KBC Market Research Desk - Havenlaan 12, 1080 Brussel

Sunrise

Thursday, 03 December 2015

Rates: ECB ready to steal the show

The ECB massaged market expectations for new drastic action throughout the past six weeks. Can the ECB deliver even more than discounted, as Draghi often does? If not, a buy the rumour sell the fact reaction may occur. Dovish surprises like a larger deposit rate cut or others should still trigger bullish market reaction, especially at the front end.

Currencies: dollar holding strong going into ECB decision and Yellen testimony

Yesterday, a lower than expected CPI weighed on the euro. The dollar was supported by comments from Yellen confirming a December rate hike. Today, the ECB policy decision is key. The amount of the deposit rate cut will be key for the euro. In the Yellen testimony before the JEC we look out whether she gives a clear assessment on the recent rise of the dollar.

Calendar

Headlines

- Yesterday, **European equities** closed the trading session with modest losses. **US equities** had a weak trading day, as it slid down the whole day, S&P closed down -1.1% . Overnight, **Asian equities** are currently trading mixed, with Chinese equities outperforming.
- **S&P has cut the ratings of eight US global banks by one notch, as they see the likelihood that the US government would provide a bail-out, if needed, as uncertain.** The move comes after the Fed proposed a new TLAC-rule on banks.
- **Fed chairwoman Yellen said that policymakers needed "only" confidence that inflation would raise to the goal over the medium term to start the cycle.** She suggests that "actual progress" in inflation is needed for more rate hikes.
- **The Chinese Caixin composite PMI for November rose to 50.5, coming from 49.9 previous month.** This is the first time it broke back into the expansion zone since July, despite a slight decline of the **services PMI** (51.2).
- **The Japanese PMI composite remained stable at 52.3 in November**, indicating an expansion of the economy. However, the **services PMI declined a bit from 52.2 to 51.6 in November.**
- Commodities continued their fall yesterday, with **Brent Crude setting a new low at 42.43 $/barrel**. **Gold prices also ended -1.5% lower**, currently trading at lowest level in almost six years.
- Today the US calendar contains **the weekly jobless claims**, the **ISM Non-manufacturing** data for November and the **October factory orders**. In the **EMU**, the **retail sales** for October is up for release. The **ECB policy meeting** is key event. **Also interesting are speeches of Fed's Mester, Yellen and Fischer.**

Rates

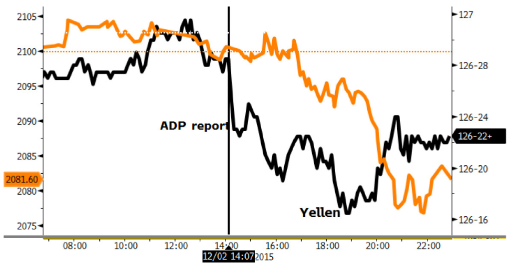
New record low for German 2- to 5-yr yields

German bonds end slightly higher, while US Treasuries lose moderate ground

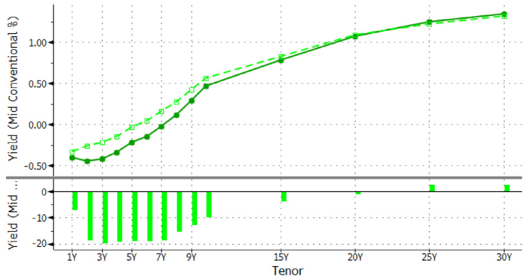
No changes in peripheral bond spreads

Global core bonds parted ways today. Economic data reflected why the monetary policies of the ECB and the Fed diverge. Weak EMU inflation data call for ECB easing action, while a strong US ADP employment report calls for Fed tightening action. In a daily perspective, the German yield curve shifted 0.3 bps (2-yr) to 1.3 bps (5-yr) lower. Changes on the US yields varied between +0.6 bps (30-yr) and +4.7 bps (5-yr). On **intra-EMU** bond markets, 10-yr yield spreads vs. Germany narrowed slightly (up to -2bps).

Fed chairwoman Yellen said yesterday that policymakers may need to have more than *just confidence* that inflation will pick up to raise rates **again after the lift-off.** For the lift-off, the guidance was that policymakers needed “only” confidence that inflation would raise to the goal over the medium term. She suggests now that *“actual progress”* in inflation towards goal is needed for more rate hikes after lift-off. This makes the forecast of a gradual tightening somewhat softer, at least unless inflation would rear its ugly head in which case the rate hikes might be faster. **Comments do suggest though that the lift-off will take place in December**. This “softer” turn of Yellen towards actual progress in inflation might be the basis of a compromise in the Committee with the doves, including 2 board members, who are concerned with low inflation.



T-Note future (black) & S&P future (orange): Treasuries hit following strong ADP report, little affected by Yellen and regaining some ground as equities and energy declines later on



German yield curve (21/10 vs. now): Since ECB signalled more easing at the Oct. meeting, the short end (till 7 yr) dipped about 20 bps, the 10 yr 10 bps while further out yields remained little changed.

ECB main topic on the calendar

Deposit rate decline?

QE extended?

Amount QE increased?

Scope QE enlarged?

TLTRO prolonged?

Quid forward guidance?

The **November Non-manufacturing ISM** is expected to decline from 59.1 to 58.0. We see some **downward risks** as the regional data have been weak, suggesting that the service sector has cooled off after October’s strong gain. The **October factory orders and weekly claims** are not expected to rock the markets. In the **eurozone**, the **October retail sales** are expected to have grown by 0.2% M/M, following a minimal decline of -0.1% M/M in September. We side with the consensus. **The ECB meeting is the key event. ECB president Draghi and his lieutenants have in the past month systemically raised market expectations. Can he match these expectations? For a full preview of the meeting (see KBC flash). Summarizing our views:** We expect a decline of the deposit rate by 10 bps to -0.30% and maybe the instauration of a second penalizing (lower) rate for bank’s excess liquidity that exceeds some level.

We expect that QE will be extended beyond September 2016, eventually even making it open-ended. The monthly amount of purchases will be raised by €20B to €80B and the scope of purchases will be broadened to local & regional official debt and maybe to corporate bonds or other debt products.

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Spain and France tap market

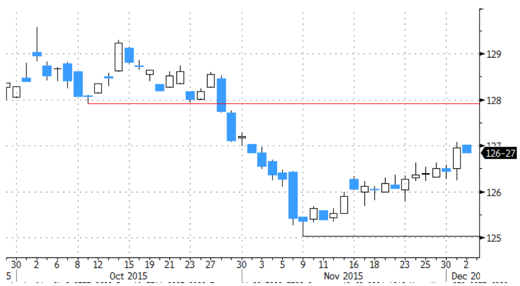
Today, Spain and France hold this week's only scheduled EMU bond auctions. The French debt agency concludes this year's issuance by tapping three off-the-run OAT's (2.25% May2024, 4.75% Apr2035 & 4.5% Apr2041) for €3.5-4.5B.This minor tap should be no problem at all. The Spanish treasury sells the on the run 5-yr Bono (1.15% Jul2020), 10-yr Obligacion (2.15% Oct2025) and 15-yr Obligacion (1.95% Jul2030) for €3-4B. The on the run 10- and 30-yr Obligacions trade rather rich on the curve. In combination with the upcoming general election, this could weigh somewhat on demand. This week's auctions will be supported by a €14.5B Italian redemption.

Today: Profit taking on Bund rally?

Overnight, most Asian stock markets trade lower, but losses are modest compared with WS yesterday. China outperforms and records some gains. Fed Yellen cleared the path for a December lift-off (see above), but the additional reaction lower of US Treasuries was limited. We expect a neutral opening for the Bund.

Today, the US eco calendar contains weekly claims, factory orders, the non-manufacturing ISM and more Fed speakers (Mester, Yellen, Fischer), **but it will be ECB president Draghi who steals the show!** We expect a 10 bps deposit rate cut, an increase of monthly purchases from €60 to €80B and an extension of the QE-programma beyond September 2016. **Rate markets are positioned for a very dovish outcome as well. Therefore, the additional positive impact might be limited in case of the outcome spelled out above.** We eventually might even see some buy-the-rumour, sell-the-fact in the Bund. **Dovish surprises like a larger deposit rate cut (or hints to extra cuts) or an open-ended QE-programme could trigger more market reaction:** Lower rates at the front end of the curve (deposit) and higher rates at the longer end of the curve (open-ended QE can lift inflation expectations). Overall, we thus believe that the Bund might fall prey to profit taking today. **In the US Treasury market, we put our sell-on-upticks approach on hold awaiting Friday's payrolls report.**

German Bund: countdown to ECB



US Note future (March contract!!): await the outcome of Yellen speech and US payrolls.

Currencies

USD losing ground slightly on poor US ISM

Euro in the defensive on soft EMU CPI

Dollar stays well bid as Yellen confirms December lift-off

On Wednesday, the balance on the currency market tilted in the disadvantage of the euro and in favour of the dollar. The EMU CPI was lower than expected, fuelling speculation of aggressive ECB easing today. On the dollar side of the story, the ADP labour market report was very strong. Later in the session, Fed's Yellen confirmed the intention for a December lift-off. The trade-weighted dollar touched a minor cycle top (100.51 area). EUR/USD also, touched a minor short term low in the 1.0550/55 area. At the same time, Yellen hinted that further hikes will depend on actual progress in inflation. This was slightly dovish suggesting a gradual rate hike cycle. The Fed beige book remained cautiously positive on the US economy and on wages, but didn't bring much new. The dollar eased after the initial Yellen spike. EUR/USD closed the day at 1.0615 (from 1.0633). USD/JPY ended the day at 123.24 (from 122.87).

Asian markets show no clear trend this morning.

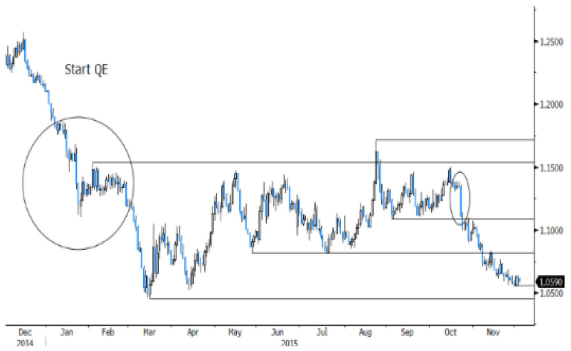
USD regains part of yesterday's losses.

This morning, most Asian equities traded with modest losses joining the decline in the US. The Chinese Caixin services PMI declined from 52.00 to 51.2. Even so, Chinese equities slightly outperformed the rest of the region. **The hint from Yellen on a December rate hike is weighing on commodities and commodity related assets.** The Aussie and the Kiwi dollar are trading off the recent highs, but hold up reasonably well. The dollar is holding strong against the euro and the yen. USD/JPY is changing hands in the 123.45 area. EUR/USD trades in the well-known 1.0585/90 area.

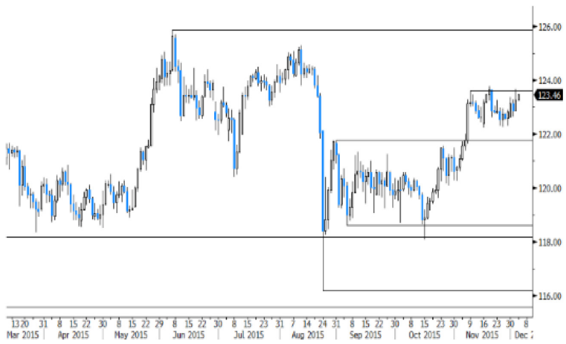
ECB policy decision and Yellen testimony key factors for currency trading

Policy divergence will be confirmed

Today, there are plenty of interesting eco data and events. In Europe, the final services PMI will be published and the ECB will hold its key policy meeting. In the US, the jobless claims, the factory orders and the Non-manufacturing ISM will be published. At CET 16.00, Yellen will testify before the Joined Economic committee. The ECB policy decision and the Yellen testimony are key for markets.
A substantial ECB easing is largely discounted in markets. For the technical factors **see our KBC flash report** and the fixed income part of this report.
The amount of the reduction in the deposit rate might be key for the currency. A further reduction of the deposit rate by more than 10 bp (-30% or lower level) might be an additional negative for the euro. In case off a cut by 10 bp or less, some short-term profit taking on euro shorts might be on the cards.



EUR/USD: holding near the recent lows ahead of the ECB meeting



USD/JPY nearing the short-term top

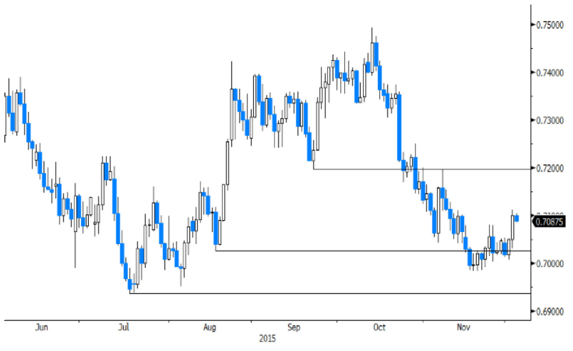
Regarding the speech of Yellen before the JEC, we expect **Yellen to hold the modestly hawkish tone from Yesterday's speech.** We look out whether she gives an assessment on the recent strength on the dollar. We expect any repositioning in the interest markets to occur at the long end of the curve. **The idea of ongoing policy divergence and substantial interest rate differentials at the short end of the curve won't change anytime soon**. A deeper negative deposit rate should cap the topside in EUR/USD. So, a short-term repositioning/rebound of the euro is possible e.g. in case of a 'small' cut in the deposit rate. Even in that scenario we expect the EUR/USD rebound to run into resistance quite soon. The 1.08/1.0830 is a first short-term resistance. After the ECB and Yellen, markets will also look forward to tomorrow's payrolls. After the strong ADP report, investors might still be a bit reluctant to be USD short going into the Payrolls.

Topside of the euro looks well protected going into the ECB policy decision

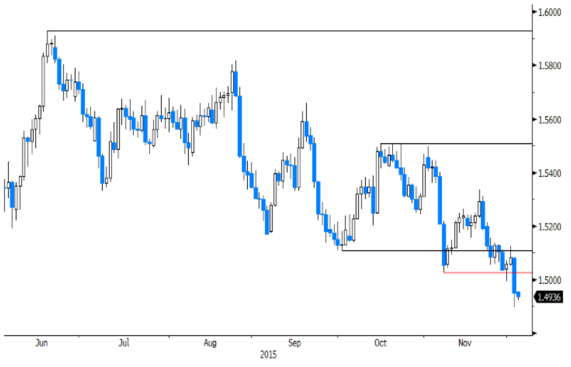
om a technical point of view, EUR/USD dropped below the 1.0809 support and ached the targets of the short-term multiple top formation in the low 1.0715 ea. With policy divergence between the Fed and the ECB still in place, we don't row against the EUR/USD downtrend, but the pace of the USD rally may slow. The post ECB QE lows in EUR/USD (1.0521/1.0458 area) are obvious targets on the charts. We maintain a EUR/USD sell-on upticks strategy for a retest of the cycle lows. For USD/JPY, the cycle tops in the 125.28/86 area came on the radar, but a test looks difficult short-term.

Cable hammered below the 1.50 barrier

On Wednesday, sterling performed again poorly, both against the euro and the dollar. The UK construction PMI was substantially weaker than expected (decline from 58.8 to 55.3, 58.5 was expected). This was a good enough reason for some additional sterling selling. EUR/GBP spiked temporarily to the 0.7065 area after the publication of the report, but dropped back to the 0.7030 area after the EMU CPI. However, this 'sterling rebound' was short-lived. EUR/GBP returned very soon north of the 0.7050 area, even as EUR/USD declined after the strong ADP report. Later in the session, the decline of cable even accelerated after the break below the 1.50 area. Cable underperformed EUR/USD in the post-Yellen moves. EUR/GBP closed the session at 0.7099 (from 0.7050).Cable ended the day with a big loss at 1.4951 (from 1.5082). **Today,** sterling traders look out for the UK Services PMI. A stabilisation at 55.00 (from 54.9) is expected. Over the previous days, the manufacturing and the construction measure were weaker than expected. The prospect of further ECB easing is also pushing BoE rate hike expectations further out in the future. A new disappointment in the services PMI might be an additional negative for sterling short-term. That said, in a longer term perspective, we don't see a good reason for a sustained rebound of the euro against sterling unless the ECB easing would be much less than expected..



EUR/GBP: off the recent lows



Cable: hammered below 1.50 barrier

Calendar

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Thursday, 3 December		Consensus	Previous
US			
14:30	**Initial Jobless Claims**	**270k**	**260k**
14:30	**Continuing Claims**	**2188k**	**2207k**
15:45	**Markit US Composite PMI (Nov F)**	**--**	**56.1**
15:45	**Markit US Services PMI (Nov F)**	**56.7**	**56.5**
16:00	**ISM Non-Manf. Composite (Nov)**	**58.0**	**59.1**
16:00	Factory Orders (Oct)	1.4%	-1.0%
16:00	Factory Orders Ex Trans (Oct)	--	-0.6%
16:00	**Durable Goods Orders (Oct F)**	**--**	**3.0%**
16:00	Durables Ex Transportation (Oct F)	--	0.5%
16:00	**Cap Goods Orders Nondef Ex Air (Oct F)**	**--**	**1.3%**
16:00	Cap Goods Ship Nondef Ex Air (Oct F)	--	-0.4%
Japan			
02:35	Nikkei Japan PMI Services (Nov)	A: 51.6	52.2
02:35	Nikkei Japan PMI Composite (Nov)	A: 52.3	52.3
China			
02:45	Caixin China PMI Composite	A: 50.5	49.9
02:45	Caixin China PMI Services	A: 51.2	52.0
UK			
10:30	Official Reserves Changes (Nov)	--	$16m
10:30	Markit/CIPS UK Services PMI (Nov)	55.0	54.9
10:30	Markit/CIPS UK Composite PMI (Nov)	55.0	55.4
EMU			
10:00	Markit Eurozone Services PMI (Nov F)	54.6	54.6
10:00	Markit Eurozone Composite PMI (Nov F)	54.4	54.4
11:00	**Retail Sales MoM/YoY (Oct)**	**0.2%/2.6%**	**-0.1%/2.9%**
13:45	**ECB Main Refinancing Rate**	**0.050%**	**0.050%**
13:45	**ECB Deposit Facility Rate**	**-0.300%**	**-0.200%**
13:45	**ECB Marginal Lending Facility**	**0.300%**	**0.300%**
Germany			
09:55	Markit Germany Services PMI (Nov F)	55.6	55.6
09:55	Markit/BME Germany Composite PMI (Nov F)	54.9	54.9
France			
07:30	ILO Unemployment Rate (3Q)	A: 10.6%	10.3%
09:50	Markit France Services PMI (Nov F)	51.3	51.3
09:50	Markit France Composite PMI (Nov F)	51.3	51.3
Italy			
09:45	Markit/ADACI Italy Services PMI (Nov)	53.9	53.4
09:45	Markit/ADACI Italy Composite PMI (Nov)	--	53.9
Spain			
09:15	Markit Spain Services PMI (Nov)	56.4	55.9
09:15	Markit Spain Composite PMI (Nov)	--	55.0
Sweden			
08:30	Swedbank/Silf PMI Services (Nov)	57.0	57.5
Events			
10:30	Spain - 1.15% Jul 2020 Bono, 2.15% Oct 2025 Obligacion, 1.95% Jul 2030 Obligacion, 1.8% Nov 2024 I/L Obligacion		
10:50	France - Eur 3.5-4bn; 2.25% May 2024, 4.75% Apr 2035, 4.5% Apr 2041 OATs		
11:03	Sweden - Sek 0.7bn 1% Jun 2025 I/L bond; Sek 0.3bn 0.125% Jun 2032 I/L bond, 3.75% Aug 2017 bond, 3.5% Jun 2022 bond		
14:30	**EMU - ECB Draghi holds press conference following policy meeting**		
14:40	**US - Fed's Mester Gives Opening Remarks at Financial Stability Conf**		
16:00	**US - Yellen Appears Before Congressional Joint Economic Committee**		
19:10	**US - Fed Vice Chair Fischer Speaks at Financial Stability Conference**		

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

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