Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Euro area government bonds rallied as the ECB stated that it expects to increase significantly its pace of PEPP purchases over the coming quarter.
- In contrast, Gilts followed USTs lower on a quiet day for economic news from the UK.
- Friday will bring January data for UK GDP and trade, and euro area industrial production.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/23	-0.701	-0.008
OBL 0 04/26	-0.634	-0.016
DBR 0 02/31	-0.335	-0.019
UKT $0^{1}/_{8}$ 01/23	0.064	+0.007
UKT $0^{1}/_{8}$ 01/26	0.322	+0.008
UKT 4¾ 12/30	0.735	+0.024

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

Euro area

ECB signals increase in the pace of PEPP purchases over the coming quarter

While the ECB today predictably left unchanged its main policy parameters, including its interest rates and the €1.85trn PEPP ceiling, the Governing Council's post-meeting statement went further than expected in addressing concerns about its willingness to tolerate the recent upwards shift in yields. In particular, it asserted that "the Governing Council expects purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year." However, quite how much faster the pace of purchase over the coming quarter will be was deliberately left unclear, leaving the ECB with plenty of room for manoeuvre. So, for example, while the net pace might theoretically be as high as the average of €25bn per week during the first quarter of the programme, it could be closer to the near-€16bn pace in the second half of 2020, which would still exceed the average pace of €12.2bn so far this year. In her press conference, President Lagarde insisted that she had no specific purchase pace in mind, while the statement underscored that "The Governing Council will purchase flexibly according to market conditions" and "with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation". Market events – including perhaps the extent of spill-overs from shifts in UST yields – will ultimately prove key.

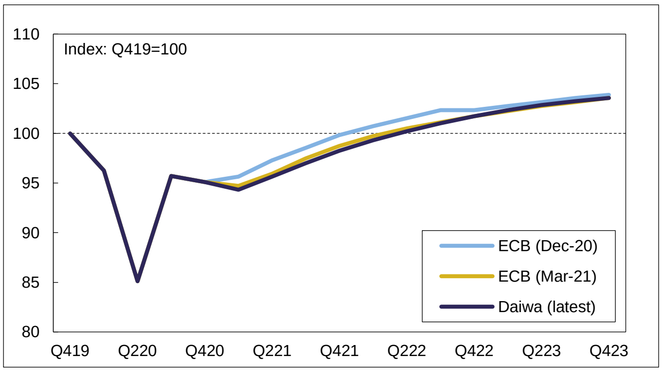
Purchase pace to be reviewed next at the June policy meeting

In her press conference, Lagarde stated that the ECB commenced buying at an accelerated rate from today. And she added that the pace would be reviewed by the Governing Council at the 10 June meeting, when it would be recalibrated according to the updated economic forecasts and a contemporaneous assessment of financial conditions. Between now and then, therefore, it will be up to the Executive Board to determine the pace of buying from week to week depending on how market pressures evolve. In that respect, Lagarde repeated that the objective of the PEPP purchases remained to maintain accommodative financial conditions in a rather opaque "holisitic" and "multi-faceted" way. So, she reiterated that conditions in the banking sector and other markets would remain just as relevant to the ECB's assessment as bond market developments. She thus repeated that the ECB was not pursuing a policy of yield curve control. Nevertheless, she noted that the whole of the yield curve would be of interest to the judgment on the appropriateness of financial conditions. And justifying the accelerated rate of bond-buying, she insisted that "If sizeable and persistent, increases in these market interest rates… could translate into a premature tightening of financing conditions for all sectors of the economy" which would be "undesirable".

ECB's forecasts suggest sluggish progress to recovery and reflation

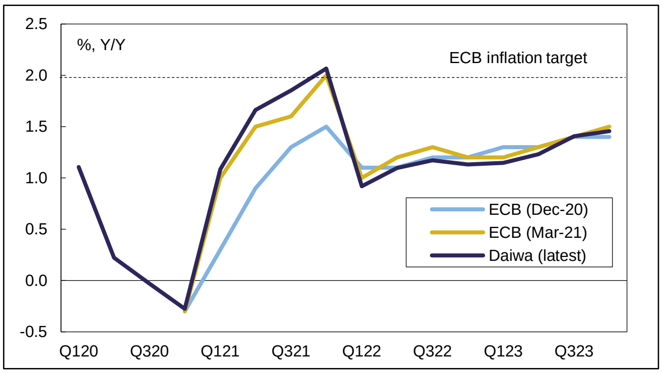
The decision to accelerate the pace of purchases within the current PEPP envelope was also justified by the ECB's updated economic projections, which were little changed for 2022 and 2023 and thus suggest relatively sluggish progress to long-run

Euro area: GDP forecasts compared



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

Euro area: Inflation forecasts compared



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

recovery and reflation. Indeed, the forecast for GDP growth over the full projection horizon was only minimally different. Given the tightening of pandemic containment measures since the start of the year, the ECB now expects GDP to contract 0.4%Q/Q in the current quarter, in contrast to the December forecast of growth of 0.6%Q/Q. But it expects the lost ground subsequently to be caught up so that the pace of expansion in 2021 would be 0.1ppt stronger than previously expected at 4.0%Y/Y. Thereafter, the revisions to the GDP outlook were trivial, with growth of 4.1%Y/Y in 2022 to be followed by a moderation to 2.1%Y/Y in 2023. The pre-pandemic level of output is thus expected to be surpassed in the middle of next year. While the ECB judged that the risks surrounding the growth outlook over the medium term had become more balanced, it admitted that downside risks remained over the near term. However, due to the ECB's long-standing convention not to include policy measures until they had passed into law, Lagarde noted that the projections had not factored in any boost from the US fiscal stimulus, which now represents a welcome upside risk to external demand.

Ongoing monetary stimulus required over the medium term

Given the jump in inflation at the start of this year due to technical and temporary factors, the revisions to the ECB's price outlook for 2021 were always going to be substantive. Indeed, headline inflation is expected by the ECB to rise to 2.0%Y/Y (or more) by Q421 and average 1.5%Y/Y over the year as a whole, up 0.5ppt from the December projection. Thereafter, however, the revisions to the inflation forecasts were very modest. Headline inflation in 2022 is expected to average 1.2%Y/Y, just 0.1ppt higher than previously expected. And the forecast of 1.4%Y/Y in 2023 was unchanged. Similarly, the forecast for core inflation (excluding energy and food) in 2022 and 2023 were revised up just 0.1ppt to 1.1%Y/Y and 1.3%Y/Y, thus remaining well short of the ECB's objective and justifying ongoing monetary stimulus into the medium term.

The day ahead in the euro area

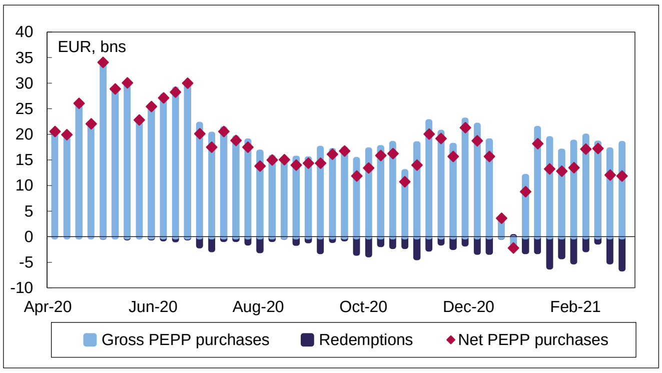
Friday will bring euro area industrial production figures for January. While production (excluding construction) dropped in Germany and Spain at the start of the year, it rose in Italy, the Netherlands and France, with growth in the latter a particularly firm 2.5%M/M. As a result, IP in the euro area as a whole should have grown by ½%M/M or more. That, however, would still leave it down roughly 2%Y/Y. Final German and Spanish inflation figures are also due tomorrow and are likely to align with their flash estimates. While German inflation on the EU-harmonised HICP measure was unchanged at 1.6%Y/Y, the equivalent Spanish figure dropped 0.5ppt to -0.1%Y/Y.

UK

The day ahead in the UK

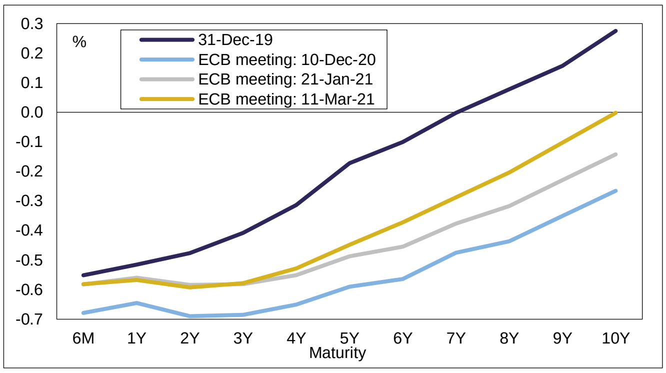
Friday will bring the UK data highlights of the week with estimates of GDP, production and trade in January, which will offer the first hard evidence of how severely overall economic activity at the start of the year was hit by the third lockdown and end to the Brexit transition. We expect a drop in GDP of 4.5%M/M and 2.2%Y/Y as tighter restrictions on activity weighed on private spending. Once again, services activity will have been hard-hit (likely dropping more than 5.0%M/M) while industrial production is expected to have fallen more modestly (perhaps less than 0.5%M/M). And the new barriers to trade with the EU that came into place at the start of the year will have weighed exceptionally heavily on exports of both goods and services. Indeed, we know already that German imports of goods from the UK fell more than 50%Y/Y while French imports of goods from the UK dropped more than 30%Y/Y. And as many of the UK's customs checks on imports from the EU have yet to be implemented but most of the EU's checks on imports from the UK were implemented from the start of the year, the UK trade deficit is likely to widen in January as the fall in exports outpaced that of imports.

ECB: PEPP purchases



Source: ECB, Refinitiv, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: GDP-weighted yield curves



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

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ <u>Daiwa forecast</u>	Previous	Revised
EMU	ECB main refinancing rate %	Mar	**0.00**	<u>0.00</u>	0.00	-
	ECB marginal lending facility %	Mar	**0.25**	<u>0.25</u>	0.25	-
	ECB deposit facility rate %	Mar	**-0.50**	<u>-0.50</u>	-0.50	-
Germany	Labour costs Q/Q% (Y/Y%)	Q4	**2.1 (3.5)**	-	-1.7 (1.7)	-
UK	RICS house price balance %	Feb	**52**	45	50	**49**

Auctions

Country	Auction
Italy	sold €5bn of 0% 2024 bonds at an average yield of -0.22%
	sold €3bn of 0.25% 2028 bonds at an average yield of 0.31%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ <u>Daiwa forecast</u>	Previous	Revised
France	Industrial production M/M% (Y/Y%)	Jan	**3.3 (-0.2)**	0.5 (-2.8)	-0.8 (-3.0)	**0.7 (3.2)**
	Manufacturing production M/M% (Y/Y%)	Jan	**3.3 (-1.0)**	1.8 (-)	-1.7 (-3.6)	**-1.4 -3.9)**
Italy	PPI Y/Y%	Jan	**-0.4**	-	-2.3	-

Auctions

Country	Auction
Germany	sold €3.26bn of 0% 2026 bonds at an average yield of -0.62%
UK	sold £800mn of 0.125% 2031 index-linked bonds at an average yield of -2.587%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ <u>Daiwa forecast</u>	Previous
EMU	10.00	Industrial production M/M% (Y/Y%)	Jan	0.3 (-2.2)	-1.6 (-0.8)
Germany	07.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	1.3 (1.6)	1.0 (1.6)
Italy	09.00	Unemployment rate %	Q4	-	9.8
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	0.0 (-0.1)	0.5 (0.4)
	08.00	Retail sales Y/Y%	Jan	-2.8	-1.5
UK	07.00	Monthly GDP M/M% (3M/3M%)	Jan	-4.9 (-2.6)	1.2 (4.1)
	07.00	Index of services M/M% (3M/3M%)	Jan	-5.5 (-3.2)	1.7 (0.6)
	07.00	Industrial production M/M% (Y/Y%)	Jan	-1.0 (-4.4)	0.2 (-3.3)
	07.00	Manufacturing production M/M% (Y/Y%)	Jan	-1.0 (-3.7)	0.3 (-2.5)
	07.00	Construction output M/M% (Y/Y%)	Jan	-1.0 (-4.8)	-2.9 (-3.9)
	07.00	Goods trade balance £bn	Jan	-12.5	-14.3
	09.30	BoE inflation expectations, next twelve months %	Feb	-	2.7

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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