Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds made losses as euro area inflation posted a record monthly rise in January, but BTPs rallied as Italy's President invited Mario Draghi to try to form the next national government.
- Gilts made losses while the UK's services and composite PMIs were revised up modestly.
- Thursday will bring the BoE's first monetary policy announcements of the year as well as euro area retail sales data and the latest construction PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/22	-0.725	+0.009
OBL 0 10/26	-0.700	+0.015
DBR 0 02/31	-0.471	+0.021
UKT 1¾ 09/22	-0.097	+0.006
UKT 0⅝ 06/25	-0.007	+0.012
UKT 4¾ 12/30	0.364	+0.017

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

Euro area

Record-breaking rise in inflation pushes core rate to highest since 2015

As had been foreshadowed by the preliminary data from Germany, France and Spain, the January flash estimates of euro area inflation were record-breaking. Indeed, the headline and core measures both posted the highest monthly increases on the respective series. Headline inflation rose 1.2ppts to an eleven-month high of 0.9%Y/Y, which was broadly in line with the most recent upwardly revised forecasts. But the core measure also increased 1.2ppts, significantly above expectations, to 1.4%Y/Y, the highest since 2015. Within the detail, inflation of non-energy industrial goods was most striking, rising 2.0ppts from December's series low to a nine-year high of 1.4%Y/Y, as prices of such items fell on the month in January by the least in almost two decades. Services prices rose for the first time in any January since the introduction of the euro, so that the respective inflation rate doubled to an eleven-month high of 1.4%Y/Y. Meanwhile, the pace of decline in energy prices slowed 2.8ppts to -4.1%Y/Y, the least since last February. Food inflation, however, edged up just 0.2ppt to 1.5%Y/Y.

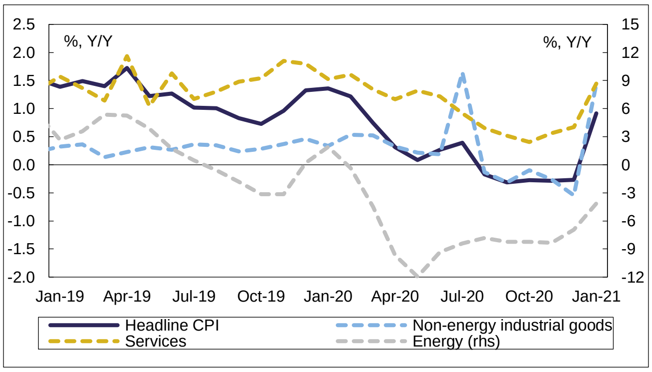
Inflation to surpass 2% in second half of the year

The leap in inflation in January largely reflects temporary factors, including a reweighting of the price basket to reflect changes to consumption patterns during the pandemic, the reversal of Germany's VAT cut, the introduction of Germany's carbon tax, the timing of France's winter sales, Spain's freak snow storms, and shifts in oil prices. Some of those effects (the timing of winter sales and Spanish weather) will reverse in the February data. But the impact of some others, such as the German tax changes and oil price movements, will persist – and indeed magnify – over coming months. So, euro area inflation is likely to remain elevated throughout 2021, and will probably rise above 2.0%Y/Y in the second half of the year.

But inflation will take a step down again in 2022

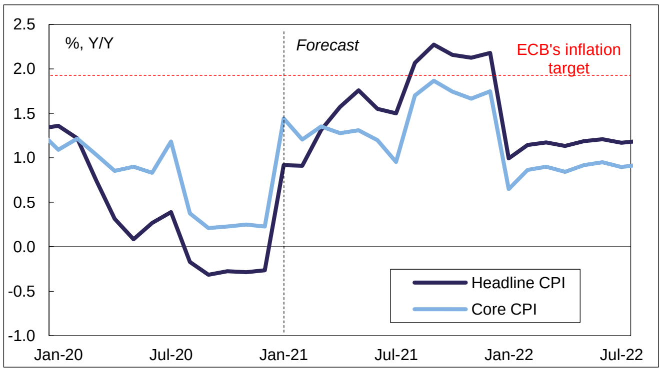
In a year's time, however, the temporary effects boosting inflation will eventually fall out of the calculation. So, in the absence of a sudden economic boom, which would allow firms to restore margins and push inflation expectations significantly higher, both headline and core inflation will take a significant step back down, probably close 1%Y/Y, at the start of 2022. Nevertheless, with the euro 5Y5Y inflation forward swap rate rising to 1.40%, the highest since May 2019, today's data do appear to have given a welcome boost to market-based price expectations. And inflation is set to exceed the ECB's forecast of just 0.3%Y/Y in Q1 and 1.0%Y/Y for 2021 as a whole. So, talk of the possibility of further rate cuts from the ECB – not least from the typically hawkish Knot – will surely halt. Nevertheless, as the rise in inflation this year is largely due to temporary factors, economic activity continues to be hit by the pandemic and roll-out of vaccination programmes has been slow, the ECB's battle with low inflation is certainly not yet won.

Euro area: Inflation – selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

German car sales and production reverse at start of 2021

Just as new car registrations got off to a slow start in the other large member states, today's equivalent data from Germany were also weak. In particular, having accelerated 10%Y/Y in December ahead of the reversal of the temporary VAT cut (albeit ending 2020 down 19%Y/Y over the year as a whole, the steepest decline since 2010), German new car registrations plunged 31%Y/Y in January, impeded also by the closure of dealerships under tightened pandemic containment restrictions. Domestic registrations fell 29%Y/Y while foreign registrations fell a larger 37%Y/Y. Meanwhile, according to the VDA, German car production fell sharply at the start of the year too, dropping 23%Y/Y, having been up on a year-on-year basis in the fourth quarter of the year. Supply-chain problems related to the shortage of semiconductors likely played a role along with pandemic restrictions. The ifo business survey flagged the deterioration in auto manufacturers' sentiment at the start of the year, with the sector's assessment of current conditions dropping by 1pt to -8.5. But near-term expectations improved somewhat, with hopes of a rebound in demand if and when the pandemic subsides later in the year.

PMIs suggest services in Spain and Ireland were worst hit in January

The final services PMIs saw only modest upwards revisions from the flash estimates. In particular, the euro area activity PMI was revised up just 0.4pt to 45.4, down 1pt from December, the second-lowest reading since May and clearly consistent with contraction in the pandemic-afflicted sector. As a result, the euro area composite PMI was nudged up 0.3pt from the flash estimate to 47.8, similarly the second-lowest since May and suggestive of a drop in economic output at the start of the year. Most interest in today's PMIs were the results published from the member states. The upwards revision to the euro area index reflected the improvement in France, for which the services PMI was revised up 0.8pt from the initial estimate to 47.3. But that still represented a deterioration from December. And with the exception of Italy, whose services PMI rose 5pts to a still contractionary 44.7, all member states registered a weakening in the sector last month as pandemic restrictions bit. Most severely hit were Ireland (down almost 14pts to 36.2, the lowest since May), where new Brexit-related restrictions to services exports to the UK compounded the misery caused by lockdown rules, and snow-hit Spain (down more than 6pts to 41.7). And if the composite PMIs are to be believed, only Germany (50.8, in line with the flash estimate) avoided a contraction in overall private sector activity at the start of the year.

The day ahead in the euro area

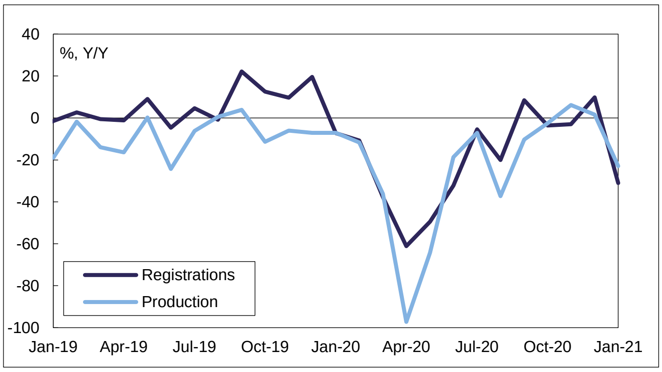
Thursday will bring euro area retail sales figures for December along with the January construction PMIs. Given the significant differences in situation between the member states – e.g. with France enjoying vigorous growth in sales that month as its lockdown restrictions were relaxed but Germany recording a drop of almost 10%M/M as its restrictions were tightened – the former is difficult to forecast with confidence. Nevertheless, overall, modest growth in euro area sales is expected in December following the drop of 6.1%M/M in November. Meanwhile, the construction PMIs are likely to continue to point to subdued activity in the sector at the start of 2021.

UK

Final PMIs suggest significant contraction despite upwards revisions

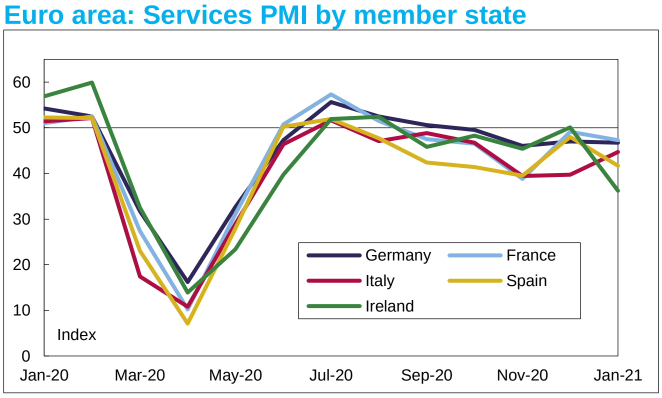
Ahead of tomorrow's BoE policy announcements, today's final services and composite PMIs reaffirmed the impression that UK GDP took a significant step down at the start of the year due to the tightening of pandemic containment measures and new post-Brexit restrictions. Despite an upwards revision of 0.7pt from the flash estimate, the services PMI dropped almost 1pt to a highly contractionary 39.5, by some margin the lowest since May. And with the manufacturing output PMI having earlier this week suggested that production was little better than flat at the start of the year, the composite PMI was revised up just 0.6pt from the initial estimate to just 41.2, down almost 9pts from December and again an eight-month low suggestive of a significant drop in GDP at the start of the year. Certainly, while the BoE's updated Monetary Policy Report will revise up its assessment of economic output in Q4, it will also forecast a drop in GDP in Q1 before recovery resumes next quarter.

Germany: Car production and new registrations



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMI by member state



Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

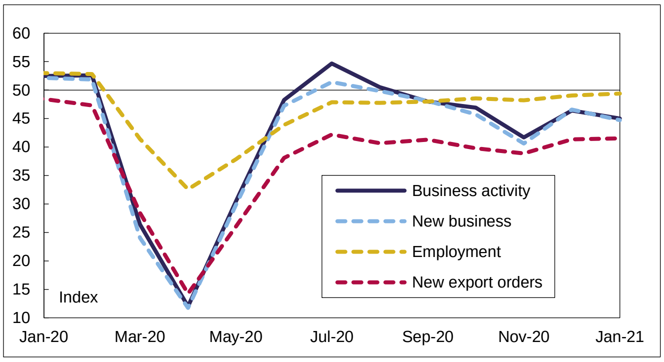
The day ahead in the UK

Thursday's main event in the UK will be the conclusion of the BoE's first monetary policy meeting of the year, which will be accompanied by a new Monetary Policy Report featuring updated economic projections. Since the December meeting, the agreement and implementation of the UK-EU Trade and Cooperation Agreement (TCA) avoided the disruption that a no-deal end to the Brexit transition would have caused, but nevertheless imposed significant new barriers to trade between the two blocs and also between Great Britain and Northern Ireland. That was broadly in line with the BoE's expectation. However, economic data have pointed to greater resilience in UK GDP in Q4 than was expected by the MPC in its November projections, which foresaw a drop of about 3%Q/Q – in contrast, overall output now looks to have been broadly flat last quarter. And while conditions in Q1 now appear weaker than the BoE expected, and restrictions on activity persist, the relatively swift start to the UK vaccination programme should have bolstered the MPC's confidence in the growth outlook for coming quarters. Moreover, inflation has seemingly behaved much like the MPC expected. And with the November projections having suggested that inflation would rise close to or above 2%Y/Y by the end of this year, and remain thereabouts over the following couple of years, a reaffirmation of that profile at the coming meeting would point to little need to adjust monetary policy over the horizon.

So, the MPC seems bound to leave policy unchanged at the coming meeting. And it will also likely retain its forward guidance, leaving open the possibility of further action if the inflation outlook weakens and repeating that it "does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made eliminating spare capacity and achieving the 2% inflation target sustainably". While the BoE will publish the findings of its survey of commercial banks on the potential impact that negative rates might have, we do not expect to see any change in the MPC's position that, while the policy tool should be available to use if necessary, it would have no intention to cut rates to negative territory if economic conditions unfold as it expects.

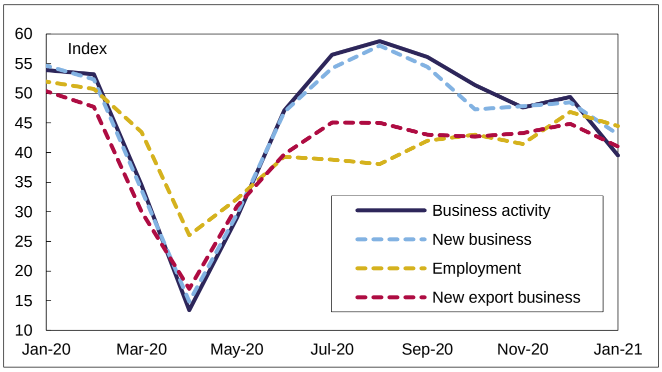
Data-wise, Thursday will bring UK new car registration data and the construction PMIs for January.

Euro area: Services PMIs



Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs



Source: Markit, 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	Final services (composite) PMI	Jan	**45.4 (47.8)**	45.0 (47.5)	46.4 (49.1)	-
	Preliminary CPI (core CPI) Y/Y%	Jan	**0.9 (1.4)**	*0.6 (1.1)*	-0.3 (0.2)	-
	PPI Y/Y%	Dec	**-1.1**	-1.2	-1.9	-
Germany	Final services (composite) PMI	Jan	**46.7 (50.8)**	46.8 (50.8)	47.0 (52.0)	-
	New car registrations Y/Y%	Jan	**-31.1**	-	9.9	-
France	Final services (composite) PMI	Jan	**47.3 (47.7)**	46.5 (47.0)	49.1 (49.5)	-
Italy	Services (composite) PMI	Jan	**44.7 (47.2)**	39.5 (42.0)	39.7 (43.0)	-
	Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	**0.2 (0.5)**	0.0 (0.1)	-0.1 (-0.3)	**-0.2 (-)**
Spain	Services (composite) PMI	Jan	**41.7 (43.2)**	45.9 (46.5)	48.0 (48.7)	-
UK	Final services (composite) PMI	Jan	**39.5 (41.2)**	38.8 (40.6)	49.4 (50.4)	-

Auctions	
Country	Auction
UK	sold £2.75bn of 0.25% 2031 bonds at an average yield of 0.441%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	Retail sales M/M% (Y/Y%)	Dec	2.5 (0.4)	-6.1 (-2.9)
Germany	08.30	Construction PMI	Jan	-	47.1
France	08.30	Construction PMI	Jan	-	40.5
Italy	08.30	Construction PMI	Jan	-	50.5
UK	09.00	New car registrations Y/Y%	Jan	-	-10.9
	09.30	Construction PMI	Jan	52.8	54.6
	12.00	BoE Bank Rate %	Feb	*0.10*	0.10
	12.00	BoE Gilt purchase target £bn	Feb	*875*	875

Auctions and events		
EMU	09.00	ECB publishes Economic Bulletin
France	09.50	Auction: 0% 2030 bonds
	09.50	Auction: 1.25% 2036 bonds
	09.50	Auction: 1.75% 2039 bonds
	09.50	Auction: 0.75% 2052 bonds
Spain	09.30	Auction: 0% 2024 bonds
	09.30	Auction: 0% 2026 bonds
	09.30	Auction: 0.1% 2031 bonds
	09.30	Auction: 0.7% 2033 index-linked bonds
UK	12.00	BoE monetary policy announcement and publication of Monetary Policy Report

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs