Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds and other euro area government bonds made losses as the record jump in euro area inflation in January was confirmed.
- Gilts also made further losses as UK average pay growth accelerated to a twelve-year high.
- Wednesday will bring final Q4 German GDP data, including the expenditure breakdown, as well as the February French INSEE business survey.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/23	-0.694	+0.004
OBL 0 04/26	-0.620	+0.012
DBR 0 02/31	-0.321	+0.021
UKT 1¾ 09/22	0.021	-0.007
UKT 0⅝ 06/25	0.267	+0.011
UKT 4¾ 12/30	0.709	+0.034

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

Euro area

Record rise in inflation in January confirmed

Today's final estimates of January inflation in the euro area confirmed the flash figures, which had reported record-breaking increases in the headline and core rates well above original expectations. So, headline inflation was confirmed to have risen by 1.2ppts to an eleven-month high of 0.9%Y/Y. And the core measure (excluding energy, food, alcohol and tobacco) also rose 1.2ppts, to 1.4%Y/Y, the highest since 2015. Within the detail, inflation of non-energy industrial goods was striking, rising 2.0ppts from December's series low to a nine-year high of 1.5%Y/Y, as prices fell on the month in January by the least in almost two decades. Services prices rose in January (if only by 0.05%M/M) for the first time since the introduction of the euro, so that the respective inflation rate doubled to 1.4%Y/Y. Meanwhile, the pace of decline in energy prices slowed 2.7ppts to -4.2%Y/Y, the least since last February. Inflation of food, alcohol and tobacco rose just 0.2ppt to 1.5%Y/Y.

Tax changes accounted for almost half of the rise in euro area inflation

Of course, the leap in inflation in January largely reflects a confluence of temporary and technical factors. Tax changes, not least the reversal of Germany's VAT cut, were a key driver, accounting for almost one half of the total rise in euro area inflation at the start of the year. On a constant tax basis, euro area inflation rose 0.7ppt to a six-month high of 1.0%Y/Y. And the increase in German inflation on a constant tax basis was just 0.4ppt (to a five-month high of 1.8%Y/Y) compared to the increase of 2.3ppts in Germany's HICP measure (to 1.6%Y/Y). Other temporary factors include the timing of France's winter sales, which delayed the usual seasonal reductions in prices of clothes and other goods, Spain's freak snow storms, and shifts in global oil prices.

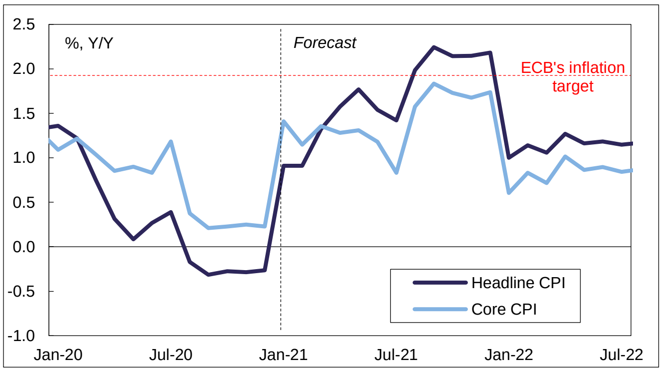
Reweighting of inflation basket also complicated matters

A reweighting of the price basket to reflect changes to consumption patterns during the pandemic also added to inflation in January. And that reweighting will alter the profile over coming months too. The shares attributed to food, alcohol and tobacco, as well as certain durable goods, were increased. And the shares attributed to fuel and certain services, including travel and hospitality, were reduced significantly. Indeed, the share attributed to hotel and restaurant prices – for which inflation in January was down 1.2ppts from a year earlier at 0.8%Y/Y – fell by about one quarter to a series low.

Inflation to rise above 2.0%Y/Y later this year before taking a big step down in a year's time

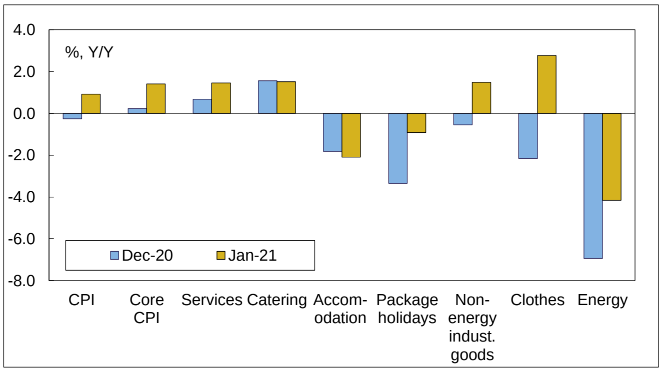
Some of the temporary effects (the timing of winter sales and Spanish weather) will reverse in the February data. But the impact of certain others, such as the German tax changes and oil price movements, will persist – and indeed magnify – over

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.

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, when German inflation will likely rise temporarily above 3.0%Y/Y. Over 2021 as a whole headline inflation is highly likely to average more than 1½%Y/Y, compared to the ECB's full-year projection of 1.0%Y/Y. In a year's time, however, the temporary effects boosting inflation should have fallen out of the arithmetic, while the basket weights will be recalibrated again. So, in the absence of a sudden economic boom, which would allow firms to restore margins and push inflation expectations significantly higher, or an acceleration in the pace of increase of oil prices, both headline and core inflation will take a significant step back down, probably close 1%Y/Y, at the start of 2022. Therefore, while the ECB will certainly need to revise up significantly its near-term inflation forecast next month, the revisions to its projections for 2022 and 2023 might be modest.

The day ahead in the euro area

Wednesday will bring the release of the French INSEE business climate survey, which is expected to suggest broadly stable confidence in February. The headline indicator is forecast to remain unchanged at 92, the highest since March. The manufacturing business climate index, meanwhile, is expected to edge up 1pt to 99, just below the long-run average. But the equivalent services index (just 91 in January) will remain weak. In Germany, final GDP figures for Q4 will be published, which will include a first detailed breakdown on the expenditure components. The preliminary data revealed that the economy avoided contraction in Q4 with growth of 0.1%Q/Q following a rebound of 8.5%Q/Q in Q3, to be down just 2.9%Y/Y.

UK

Labour market broadly stable around the turn of the year

The latest UK labour market figures were largely consistent with stability around the turn of the year. Indeed, despite the renewed nationwide lockdown measures, the ONS reported a small increase in the number of payroll employees in January for a second successive month. The rise of almost 83k, however, still meant that there were 730k (2.5%) fewer workers in payroll employment last month than a year earlier. In addition, in the three months to December, the unemployment rate continued to increase, albeit by a smaller-than-expected 0.1ppt on the month (and 1.3ppt from a year earlier) to 5.1%, the highest in almost five years. And the employment rate continued to fall, dropping 0.2ppt to 75.0%, the lowest since the three months to May 2017. Meanwhile, the claimant count rate, which includes those working on low incomes or hours as well as those who are not working at all, fell for a second successive month in January by 20k, with the equivalent rate down 0.1ppt to 7.2%. However, the rebound in vacancies – a key measure of demand – slowed towards the end of 2020 to about 578k in the three months to December, up 64k (less than half the rate) from the prior quarter and still 210k (26%) below the level a year ago. And although total hours worked remained well above the historically low level the prior quarter, the pace of improvement slowed over Q4 and ended the year down more than 7%Y/Y.

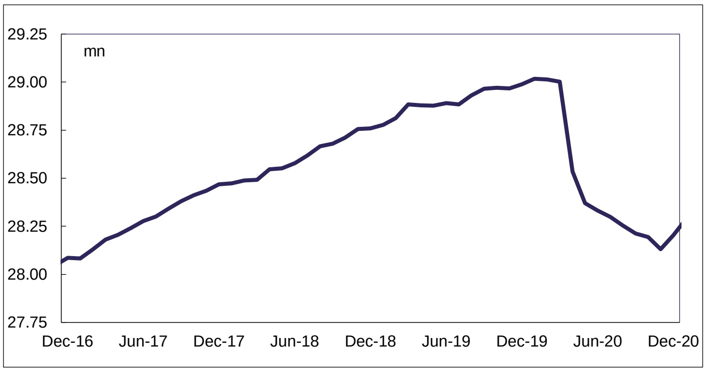
One fifth of workers still furloughed

The broadly stable jobs picture largely reflects the continued support provided by the Government's Job Retention Scheme. The Business Insights and Conditions Survey reported that about 20% of the workforce (about 6.4mn workers) was still furloughed in the three weeks to 16 February, up about 2ppts from the prior period. In December, the Job Retention Scheme was extended to the end of April while the government-guaranteed Covid-19 business loan schemes were extended to the end of March. In his Budget statement next week, Chancellor Sunak is expected to extend the furlough schemes to June, albeit likely with a degree of tapering to match the Government's timetable for a gradual reopening of the economy announced yesterday.

UK pay growth at twelve-year high partly due to composition effects

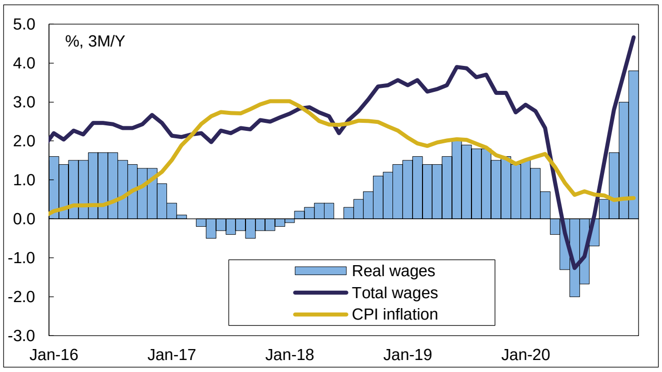
Strikingly, with lower-paid workers more likely to have lost their jobs over the past year, growth in average total pay (including or excluding bonuses) in the three months to December jumped a further 1.0ppt to 4.7%3M/Y (4.1%3M/Y excluding

UK: Payroll employment*



Preliminary estimates for December 2020 and January 2021. Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Wages and prices



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

bonuses) in nominal terms – the highest in more than twelve years – to be up 3.8%3M/Y in real terms. There remained significant variation between sectors, with average pay in the finance and business services sector up 6.8%3M/Y but just 1.9% and 1.5% in construction and manufacturing respectively. Adjusting for changes in the composition of employment, the ONS estimated that underlying pay growth was likely still slightly less than 3%Y/Y, something that should reinforce the confidence of the BoE in its central projection of firm economic recovery and a rise in inflation back to target – but not necessarily markedly above target – from the second half of the year.

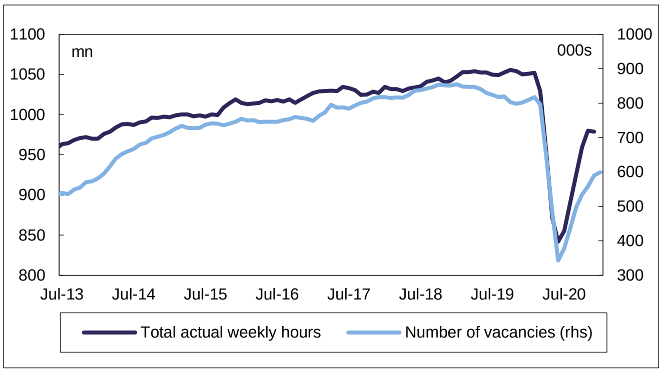
CBI survey suggests minimal improvement in retail sales in February

After retail sales (excluding auto fuel) fell a steep 8.8%M/M in January as the nation-wide lockdown took its toll, businesses might have hoped for an improvement in February. However, if the CBI's distributive trades survey is anything to go by, that improvement was likely very modest indeed. Despite record growth in internet sales, the reported sales balance rose just 5ppts to a weaker-than-expected -45, still close to the bottom of the range of the past year. According to the survey, only grocers saw any growth in sales volumes from a year ago. And retailers expect an even steeper fall in sales and orders in March, which would be consistent with the Government's plan for non-essential stores to remain closed at least until early April. So, while recent BoE data suggested that household spending on debit and credit cards in the first eleven days of February was 74% of its equivalent level a year, up from 66% in January, private consumption in the UK appears on track for a steep drop in Q1. And while retailers' sentiment for the quarter ahead stabilised, the drop in employment in the distributive sector implied by the CBI survey accelerated to a record pace, slightly faster than during the global financial crisis, suggesting that the stability reported in today's labour market figures might prove temporary.

The day ahead in the UK

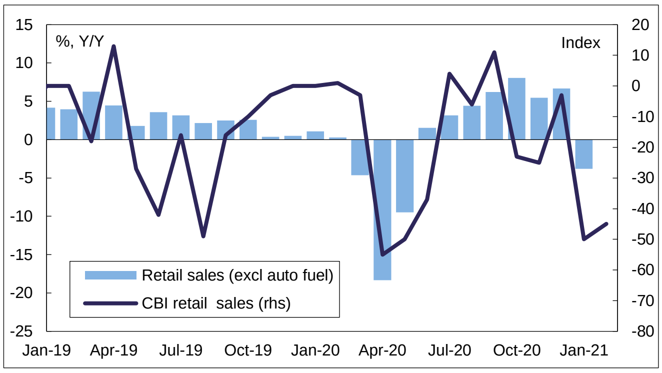
Data-wise, tomorrow will be a quiet day in the UK, with no key releases scheduled. However, the BoE's Chief Economist Andy Haldane is due to speak an event on the changing world of work.

UK: Working hours and vacancies



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Retail sales indicators



Source: 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 CPI (core CPI) Y/Y%	Jan	**0.9 (1.4)**	0.9 (1.4)	-0.3 (0.2)	-
Italy		Industrial orders M/M% (Y/Y%)	Dec	**1.7 (7.0)**	-	-1.3 (5.3)	**-1.4 (5.0)**
		Industrial sales M/M% (Y/Y%)	Dec	**1.0 (-0.5)**	-	-2.0 (-4.6)	-
UK		Unemployment claimant count rate % (change '000s)	Jan	**7.2 (-20.0)**	-	7.4 (7.0)	**7.3 (-20.4)**
		Average earnings including bonuses (excluding bonuses) 3M/Y%	Dec	**4.7 (4.1)**	4.1 (4.0)	3.6 (3.6)	**3.7 (3.6)**
		ILO unemployment rate 3M%	Dec	**5.1**	5.1	5.0	-
		Employment change '000s, 3M/3M	Dec	**-114**	-30	-88	-
		Preliminary output per hour Y/Y%	Q4	**-1.1**	-	4.0	-
		CBI distributive trades survey, reported sales	Feb	**-35**	-	-44	-

Auctions

Country		Auction
Italy		sold €2.5bn of 0% 2022 bonds at an average yield of -0.308%
UK		sold £2bn of 0.625% 2050 bonds at an average yield of 1.302%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Final GDP Q/Q% (Y/Y%)	Q4	0.1 (-3.9)	8.5 (-4.0)
France		07.45	INSEE business confidence	Feb	92	92
		07.45	INSEE manufacturing confidence (production outlook)	Feb	99 (-8)	98 (-9)

Auctions and events

Country		GMT	Event
Germany		10.30	Auction: €4bn of 0% 2031 bonds
UK		12.00	BoE Chief Economist Haldane scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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