Daiwa Capital Markets

Euro wrap-up

Overview

- While euro area consumer confidence deteriorated, Bunds made losses and BTPs underperformed as the ECB reiterated that it need not use its PEPP purchase envelope in full and downplayed suggestions that it was targeting yields.
- Gilts also made losses despite a very downbeat survey of UK manufacturers.
- Friday will bring the flash PMIs for January as well as UK retail sales figures for December.

Chris Scicluna
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.708	+0.009
OBL 0 10/26	-0.704	+0.021
DBR 0 02/31	-0.499	+0.032
UKT 1¾ 09/22	-0.122	+0.006
UKT 0⅝ 06/25	-0.025	+0.012
UKT 4¾ 12/30	0.323	+0.025

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

Euro area

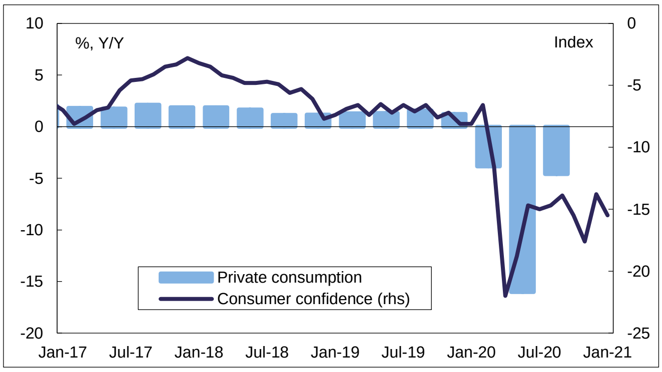
Lagarde emphasizes flexibility in asset purchases, refutes accusation of yield curve control

After the ECB today predictably left all its key monetary policy parameters unchanged at its first Governing Council meeting of the year, the main focus of Christine Lagarde's press conference was the ECB's PEPP purchases. While the €1.85trn envelope, augmented only last month, was unsurprisingly reaffirmed, Lagarde emphasised that the ECB would be flexible in its bond purchases. Indeed, adopting language used last month in Lagarde's press conference opening remarks, the Governing Council's policy statement made clear that 'the envelope need not be used in full' but '[e]qually, the envelope can be recalibrated [i.e. augmented] if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation'. In her press conference today, Lagarde underscored that the ECB would not be fixated on a particular target volume for its purchases, which would also thus not be linear. Instead, the amounts bought would be adjusted from week to week in order to ensure that financial conditions remained favourable. And while the ECB would maintain a presence in bond markets at least until the end of March 2022, she made clear that the Governing Council would also not target any particularly levels for yields. Instead, she emphasized that the ECB would assess financial conditions on a holistic basis, looking at borrowing costs for households and corporations as well as sovereigns, and interest rates on bank loans and the cost of equity as well as yields on bonds. She thus refuted suggestions that the ECB was pursuing a policy of yield curve control.

Lagarde stands by ECB projections, ECB continues to watch FX developments closely

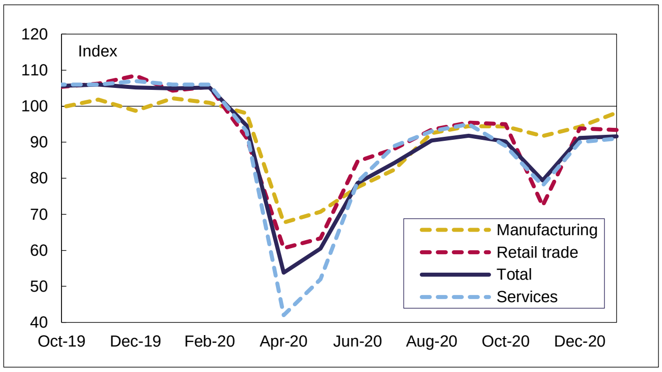
The other main focus of Lagarde's press conference was the economic outlook. And she acknowledged that economic activity had weakened over the course of Q4 and that the intensification of the pandemic and tightening of lockdown restrictions across many member states would imply a subdued first quarter. But she would not be drawn into judging whether or not euro area GDP might contract in Q1 (we think it will). She also reiterated that the ECB's December projections had assumed that lockdown measures would persist through to end-March. And she pointed to several positive developments since those forecasts had been finalized, including progress implementing vaccine programmes, the UK-EU Trade and Cooperation Agreement (the ECB had previously assumed there would be no deal), and the strong likelihood of fiscal stimulus in the US. So, she judged that the ECB's forecasts for 2021 as a whole were still valid. Nevertheless, she acknowledged that the risks to the outlook remained skewed to the downside. And the Governing Council was also aware that euro strength remained a key risk to the inflation outlook. So, Lagarde reiterated that the ECB would continue to monitor exchange rate development, and stands ready to adjust all of its instruments if necessary. Indeed, she insisted that all policy

Euro area: Consumer confidence and spending



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: INSEE business climate indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

options were still on the table. We very much doubt, however, that the ECB would intervene to try to weaken the euro, nor would it amend any of its monetary policy parameters in order to achieve the same aim.

Consumer confidence weakens at start of 2021 while French business sentiment edges higher

Today's economic data, which provided insights into sentiment at the start of 2021, provided few clues as to whether GDP will contract in Q1. The Commission's flash index of euro area consumer confidence index weakened a little further than expected in January, dropping 1.7pts to -15.5, still above November's trough but no higher than in October when the second wave of the pandemic started to intensify. Meanwhile, in France, the INSEE business survey pointed to a marginal improvement in conditions this month following a weak fourth quarter. In particular, the headline INSEE business climate indicator rose just 1pt from December to 92, still, however, no higher than in September and well below the long-run average of 100. The improvement largely reflected better conditions in manufacturing, for which the headline index rose 4pts to 98, the highest since last February. In contrast, the business climate in retail was judged to have deteriorated slightly again while services were stable. The employment climate index edged slightly higher, but remained low by historical standards at just 87.

The day ahead in the euro area

The flow of economic sentiment surveys continues tomorrow with the release of the January flash PMIs for the euro area, Germany and France. Given the intensification of the pandemic, the euro area composite PMI is expected to fall about 1.5pts to 47.6 due to an accelerated decline in activity in services and a slowdown in growth in manufacturing. At the country level, the flash PMIs are expected to indicate that German manufacturers continue to outperform their French counterparts, but also that Germany's services firms are now more significantly hampered by the pandemic than those in France.

UK

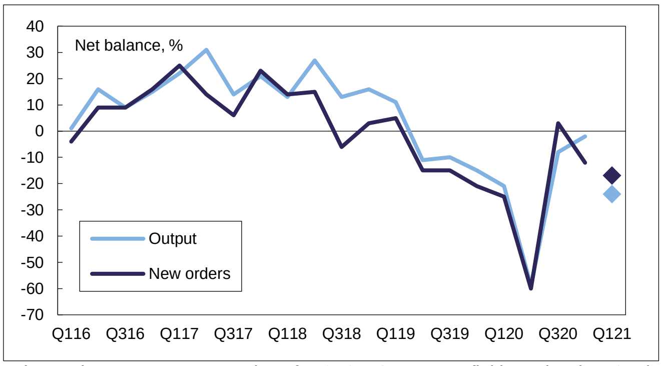
Manufacturers much more downbeat amid falling orders and rising costs

Today's UK economic data focus was a pair of surveys providing a stock-take of conditions in the manufacturing and banking sectors at the turn of the year. Most strikingly, the CBI's latest quarterly industrial trends survey was very downbeat, suggesting that many firms are struggling with shocks to both demand and supply from the pandemic and new post-Brexit trading arrangements. While recent hard data have pointed to a pick-up in production in the sector throughout the second half of 2020 – with manufacturing growth likely having helped to prevent a quarterly contraction in GDP in Q4 – today's survey suggested a turn for the worse at the start of 2021. In particular, while the measure of output volumes had been broadly flat on a year-on-year basis in the three months to January (with a respective net balance of -2% of firms), output was expected to decline significantly in the coming three months (with the net balance dropping to -24%). Moreover, the pace of decline of new orders was anticipated to decline somewhat from -12% in the three months to January to -17% in the coming quarter, with orders from at home and abroad expected to weaken in the aftermath of stock-building ahead of the end of the Brexit transition. Notably, the CBI survey reported a marked pickup in average cost growth in the quarter to January (up 18ppts to +34%, the highest since July 2018). And costs are expected to accelerate markedly further over the coming three months, with the respective index up to +55, the highest since July 2008. Moreover, almost half of firms surveyed – the highest share since January 1975 – flagged worries that impaired access to materials or components may constrain production over coming months. Unsurprisingly perhaps, business sentiment declined in the quarter to January (a net balance of -22% from 0% three months earlier), while firms' investment intentions for this year have been revised down for both plant and machinery as well as product and process innovation.

Mortgage demand expected to moderate in Q1

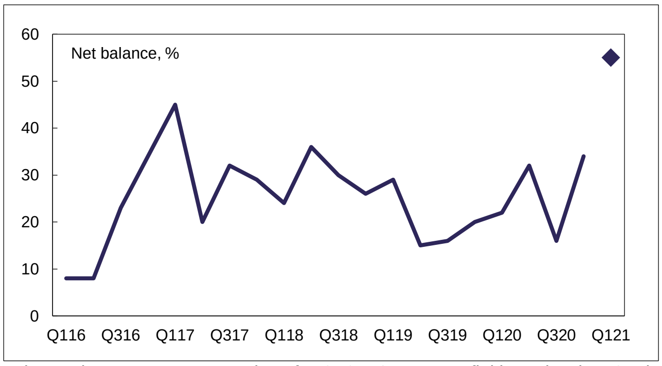
Meanwhile, bank lending data in the second half of 2020 had clear trends, with a [jump in mortgage lending but a shift to net repayments of consumer credit](#) , as well as a marked slowdown in lending to non-financial corporations following the surge in

UK: CBI Industrial trends survey key indicators



Diamonds represent expectations for Q121. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI Industrial trends survey average costs



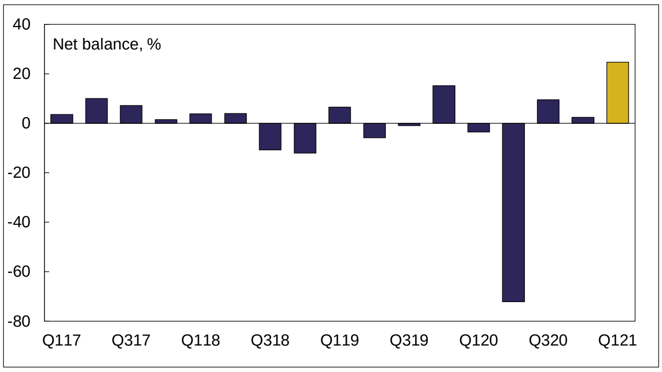
Diamond represents expectations for Q121. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Q220. And today's BoE credit conditions survey suggested that little would change in early 2021. However, while they expected the availability of secured loans to households to jump sharply this quarter, banks expected demand for loans for house purchase to fall slightly. Having reported an increase in Q4 in the overall demand for, and availability of, unsecured consumer lending, including on credit cards, banks expected demand for credit card loans to rise further in Q1 and overall consumer credit to remain steady against the backdrop of unchanged supply. Meanwhile, with respect to lending to non-financial corporations (NFCs), overall demand for and supply of loans for small firms was judged to have fallen last quarter, and their demand was expected to drop further in Q1 too. In contrast, loan demand from large firms reportedly picked up in Q4 and was expected to do so again in the current quarter. Spreads on loans to firms of all sizes rose in Q4, with that trend expected to continue in Q1.

The day ahead in the UK

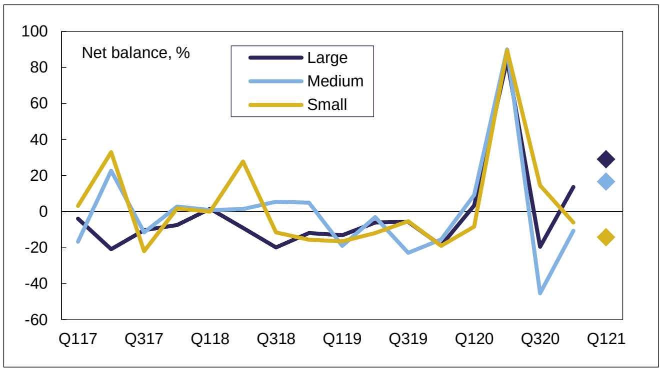
As in the euro area, tomorrow will bring the flash PMI estimates for January. These are expected to suggest that activity in the services sector fell at the start of year due to the pandemic, while growth in the manufacturing sector slowed as the boost from stock-building ahead of the end of the Brexit transition period wore off. So, the composite PMI is expected to fall to 45.5 in January, firmly below the key 50 level and the lowest since May. Tomorrow will also bring the December retail sales figures, which will provide further evidence as to whether a contraction in GDP was avoided in Q4. Non-essential stores in England were able to reopen on the 2 December for a little over three weeks and the latest BRC retail survey suggested that shoppers spent more in the run up to Christmas, particularly of food and online. Retail sales, excluding fuel, are forecast to have risen 1.0%M/M in December, after dropping 2.6%M/M previously, leaving them 7.4% higher compared to a year earlier. Tomorrow will also see the release of the December public finances data and GfK consumer confidence survey.

UK: Household secured credit availability



Gold bar represents expectations for Q121. Source: BoE Credit conditions survey Q420, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Corporate demand for lending by firm size



Diamonds represent expectations for Q121. 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		ECB main refinancing rate %	Jan	**0.00**	*0.00*	0.00	-
		ECB marginal lending facility %	Jan	**0.25**	*0.25*	0.25	-
		ECB deposit facility rate %	Jan	**-0.50**	*-0.50*	-0.50	-
		European Commission consumer confidence	Jan	**-15.5**	-15	-13.9	**-13.8**
France		INSEE business confidence	Jan	**92**	92	91	-
		INSEE manufacturing confidence (production outlook)	Jan	**98 (-9)**	94 (-3)	93 (-4)	**94 (-5)**
Italy		Industrial orders M/M% (Y/Y%)	Nov	**-1.3 (5.3)**	-	3.0 (1.2)	-
		Industrial sales M/M% (Y/Y%)	Nov	**-2.0 (-4.6)**	-	2.2 (-1.7)	**2.1 (-2.0)**
Spain		Trade balance €bn	Nov	**-0.6**	-	-0.7	-
UK		CBI industrial trends survey, total orders (business optimism)	Jan	**-38 (-22)**	-35 (-)	-25 (0)	-

Auctions

Country		Auction
France		sold €3.74bn of 0% 2024 bonds at an average yield of -0.66%
		sold €2.25bn of 0.75% 2028 bonds at an average yield of -0.46%
		sold €2.40bn of 0.1% 2031 index-linked bonds at an average yield of -1.44%
Spain		sold €1.57bn of 0% 2026 bonds at an average yield of -0.381%
		sold €1.33bn 0.8% 2027 bonds at an average yield of -0.254%
		sold €1.75bn of 1.85% 2035 bonds at an average yield of 0.366%
		sold €1.45bn of 1.2% 2040 bonds at an average yield of 0.619%
UK		sold £3.25bn of 0.125% 2024 bonds at an average yield of -0.025%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Preliminary manufacturing (services) PMI	Jan	54.4 (44.5)	55.2 (46.4)
		09.00	Preliminary composite PMI	Jan	47.6	49.1
Germany		08.30	Preliminary manufacturing (services) PMI	Jan	57.2 (45.0)	58.3 (47.0)
		08.30	Preliminary composite PMI	Jan	50.0	52.0
France		08.15	Preliminary manufacturing (services) PMI	Jan	50.5 (48.4)	51.1 (49.1)
		08.15	Preliminary composite PMI	Jan	49.0	49.5
UK		00.01	GfK consumer confidence	Jan	-30	-26
		07.00	Retail sales including fuel M/M% (Y/Y%)	Dec	1.3 (4.0)	-3.8 (2.4)
		07.00	Retail sales excluding fuel M/M% (Y/Y%)	Dec	1.0 (7.4)	-2.6 (5.6)
		07.00	Public sector net borrowing £bn	Dec	31.4	30.8
		09.30	Preliminary manufacturing (services) PMI	Jan	53.0 (45.5)	57.5 (49.4)
		09.30	Preliminary composite PMI	Jan	46.5	50.4

Auctions and events

Country		GMT	Event
EMU		09.00	ECB publishes Survey of professional forecasters

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs