Euro wrap-up

Overview

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- Bunds made gains as the euro area's industrial sector remained in recession at the start of Q4.
- Gilts made larger gains as UK GDP fell more than expected in October, with a broad-based decline across the major sectors.
- Thursday will bring monetary policy announcements from the ECB and BoE, although rates are set to remain unchanged. The ECB's updated growth and inflation forecasts are likely to be softer than in September.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.636	-0.063
OBL 2.4 10/28	2.157	-0.048
DBR 2.6 08/33	2.170	-0.053
UKT 3½ 10/25	4.347	-0.136
UKT 4½ 06/28	3.870	-0.161
UKT 3¼ 01/33	3.822	-0.138

*Change from close as at 4:50pm GMT.
Source: Bloomberg

Euro area

Industrial sector remains in recession with bigger-than-expected contraction in October

Euro area industrial production dropped in October for the fourth month in the past five, and by a larger-than-expected 0.7%M/M, to be firmly on track for a fifth successive quarterly contraction in Q4. Indeed, production fell 1.1% below the Q3 average to be down a steep 6.6%Y/Y, hitting a three-year low 1.1% short of the pre-pandemic level. Each of the four largest member states registered modest declines in output, ranging from -0.1%M/M in Germany to -0.6%M/M in Spain. So, the steeper fall for the euro area as a whole reflected the sharp contraction recorded by firms based in Ireland (-7.0%M/M and an extreme -34.0%Y/Y), which reflects the activities of certain large multinational corporations. But while production in Ireland was still almost 50% above the pre-pandemic level, and IP in Italy and Spain was less than 1% below that benchmark, it was almost 10% lower in Germany and more than 5% lower in France illustrating the ongoing underperformance of the two largest member states.

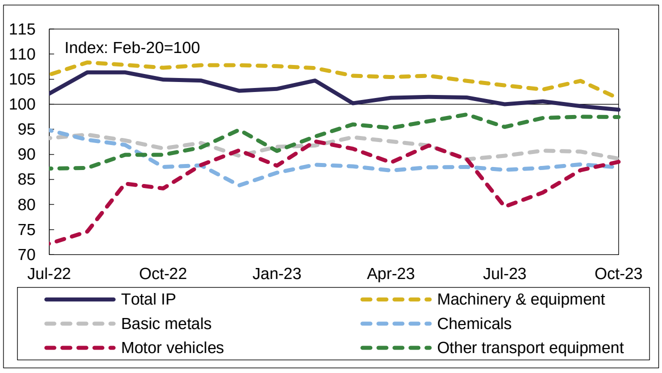
Broad-based weakness led by machinery and equipment tallies with soft capex outlook

By sub-sector, manufacturing output in the euro area fell 0.5%M/M in October. The weakness was relatively broad-based and led by capital goods production (-1.4%M/M), which fell to a seven-month low and 1.1% shy of the Q3 average. With a drop in machinery and equipment output (-3.4%M/M) to a 2½-year low centered on Germany more than offsetting growth in motor vehicles output (1.9%M/M) to a four-month high, the data tallied with recent declines in factory orders that point to a soft outlook for capex both within and beyond the region. Meanwhile, production of intermediate goods fell for a third successive month and by the most since June (-0.6%M/M) to hit its lowest level since July 2020. And as structural adjustment to last year's gas price shock seemingly continued, production in energy-intensive sectors (-1.2%M/M) fell to a new series low due not least to sizeable declines in the chemicals, coke and petroleum subsectors. With production of nondurable consumer items also down for a second consecutive month, only durable consumer goods output (0.2%M/M) and energy generation (1.2%M/M) of the major components posted positive growth.

Industrial sector to remain in reverse over the near term as inventory adjustments continue

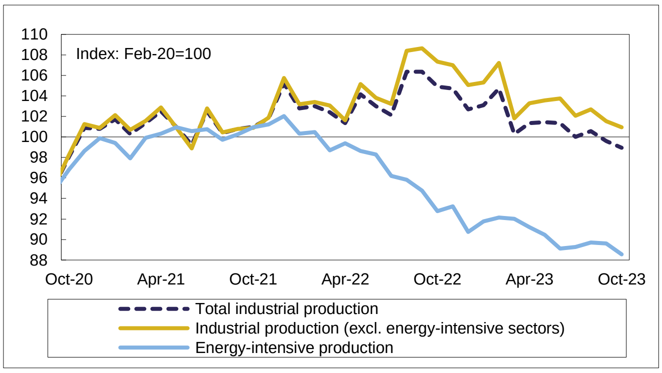
Surveys provide somewhat mixed messages about the strength of factory output in November and the likely outlook beyond. But none have been particularly upbeat. Thanks to an improvement in Germany, the euro area manufacturing PMI rose to a six-month high (44.6) last month. But that merely suggested a moderation in the pace of contraction rather than a return to positive growth. Moreover, the Commission indicator of industrial confidence fell back to a three-month low due to a marked decline in optimism in the investment goods subsector to the lowest level since the first wave of Covid-19. Importantly

Euro area: Industrial output by selected subsector



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Energy-intensive production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

perhaps, in aggregate, manufacturers reported a deterioration in order books to a three-year low, weighed particularly by falling demand from abroad. Moreover, probably unintentionally, inventories edged higher again, to remain elevated, particularly relative to orders. So, despite attempts at destocking, which subtracted 0.3ppt from GDP growth in Q3, firms' inventory adjustments are likely to continue to weigh on demand and production over coming months, ensuring that the industrial sector recession persists into the first quarter of next year. We expect IP to drop 1¼-1½%Q/Q in Q4, in line with the pace of decline of each of the prior three quarters.

ECB to revise down profile of GDP and inflation, but Lagarde to push against dovish market pricing

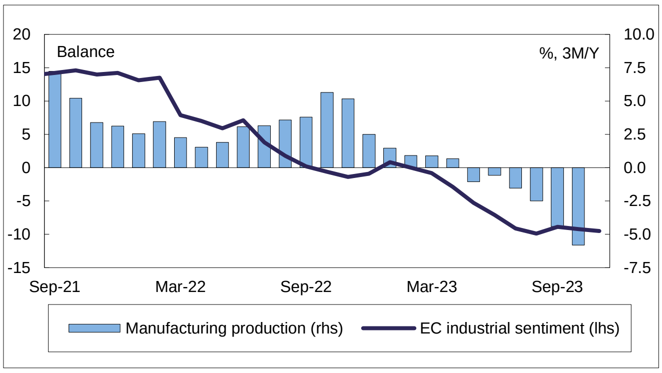
The main event in the euro area tomorrow will be the ECB's latest policy decision and publication of its updated economic projections. Admittedly, the immediate announcement should be relatively uneventful, with policy widely expected to be unchanged and therefore the Deposit Rate to be left at a record high 4.00%. And while the statement will reiterate that policy will be data dependent and that rates will be set at sufficiently restrictive levels for as long as necessary, we suspect that President Lagarde will not dissent from the recent comments of Executive Board member Schnabel – who has typically been the most eloquent advocate of the hawks – that a further rate hike is now "unlikely". Certainly, the ECB looks set to revise down its projections for GDP and inflation from three months ago, with full-year GDP growth in 2023 likely to be nudged down by 0.2ppt to 0.5%Y/Y, and its GDP projection for 2024 to be below 1.0%Y/Y. More importantly for monetary policy, the revised projections should suggest that headline inflation will average less than 3.0%Y/Y in 2024 and return to the 2.0% target by mid-2025. Nevertheless, with core inflation still well above the 2.0% target at 3.6%Y/Y in November and likely to remain above 3.0%Y/Y until February at the earliest, and unit labour costs having risen at a record rate in Q3, Lagarde will be reluctant to suggest that a rate cut could come as soon as the first quarter of 2024. Indeed, given the likely discomfort of many Governing Council members to recent swap market moves, she might well try to push back somewhat against the marked downward shift in expectations of future rates, which currently imply five cuts of 25bps apiece over the course of next year. Moreover, in her press conference, Lagarde might remind that the Governing Council will soon discuss the possibility of an early end to PEPP reinvestments, which would tighten financial conditions somewhat even as the ECB pivots towards lower policy rates.

UK

UK GDP contracts more than expected in October, pointing to ongoing stagnation at best in Q4

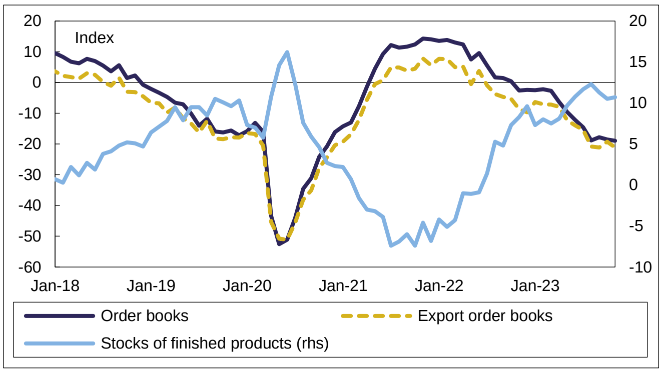
Today's GDP figures disappointed expectations to continue the run of softer data from the UK – including October's inflation and wage figures – and reinforce the view that the UK's economy continues to stagnate (at best) heading into year-end.

Euro area: Manufacturing output & confidence



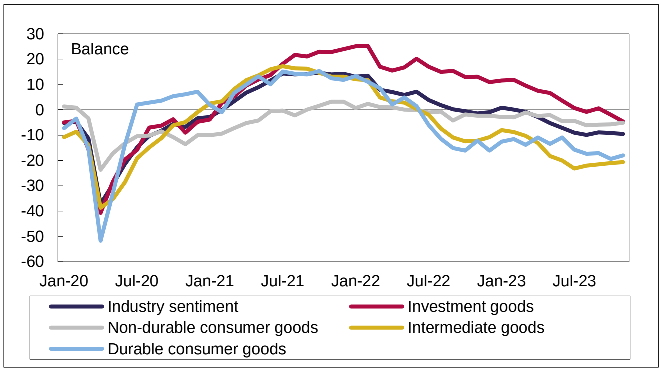
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing orders & inventories



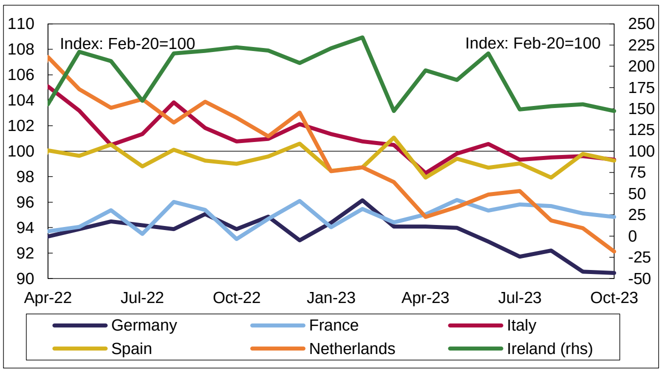
Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial sentiment by subsector



Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial output by member state



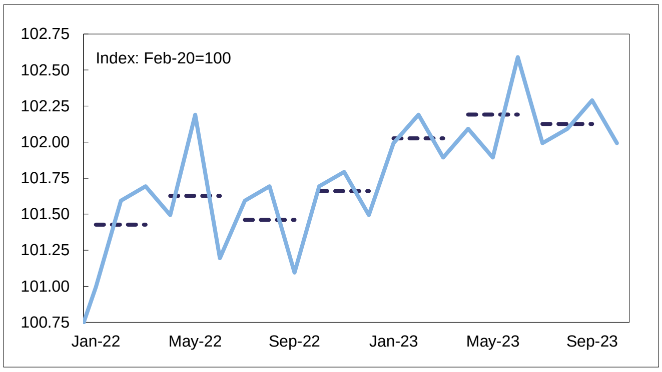
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Certainly, even as the energy-price shock has started to fade, the economy continues to suffer from structural supply-side weaknesses as well as the dampening impact of the BoE's aggressive tightening cycle on demand. In particular, GDP fell in October for the first month in three and by a steeper-than-expected 0.3%M/M, to leave output unchanged on a three-month basis. And while this still left output around 2% above the pre-pandemic level in February 2020, it was just 0.3% higher than a year earlier and continued to lag behind the post-pandemic recoveries in the US (7.4%), Japan (3.0%) and euro area (3.0%). Admittedly, firms reported that heavy rainfall that month dampened activity in the construction, retail, hospitality and tourism subsectors. The latter was also impacted by the timing of the school half-term holidays, which for some local authorities fell into November this year. While the PMIs point to a bounce back in manufacturing and services activity in November, other surveys suggest that retail sales remained weak for the time of the year last month, while construction indicators point to ongoing marked contraction. As such, we might well see BoE staff revise down slightly their expectation for a return to very modest growth in Q4 (0.1%Q/Q). And overall, today's figures raise the risk that GDP contracted slightly in Q4.

Services, manufacturing and construction output start Q4 on the back foot

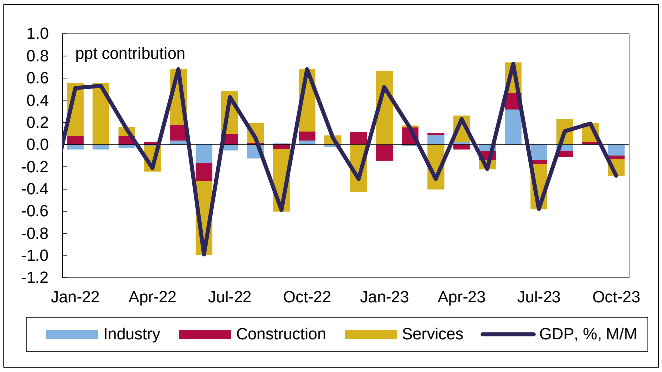
The detail of today's report suggested that the weakness at the start of the fourth quarter was broad-based. The decline was led by services (-0.2%M/M), with almost half the subsectors a drag in October, including notable falls in computer programming, motion picture, video and TV production, and legal activities. And while healthcare was boosted by the latest Covid vaccination campaign, and repair of motor vehicles rose to a near-2½-year high, output from consumer-facing services slipped back slightly (-0.1%M/M) to a seven-month low some 5% below the pre-pandemic benchmark. Healthcare and education also benefitted from fewer strike days, with the number of workers involved in labour disputes in October down 55% to 49k, the lowest since June 2022. Meanwhile, consistent with the lacklustre manufacturing performance across the euro area, today's figures also confirmed a further retrenchment in industrial production in the UK in October (-0.8%M/M) to its lowest level since May and more than 12% below the pre-pandemic benchmark. The weakness in manufacturing (-1.1%M/M) was widespread, with 10 of the 13 subsectors contracting, and sizeable decreases reported in production of machinery and equipment, and computer, electronic and optical products. Today's construction figures also illustrated the acute impact of the BoE's interest rate hikes on the sector, with new private house building down for a seventh month out of the past eight and by a whopping 5.2%M/M in October to its lowest level since July 2020 and down almost 20%Y/Y. And while a third successive rise in repair and maintenance work (1.3%M/M) provided some offset, total construction output was still down 0.5%M/M at a five-month low.

UK: Monthly GDP level*



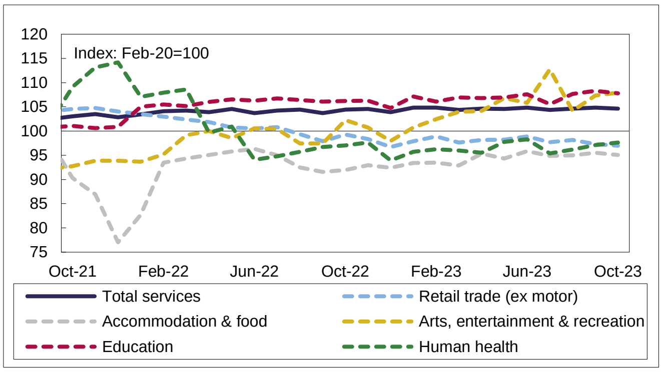
*Dashed dark blue line represents quarterly averages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to GDP growth



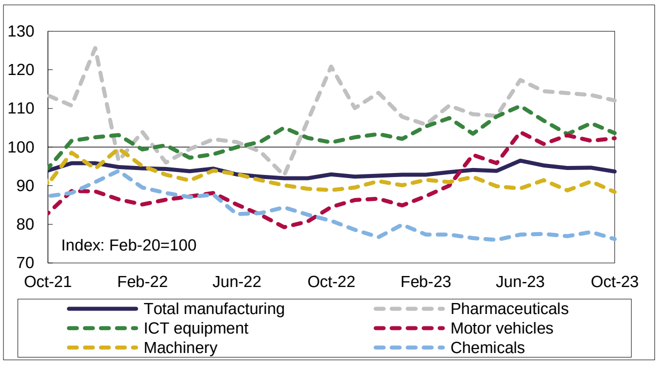
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Services output



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Industrial production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

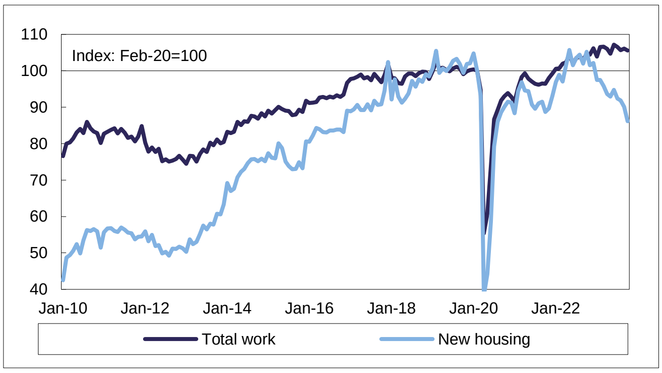
Trade deficit widens on the back of subdued export growth and a jump in imported goods

Today's trade figures were also suggestive of a drag on GDP growth at the start of Q4, with the deficit widening almost £3.0bn in October to £4.5bn, the largest since May. While this in part reflected a pick up in import prices, the volume of imports also jumped in October (3.7%M/M), with imported goods up for the first month in six (6.1%M/M) amid a surge in machinery and transport equipment (10.7%M/M). Admittedly, when smoothing out monthly volatility, import volumes were down more than 2%3M/3M and up 1.1% from the Q3 average. But while shipments of goods to non-EU countries rose a sizeable 8.0%M/M in October, they fell sharply to EU countries (-7.0%M/M). And given a second-successive decline in services exports, total export volumes were up just 0.6%M/M, to leave still more than 2% below the Q3 average. The lacklustre performance, however, partly reflected precious metals, which complicate the picture. Indeed, when excluding such items, exports were up more than 1%M/M to be broadly in line with the Q3 average. Nevertheless, given the rise in imports, today's figures suggest that, having provided a non-negligible boost to GDP growth in Q3, net trade will probably subtract from growth this quarter.

BoE to maintain a tightening bias despite recent drop in inflation

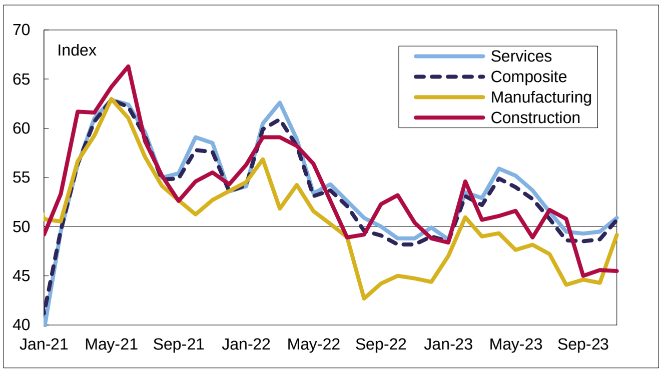
The main focus in the UK tomorrow will be the BoE's latest monetary policy announcement. Like the ECB, we expect BoE policy to be kept unchanged, leaving Bank Rate at 5.25% for a fourth successive meeting. Notwithstanding the downside surprise to October's GDP, given the recent financial market shifts – with swaps markets current pricing in three or more rate cuts next year – and fiscal policy easing, the MPC might well judge that economic growth over coming quarters is likely to be somewhat firmer than it anticipated in its projections published last month. And although the MPC will have welcomed the big drop in inflation in October of 2.1ppts to 4.6%Y/Y, 0.2ppt below the MPC's projection, it will remain wary that it remains significantly higher than in the US and euro area, with services inflation (6.6%Y/Y) remaining highly elevated. So, also given significant uncertainties surrounding the extent of tightness in the labour market, the BoE's policy statement seems likely to repeat its concerns that the risks to the inflation outlook remain skewed to the upside. The MPC will therefore also again underscore that "monetary policy is likely to need to be restrictive for an extended period of time". And so, pushing back against market pricing, which is now consistent with a first rate cut next June, it will maintain a tightening bias, restating that "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures." Indeed, as in November, we suspect that three MPC members will again vote for a hike this month. In terms of economic data, tomorrow will bring the RICS residential survey, which is likely to illustrate expectations of a further downwards adjustment in house prices as demand remains stifled by high borrowing costs.

UK: Construction output



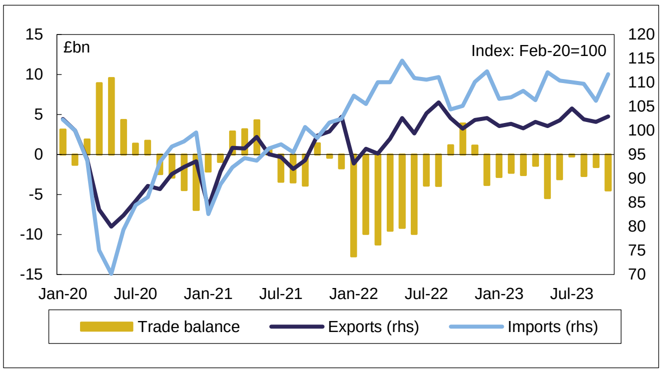
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Output PMIs



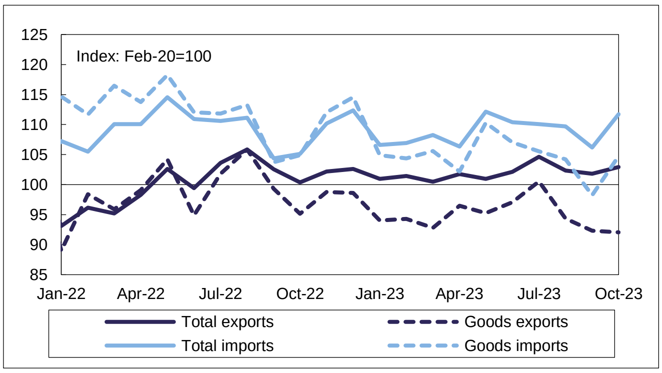
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Trade balance, exports & import values



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Export & import volumes



Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area		Industrial production M/M% (Y/Y%)	Oct	**-0.7 (-6.6)**	_-0.5 (-4.7)_	-1.1 (-6.9)	-1.0 (-6.8)
UK		GDP M/M% (3M/3M/)	Oct	**-0.3 (0.0)**	-0.1 (0.1)	0.2 (0.3)	-
		Industrial production M/M% (Y/Y%)	Oct	**-0.8 (0.4)**	-0.1 (1.1)	0.0 (1.5)	-
		Manufacturing production M/M% (Y/Y%)	Oct	**-1.1 (0.8)**	0.0 (1.9)	0.1 (3.0)	-
		Index of services M/M% (3M/3M%)	Oct	**-0.2 (0.1)**	-0.1 (0.2)	0.2 (-0.1)	-
		Construction output M/M% (Y/Y%)	Oct	**-0.5 (1.1)**	-0.2 (1.4)	0.4 (2.8)	-
		Trade (goods) balance £bn	Oct	**-4.5 (-1.7)**	- (-14.1)	-1.6 (-14.3)	-

Auctions

Country		Auction
Italy		sold €3bn of 3.85% 2026 bonds at an average yield of 3.24%
		sold €3bn of 4.00% 2030 bonds at an average yield of 3.63%
UK		sold £2bn of 3.75% 2053 bonds at an average yield of 4.43%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ _Daiwa forecast_	Previous
Euro area		13.15	ECB Deposit Rate %	Dec	_4.00_	4.00
Spain		08.00	Final HICP (CPI) Y/Y%	Nov	_3.2 (3.2)_	3.5 (3.5)
UK		00.01	RICS house price balance %	Nov	-58	-63
		12.00	BoE Bank Rate %	Dec	_5.25_	5.25

Auctions and events

Country		GMT	Event
Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds post-meeting press conference
UK		12.00	BoE monetary policy decision, statement and minutes published
		12.00	BoE Agents' summary of business conditions – Q423

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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