Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds largely made further modest losses while data showed that German factory orders and French goods trade grew at the start of the year.
- Gilts made losses while the aforementioned French trade data illustrated the hit to UK exports in January from the end of the Brexit transition.
- The coming week will bring an opportunity for the ECB to craft a response to the bond market sell-off at its latest monetary policy meeting while UK GDP and trade data for January are also due.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/23	-0.703	-0.004
OBL 0 04/26	-0.620	+0.007
DBR 0 02/31	-0.306	+0.009
UKT 0¹/₈ 01/23	0.079	+0.014
UKT 0¹/₈ 01/26	0.353	+0.018
UKT 4¾ 12/30	0.747	+0.020

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

Euro area

German factory orders beat expectations at start of the year

German new factory orders started 2021 with a stronger-than-expected gain of 1.4%M/M. With the drop in December a little larger than previously thought at 2.2%M/M, that was insufficient to return to November's three-year high. However, it still left German factory orders up 2.5%Y/Y, 0.8% above the Q4 average, and 3.7% above the pre-pandemic level in February last year. Moreover, the headline figure was suppressed somewhat by a drop in bulk major orders – excluding such items, orders rose 2.8%M/M to the highest since December 2018. The intensified spread of Covid-19 and associated restrictions weighed on demand at home, with domestic orders falling 2.6%M/M in January. But foreign orders rose 4.2%M/M, with new orders from the euro area up 3.9%M/M and new orders from elsewhere up 4.4%M/M.

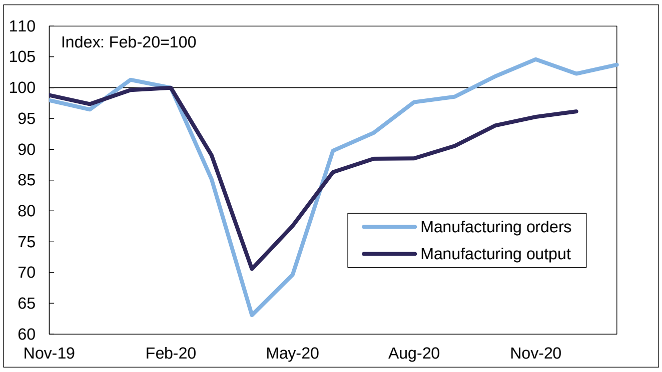
Growth in orders led by capital goods and autos

By sub-sector, growth in demand was strongest for producers of capital goods, who saw orders rise 3.3%M/M. Orders for motor vehicles rose 2.3%M/M back close to the pre-pandemic level. But following a steady uptrend over the previous months, manufacturers of intermediate items saw only modest growth (up just 0.2%M/M), with orders for chemicals dropping 2.6%M/M albeit still above the February 2020 level. And orders of consumer goods fell a steep 5.8%M/M back below the level before Covid-19 hit. Meanwhile, real turnover in manufacturing fell 1.1%M/M in January suggesting that data due on Monday will confirm a drop in industrial production of more than 1%M/M too.

French goods trade grew in January despite substantive hit to exports and imports from Brexit

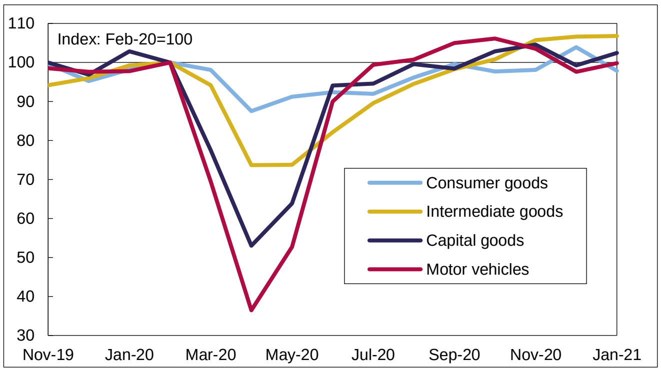
French goods trade also grew at the start of 2021. On a seasonally adjusted basis, the value of exports rose 2.8%M/M to the highest level since February 2020, to be down just 1.1%Y/Y. Imports rose 3.5%M/M on the same basis, also to an eleven-month high, albeit still down 3.8%Y/Y. As a result, the trade deficit widened less than €0.4bn to €3.95bn. The deterioration in the trade balance was more than accounted for by an increase in the value of imports of petrol and associated items, while capital goods exports stood out with the firmest growth at the start of the year. The strength in the headline trade figures masked a significant hit to both exports to and imports from the UK due to the end of the Brexit transition. French exports to the UK in January were down 19.4%Y/Y and about 13% below their average level in the second half of 2020. And imports from the UK fell a steeper 32.4%Y/Y to be down about 20% from the average level in the second half of 2020. Earlier this week, Destatis reported preliminary data suggesting a drop of about 30%Y/Y in German goods exports to the UK in January.

Germany: Manufacturing orders and output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing orders by type of good



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

ECB to try to give a clearer message about the bond market sell-off

The coming week brings the latest ECB Governing Council policy meeting, providing an opportunity for the policymakers to send a clearer message to investors about the recent bond market sell-off. Today's moves took the GDP-weighted euro area 10Y yield back up close to 0.07%, about 20bps above the level after the last Governing Council meeting on 21 January, and almost 35bps above the level immediately after the December meeting when the PEPP and TLTRO-iii programmes were enhanced and extended. Of course, the past few weeks have already brought plenty of comments from individual members of the Governing Council outlining their thinking about the market developments and their implications (see table on page 4). And there has been a good deal of commonality of opinion. For example, the policymakers recognize the importance of maintaining accommodative financial conditions to increase the chances of the ECB pushing inflation higher on a sustainable basis. And they also acknowledge that maintaining relatively low nominal and real sovereign yields will be necessary (if not sufficient) to maintain such accommodative financial conditions.

A spectrum of opinion on the Governing Council

Despite the areas of agreement, however, there are also clearly differences of view on the Governing Council, regarding both the extent to which recent developments are a cause for concern and what the ECB might do about it. At the dovish extreme, Executive Board member Panetta would like the ECB to pin yields back to their December levels in an approximation of yield curve control, in order to maximise the boost to GDP growth and inflation. Indeed, he argued that the ECB "should not hesitate to increase the volume of purchases and to spend the entire PEPP envelope or more if needed". At the more hawkish end of the spectrum, Dutch National Bank Governor Knot would seem to believe no action is required, not least as he believes the recent moves reflect an improvement in the economic outlook. It will be Christine Lagarde's task to try to forge a consensus on both the message and the policy.

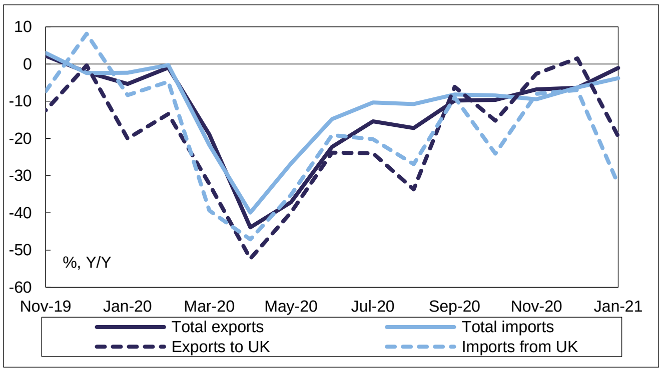
PEPP purchases probably picked up in the past week

The ECB's latest PEPP purchase data suggest that Panetta's views are not widely shared at the ECB. Net purchases settled in the week to 26 February fell more than €5bn to €12.0bn, the lowest since the first full week of the year. And while redemptions weighed on that total, net purchases of €16.9bn were the lowest in seven weeks. Given the time lag for settlement, those data only represent purchases conducted up to 24 February. And we do expect to see a significant increase in the past week's purchases when the data are published on Monday. Nevertheless, the most recent net purchases are likely to remain well down on the average pace of more than €25bn per week through the first three months of the programme – indeed they will probably maintain the average pace since the start of 2021 at roughly half that rate. And so, there will remain plenty of headroom within the current PEPP envelope to accelerate purchases over coming weeks and months if necessary. (Indeed, at the current pace of buying, the envelope would not be exhausted until July next year, more than three months after the current deadline for the programme).

ECB is unlikely to be panicking

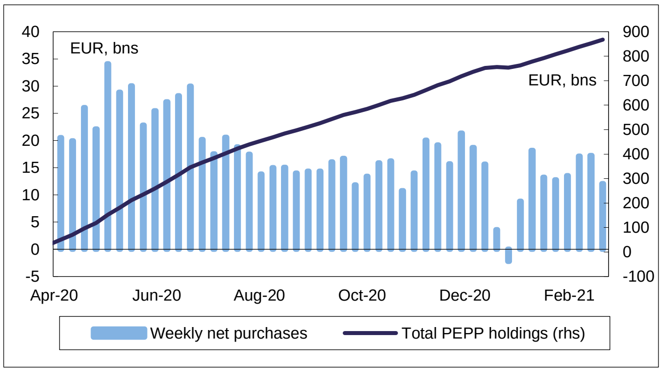
Indeed, the ECB will not be panicking. Despite recent evidence of a tightening of credit standards on bank loans, overall financial conditions remain highly accommodative by historical standards, while the GDP-weighted yield curve remains well below its level before the pandemic struck. The Governing Council will welcome the recent upwards shift in financial market inflation expectations as well as the modest weakening of the euro against the US dollar. And the ECB's updated economic projections will also suggest that it doesn't see the need suddenly to change course with policy. GDP fell less than the Bank expected in Q4. And while a contraction is now highly likely in Q1 (unlike the growth of 0.6%Q/Q forecast by the ECB), the GDP outlook ahead might be revised up thanks to the more favourable outlook for external demand. Indeed, we expect only a modest downwards revision to the forecast for GDP growth this year (currently 3.9%Y/Y) but a modest upwards revision to the forecast for 2022 (4.2%Y/Y). Moreover, the ECB's current forecast for inflation this year (1.1%Y/Y) is now clearly far too low while the forecasts for the following two years (1.1%Y/Y and 1.4%Y/Y) appear to merit little revision.

France: Trade in goods



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: ECB total PEPP holdings



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

Lagarde will emphasise readiness to up PEPP purchases within the current envelope

So, what might the Governing Council agree to do at the coming policy meeting? Probably not a great deal. In her press conference, Lagarde will certainly signal that the ECB is mindful of the risks that excessive increases in yields might cause an undesirable and unwarranted tightening of financial conditions, which could ultimately undermine its ability to achieve its inflation target. So, she will likely state that the ECB will monitor financial market developments closely and emphasise a readiness to adjust all policy tools in future if necessary. She will also likely signal the ECB's willingness to accelerate purchases under the PEPP programme, albeit within the current envelope, if required to maintain accommodative financial conditions. In this context, however, it is notable that the PEPP legislation states that the "The Governing Council delegates to the Executive Board the power to set the appropriate pace and composition of PEPP monthly purchases within the total overall envelope". Therefore, the Executive Board will retain the discretion to respond to market events as they see fit after Thursday's meeting. So, at this current juncture, the views of some members of the Governing Council (i.e. the members of the Executive Board) might be more important than the others (the national bank Presidents).

The week ahead in the euro area

Ahead of the Governing Council meeting, the ECB's latest weekly PEPP bond purchase data, due Monday and Tuesday, will be closely watched. After the drop in both net and gross purchases to multi-week lows in the week to the 26 February, the pace of purchases settled this past week is likely to have accelerated notably. Beyond the ECB, the coming week brings further data from the manufacturing sector, with January industrial production figures from Germany and Spain due out on Monday, followed by the Italian, French and euro area numbers on Tuesday, Wednesday and Friday respectively. Euro area output figures for December were somewhat weaker than expected and meant that manufacturing production ended the year 2.6% below February's pre-pandemic level. And while the Bloomberg consensus is for another modest 0.5%M/M decline (-2.7%Y/Y) in euro area industrial production in January, survey and new orders indicators suggest a pick-up in manufacturing activity over coming months. Meanwhile, like today's equivalent numbers from France, German goods trade figures, to be published on Tuesday, will highlight the impact of the end of the Brexit transition. Preliminary data from Destatis suggested a drop of about 30%Y/Y in exports to the UK in January. But imports from the UK are also likely to have plunged.

Separately, survey results due include the Sentix investor confidence indices for March and the Bank of France's business sentiment survey for February, both on Monday. Tuesday brings the release of final euro area Q4 GDP figures, which are expected to confirm the preliminary estimate (-0.7%Q/Q and -5.1%Y/Y). The expenditure breakdown of euro area Q4 GDP is likely to show that household consumption declined significantly due to the intensified pandemic and associated containment restrictions. But net trade and inventories, and perhaps also certain components of fixed investment, likely provided some offset. And February inflation figures for Germany and Spain, due Friday, are expected to confirm the flash estimates. So, Germany's EU-harmonised measure will likely have remained unchanged at 1.6%Y/Y, matching the highest since February 2020, while Spanish inflation on the same basis probably fell 0.5ppt to -0.1%Y/Y. Looking ahead, inflation is bound to rise sharply in all member states due to a steep jump in energy inflation.

UK

The week ahead in the UK

The highlight of the coming week in the UK will be the initial estimate of GDP in January (on Friday), which will offer the first official glimpse of how severely the economy has been hit by the third lockdown and end to the Brexit transition. We expect a drop of 4.5%M/M and 2.2%Y/Y as the restrictions on activity weighed on private spending. (Indeed, we already know that retail sales fell a very steep 8.8%M/M that month). Once again, services activity will be hardest hit while industrial production is expected to have fallen more modestly (perhaps less than 0.5%M/M, albeit likely leaving it down more than 3.5%Y/Y). And the new barriers to trade with the EU that came into place at the start of the year will have weighed on exports of both goods and services. Indeed, as today's French data suggested, and as the UK controls on imports from the EU have yet to be fully implemented, the trade deficit is likely to widen in January as the fall in exports outpaced that of imports. The other noteworthy data due is the BRC retail sales survey for February, out Tuesday, which will highlight the ongoing impact of the closure of non-essential stores last month. In other news, Bank of England Governor Bailey is due to speak on Monday about the economic outlook.

Selected ECB comments about recent financial market developments

Christine Lagarde* 22 February	*"Within the broad-based set of indicators that we monitor to assess whether financing conditions are still favourable, risk-free overnight indexed swap (OIS) rates and sovereign yields are particularly important …Accordingly, the ECB is closely monitoring the evolution of longer-term nominal bond yields."*
Philip Lane* 25 February	*"Ensuring that the risk-free yield curve remains at highly accommodative levels is a necessary (but not sufficient) condition for ensuring that overall financing conditions are supportive enough…* *"We will purchase flexibly according to market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation… Accordingly, the ECB is closely monitoring the evolution of longer-term nominal bond yields."*
Isabel Schnabel* 26 February	*"changes in nominal rates have to be monitored closely and interpreted in the light of their driving forces. For example, a rise in nominal yields that reflects an increase in inflation expectations is a welcome sign that the policy measures are bearing fruit. Even gradual increases in real yields may not necessarily be a cause of concern if they reflect improving growth prospects.* *"However, a rise in real long-term rates at the early stages of the recovery, even if reflecting improved growth prospects, may withdraw vital policy support too early and too abruptly given the still fragile state of the economy. Policy will then have to step up its level of support."*
François Villeroy de Galhau, 1 March	*"We can and must react against [any unwarranted rise in bond yields]…we continue to stand ready to adjust all of our instruments, as appropriate, including possibly a lowering of the deposit rate"*
Fabio Panetta* 2 March	*"the steepening in the nominal GDP-weighted yield curve we have been seeing is unwelcome and must be resisted… we should not hesitate to increase the volume of purchases and to spend the entire PEPP envelope or more if needed. In this way, we can prevent a tightening of financing conditions which would otherwise lead to inflation remaining below our aim for longer.* *"Eventually, firm commitment to steering the euro area yield curve may allow us to slow the pace of our purchases. But in order to reach that point, we must establish the credibility of our strategy by demonstrating that unwarranted tightening will not be tolerated."*
Pablo Hernandez de Cos 3 March	*"the increases in long-term nominal interest rates have not been accompanied by increases of the same magnitude in long-term inflation expectations, resulting in a slight de facto increase in the real interest rate. This may have a negative impact on economic activity and thus inflation.* *"In this regard, we must closely monitor long-term nominal interest rates and act accordingly in order to maintain favourable financing conditions…"*
Luis de Guindos* 3 March	*"In terms of spreads, the situation is very calm… What we have to analyse is what's the reason behind then increase in yields. If it's a response that has nothing to do with the improvement of the outlook it's much more worrisome and we have to react"*
Jens Weidmann 3 March	*"the size of the movements is not such that this is a particularly worrisome development… But we have to look at it and we are ready to adjust the volume of PEPP purchases. The PEPP has that flexibility embodied in it so we can react to unwarranted tightening of financing conditions…. We want to preserve favourable financing conditions for the non-financial sector. That's not just looking at financing costs for governments."*
Klaas Knot 4 March	*"There is reason to be optimistic about the second half of the year when the lockdowns will be lifted. What the market is actually doing is pricing that optimism… the starting point should be that the rise in rates reflects better growth prospects and better, higher inflation expectations."*
Account of 21 January Governing Council meeting	*"Looking ahead, assessing the impact of upward pressure on nominal yields on the favourability of financing conditions would be an important task ...[But] not every increase in nominal yields should be interpreted as an unwarranted tightening of financing conditions and trigger a corresponding policy response… as they could rise because of a better economic outlook and higher inflation expectations. What mattered from a monetary policy perspective was the evolution of real rates…* *"a holistic approach was needed when defining the relevant range of financing conditions to be targeted in a broad and flexible manner, for all sectors of the economy, private and public."*

** represents member of the Executive Board. Source: ECB, Bloomberg, Bank of Spain, and Daiwa Capital Markets Europe Ltd.*

Daiwa economic forecasts

	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2020	2021	2022
GDP growth, %, Q/Q									
Euro area	-0.6	-0.8	1.4	1.4	1.3	1.1	-6.8	3.5	4.4
Germany	0.3	-1.0	1.2	1.2	1.2	1.0	-5.3	2.5	4.0
France	-1.3	-0.5	1.2	1.4	1.2	1.2	-8.3	5.1	4.5
Italy	-2.0	-0.5	1.5	1.5	1.4	1.2	-8.9	4.0	4.7
Spain	0.4	-1.0	1.5	1.4	1.2	1.2	-11.0	3.9	5.0
UK	1.0	-2.8	3.5	3.0	2.2	1.5	-9.9	4.5	6.9
Euro area									
Headline CPI	-0.3	1.1	1.7	2.1	2.4	1.3	0.3	1.8	1.3
Core CPI	0.2	1.3	1.2	1.5	1.9	0.9	0.7	1.5	1.0
UK									
Headline CPI	0.5	0.9	1.9	2.0	2.4	2.3	0.9	1.8	2.0
Core CPI	1.3	1.5	2.0	2.0	2.1	2.0	1.4	1.9	1.9
ECB									
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
PEPP envelope* (€bn)	1850	1850	1850	1850	1850	1850	1850	1850	1850
BoE									
Bank Rate %	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Bond purchases** (£bn)	895	895	895	895	895	895	895	895	895

**Monthly target €bn, end of period. **Monthly target £bn, end of period. Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
Germany	Factory orders M/M% (Y/Y%)	Jan	**1.4 (2.5)**	0.5 (1.9)	-1.9 (6.4)	**-2.2 (6.1)**
France	Trade balance €bn	Jan	**-3.9**	-3.4	-3.4	**-3.6**
Italy	Retail sales M/M% (Y/Y%)	Jan	**-3.0 (-6.8)**	-0.5 (-)	2.5 (-3.1)	**2.4 (-3.2)**
Auctions						
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

The coming week's key data releases

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
		Monday 08 March 2021			
EMU	09.30	Sentix investor confidence	Mar	1.0	-0.2
Germany	07.00	Industrial production M/M% (Y/Y%)	Jan	-0.1 (-2.3)	0.0 (-1.0)
France	-	Bank of France industrial sentiment	Feb	99	98
Spain	08.00	Industrial production M/M% (Y/Y%)	Jan	-0.4 (-0.5)	1.1 (-0.6)
		Tuesday 09 March 2021			
EMU	10.00	Final GDP Q/Q% (Y/Y%)	Q4	-0.6 (-5.0)	12.4 (-4.3)
	10.00	Final employment Q/Q% (Y/Y%)	Q4	0.3 (-2.0)	1.0 (-2.3)
Germany	07.00	Trade balance €bn	Jan	15.7	15.2
France	06.30	Final private sector payrolls Q/Q%	Q4	-0.2	1.6
Italy	09.00	Industrial production M/M% (Y/Y%)	Jan	0.7 (-4.2)	-0.2 (-2.0)
UK	00.01	BRC retail sales monitor Y/Y%	Feb	-	7.1
		Wednesday 10 March 2021			
France	07.45	Industrial production M/M% (Y/Y%)	Jan	0.6 (-2.8)	-0.8 (-3.0)
	07.45	Manufacturing production M/M% (Y/Y%)	Jan	-	-1.7 (-3.6)
Italy	10.00	PPI Y/Y%	Jan	-	-2.3
		Thursday 11 March 2021			
EMU	12.45	ECB main refinancing rate %	Mar	*0.00*	0.00
	12.45	ECB marginal lending facility %	Mar	*0.25*	0.25
	12.45	ECB deposit facility rate %	Mar	*-0.50*	-0.50
Germany	07.00	Labour costs Q/Q% (Y/Y%)	Q4	-	-1.7 (1.7)
UK	00.01	RICS house price balance %	Feb	45	50
		Friday 12 March 2021			
EMU	10.00	Industrial production M/M% (Y/Y%)	Jan	0.4 (-2.2)	-1.6 (-0.8)
Germany	07.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	1.3 (1.6)	1.0 (1.6)
Italy	09.00	Unemployment rate %	Q4	-	9.8
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	0.0 (-0.1)	0.5 (0.4)
	08.00	Retail sales Y/Y%	Jan	-	-1.5
UK	07.00	Monthly GDP M/M% (3M/3M%)	Jan	-5.0 (-2.6)	1.2 (4.1)
	07.00	Index of services M/M% (3M/3M%)	Jan	-5.5 (-3.2)	1.7 (0.6)
	07.00	Industrial production M/M% (Y/Y%)	Jan	-0.8 (-3.9)	0.2 (-3.3)
	07.00	Manufacturing production M/M% (Y/Y%)	Jan	-0.8 (-3.5)	0.3 (-2.5)
	07.00	Construction output M/M% (Y/Y%)	Jan	-1.1 (-4.8)	-2.9 (-3.9)
	07.00	Goods trade balance £bn	Jan	-12.5	-14.3
	09.30	BoE inflation expectations, next twelve months %	Feb	-	2.7

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 08 March 2021
UK		10.00	BoE Governor Bailey scheduled to speak on the economic outlook
			Tuesday 09 March 2021
EMU		10.00	OECD publishes interim Economic Outlook
UK		10.00	Auction: £2.25bn of 1.25% 2041 bonds
			Wednesday 10 March 2021
Germany		10.30	Auction: €4bn of 0% 2026 bonds
UK		10.00	Auction: £800mn of 0.125% 2031 index-linked bonds
			Thursday 11 March 2021
EMU		12.45	ECB monetary policy announcement
		13:30	ECB President Lagarde holds press conference
Italy		10.00	Auction: index-linked bonds
		10.00	Auction: 3Y and 7Y fixed-rate bonds
			Friday 12 March 2021
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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