Euro wrap-up

Overview

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- Bunds made gains as Germany's GDP and fiscal data beat expectations while BTPs made measured losses following yesterday's withdrawal of support for Italy's government by former PM Renzi.
- Gilts made gains despite another strong UK housing survey.
- Friday will bring UK GDP data for November along with euro area trade figures for the same month.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.737	-0.023
OBL 0 10/26	-0.748	-0.034
DBR 0 02/31	-0.555	-0.031
UKT 1¾ 09/22	-0.136	-0.013
UKT 0⅝ 06/25	-0.037	-0.019
UKT 4¾ 12/30	0.281	-0.023

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

Euro area

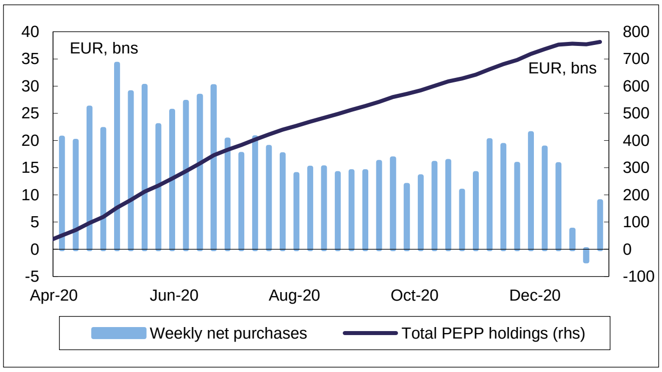
A measured reaction from BTPs to Italy's government crisis

BTPs sold off again today, pushing 10Y spreads to Bunds to the highest since November. But 10Y yields remained just below Tuesday's highs despite intensified doubts about the future of PM Giuseppe Conte's Italian government, after former PM Matteo Renzi yesterday evening carried out his threat to withdraw the three ministers from his Italia Viva (IV) party. While IV was only a bit-part actor in the coalition, which is dominated by the uncomfortable alliance of the populist Five Star Movement and centre-left Democrats, it has up to now held the balance of power in the Senate, with its 18 members out of 315. Nevertheless, with his party's popularity ratings extremely low – averaging only about 3% of late – Renzi will still want to avoid early elections, which a right-wing coalition would be expected to win. Indeed, in his press conference, Renzi stated that he wouldn't necessarily veto a new government led by Conte. But it remains to be seen whether Conte would be able to win any new parliamentary confidence vote to retain his position via the support of members of some smaller parties or unaffiliated lawmakers. And it is possible that he might first resign his position before attempting to form a new coalition. Of course, one eventual solution could be a new government under an alternative non-aligned Prime Minister – with Mario Draghi's name one of those often mooted. Whatever path is taken, not least as none of the current ruling parties would have anything to gain, we continue to doubt that the current spat will lead to an early general election.

ECB policy decision left plenty of scope to adjust pace of bond purchases

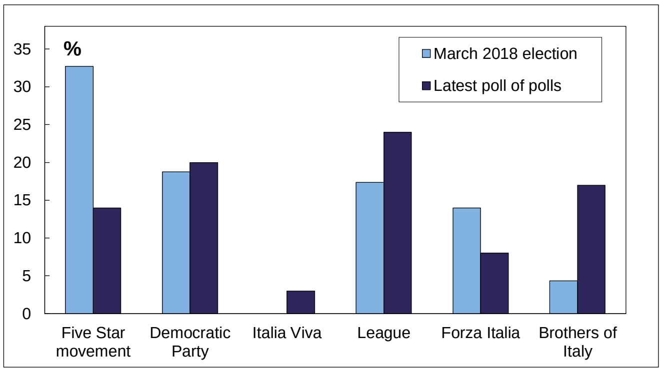
The measured response of the BTP market to the latest Italian political noise owes itself at least in part to the ECB's ongoing PEPP purchases. The account of the December Governing Council meeting, at which the PEPP envelope was augmented by a further €500bn to €1.85trn and the net purchases were extended to at least the end of March 2022, today revealed that the policy decision was inevitably the product of a compromise among the doves and hawks. While there was "broad agreement" on the policy package, a number of members advocated "a more moderate increase in the PEPP envelope" although "some arguments were also made in favour of a larger envelope" given that the proposed increase "was insufficient to ease financing conditions further and bring inflation closer to the Governing Council's aim". Importantly, however, the flexibility in the PEPP programme was underscored, with members accepting that the pace of purchases could be adjusted according to market conditions. Indeed, while the account noted that the envelope might not need to be used in full, "equally, the envelope could be recalibrated if required to maintain favourable financing conditions". For the time being, however, should it need to respond against a sudden significant tightening of financial conditions – resulting say from a further deterioration in political conditions in Italy – the ECB would have plenty of scope to accelerate its weekly purchases from the average of less than €14bn per week since the start of October without requiring an increase in the envelope. Indeed, if it

Euro area: ECB's PEPP purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

Italy: National parliament voting intention



Source: Politico and Daiwa Capital Markets Europe Ltd.

continued to buy assets at that recent pace, its total PEPP purchases would fall short of the full envelope by more than €200bn at the end of the programme next March.

German GDP contraction in 2020 smaller than in 2009

While most major economies suffered declines in economic output in 2020, today's first estimate of full-year German GDP suggested that the drop in economic output was less severe than in 2009 during the global financial crisis. In particular, German GDP contracted by a smaller-than-expected 5.0%Y/Y in 2020, marking the first drop since 2009 when it fell by a steeper 5.7%Y/Y. Adjusting for the number of working days, the contraction in 2020 of 5.3%Y/Y was also slightly smaller than that in 2009 (-5.6%Y/Y) and implies that GDP was broadly flat in Q4. Within the detail on the expenditure side, household consumption fell a record 6.0%Y/Y. But gross fixed investment dropped a more moderate 3.5%Y/Y, with increased construction investment (up 1.5%Y/Y) partly offsetting a relatively modest decline in R&D (-1.1%Y/Y) and a very steep fall in spending on machinery and investment (-12.5%Y/Y). Exports and imports of goods and services fell 9.9%Y/Y, outpacing the drop in imports (-8.6%Y/Y). On the production side, the drop in manufacturing output (10.4%Y/Y) exceeded that in services (6.3%Y/Y) despite double-digit percentage decline in trade, transport and hospitality.

German budget deficit somewhat smaller than expected

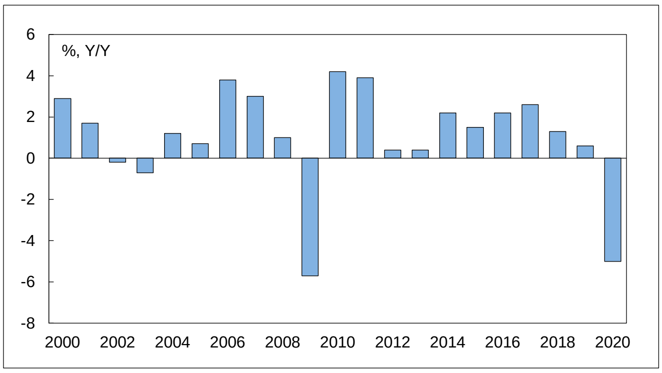
A key reason for the outperformance of the German economy relative to its European peers last year was the larger scale of support provided by fiscal policy. Indeed, government consumption rose 3.4%Y/Y in 2020, not least due to increased spending on healthcare and personal protective equipment. And thanks to the substantive support from the government's short-term working scheme, unlike during the global financial crisis, nominal household disposable income continued to rise last year, increasing 0.8%Y/Y. Given the marked loosening in fiscal policy, however, Germany's general government budget returned to deficit for the first time since 2011. But following the surplus of 1.5% of GDP in 2019, last year's deficit of 4.8% of GDP was roughly 1½ppts than smaller than expected by the government in its draft budgetary plan just three months ago. And we expect this year's deficit to come in below the projection of 4¼% of GDP too.

The day ahead in the euro area

While attention tomorrow will remain on Italian politics, one eye should also shift to German politics, as Angela Merkel's CDU will commence its virtual Congress ahead of Saturday's vote among delegates to determine the successor to Annegret Kramp-Karrenbauer as party leader. The candidates for Saturday's vote – the outcome of which currently looks impossible to predict – are the more centrist Armin Laschet (currently Minister-President of North Rhine-Westphalia), the right-wing Friedrich Merz (previously key Merkel rival and BlackRock Germany Supervisory Board Chair), and Norbert Röttgen (Chair of the Bundestag's Foreign Affairs Committee). But while the winner of the vote will be well-placed to become the centre-right's choice of candidate to run as successor to Angela Merkel as German Chancellor, he would not be guaranteed that honour. In particular, the CDU's sister CSU party will have a say and might push for its own leader, Markus Söder, to get the nod. And while he is nominally Laschet's running-mate, Health Minister Jens Spahn has also signaled a possible candidacy for the Chancellor role.

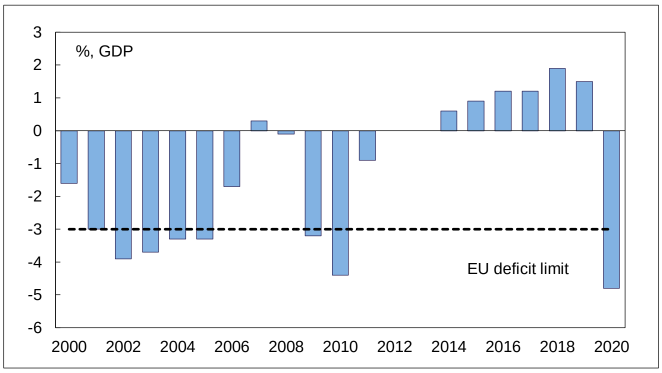
Data-wise, tomorrow sees the release of euro area trade figures for November, as well as final French and Spanish inflation data for December. As suggested by last week's data from Germany and France, the trade data are likely to report a seventh successive monthly increase in exports in November. Meanwhile, the preliminary inflation data revealed that the EU-harmonised measure of French inflation fell 0.2ppt to 0.0%Y/Y, matching September's four-year low, while the equivalent measure of Spanish inflation rose 0.2ppt to -0.6%Y/Y.

Germany: GDP



Source: Bundesbank, Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: General government budget balance



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK

The day ahead in the UK

The focus in the UK tomorrow will be on the monthly GDP data for November. We expect the economy to have shifted back into reverse as new restrictions on activity were brought in to curb the rising number of coronavirus cases. GDP is expected to have fallen by about 4½%M/M in November, after growth already slowed significantly to just 0.4%M/M in October. The drop in output, however, should be concentrated in the services sector, where activity is expected to fall 5.7%M/M. Indeed, manufacturing production is likely to have benefited from stock-building ahead of the end of the Brexit transition period, with manufacturing output forecast to rise 1.0%M/M, while construction output likely continued to grow, albeit by a smaller 0.5%M/M, against the backdrop of the strong rebound in housing market activity.

European calendar

Today's results						
Economic data						
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	GDP Y/Y%	2020	**-5.0**	*-5.5*	0.6	-
	General government deficit/surplus, % of GDP	2020	**-4.8**	-6.0	1.5	-
UK	RICS house price balance %	Dec	**65**	61	66	-
Auctions						
Country	Auction					
Italy	sold €4.5bn of 0.25% 2028 bonds at an average yield of 0.3%					
	sold €2bn of 1.7% 2051 bonds at an average yield of 1.47%					

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	Total trade balance €bn	Nov	22	25.9
France	07.45	Final CPI (EU-harmonised CPI) Y/Y%	Dec	0.0 (0.0)	0.2 (0.2)
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Dec	-0.5 (-0.6)	-0.8 (-0.8)
UK	07.00	Monthly GDP M/M% (3M/3M)	Nov	-4.6 (3.3)	0.4 (10.2)
	07.00	Industrial production M/M% (Y/Y%)	Nov	0.5 -4.2)	1.3 (-5.5)
	07.00	Manufacturing production M/M% (Y/Y%)	Nov	1.0 (-4.8)	1.7 (-7.1)
	07.00	Construction output M/M% (Y/Y%)	Nov	0.5 (-8.0)	1.0 (-7.5)
	07.00	Index of services M/M% (3M/3M%)	Nov	-5.7 (2.5)	0.2 (9.7)
	07.00	Goods trade balance £bn	Nov	-11.0	-11.9
Auctions and events					
- Nothing scheduled -					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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