporting that a net 43% of the survey panel reported delays in receiving goods from suppliers, a balance exceeded since 1992 only by those reported in April and May due to pandemic lockdowns. Brexit-related stockpiling appears to have seriously exacerbated strains in global container shipping capacity, and so manufacturing output backlogs reportedly rose to the highest since 2010. More positively, the pace of decline in employment implied by the PMIs moderated to the slowest since the start of the pandemic. And business optimism about the outlook twelve-months ahead remained relatively firm, buoyed by vaccine news.

The day ahead in the UK

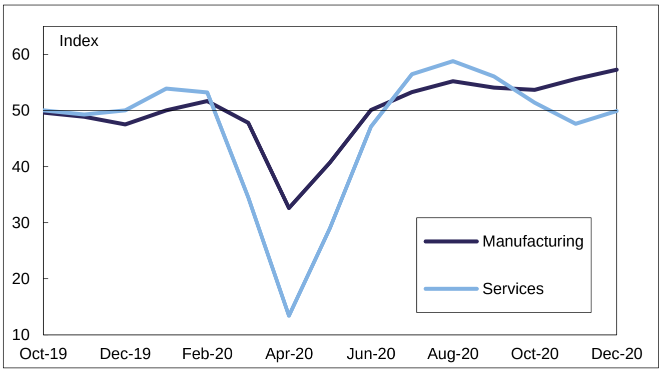
With rising hopes that a trade deal between the EU and UK will be reached in the coming days, to clear the path for its implementation from 1 January, markets will remain firmly focused on Brexit news. But assuming there is no firm breakthrough by then, tomorrow's final BoE MPC meeting of the year should be a non-event, not least as the MPC already agreed last month an increase in its asset purchase programme to last well into the second half of next year.

UK: Composite PMIs



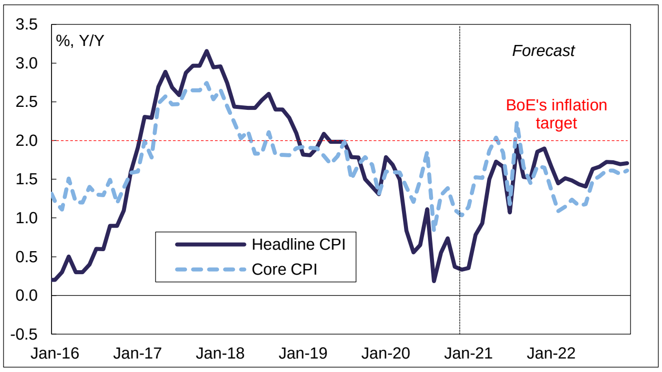
Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Headline sectoral PMIs



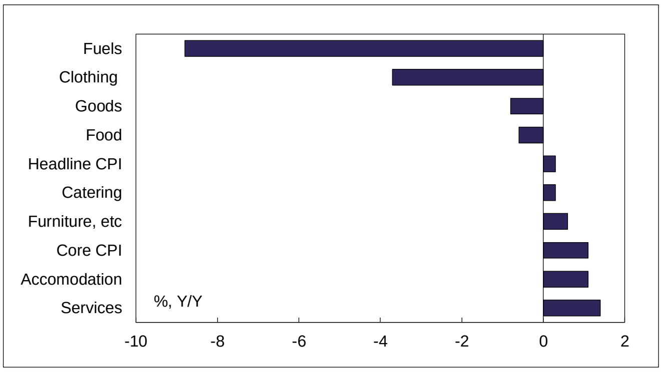
Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Inflation



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

UK: November CPI changes



Source: Bank of England, 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		Preliminary manufacturing (services) PMI	Dec	**55.5 (47.3)**	53.0 (42.0)	53.8 (41.7)	-
		Preliminary composite PMI	Dec	**50.7**	45.5	45.3	-
		Labour costs Y/Y%	Q3	**1.6**	-	4.2	**3.6**
		Trade balance €bn	Oct	**25.9**	-	24.0	**23.7**
		Construction output Y/Y%	Oct	**-1.4**	-	-2.5	**-2.3**
Germany		Preliminary manufacturing (services) PMI	Dec	**58.6 (47.7)**	56.0 (44.0)	57.8 (46.0)	-
		Preliminary composite PMI	Dec	**52.5**	50.8	51.7	-
France		Bank of France retail sales Y/Y%	Nov	**-24.5**	-	6.0	**6.2**
		Preliminary manufacturing (services) PMI	Dec	**51.1 (49.2)**	49.6 (38.0)	49.6 (38.8)	-
		Preliminary composite PMI	Dec	**49.6**	41.3	40.6	-
Italy		Industrial orders (sales) Y/Y%	Oct	**1.2 (-1.7)**	-	3.2 (-4.6)	**-4.5 (3.3)**
UK		CPI (core CPI) Y/Y%	Nov	**0.3 (1.1)**	*0.6 (1.4)*	0.7 (1.5)	-
		PPI input (output) prices Y/Y%	Nov	**-0.5 (-0.8)**	-0.5 (-0.8)	-1.3 (-1.4)	**-1.2 (-)**
		Preliminary manufacturing (services) PMI	Dec	**57.3 (49.9)**	56.0 (50.7)	55.6 (47.6)	-
		Preliminary composite PMI	Dec	**50.7**	51.5	49.0	-
		House price index Y/Y%	Oct	**5.4**	-	4.7	**4.3**

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		07.00	EU-27 new car registrations Y/Y%	Nov	-	-7.8
		10.00	Final CPI (Core CPI) Y/Y%	Nov	-0.3 (0.2)	-0.3 (0.2)
France		07.45	INSEE business confidence	Dec	81	79
		07.45	INSEE manufacturing confidence (production outlook)	Dec	93 (-25)	92 (-39)
Spain		08.00	Labour costs Y/Y%	Q3	-	-8.3
UK		12.00	BoE Bank Rate %	Dec	*0.10*	0.10
		12.00	BoE corporate bond target £bn	Dec	*20*	20
		12.00	BoE Gilt purchase target £bn	Dec	*875*	875

Auctions and events

Country		GMT	Event
EMU		16.00	ECB's Schnabel scheduled to speak
UK		12.00	BoE monetary policy announcement and minutes published
		12.00	BoE publishes Agents' summary of business conditions Q420

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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