

Euro wrap-up

Overview

- Bunds were little changed after Germany's government confirmed an extension of its pandemic containment measures, but BTPs made losses despite the survival of Italian PM Conte in yesterday evening's Senate confidence vote.
- Gilts made modest losses as the latest UK inflation data surprised on the upside.
- Thursday will bring the latest monetary policy announcement from the ECB along with survey indicators of euro area consumer confidence, French and UK business sentiment and UK credit conditions.

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Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.718	-0.001
OBL 0 10/26	-0.724	-0.005
DBR 0 02/31	-0.530	-0.001
UKT 1¾ 09/22	-0.126	+0.011
UKT 0% 06/25	-0.036	+0.011
UKT 4¾ 12/30	0.300	+0.013

*Change from close as at 4:00pm GMT.
Source: Bloomberg

Euro area

Lower clothes and food prices offset higher prices of services and energy

There were no surprises from the euro area's final December inflation figures which by and large matched the flash estimates. So, headline inflation remained unchanged in December at -0.3%Y/Y for a fourth month in a row. And the core CPI measure was similarly unchanged at the series low of 0.2%Y/Y for a fourth month. The inertia in those main rates, however, masked offsetting changes in the various components. As flagged by the preliminary release, prices of non-energy industrial goods fell 0.4%M/M, the biggest December drop on the series, to leave the annual rate similarly at a record low of -0.5%Y/Y. The additional detail published today showed that a key driver was clothing inflation, which fell 1.3ppt to -2.2%Y/Y, the weakest since 2011. In contrast, similarly in line with the flash estimate, inflation of services edged up 0.1ppt to a four-month high of 0.7%Y/Y. The detail published today revealed that a range of components affected by the pandemic – including inflation of package holidays, accommodation and recreation – contributed to the rise. We caution, however, that, as in November, 20% of services prices (and 11% of all prices) were imputed by the statisticians. In terms of non-core items, prices of food, alcohol and tobacco fell 0.4%M/M, also a record decline for December. And that resulted in a drop of 0.6ppt in the annual rate of increase to 1.3%Y/Y, the lowest since February 2018. In contrast, energy prices rose 1.6%M/M, the most in six months, to push the annual rate of increase up 1.4ppts to -6.9%Y/Y, the highest since March.

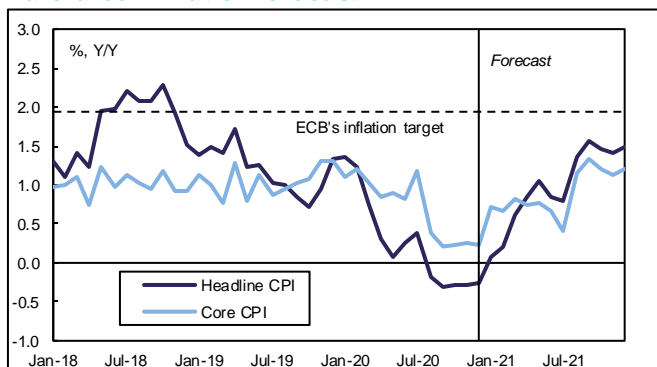
Inflation to rise back above zero in January and move gradually higher throughout 2021

While inflation was extremely low and stable at the end of 2020, a turning point has now been reached. Headline euro area inflation will rise back above zero percent in January due to higher oil prices, the reversal of the German temporary VAT cut and also the impact of the German carbon tax on domestic energy bills. And base effects from past shifts in prices of fuel and many other items affected by the pandemic should continue to see inflation push higher as the year goes on, particularly if – as we currently forecast – we see a gradual normalization of activity from the second half of 2021 in response to the (admittedly so far disappointingly slow) vaccine programmes. So, like the ECB, we expect headline inflation to end the year close to 1½%Y/Y, with core inflation around 1¼%Y/Y. Thereafter, however, in the absence of further pressure from energy prices, we expect both headline and core inflation to ease back a touch before levelling off through 2022 at levels well below the ECB's inflation aim of close to 2%Y/Y.

The day ahead in the euro area

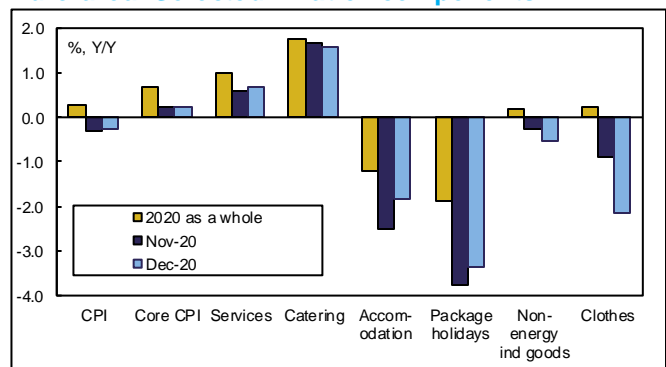
The conclusion of the ECB's Governing Council meeting tomorrow is likely to be uneventful, not least given [last month's decision](#) to extend its monetary policy support into 2022. There will clearly be no change to any of the main policy

Euro area: Inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Selected inflation components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

parameters or the forward guidance, which leaves the door open to additional easing. So, the focus of the post-meeting press conference is likely to be the economic outlook, not least in light of the recent intensification of the pandemic and extension of national lockdown measures. Indeed, with the daily number of deaths from covid-19 in Germany having yesterday risen to a new high, Chancellor Merkel last night confirmed a further extension of the closure of non-essential retail and other consumer-facing services to 14 February, with the possibility of additional tightening of measures (including tighter border controls) to come. Judging from Christine Lagarde's comments last week, however, she might insist tomorrow that the ECB's economic projections, published last month, remain credible. In our opinion, however, its forecast of positive GDP growth in the current quarter appears overoptimistic while slow progress implementing vaccine programmes poses a risk to the outlook for later in the year. Meanwhile, not least given the record weakness in inflation of non-energy industrial goods confirmed in today's consumer price data, we expect the ECB to reiterate that it will "continue to monitor developments in the exchange rate with regard to their possible implications for the medium-term inflation outlook".

Data-wise, tomorrow sees the release of the flash Commission estimate of euro area consumer confidence for January. Given the intensification of the pandemic, the consumer confidence indicator is expected to fall a little more than 1pt to -15.0. Meanwhile, at the country level, the French Insee business confidence survey for January is also due along with Italian industrial orders and sales data for November and Spanish trade figures for the same month.

UK

Inflation surprises on the upside in December

Having surprised on the downside in November, UK inflation did the opposite last month, with the headline rate rising 0.3ppt to 0.6%Y/Y, to return to the average level of the previous six months. Likewise, core inflation rose 0.3ppt to 1.4%Y/Y, also matching the average of the prior six months. Once again, a key driver of the volatility was prices of clothing, for which the respective inflation rate reversed roughly half of its decline the prior month, rising 1.9ppts in December to -1.8%Y/Y. In addition, higher inflation of transport services (up 3.8ppt to 7.2%Y/Y on the back of higher fares, partly due to the change in the timing of the sample) and recreation (up 0.7ppt to 2.6%Y/Y) also made significant contributions to the rise in the headline rate. In contrast, inflation of energy was broadly stable (-8.5%Y/Y). As in the euro area, food inflation fell back sharply, dropping 0.8ppt to -1.4%Y/Y, although a sharp jump in tobacco prices provided some offset.

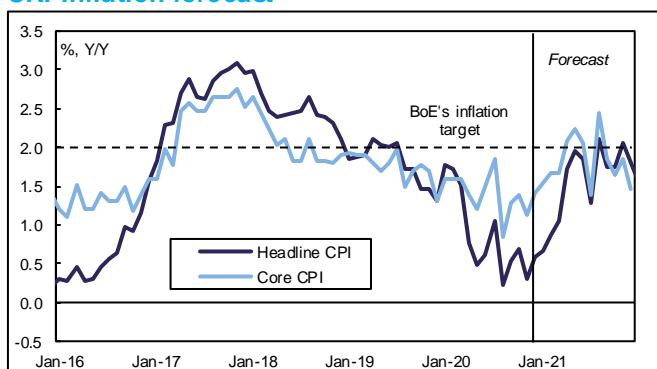
Plenty of uncertainties but inflation to jump above 1½%Y/Y in Q2

Looking ahead, the near-term outlook for UK inflation is more uncertain than usual. The intensification of the pandemic and tightening of containment measures at the start of the year might be expected to add some downwards pressure. A reweighting of the components in the inflation basket might also contribute negatively, as could recent sterling strengthening. But the extra costs faced by businesses due to Brexit are likely to provide an upwards impulse, particularly to prices of imported items and goods containing a large share of imported components. On balance, we expect inflation to continue to move broadly sideways in Q1. But inflation will take a step up in Q2. Energy inflation will jump due to an increase in Ofgem's tariff cap for electricity and natural gas prices in April as well as base effects associated with last year's plunge in oil prices. In addition, last summer's cut in the VAT rate for hospitality and tourism, by 15ppts to 5%, will reverse in April. Food inflation is also likely to contribute positively. So, for some months this year, inflation will likely rise above 2.0%Y/Y. And we now expect full-year inflation to come in above 1½%Y/Y, reducing pressure on the BoE to add extra stimulus.

The day ahead in the UK

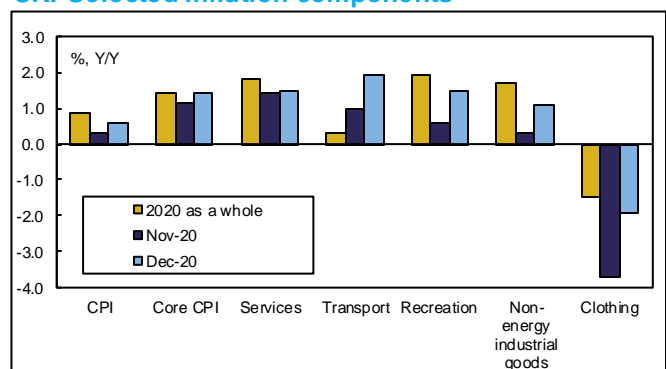
Tomorrow sees the release in the UK of the CBI industrial trends survey for January. Last month, the survey revealed that firms expect output to fall at a modest pace in Q121, although the rollout of the Covid vaccine is likely to bring hope that conditions for manufacturers will improve in coming months. In other news, the BoE will publish its Credit Conditions Survey for Q420.

UK: Inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected inflation components









Source: Refinitiv and Daiwa Capital Markets Europe Ltd.


European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 CPI (Core CPI) Y/Y%	Dec	-0.3 (0.2)	-0.3 (0.2)	-0.3 (0.2)	-
Germany	 PPI Y/Y%	Dec	0.2	-0.4	-0.5	-
Spain	 House transactions Y/Y%	Nov	1.9	-	-13.3	-
UK	 CPI (Core CPI) Y/Y%	Dec	0.6 (1.4)	0.5 (1.3)	0.3 (1.1)	-
	 PPI input prices (output prices) Y/Y%	Dec	0.2 (-0.4)	- (-0.7)	-0.5 (-0.8)	-0.3 (-0.6)
	 House price index Y/Y%	Nov	7.6	-	5.4	5.9











Auctions

Country	Auction
Germany	 sold €1.264bn of 0% 2050 bonds at an average yield of -0.13%












Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
EMU	12.45	 ECB main refinancing rate %	Jan	<u>0.00</u>	0.00
	12.45	 ECB marginal lending facility %	Jan	<u>0.25</u>	0.25
	12.45	 ECB deposit facility rate %	Jan	<u>-0.50</u>	-0.50
	15.00	 European Commission consumer confidence	Jan	-15	-13.9
France	07.45	 INSEE business confidence	Jan	92	91
	07.45	 INSEE manufacturing confidence (production output)	Jan	94 (-3)	93 (-4)
Italy	09.00	 Industrial orders M/M% (Y/Y%)	Nov	-	3.0 (1.2)
	09.00	 Industrial sales M/M% (Y/Y%)	Nov	-	2.2 (-1.7)
Spain	09.00	 Trade balance €bn	Nov	-	0.6
UK	11.00	 CBI industrial trends survey, total orders (business optimism)	Jan	-35 (-)	-25 (0)

Auctions and events

EMU	12.45	 ECB monetary policy announcement
	13:30	 ECB President Lagarde holds press conference
France	09.50	 Auction: 0% 2024 bonds
	09.50	 Auction: 0.75% 2028 bonds
	10.50	 Auction: €2.5bn of 0.1% 2031 index-linked bonds
Spain	09.45	 Auction: 0% 2026 bonds
	09.45	 Auction: 0.8% 2027 bonds
	09.45	 Auction: 1.85% 2035 bonds
	09.45	 Auction: 1.2% 2040 bonds
UK	09.30	 BoE publishes Credit conditions survey Q420
	10.00	 Auction: £3.25bn of 0.125% 2024 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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