Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds were little changed even as the flash estimates of German inflation in January surprised significantly on the upside while the deterioration in the Commission's economic sentiment survey was not as marked as feared.
- Gilts followed USTs lower on a quiet day for UK economic news.
- Friday will bring the first estimates of Q4 GDP in Germany, France and Spain, as well as flash Spanish inflation data for January.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.757	-0.007
OBL 0 10/26	-0.758	-0.004
DBR 0 02/31	-0.544	+0.005
UKT 1¾ 09/22	-0.125	+0.017
UKT 0⅝ 06/25	-0.049	+0.010
UKT 4¾ 12/30	0.283	+0.016

*Change from close as at 4:30pm GMT.
Source: Bloomberg

Euro area

German inflation jumps further than expected in January

German inflation was always bound to leap at the start of the year due not least to the reversal of the temporary 3ppt cut in the main VAT rate (to 16%) and 2ppt cut in the reduced VAT rate (to 2%) in place from 1 July through to the end of last year. However, today's flash data for January were even stronger than expected, with prices rising by more than would have been implied merely by those tax changes. Indeed, the EU-harmonised HICP measure jumped a whopping 2.3ppts – the most in any single month since the introduction of the euro – to 1.6%Y/Y, the highest rate since February. With the increase in the HICP measure accentuated by changes to the weights used in the calculation, the rise in inflation on the national measure of 1.3ppts to 1.0%Y/Y was not quite so marked but sizeable nonetheless. The German statistical institute Destatis noted that the effects of the new carbon tax and increase in the minimum wage likely compounded the rise in inflation caused by the end of the VAT cut.

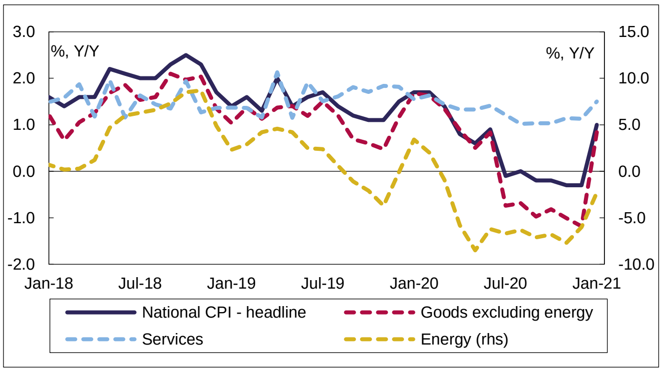
Reversal of VAT cut and other one-offs to blame, but rate-cut bets look even less reasonable now

The details published on the national basis showed that German inflation rose across all key components in January. Inflation of services (including rents) rose 0.4ppt to an eleven-month high of 1.5%Y/Y. And non-energy goods inflation looks to have risen 2ppts to 0.8%Y/Y, which would be the highest since just before the VAT cut in June. Boosted by both base effects from past shifts in oil prices as well as the introduction of the new carbon tax, energy inflation jumped 3.7ppts to -2.3%Y/Y, the highest since March. And food inflation rose 1.7ppts from December's four-year low to 2.2%Y/Y. So, the core German rate on the national measure looks to have risen 0.9ppt to 1.3%Y/Y, with the increase on the core HICP rate likely greater to about 1.5%Y/Y. As a result of today's upside surprise, the flash estimates of euro area inflation, due next Wednesday, are bound to rise sharply too, with forecasts likely to revised up ahead of that release. Indeed, the rise in Germany from December will have added 0.6ppt to the headline euro area inflation rate for January, which we now expect to leap to 0.5%Y/Y. And while the drivers of today's jump in German inflation are likely to be one-offs so that the core rates this time next year are unlikely to be significantly higher, it is hard to believe that many members (if any at all) of the Governing Council would countenance the further rate cut mooted yesterday by the Dutch hawk Knot. Indeed, today's data underscore the likelihood that those remarks were intended more than anything to weaken the euro than provide a guide to the likely next policy steps of the ECB.

Drop in Commission sentiment index not as marked as feared

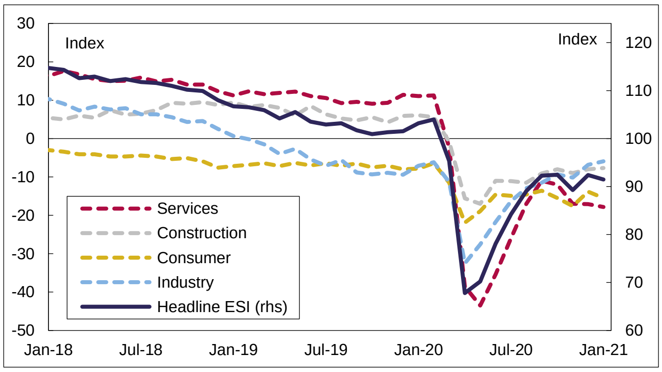
Like last week's composite PMI, the European Commission's Economic Sentiment Indicator (ESI) for the euro area unsurprisingly indicated a weakening in economic activity at the start of 2021. However, with the prior month's estimate

Germany: CPI inflation*



*National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Economic Sentiment Indices (ESIs)



Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

revised up, the modest drop of 0.9pt in the ESI left it at a stronger-than-expected 91.5. Bar November, that, nevertheless, was still the lowest level since August. Among the member states, the survey highlighted a deterioration in the euro area's core, with ESIs falling more than 2pts in Germany (to a six-month low of 92.8) and France (90.4, just a two-month low). In the Southern periphery, however, the ESI rose more than 2pts in Spain (93.9, the best since March) and inched up in Italy (to a three-month high of 90.2). The deterioration in the aggregate euro area ESI was caused primarily by a sharp drop in confidence in retail trade, for which the respective index dropped to the lowest since June. Services sector sentiment was also inevitably somewhat weaker. But with new orders up, confidence improved in industry, while sentiment among construction firms was little changed. Nevertheless, weaker hiring intentions in retail and construction caused the survey's Employment Expectations Index to fall back. And tallying with yesterday's weaker readings from Germany and France, the decline in consumer confidence to the lowest since July flagged by the flash estimate was confirmed. Finally, reflecting the contrasting demand conditions, selling price expectations eased in services and retail trade but firmed in construction and industry.

The day ahead in the euro area

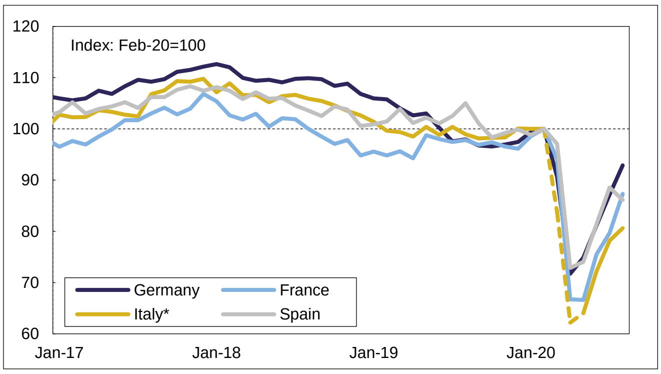
All eyes tomorrow will be on the first estimates of Q4 GDP, with data from Germany, France and Spain to be published. Following stronger-than-expected growth in Q3, the second wave of the pandemic and consequent re-imposition of lockdown measures will have resulted in a weak fourth quarter. Given the solid contribution from industrial production, however, German GDP looks to have just about avoided negative growth in Q4. In contrast, French GDP likely fell by about 4.0%Q/Q in Q4, while in Spain we forecast a contraction of 2.5%Q/Q. Spain will also publish flash inflation data for January as well as retail sales data for December. In contrast to today's jump in German inflation, the EU-harmonised measure of Spanish inflation is expected to remain unchanged at -0.6%Y/Y. French data for consumer spending on goods, also due tomorrow, are expected to show a moderate rebound in December after falling 17.1%Y/Y in November. Meanwhile, German labour market figures are expected to show a rise in the number of jobless claims in January, albeit leaving the unemployment rate unchanged at 6.1%.

UK

The day ahead in the UK

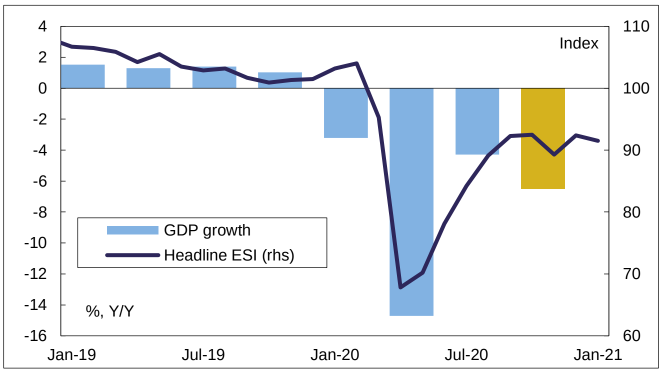
The quiet tone to the UK dataflow continues tomorrow, with only the Lloyds business barometer scheduled for release. This survey's measure of overall business confidence climbed by 17ppts in December to -4%, marking the sharpest rise for more than four years, as news of vaccines more than offset uncertainties surrounding the UK's new trading relationship with the EU. The latest survey will provide additional evidence as to whether the re-intensification of the pandemic, stricter lockdown measures and the new barriers to trade with the EU have had a deleterious effect on business confidence in the New Year.

Euro area: Economic Sentiment Indices (ESIs)



*No ESI was estimated for Italy in April 2020.
Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP* and Economic Sentiment Index



*GDP forecast for Q420. Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		European Commission's final consumer confidence	Jan	**-15.5**	-15.5	-13.9	-
		European Commission's economic confidence	Jan	**91.5**	89.5	90.4	**92.4**
		European Commission's industrial confidence (services)	Jan	**-5.9 (-17.8)**	-7.2 (-18.3)	-7.2 (-17.4)	**-6.8 (-17.1)**
Germany		Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	**1.0 (1.6)**	0.7 (0.5)	-0.3 (-0.7)	-
Italy		ISTAT economic confidence	Jan	**87.9**	-	87.7	-
		ISTAT consumer confidence (manufacturing)	Jan	**100.7 (95.1)**	100.1 (95.8)	102.4 (95.9)	**101.1 (96.0)**
Spain		Unemployment rate %	Q4	**16.1**	16.7	16.3	-

Auctions

Country		Auction
Italy		sold €3.5bn of 0.5% 2026 bonds at an average yield of 0.07%
		sold €3.75bn of 0.9% 2031 bonds at an average yield of 0.65%
		sold €1.5bn of 2026 floating-rate bonds at an average yield of 0.04%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	M3 money supply Y/Y%	Dec	11.0	11.0
Germany		07.00	Preliminary GDP Q/Q% (Y/Y%)	Q4	*0.0 (-4.0)*	8.5 (-4.0)
		08.55	Unemployment rate % (change '000s)	Jan	6.1 (7.5)	6.1 (-37.0)
France		06.30	Preliminary GDP Q/Q% (Y/Y%)	Q4	*-4.0 (-7.6)*	18.7 (-3.9)
		06.30	Consumer spending M/M% (Y/Y%)	Dec	23.7 (3.4)	-18.9 (-17.1)
		07.45	PPI Y/Y%	Dec	-	-1.8
Italy		09.00	PPI Y/Y%	Dec	-	-2.8
Spain		08.00	Preliminary GDP Q/Q% (Y/Y%)	Q4	*-2.5 (-11.4)*	16.4 (-9.0)
		08.00	Retail sales Y/Y%	Dec	-	-4.3
		08.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	-0.5 (-0.6)	-0.5 (-0.6)
UK		00.01	Lloyds business barometer	Jan	-	-4

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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