Daiwa Capital Markets

Euro wrap-up

Overview

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- Longer-dated euro area government bonds followed USTs higher while final euro area inflation data for November provided no surprises.
- Sterling strengthened further while Gilts were little changed as reports suggested further progress towards a deal between the EU and UK and the BoE left policy unchanged but signalled a readiness to ease further if necessary.
- Friday will bring the latest German ifo business survey and UK retail sales data, while attention will remain on the EU-UK negotiations.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.742	+0.002
OBL 0 10/25	-0.760	-0.007
DBR 0 08/30	-0.584	-0.014
UKT 1¾ 09/22	-0.092	-0.001
UKT 0⅝ 06/25	-0.038	-0.002
UKT 4¾ 12/30	0.253	-0.003

*Change from close as at 4:00pm GMT.
Source: Bloomberg

Euro area

Headline and core inflation unchanged for a third month

Despite an upwards revision in Spain, today's final euro area inflation data were essentially left unchanged from the flash estimates. The headline CPI rate was unchanged at -0.3%Y/Y, matching the lowest rate since February 2015 for a third month. And the core rate was similarly unchanged for a third month at the flash estimate and record low of 0.2%Y/Y. Indeed, there were no meaningful revisions to the detail. So, for example, the pace of decline in non-energy industrial goods prices was confirmed at -0.3%Y/Y, down 0.2ppt from October to match the series low, as prices of clothing continued to fall against the backdrop of continued falling sales. In addition, services inflation rose 0.2ppt from its record low to 0.6%Y/Y as, among other things, the pace of decline of accommodation was judged to have moderated despite the closure of hotels to all but business travellers. Among the non-core components, a modest easing in food inflation (down 0.1ppt to 1.9%Y/Y) was confirmed, while energy inflation was only a touch higher than previously thought at -8.3%Y/Y, similarly only marginally down from the previous two months. We caution that, given the intensification of the pandemic, 11% of the items in the inflation basket had to be imputed by the statisticians in November, the highest share since May. The bulk of those items were services, for which 20% of items had to be imputed, raising particularly doubts about the respective estimates.

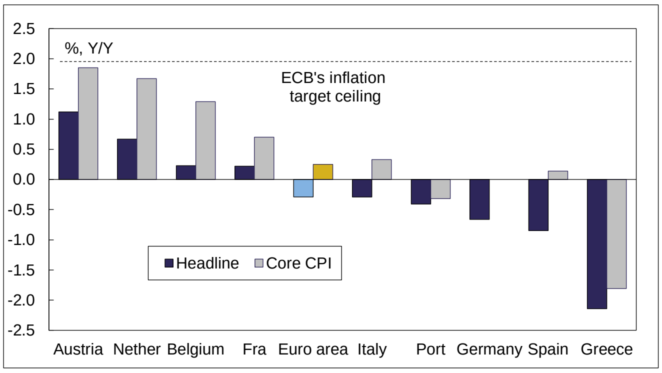
Core inflation to remain below target for the foreseeable future

While headline inflation will remain negative at the end of this year, it will rise in early 2021 partly due to the base effects from past moves in energy prices and the reversal of the German VAT cut, which will expire at year-end. However, weakness in core inflation is a theme common to most member states, not just Germany. And due to the adverse impact on demand from the pandemic, as well as the strengthening of the euro, we expect core inflation to remain well below target over the coming year and into 2022 and beyond too. Indeed, while we acknowledge the desire of firms in many of the most affected sectors to try to rebuild margins as and when improved conditions materialize – and we note the decision of German travel company Tui to raise prices for holidays in 2021 14% above 2019 levels – spare capacity in the labour market and overall economy seems likely to continue to weigh on underlying inflation over the coming years. Indeed, core inflation averaged less than 1½% in the decade ahead of the pandemic, and so we expect it to continue to do so for the foreseeable future. Of course, the ECB's December forecasts also suggested that core inflation will average just 1.2%Y/Y in 2023, while financial market measures, such as the 5Y5Y inflation swap rate, point to a similar rate on average over the longer term too.

Car registrations on track to drop by roughly one quarter in 2020

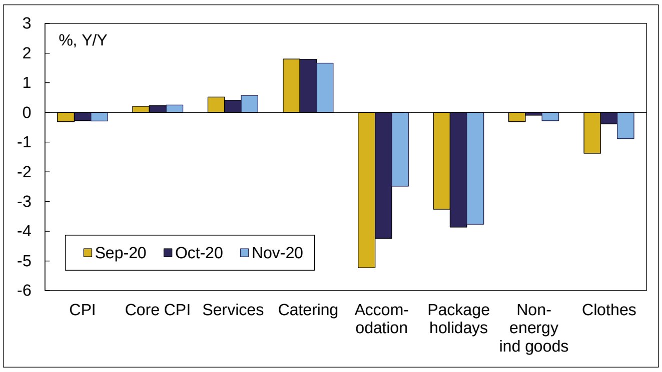
As foreshadowed by the data already released from the large member states, new car registrations in the EU plunged last

Euro area: Headline inflation in November 2020*



*HICP measure of consumer price inflation.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Selected CPI components



*HICP measure of consumer price inflation.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

month as some showrooms were forced to close. In particular, registrations fell 12.0%Y/Y in the EU27 to be down 25.5%YTD/Y. Unsurprisingly, the figures for the euro area were little different at -12.5%Y/Y and -26.1%YTD/Y, and thus on track for the worst year since the 1980s despite the V-shaped rebound in the summer. On a seasonally-adjusted basis, registrations were down 7.8%M/M to the lowest level since June. Among the large member states, Germany (down 0.3%Y/Y and 16.2%YTD/Y) fared better than France (-27.0%Y/Y and -26.9%YTD/Y), Italy (-8.3%Y/Y and -29.0%YTD/Y) and Spain (-5.7%Y/Y and -25.0%YTD/Y). The deterioration over the past two months in the Commission consumer confidence survey's indicator of major purchase intentions points to continued weakness in new car registrations over coming months.

INSEE survey adds to evidence of a better mood among French firms

The INSEE French business sentiment survey for December tallied with yesterday's flash PMIs to point to a notable improvement in mood after the easing of pandemic restrictions this month. In particular, the headline confidence indicator rose more than 11pts, the most since June, to a three-month high of 91.0, still nevertheless well below the long-run average (100). The improvement principally reflected stronger sentiment in services and retail. Admittedly, the improvement in accommodation and food services was still relatively modest. But confidence in many other services – including scientific, technical and professional functions, and administrative and support services – rebounded vigorously, while the business climate in ICT and road freight transport was judged to be close to the long-run average. Manufacturers were a touch more upbeat too. Overall expectations about the outlook for the coming three months improved significantly to the best since September as did expected selling prices, but firms remained relatively pessimistic about their employment intentions (the employment climate index edged up just 2pts to 86, compared to pre-covid levels above 105).

The day ahead in the euro area

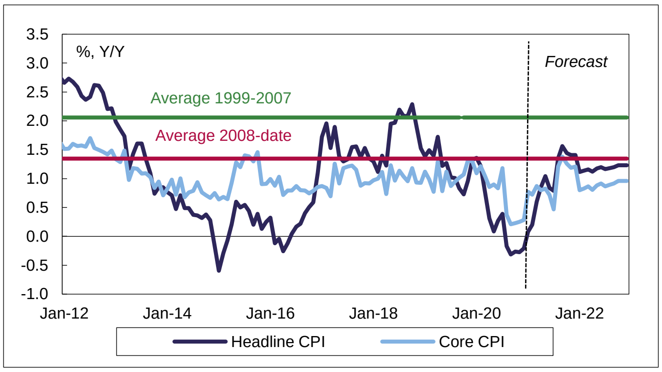
The data focus in the euro area tomorrow will be the German ifo business sentiment survey for December. The headline business climate index is expected to fall for the third month in a row, albeit by less than 1pt to 90.0. The current assessment balance will likely fall due to the worsening of the pandemic and extension of containment measures into the New Year. But the expectations balance is expected to rise 1pt to 92.5, albeit leaving it still some way off September's high of 97.3.

UK

BoE leaves powder dry as hopes of a deal with the EU continue to rise

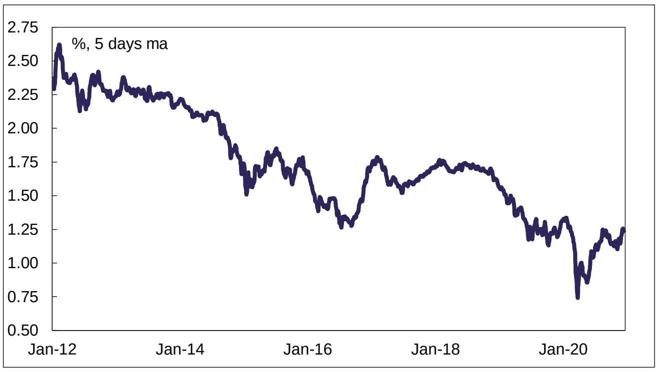
With signs of continued progress in the negotiations between the EU and UK on a deal, including reports that an agreement has now been reached on public procurement rules, sterling continued to appreciate today, moving above $1.36 for the first

Euro area: Inflation forecasts



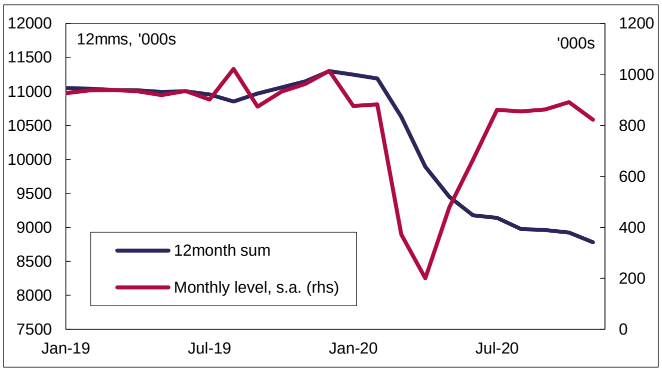
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: 5Y5Yinflation expectations



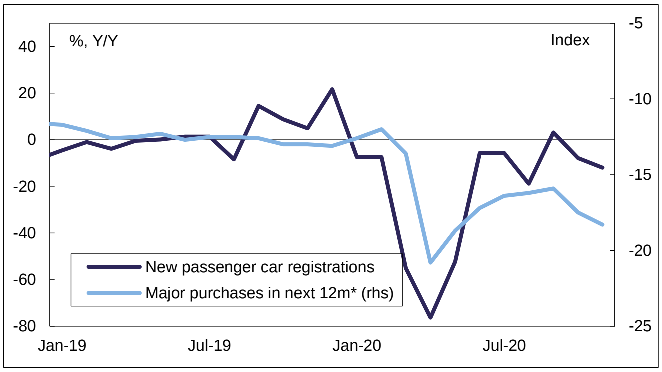
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations



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

Euro area: Car registrations & purchase intentions



**European Commission consumer confidence survey. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

time in 2½ years. And with no reason to panic, at its final scheduled policy meeting of the year, the BoE's MPC inevitably and unanimously left its main policy parameters unchanged. So, Bank Rate was left at 0.1%, its level since the intensification of the pandemic in March. And the total Gilt purchase target was maintained at £875bn with the equivalent target for corporate bond purchases maintained at £20bn. The BoE did, however, extend its Term Funding Scheme for SMEs (TFSME) by a further six months to October 2021, when the current bond purchase target is expected to be close to being fulfilled.

BoE less confident about near-term growth outlook due to pandemic

In terms of its economic assessment, the MPC judged that the positive news surrounding vaccine trials and the government's roll-out plans meant that the downside risks to the economic outlook might be reduced somewhat. However, given the recent intensification of the pandemic, UK-weighted global GDP was expected to be weaker this quarter than it expected last month. And while recent UK economic activity data had been a little stronger than the BoE had previously anticipated, the subsequent imposition of pandemic containment measures had been more stringent than anticipated and was expected to weigh more heavily on GDP in Q1. A "substantial further increase" in unemployment over coming months was still expected. But inflation was expected "to rise quite sharply towards the target in the spring" due to the end of the temporary VAT cut and energy price base effects.

Expect no change to policy over coming quarters, unless the EU-UK negotiations collapse

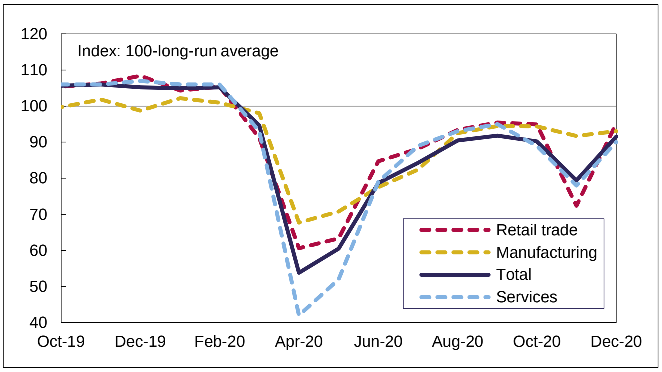
Of course, the BoE acknowledged that the economic outlook remained unusually uncertain due to the pandemic and end to the Brexit transition. And in terms of policy guidance, the MPC reiterated that it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably. The MPC added that it will continue to monitor the situation closely. And making clear that, over the near term it would be more likely to add stimulus than withdraw it, the MPC stated that, if the outlook for inflation weakens, it "stands ready to take whatever additional action is necessary to achieve its remit". Given that we expect a deal soon to be reached with the EU, our baseline forecast is for no change in BoE monetary policy in 2021. However, on the outside chance that the EU and UK fail to implement an agreement at the start of the year, we would expect additional BoE action to ease financial conditions. And that could include a mix of extra liquidity with a zero or negative interest rate, accelerated asset purchases, and – at some point – further cuts in Bank Rate, also perhaps to negative territory.

The day ahead in the UK

Markets will remain firmly focused on Brexit news at the end of the week, with a deal seemingly possible within days. Demands from the European Parliament for a deal by Sunday, to leave open the door to its ratification before the end of the year, are unlikely to change things one way or the other, as leaders could still simply agree to provisional application of an agreement from 1 January and perhaps certain other facilitating measures without the immediate assent of the EP. Nevertheless, the groundwork does appear to have been laid for the UK Parliament to consider the draft Treaty next week.

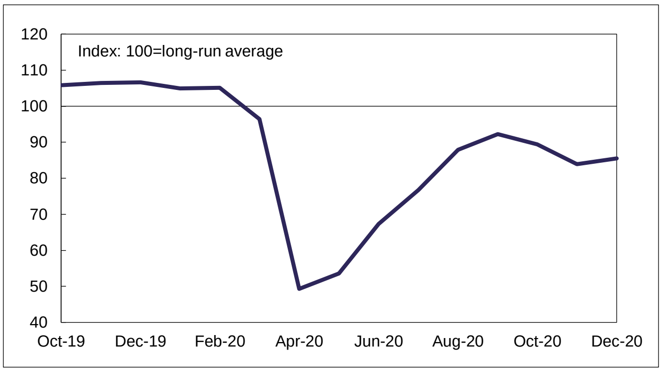
Data-wise, tomorrow sees the release of November retail sales figures. With non-essential stores having been closed last month, retail sales seem bound to fall back sharply even though online and click-and-collect sales will have provided some support. The Bloomberg consensus is for a drop of 4.2%M/M, which would compare favourably with the fall of 18.1%M/M in April when the UK was plunged into a stricter lockdown during the first wave of Covid-19. A result in line with expectations would mean that the annual growth rate would remain positive above 2%Y/Y, albeit down from 5.8%Y/Y in October. Meanwhile, given the sharp rise in coronavirus cases and tighter containment measures on the horizon, the GfK survey measure of consumer confidence is expected to remain at a low level, perhaps edging up slightly from -33 in November, but thus remaining well below the average of -13 in 2019. Finally, the CBI industrial trends survey for December will provide further insight into business optimism ahead of the New Year.

France: Insee business climate by sector



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

France: INSEE employment climate index



Source: Insee, 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	EU-27 new car registrations Y/Y%	Nov	**-12.0**	-	-7.8	-
	Final CPI (Core CPI) Y/Y%	Nov	**-0.3 (0.2)**	-0.3 (0.2)	-0.3 (0.2)	-
France	INSEE business confidence	Dec	**91**	81	79	-
	INSEE manufacturing confidence (production outlook)	Dec	**93 (-4)**	93 (-25)	92 (-39)	-
Spain	Labour costs Y/Y%	Q3	**-1.1**	-	-8.3	-
UK	BoE Bank Rate %	Dec	**0.10**	*0.10*	0.10	-
	BoE corporate bond target £bn	Dec	**20**	*20*	20	-
	BoE Gilt purchase target £bn	Dec	**875**	*875*	875	-

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
Germany	07.00	PPI Y/Y%	Nov	-0.6	-0.7
	09.00	Ifo business climate	Dec	89.8	90.7
	09.00	Ifo current assessment (expectations)	Dec	89.0 (93.0)	90.0 (91.5)
Italy	09.30	PPI Y/Y%	Nov	-2.9	-2.9
Spain	09.00	Trade balance €bn	Oct	-	-1.5
UK	00.01	GfK consumer confidence	Dec	-31	-33
	07.00	Retail sales including fuel M/M% (Y/Y%)	Nov	-1.3 (5.2)	1.2 (5.8)
	07.00	Retail sales excluding fuel M/M% (Y/Y%)	Nov	-2.1 (-)	1.3 (7.8)
	11.00	CBI industrial trends survey, total orders	Dec	-	-40

Auctions and events

Country	GMT	Event
UK	12.00	BoE publishes Q420 Quarterly Bulletin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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