Investec
Investec Bank plc (UK)

Week commencing Monday 5 December 2016

Economics

Investec Economics

The week ahead: Monday 5 December 2016

- Next week will open in the wake of two weekend votes which could provide an important steer on the direction of political momentum in Europe ahead of a year of key European elections. On Sunday Italy votes on its constitutional reform referendum; polling has pointed firmly to a 'no' vote which could push PM Matteo Renzi into resigning. Our detailed thoughts on the ramifications of such a vote are published in our note (**please click here**), including on possible implications for Monte Dei Paschi Di Siena's capital raise. The Austrian Presidential race re-run due the same day could also be significant because the far-right candidate Norbert Hofer came a close second in the initial vote. Earlier this year Mr Hofer suggested he would like Austria to hold an EU referendum 'if the EU failed to refocus on its original role as an economic and trade alliance within a year'. Most recently though Mr Hofer has been more guarded in what he might press for (the President's role is largely ceremonial), admitting that it would currently be damaging for Austria to leave the EU.

- The focus on the Eurozone will continue through the week with Euro area finance ministers meeting Monday to discuss Greece's second review (of its third bailout) with the aim of signing off on Greece's next aid tranche. Later in the week the ECB gathers for a crunch meeting, with the Governing Council likely to decide on whether to extend the QE programme's €80bn per month purchases beyond March; we forecast an extension through to September 2017 as detailed in our preview below. The ECB will also publish updated economic forecasts.

- Domestically, politics can also be expected to take centre stage with the British Supreme Court hearing the government's appeal against the recent High Court ruling that would see the government having to seek parliamentary approval to trigger Brexit and invoke Article 50. If the Supreme Court upholds the decision, preventing the use of Royal Prerogative in this case, there is a risk that the start of the Brexit process could slip back from the planned March 2017 date. Currently the government maintains that it still thinks it could hit this date however. Note that the outcome of the 5-8 December hearing is not likely to come until January and that this could well be one of many legal discussions on Brexit over coming months. Indeed, it has been reported in the last week that there may be an upcoming legal debate on whether, when the UK leaves the EU, it automatically leaves the European Economic Area.

- Over in the US, the focus is likely to be on the final run of pre-FOMC meeting economic data. Following the non-farm payrolls numbers at the end of this week, next week we will see the ISM for the non-manufacturing sector released; the data will pick-up some of the post-election period after Donald Trump's victory. Other US economic releases due include preliminary consumer confidence for December (Michigan), the Fed's Labor Market Conditions index for November and October's factory orders. It would take a big downside surprise now to stop a 14 December Fed hike.

- Wrapping up globally, note there are two major central bank announcements expected. Both Australia's Reserve Bank and the Bank of Canada are expected to remain on hold, at 1.50% and 0.50% respectively. On the data front, from China we have the monthly trade and CPI numbers due out (November) whilst from Japan we will see 'final' Q3 GDP, initially estimated at +0.5% q/q. **VC**

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ECB preview: Figuring out how to do more QE

The ECB Governing Council (GC) meets next Thursday for its final policy meeting of 2016. It is an important one given that the central bank has taken a long, hard look at its policy options, including whether to loosen policy further, especially via its asset purchases (QE). The decision itself will be announced at GMT 12.45 and President Mario Draghi's press conference starts at GMT 13.30

In recent months the GC has shied away from lowering its interest rate corridor further. While the ECB has considered whether to deliver further stimulus, there has been increasing recognition that negative interest rates carry unintended consequences, especially in terms of imposing costs on the banking system. Accordingly it seems likely that the ECB will leave key interest rates unchanged. The deposit rate looks set to remain at -0.40%; the 'refi' rate at 0.0% and the marginal lending rate at +0.25% .

Hence the real debate concerns the GC's intentions on QE, where purchases are currently set at €80bn per month until March next year. A major question over much of 2016 has been whether the ECB's various rules over bond buying would result in shortages of available assets, which would constrain an extension of the programme. In brief, the most significant rules are: i) purchases of government securities must be broadly in line with the ECB's capital key (i.e. the proportion of countries' shareholdings in the central bank); ii) the ECB cannot buy bonds yielding below its deposit rate; iii) the sovereign bonds bought must be between 2-30 years' maturity; and iv) the ECB cannot own more than 33% of any individual sovereign issue.

This point has only recently been conceded by ECB members, Mr Draghi stating in September that the central bank had set up 'relevant committees' to find ways of overcoming potential scarcities. Our suspicion is that the ECB will aim to relax one or more of these rules, possibly iv), although this it is not clear. But one helpful factor has been the general rise in yields in recent weeks. For example since the end of September, 10-year Bund yields have risen in excess of 40bps, from -0.12% to +0.30%. This has resulted in a number of issues now meeting the yield criterion (i.e. ii) above). Our calculations suggest that in terms of the four largest economies (Germany, France, Italy and Spain), the universe of bonds *potentially* eligible for purchase is now €400bn higher. The GC will still be constrained by the ownership limit (rule iv) above) however. And of course a decline in yields could rule these bonds ineligible again. But it is at least helpful (although of course this represents a tightening in monetary conditions, the opposite to what the GC is trying to achieve).

Will the GC wish to extend QE? In our view yes. The recent run of activity indicators suggest little change to growth prospects, from September staff projections of 1.7% for this year and 1.6% next. Clearly deflation risks have eased. Hopes of a substantial Trump fiscal reflation in the US and the recent OPEC agreement to reduce oil production have lifted oil and other commodity prices. In this respect we note that market 5y/5y derived inflation expectations currently stand at 1.62% from lows of close to 1.25% during the summer. But a pick-up in recorded levels of underlying inflation remains absent. The headline rate currently stands at +0.6%, having spent more months in negative territory earlier this year. But the 'core' rate has remained stubbornly low at +0.8% in recent months. Indeed over the past three years core HICP inflation has exceeded 1.0% on just one occasion. Over the past couple of meetings the GC has concluded that the risks to its baseline scenario lie to the downside.

Hence we maintain our view that the will ECB announce a six month extension to its QE programme, to September 2017, maintaining the pace of bond buying at €80bn per month. This certainly chimes with the more recent mood music of various GC members' comments, which have hinted strongly at the need for continued accommodation. Our suspicion is that the ECB might tweak some of its self-imposed rules on which assets it can buy, but as mentioned above the higher yield curve removes some constraints in any case. Thereafter it is difficult to plot the path of asset purchases with any confidence. However our suspicion is that it could begin to taper the programme next September over a period of six, or perhaps three months.

One final point is that we expect Mr Draghi to be questioned on the implications of a potential 'no;' vote in the Italian referendum on Sunday. Newswire stories suggest that the ECB could be sympathetic towards the idea of purchases of Italian bonds in excess of the capital key benchmark, at least for a while, should there be a material sell-off in Italian bonds. He may choose to elaborate on this and offer some comments on how he views the prospects of the recapitalisation of banks in Italy. **PS**

Weekly Key Indicators

Indicator	Comment
Services PMI (Nov) 09:30 Monday 5 December Business activity — **Forecast** 53.8 — **Last** 54.5	• The services PMI climbed from 52.6 to 54.5 in October, the highest level seen since January. That was materially higher than most economists (including us) had expected. The strength was broad based, with gains seen in the indices for new orders, business expectations and employment. According to IHS Markit, the survey provider, the 'composite' UK PMI would be consistent with GDP growth of between 0.4% and 0.5% q/q. • We do note, however, that the input price reading saw its biggest rise in the survey's 20-year history, pointing to notable inflation pressures ahead as a result of recent falls in the pound. • Upcoming price pressures notwithstanding, we see the service sector in decent health for now. On the whole, businesses appear to have shrugged off the immediate Brexit shock. Indeed, the official data showed the service sector expanding by 0.8% in Q3. • We expect the business activity index to see a slight retracement following October's strength. However, our November forecast is for a relatively solid 53.8. **CH**
BRC Retail Sales Monitor (Nov) 00:01 Tuesday 6 December **Last** Total +2.4% (yoy) Like-for-like +1.7% (yoy)	• The BRC monitor pointed to total annual retail sales growth of +2.4% in October (+1.7% on a like-for-like basis). That is the highest pace of growth seen since January. • Because rates of inflation are beginning to rise, it is unsurprising that retail sales values growth is picking up. • But growth in sales volumes (i.e. retail spending adjusted for inflation) is holding up well, too. Households are continuing to spend following the UK's vote to leave the UK. And there is even a chance that, in anticipation of higher inflation around the corner, consumers are snapping up bargains while they still can. • Next year, we see post-EU referendum falls in sterling weighing significantly on household incomes – that should begin to depress the retail sector. Retailers will also face some tricky decisions about the extent to which they should pass higher import costs onto higher prices. • In the near term, however, we expect next week's BRC monitor to continue to show a fairly benign picture of the retail sector. **CH**
Industrial Production (Oct) **Manufacturing output (Oct)** 09:30 Wednesday 7 December Industrial production — **Forecast** +0.3% (+0.5% yoy) — **Last** -0.4% (+0.3% yoy) Manufacturing output — **Forecast** +0.2% (+0.8% yoy) — **Last** +0.6% (+0.2% yoy)	• Manufacturing output was seen 0.6% up on the month in September whilst the wider measure of industrial production was seen down 0.4%. That weakness in the industrial production measure was driven by softness in oil and gas as a result of some oil fields extending maintenance work into September. Indeed, mining and quarrying output decreased by 3.8% on the month. Manufacturing output on the other hand has been on a relatively solid run since August, with the plunge in the pound helping export focused producers. • Our expectation is that manufacturing output expands again in October, albeit by a bit less than the previous month. We also see the broader measure of industrial output rising and by a touch more than the manufacturing index, with some correction from the oil field maintenance factor pencilled in. Overall, we are forecasting a 0.2% monthly rise in manufacturing (0.8% yoy) and a 0.3% increase in wider industrial output (0.5% yoy). **VC**
RICS Housing Survey (Nov) 00:01 Thursday 8 December House price balance — **Forecast** +30 — **Last** +23	• The October 2016 RICS Residential Market Survey showed new buyer enquiries increasing again. On the supply side new instructions to sell remained in the red, helping to underpin prices. Indeed, the prices balance climbed to +23% (i.e. net respondents seeing an increase in prices) up from +13% in August. • Our expectation is that the activity picture is likely to have firmed further in the upcoming November figures, as evidenced in the recent BBA and Bank of England mortgage approval numbers. That is likely to have notched up the prices balance again in November; we are pencilling in +30%. • Note that the aggregate national picture masks the regional breakdown which shows prices continuing to fall in Central London and the North East, although the pace of decline eased noticeably across the latter. The London

data recorded an eighth consecutive negative monthly reading with 16% more respondents reporting a fall rather than a rise. **VC**

Trade in goods & services (Oct)
09:30 Friday 9 December

	Forecast	Last
Trade in goods	-£11.3bn	-£12.7bn
- ex oil and erratics	-£10.5bn	-£11.8bn
Goods & services trade	-£3.9bn	-£5.2bn

- September saw a hefty goods trade deficit of £12.7bn. At £11.8bn, the shortfall excluding oil and erratics items was a record high.
- Overall there are no signs that the decline in sterling, down by 16% in trade weighted terms over the past year, is having a tangible effect on rebalancing the economy.
- We suspect that this will remain the case in October. However last month's numbers were exceptionally poor and we are pencilling in a modest improvement this time. Our forecast is a deficit of £11.3bn for the headline trade in goods measure. We are factoring in a £7.4bn surplus for the services balance, which would result in a goods and services shortfall of a more respectable £3.9bn. **PS**

Constructio output (Oct)
09:30 Friday 9 December

	Last
Construction output	+0.3% (+0.2% yoy)

- Construction output rose by 0.3% on the month in September although the sector did not fare so well in Q3 as a whole – over the period activity declined by 1.1%, construction's worst quarter for four years.
- While we do not forecast this indicator each month, we do track it closely as it has a 6% weight in GDP and can therefore be a material influence.
- We should get a clue as to construction's direction from these numbers, specifically whether they confirm September's increase. However they are notoriously volatile. Our forecast for Q4 is for an improved performance i.e. a small expansion.
- Overall we are looking for a quarterly increase of 0.4% in Q4 GDP, which implies economic growth of 2.0% in 2016 as whole. **PS**

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The Week Ahead

Date	Venue	GMT		Indicator/event	For	Investec Forecast	Previous
Sun 4	IT		♦	Italian referendum on constitutional reform			
	AT			Austrian presidential election re-run			
Mon 5	UK	09:00		New car registrations	Nov		+1.4% (yoy)
		09:30	♦	Services PMI	Nov	53.8	54.5
			♦	Supreme Court appeal hearing on Article 50 (day 1 of 4, ruling expected Jan 2017)			
		17:30		BoE's Carney gives a speech at Liverpool John Moores University			
	JA	05:00		Consumer confidence	Nov		42.3
	CH	01:45	♦	Services PMI	Nov		52.4
	EU19	09:00		Composite PMI (final)	Nov		54.1 (p)
		09:00		Services PMI (final)	Nov		54.1 (p)
		10:00		Retail sales	Oct		-0.2% (+1.1% yoy)
				Eurogroup meeting of eurozone finance ministers			
	GE	08:55		Services PMI (final)	Nov		55.0 (p)
	FR	08:50		Services PMI (final)	Nov		52.6 (p)
	IT	08:45		Services PMI	Nov		51.0
	SP	08:00		Industrial production	Oct		-1.4% (+0.8% yoy)
		08:15		Services PMI	Nov		54.6
	US	14:45		Services PMI (final)	Nov		54.7 (p)
		15:00		ISM non-mfg index	Nov		54.8
		15:00		Labour Market Conditions index	Nov		0.7
Tue 6	UK	00:01		BRC Retail Sales monitor	Nov		+1.7% (l-f-l), +2.4% tot (yoy)
	AU	03:30		RBA announcement			unch (cash rate 1.50%)
	EU19	10:00		GDP (final)	Q3		+0.3% (+1.6% yoy) (p)
	EU27			Ecofin meeting of EU finance ministers			
	GE	07:00		New manufacturing orders	Oct		-0.6% (+2.6% yoy)
	US	13:30		Non-farm productivity (final)	Q3		+3.1% (saar) (p)
		13:30		Unit labor costs (final)	Q3		+0.3% (saar) (p)
		13:30		Trade balance	Oct		-$36.4bn
		15:00		Durable goods orders (final)	Oct		+4.8% (p)
		15:00		- ex transportation (final)	Oct		+1.0% (p)
		15:00		Factory orders	Oct		+0.3%
Wed 7	UK	08:30		Halifax house prices	Nov	-0.7% (+5.8% 3m yoy)	+1.4% (+5.2% 3m yoy)
		09:30	♦	Industrial production	Oct	+0.3% (0.5% yoy)	-0.4% (+0.3% yoy)
		09:30	♦	Manufacturing output	Oct	+0.2% (0.8% yoy)	+0.6% (+0.2% yoy)
	CH			Foreign exchange reserves	Nov		+CNY3120.7bn
	GE	07:00		Industrial production	Oct		-1.8% (+1.2% yoy)
	CA	15:00		Bank of Canada monetary policy decision			unch (0.50%)
Thu 8	UK	00:01		RICS Housing Survey	Nov	+30	+23 (house price balance)
				By-election in Sleaford and North Hykeham			
	JA	(23:50)		Trade balance	Oct		+¥642.4bn
		(23:50)		GDP (final)	Q3		+0.5% (+0.8% yoy) (p)
	CH		♦	Trade balance	Nov		+CNY325.25bn
				Exports, Imports	Nov		-3.2% (yoy), +3.2% (yoy)
	EU19	12:45	♦	ECB announcement – rates (& press conference)		unch (refi 0.0%, depo -0.4%)	unch (refi 0.0%, depo -0.4%)
			♦	ECB announcement - QE		QE extended 6 months	unch (QE €80bn/month)
	US	13:30		Weekly jobless claims	3-Dec		+15k (268k)
Fri 9	UK	09:30	♦	Trade in goods	Oct	-£11.3bn	-£12.7bn
		09:30		- ex oil and erratics	Oct	-£10.5bn	-£11.8bn
		09:30		Trade in goods and services	Oct	-£3.9bn	-£5.2bn
		09:30		Construction output	Oct		+0.3% (+0.2% yoy)
				Fitch to review UK credit rating			
	CH	01:30	♦	CPI	Nov		+2.1% (yoy)
	GE	07:00		Current account	Oct		+€24.2bn (r)
		07:00		Trade balance	Oct		+€24.2bn
	FR	07:45		Industrial production	Oct		-1.1% (-1.1% yoy)
	US	15:00	♦	Michigan consumer sentiment (prel.)	Dec		93.8

Further ahead

14 Dec	US	FOMC announcement
15 Dec	UK	MPC announcement
19 Jan	EU19	ECB announcement

Key

♦ Key event indicator