A Busy Week in Europe

Last week, EU leaders finally adopted the post-pandemic recovery fund while the European Central Bank (ECB) eased monetary policy as previously signalled. Then this week, the ECB’s supervisory board lifted the ban of euro zone banks distributing dividends while UK and EU trade negotiators inched towards some form of agreement. What do these events mean for the European economy and what might be the impact on markets?

Last week’s European Council brought together the 27 EU leaders for a two-day summit. One of the key items on the agenda was the approval of the next multi-year EU budget of €1.1tn and the €750bn recovery package – also known as the Next Generation EU fund. The fund was launched at the July summit, but its formal approval had been held up by pushback from Poland and Hungary regarding provisions making disbursements from NGEU conditional on the respect of the rule of law.

Thanks to the compromise struck last week, the European Commission will be able to push ahead with the issuance of € 390bn in EU debt which will be jointly guaranteed by members, a first for the Union. The proceeds from the bonds will be distributed in the form of grants to member states, with the remainder of the package coming as loans. The €750bn total represents around 5.4% of EU GDP and its disbursements will be skewed towards those members most in need – Italy for example is set to receive around 10% of its GDP in total and Spain some 14% (their domestic support measures this year represented 3.6% and 2.9% of respective GDPS).

The ECB’s last meeting of the year brought no surprises – the Pandemic Emergency Purchase Programme was boosted by €500bn to €1.85tn and will now continue until March 2022 while the support measures for bank lending were increased by €300bn and extended until June 2022. With headline euro zone inflation falling to -0.3% year-on-year in November and the economy back in lockdown-induced recession in Q4, easy monetary policy is likely to remain in place for years to come.

Brexit negotiators are running out of time. The UK exited the EU on January 31 this year and the transition period – during which it remains part of the single market and customs union – will end on December 31. Yesterday, the European Parliament’s Conference of Presidents stated that an agreement on trade would have to be finalised by Sunday to enable the Parliament to organise an extraordinary session before year-end to approve the deal.

It does appear from press reports that negotiators have made progress on the remaining stumbling blocks – fishing rights, state aid provisions and governance – but as yet no final agreement is in sight. Of course, the EU has accustomed us over the years to last-minute deals just when one was least expected. Looking at sterling, which reached its high for the year yesterday against the dollar at 1.3585, it appears that traders are convinced that another eleventh-hour agreement will be struck.

**Bottom line.** The NGEU deal eases market concerns about euro zone breakup and reinforces our conviction that the euro will continue to gain ground next year. The ECB’s asset purchases will serve to keep bond yields low for both core and periphery euro zone borrowers, a positive for financial markets in 2021 and beyond. The resumption of dividend payments by euro zone banks is good news but should not hide the fact that flat yield curves and rising bad loan risks are lasting negatives for bank profitability. And finally, a Brexit trade deal may see sterling spike a bit higher, but the move should prove short-lived – whatever the terms of the agreement, trade with the EU (the UK’s main export market) will be handicapped next year.

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**Germany is better positioned than its neighbours**

*Public debt in % of GDP*

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**EUR/USD remains undervalued**

*EUR/USD exchange rate black, Purchasing Power Parity red*

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*Past performance should not be seen as a guarantee of future returns.*

All data taken from Bloomberg, Macrobond, (18/12/2020). In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document. CA0145/H2/2020
**OUR MACRO COMMENTS**

**This week and next**

**EUROZONE**
- The preliminary PMI surveys for December were much better than expected. Confidence in manufacturing rose to 55.5 while the services measure shot up from 41.7 to 47.3 as vaccine news buoyed hopes of a recovery in consumer spending. However, new lockdown restrictions could push the final figure lower.
- November’s final headline inflation saw prices fall -0.3% YoY while core inflation – excluding volatile items like food and energy – rose a modest 0.2%, both in line with initial estimates.

**UNITED KINGDOM**
- October’s unemployment rate inched higher to 4.9% as companies adjusted workforces to adapt to new lockdown restrictions.
- The initial services PMI figure for December moved back into expansion territory at 50.7 while the manufacturing survey improved further from 55.6 to 57.3.
- YoY inflation declined in November with headline prices only rising 0.3% from 0.7% previously while core inflation was up 1.1% after 1.5% in October.

**UNITED STATES**
- Initial jobless claims for the week ending December 12 continued to rise, reaching 885,000, well above expectations and the highest level in three months.
- December’s flash PMIs showed confidence in manufacturing almost unchanged at 56.5, while the services survey slipped from November’s 58.4 five-year high to a still robust 55.3.
- November industrial production rose 0.4% MoM, growth slowing from October’s downwardly revised 0.9%.

**ASIA & EMERGING**
- China’s November industrial production rose 7.0% YoY, back in line with the 2016-2019 pace, while retail sales continued to catch up, gaining 5.0% YoY after 4.3% in October.
- Japan’s quarterly Tankan survey of large manufacturers improved to -10 from -27 in Q3 on a strong rebound by auto makers.
- Industrial production in India jumped 3.6% YoY in October, well ahead of economists’ 1.1% forecast.

**Next week’s key events**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Per.</th>
<th>Prev.</th>
<th>Cons.</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 Dec</td>
<td>Consumer confidence</td>
<td>Dec</td>
<td>-17.6</td>
<td>-17.4</td>
</tr>
<tr>
<td>4 Jan</td>
<td>Manufacturing PMI (final)</td>
<td>Dec</td>
<td>53.8</td>
<td>55.5</td>
</tr>
<tr>
<td>23 Dec</td>
<td>Personal spending MoM</td>
<td>Nov</td>
<td>0.5%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>23 Dec</td>
<td>New home sales MoM</td>
<td>Nov</td>
<td>-0.3%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>30 Dec</td>
<td>Nationwide house prices YoY</td>
<td>Dec</td>
<td>6.5%</td>
<td>6.4%</td>
</tr>
<tr>
<td>4 Jan</td>
<td>Manufacturing PMI (final)</td>
<td>Dec</td>
<td>55.6</td>
<td>57.3</td>
</tr>
<tr>
<td>24 Dec</td>
<td>Tokyo core inflation YoY</td>
<td>Dec</td>
<td>-0.4%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>30 Dec</td>
<td>China NBS manufacturing PMI</td>
<td>Dec</td>
<td>52.1</td>
<td>51.9</td>
</tr>
</tbody>
</table>

Sources: DataStream, Bloomberg, 18 December 2020. Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, PMI = Purchasing Manager’s Index.

**Our 3-month targets for currencies and commodities**

<table>
<thead>
<tr>
<th>Currency</th>
<th>Thursday close</th>
<th>3mth target</th>
</tr>
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<tbody>
<tr>
<td>EUR/USD</td>
<td>1.23</td>
<td>1.21</td>
</tr>
<tr>
<td>GBP/USD</td>
<td>1.36</td>
<td>1.35</td>
</tr>
<tr>
<td>EUR/CHF</td>
<td>1.09</td>
<td>1.09</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>103.1</td>
<td>104.0</td>
</tr>
<tr>
<td>Brent</td>
<td>$51.6</td>
<td>$45.0</td>
</tr>
<tr>
<td>Gold (oz.)</td>
<td>$1888</td>
<td>$1800</td>
</tr>
</tbody>
</table>

Forecast figures are not a reliable indicator of future performance.

NB No changes to our 3-month targets this week.
THIS WEEK’S Q&A

What is the outlook for the Australian dollar against USD and EUR?

The Australian economy looks set to benefit from being in the right place at the right time. The country’s containment of the pandemic has been superior to both the US and major European economies – Australia has suffered 11 cases per 10,000 inhabitants versus 286 in the UK, 369 in France and 525 in the US. Its success has been aided by its location, far removed from other major concentrations of population and, as an island, easily able to close its borders. It is further advantaged by being in the Southern hemisphere – vaccines will already be widely available by the time Australia enters its winter season.

Moreover, Australia continues to benefit from its location in the South Pacific, which has enabled the country to benefit directly from rapid growth in China and across the Asia-Pacific in recent decades, given its great wealth of natural resources. In addition, Australia was recently a signatory to the Regional Comprehensive Economic Partnership trade pact with 14 other regional economies (the 10 ASEAN states, China, Japan, South Korea and New Zealand).

As a major commodity exporter, Australia stands to benefit from the global cyclical recovery we expect from mid-2021 onwards. Moreover, we expect the Biden administration to take a less confrontational approach with China and to prefer multilateral engagement over bilateral punitive tariffs. The resulting easing in trade tensions and pickup in export volumes will be of direct benefit to Australia.

All of this means that business confidence has recovered sharply in recent months. The flash December Purchasing Manager Index surveys showed confidence in manufacturing businesses at 56.0 versus 55.8 last month – 50 points marks the dividing line between expansion and contraction in activity – while the services index hit 57.4 versus 55.1. Our economists expect the Australian economy to continue its rapid recovery from its first recession in almost 30 years and to have regained its pre-crisis level by mid-2021.

The Reserve Bank of Australia has cut its key rates to 0.1% and looks unlikely to tighten policy before other G10 central banks begin to tighten theirs. The RBA also launched its first ever asset purchase programme totalling AUD100bn. This is designed to keep bond yields under control and to provide forward guidance of easy financial conditions in the quarters to come. The RBA started by targeting 3-year bond yields at 25bp in March and has since lowered this to 10bp. This means that the entire AUD yield curve trades very close to USD rates, removing its previous attraction as a “carry” currency. On the other hand, the easy monetary stance looks likely to further fuel the economic recovery.

The Australian economy also benefits from relatively robust fundamentals. Its budget deficit should reach 10% of GDP this year versus 14% in the US, taking next year’s debt to GDP ratio to 69% versus 129%. Australia also runs a healthy current account surplus of +2.0% of GDP whereas the US will run a 2.5% deficit this year. Finally, the AUD ranks as relatively cheap against the USD – the OECD estimate of purchasing power parity, a measure of fair value, is at 1.440 at present, well above today’s 0.762.

**Bottom line.** We expect the AUD to gain further ground against the greenback next year, reaching 0.770 in 3 months and 0.795 by year-end. Against the euro, this means targets of 1.57 in 3 months and 1.56 by end-2021.
**MARKET PERFORMANCE**

### Interest rates

<table>
<thead>
<tr>
<th></th>
<th>Last</th>
<th>1wk</th>
<th>3mth</th>
<th>YTD</th>
<th>12mth</th>
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<tbody>
<tr>
<td>EONIA (EUR)</td>
<td>-0.47%</td>
<td>0 bp</td>
<td>0 bp</td>
<td>-3 bp</td>
<td>-2 bp</td>
</tr>
<tr>
<td>3mth Euribor (EUR)</td>
<td>-0.54%</td>
<td>1 bp</td>
<td>-4 bp</td>
<td>-16 bp</td>
<td>-14 bp</td>
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<tr>
<td>3mth Libor (USD)</td>
<td>0.24%</td>
<td>2 bp</td>
<td>1 bp</td>
<td>-167 bp</td>
<td>-166 bp</td>
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<tr>
<td>3mth Libor (GBP)</td>
<td>0.04%</td>
<td>0 bp</td>
<td>-2 bp</td>
<td>-75 bp</td>
<td>-76 bp</td>
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<tr>
<td>10-year US Treasury bond</td>
<td>0.93%</td>
<td>2 bp</td>
<td>25 bp</td>
<td>-98 bp</td>
<td>-96 bp</td>
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<tr>
<td>10-year German bond</td>
<td>-0.58%</td>
<td>2 bp</td>
<td>-9 bp</td>
<td>-19 bp</td>
<td>-29 bp</td>
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<tr>
<td>10-year French bond</td>
<td>-0.34%</td>
<td>2 bp</td>
<td>-10 bp</td>
<td>-46 bp</td>
<td>-34 bp</td>
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<tr>
<td>10-year UK bond</td>
<td>0.29%</td>
<td>8 bp</td>
<td>10 bp</td>
<td>-54 bp</td>
<td>-48 bp</td>
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### Credit

<table>
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<tr>
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<th>3mth</th>
<th>YTD</th>
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</thead>
<tbody>
<tr>
<td>BAML EUR Corp. IG</td>
<td>-0.1%</td>
<td>1.8%</td>
<td>2.7%</td>
<td>2.3%</td>
</tr>
<tr>
<td>BAML EUR Corp. HY</td>
<td>0.1%</td>
<td>4.2%</td>
<td>2.7%</td>
<td>3.0%</td>
</tr>
<tr>
<td>BAML GBP Corp. IG</td>
<td>-0.5%</td>
<td>2.4%</td>
<td>8.3%</td>
<td>7.9%</td>
</tr>
<tr>
<td>BAML US Corp. IG</td>
<td>0.1%</td>
<td>1.7%</td>
<td>9.2%</td>
<td>9.3%</td>
</tr>
<tr>
<td>BAML US Corp. HY</td>
<td>0.3%</td>
<td>4.9%</td>
<td>5.5%</td>
<td>5.9%</td>
</tr>
<tr>
<td>BAML Global EM Sov. External Plus</td>
<td>1.0%</td>
<td>4.7%</td>
<td>5.6%</td>
<td>6.3%</td>
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### Exchange rates

<table>
<thead>
<tr>
<th></th>
<th>Last</th>
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<th>3mth</th>
<th>YTD</th>
<th>12mth</th>
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<tbody>
<tr>
<td>EUR/USD</td>
<td>1.23</td>
<td>1.1%</td>
<td>3.5%</td>
<td>9.4%</td>
<td>10.0%</td>
</tr>
<tr>
<td>EUR/CHF</td>
<td>1.09</td>
<td>0.9%</td>
<td>0.8%</td>
<td>0.0%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>GBP/USD</td>
<td>1.36</td>
<td>2.2%</td>
<td>4.7%</td>
<td>2.4%</td>
<td>3.5%</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>103.1</td>
<td>-1.1%</td>
<td>-1.6%</td>
<td>-5.1%</td>
<td>-5.8%</td>
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<tr>
<td>USD/BRL</td>
<td>5.06</td>
<td>-0.6%</td>
<td>-3.5%</td>
<td>25.8%</td>
<td>24.2%</td>
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<tr>
<td>USD/CNY</td>
<td>6.53</td>
<td>-0.2%</td>
<td>-3.4%</td>
<td>-6.2%</td>
<td>-6.6%</td>
</tr>
<tr>
<td>USD/RUB</td>
<td>72.9</td>
<td>-0.1%</td>
<td>-2.9%</td>
<td>17.8%</td>
<td>16.9%</td>
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### Government bonds*

<table>
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<tr>
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<th>12mth</th>
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<tbody>
<tr>
<td>United States (3-7yr)</td>
<td>0.0%</td>
<td>0 bp</td>
<td>-0.3%</td>
<td>6.9%</td>
</tr>
<tr>
<td>United Kingdom (3-7yr)</td>
<td>-0.3%</td>
<td>-4 bp</td>
<td>-0.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Germany (3-7yr)</td>
<td>-0.2%</td>
<td>0 bp</td>
<td>0.0%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Japan (3-7yr)</td>
<td>0.0%</td>
<td>-8 bp</td>
<td>0.0%</td>
<td>-0.1%</td>
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### Equities*

<table>
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<tr>
<th></th>
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<th>1wk</th>
<th>3mth</th>
<th>YTD</th>
<th>12mth</th>
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<tbody>
<tr>
<td>MSCI AC World</td>
<td>642</td>
<td>1.7%</td>
<td>13.1%</td>
<td>16.0%</td>
<td>17.2%</td>
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<tr>
<td>Eurostoxx 50</td>
<td>3 561</td>
<td>1.1%</td>
<td>7.6%</td>
<td>-2.4%</td>
<td>-2.4%</td>
</tr>
<tr>
<td>DAX</td>
<td>13 667</td>
<td>2.8%</td>
<td>3.5%</td>
<td>3.2%</td>
<td>2.9%</td>
</tr>
<tr>
<td>SCA 40</td>
<td>5 549</td>
<td>0.0%</td>
<td>10.4%</td>
<td>5.0%</td>
<td>4.9%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>3 722</td>
<td>1.5%</td>
<td>11.3%</td>
<td>17.3%</td>
<td>18.8%</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>6 551</td>
<td>0.6%</td>
<td>9.0%</td>
<td>-10.3%</td>
<td>-10.0%</td>
</tr>
<tr>
<td>CSI 300</td>
<td>10 540</td>
<td>0.4%</td>
<td>0.4%</td>
<td>2.8%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Topix</td>
<td>1 793</td>
<td>0.9%</td>
<td>10.4%</td>
<td>6.5%</td>
<td>5.1%</td>
</tr>
<tr>
<td>IBOV Brazil</td>
<td>118 401</td>
<td>2.8%</td>
<td>18.3%</td>
<td>2.4%</td>
<td>5.1%</td>
</tr>
<tr>
<td>MICEX Russia *</td>
<td>3 283</td>
<td>0.8%</td>
<td>10.5%</td>
<td>7.8%</td>
<td>8.9%</td>
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<tr>
<td>MSCI EM</td>
<td>1 273</td>
<td>1.5%</td>
<td>15.3%</td>
<td>16.8%</td>
<td>18.4%</td>
</tr>
<tr>
<td>SENSEX30 India</td>
<td>46 890</td>
<td>2.1%</td>
<td>20.5%</td>
<td>15.1%</td>
<td>14.8%</td>
</tr>
<tr>
<td>Hang Seng (H-K)</td>
<td>26 678</td>
<td>1.0%</td>
<td>9.8%</td>
<td>-2.3%</td>
<td>-1.1%</td>
</tr>
<tr>
<td>Shanghai Composite</td>
<td>3 405</td>
<td>0.9%</td>
<td>4.1%</td>
<td>11.6%</td>
<td>12.7%</td>
</tr>
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### Commodities

<table>
<thead>
<tr>
<th></th>
<th>Last</th>
<th>1wk</th>
<th>3mth</th>
<th>YTD</th>
<th>12mth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brent</td>
<td>$51.6</td>
<td>2.4%</td>
<td>18.9%</td>
<td>-22.2%</td>
<td>-22.0%</td>
</tr>
<tr>
<td>Gold</td>
<td>$1 888</td>
<td>2.9%</td>
<td>-3.1%</td>
<td>24.2%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Copper</td>
<td>$7 900</td>
<td>0.5%</td>
<td>16.1%</td>
<td>28.5%</td>
<td>28.0%</td>
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</tbody>
</table>

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Source: DataStream, on 17 December 2020.

1 wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7-year returns. Figures are rounded.
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