Euro wrap-up

Overview

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- Longer-dated Bunds made losses and periphery bonds underperformed as the ECB announced a slowdown in the pace of net asset purchases throughout 2022 and the end of the net PEPP purchases at end-March.
- Gilts made losses across the curve as the BoE hiked Bank Rate for the first time this cycle despite the rapid spread of the Omicron variant in the UK.
- Friday will bring the latest German ifo business survey, final euro area inflation data for November, and updates on UK retail sales and consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/23	-0.707	-0.011
OBL 0 10/26	-0.587	+0.005
DBR 0 08/31	-0.351	+0.016
UKT 0 1/8 01/24	0.492	+0.029
UKT 0 5/8 10/26	0.607	+0.030
UKT 0¼ 07/31	0.762	+0.031

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

Euro area

ECB confirms net PEPP purchases to end in March, and steady slowing of all purchases over 2022

In contrast to the BoE (see below), the ECB's monetary policy announcement today was broadly within the range of expected outcomes. Most predictably, the Governing Council decided that the ECB will slow its net asset purchases steadily over the course of 2022. To start with, the pace of net PEPP purchases will be reduced in Q1 from the average close to €65bn per month in Q4. And it will end its net PEPP purchases at the end of March. To avoid what ECB President Lagarde judged would otherwise have been a "brutal transition", the Governing Council will then double its monthly net purchase pace under the regular APP to €40bn per month in Q2. But that pace will slow to €30bn in Q3. And from October, the ECB will maintain net asset purchases under the APP at a monthly pace of €20bn "for as long as necessary" – an open-ended commitment to maintain QE that allows it to deflect accusations of tapering to zero. Moreover, the Governing Council extended its commitment to maintain reinvestments of maturing PEPP proceeds by one extra year to at least until the end of 2024. Those reinvestments will be conducted flexibly across countries, including Greece (unlike for the regular APP purchases), to support the monetary transmission. In addition, the ECB retained the option to resume net purchases under the PEPP, if necessary, to counter any new negative shocks related to the pandemic. But it postponed a decision on whether to follow the final TLTRO-iii operation allotment with further longer-term liquidity operations. And it also maintained "optionality" to adjust policy in either direction in due course as events unfold and new data emerge.

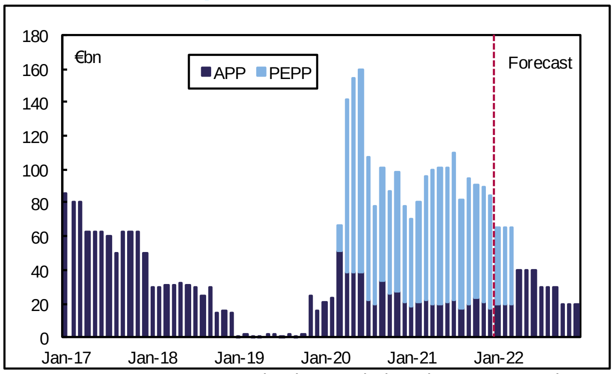
Lagarde judges rate hike in 2022 "very unlikely"

In terms of the outlook for interest rates, there was relatively little new today from the Governing Council, although the ECB's updated projections gave an insight to the possible timing of rate take-off. Forward guidance on rates was inevitably left unchanged, requiring inflation to be seen at target on a sustainable basis well before the end of the projection period. And Lagarde again judged that a rate hike in 2022 was "very unlikely", not least given the persisting lack of wage pressure. Moreover, the near-term GDP growth outlook was revised down on account of renewed pandemic restrictions, ongoing supply bottlenecks and the adverse impact of energy prices on real incomes. With GDP growth of just 0.2%Q/Q expected in Q421, the ECB now forecasts the pre-pandemic level to be reached next quarter, one quarter later than previously thought. And the projection of full-year growth in 2022 was revised down 0.4ppt from September to 4.2%.

Inflation projections suggest hike in 2023 is feasible

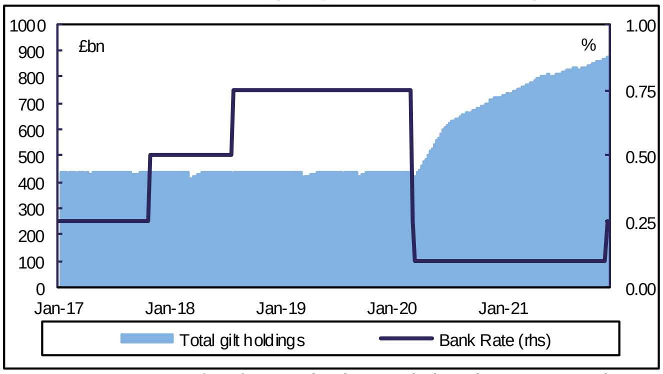
More importantly for monetary policy, however, the inflation forecast was revised up over the horizon. Headline HICP inflation is expected to remain above 2.0%Y/Y until Q422. It is expected to average 3.2%Y/Y over next year as a whole, a full 1.5ppts

ECB: Net asset purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

BoE: Bank Rate and gilt purchase holdings



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

more than previously predicted, with two-thirds of that revision reflecting higher energy prices. Further ahead, headline inflation is expected to average 1.8%Y/Y in 2023 and 2024, with core inflation also averaging 1.8%Y/Y by the end of the horizon. As the ECB acknowledged that inflation could well exceed its central projection, and also stated in its strategic review that its monetary policy assessments should take into account estimates of owner-occupied housing costs, which might be expected to outpace HICP inflation for a while yet, conditions for a rate hike might yet be in place in 2023. In our view, however, inflation in 2023 also risks significantly undershooting the 2% target, as energy price base-effects might turn negative and global supply chains rebound.

Euro area flash PMIs suggest softest growth in 9 months while German growth stalls

Consistent with the ECB's GDP forecast, the December flash PMIs suggested a slowdown in economic activity at the end of Q4. The loss in momentum was concentrated in services, for which the euro area activity index dropped 2.6pts to an eight-month low of 53.3. While the equivalent French PMI was relatively steady at 57.1, the German index dropped more than 4pts to a contractionary 48.4 as tightened pandemic restrictions took their toll on recreation activity, tourism and hospitality. In contrast, hints at an easing of supply-side constraints saw the German manufacturing output PMI rise 1.8pts to 53.3. So, while the equivalent French indicator was softer at a contractionary 49.2, the euro area manufacturing output PMI edged up slightly to a three-month high of 53.9. Nevertheless, with services accounting for a much larger share of the economy, the euro area composite PMI dropped 2pts to a nine-month low of 53.4. And while the equivalent French index was consistent with ongoing respectable expansion (55.6), the German composite output index dropped more than 2pts to an eighteen-month low of 50.0, suggesting that growth in the euro area's largest member state had paused at the end of Q4. Perhaps needless to say, the detail on the PMIs also suggested that firms' costs and selling prices continued to rise sharply in December, although the rates of increase reportedly eased somewhat from last month's record highs.

The day ahead in the euro area

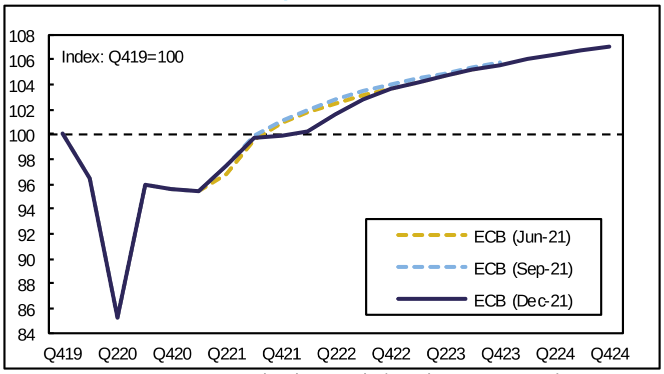
The end of the week brings another top-tier December sentiment business survey, from the German ifo institute. Ahead of today's flash PMIs, this was expected to report a further moderate deterioration in both current and future conditions, consistent with persisting supply constraints, to leave the headline business climate index at its lowest since February. And today's data might suggest a more significant weakening on account of the challenges in the services sector. Friday will also bring updated euro area inflation figures for November. Given the modest downwards revisions to the final Italian and Spanish headline CPI rates (by 0.1ppt a piece), we might well see headline euro area inflation nudged a touch lower from the flash estimate (4.9%Y/Y), albeit this would still mark a notable increase from October (4.1%Y/Y) and a euro-era high. The flash core CPI rate was up 0.6ppt to 2.6%Y/Y. Tomorrow's release will also provide the full component breakdown including the ECB's estimate of the trimmed-mean rate of inflation. Euro area construction output figures for October, new car registration figures for November and German PPI numbers for November are also due. The Bundesbank will also publish its semi-annual economic forecast update.

UK

BoE unexpectedly starts tightening cycle despite new wave of Covid-19

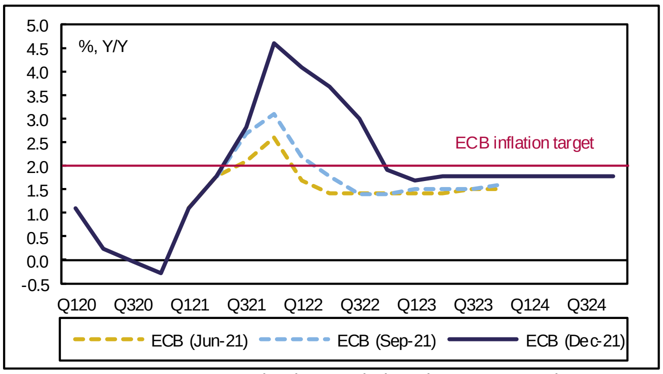
Having early last month left policy unchanged despite loud signals of imminent tightening, today the BoE unexpectedly raised Bank Rate by 15bps to 0.25% in the midst of a new extremely rapidly spreading wave of pandemic. Far more predictably, the end of the BoE's net asset purchases was also confirmed, with the stock of Gilt holdings to be maintained at £875bn and the stock of corporate bonds to be maintained at £20bn. Despite today's decision to start tightening policy, Bank Rate remains a substantive 50bps below the pre-pandemic level with the BoE's stock of Gilts holdings roughly twice the pre-pandemic level. So, it is hard to argue that UK financial conditions are not still highly accommodative, and the majority of members probably regret last month's decision not to hike Bank Rate. It was also not surprising that the MPC repeated that it still expects some "modest tightening of monetary policy over the forecast period" to be necessary. However, the recent

Euro area: ECB GDP growth forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ECB inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

mismatch between the BoE's communication and action, as well as the unpredictable consequences of the Omicron variant, leaves plenty of uncertainty about the extent of tightening. Not least given the likely hit to UK trend productivity from Brexit, we doubt that Bank Rate will need to be hiked over the course of 2022 by the 125bps or more priced by sterling OIS markets immediately after today's BoE announcement. Some of that move eventually unwound. And, indeed, we pencil in only two further rate hikes over the course of 2022, to take Bank Rate to 0.75% at end-year. But, of course, the outlook for rates – as for growth and inflation – clearly remains highly unpredictable.

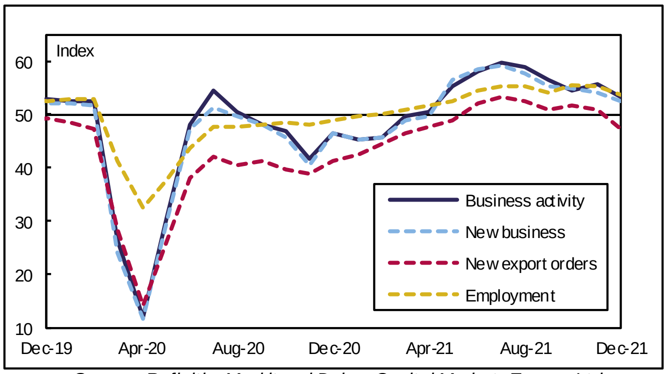
Inflation concerns prompted today's hike

The MPC's statement noted that Bank staff have revised down their expectations for UK GDP in Q421 by around ½% since last month's policy meeting, leaving economic output around 1½% below its pre-Covid level. It also acknowledged that the Omicron variant is likely to weigh on near-term economic activity, and that its impact on medium-term inflationary pressures is unclear. But, consistent with this week's jobs data, it judged that the labour market remained tight despite the end of the government's furlough scheme. And despite some moderation in recent wage growth, Bank staff continue to estimate that underlying earnings growth remains above pre-pandemic rates, and upside risks remain around the pay outlook. Moreover, following yesterday's further big upside surprise to UK CPI inflation in November – which at 5.1% Y/Y was ½ppt or more above the BoE's expectation early last month – it also noted signs of greater persistence in domestic cost and price pressures. So, Bank staff now expect inflation to remain around 5% Y/Y through the majority of the winter period, and to peak at around 6% Y/Y in April when household energy prices will be increased again. And while CPI inflation is still expected to fall back in the second half of next year, contacts of the Bank's Agents expect further price increases next year driven in large part by pay and energy costs, which also flags risks of an overshooting of the inflation target over the medium term.

One member out of nine wanted to wait for updated forecasts in February

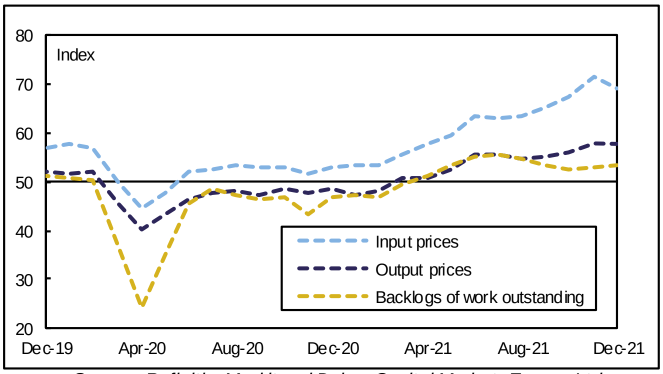
Admittedly, the MPC continues to judge that there are two-sided risks around the inflation outlook in the medium term, with the outlook for energy prices one source of downside risks. And today's decision to raise rates was not quite unanimous, with one external member (Sylvia Tenreyro) voting to leave policy unchanged. Given the uncertainty represented by the Omicron variant, she wanted to await updated economic forecasts in February before considering any change in Bank Rate. In particular, given risk management concerns, she had wanted to ensure that the economic recovery would not be materially threatened by the new variant before raising rates. Those concerns seem justifiable – while today's 15bps hike might ultimately have little direct impact on demand, it is likely to have an additional unhelpful negative impact on business sentiment, particularly for those consumer-facing services firms – many of which will be highly indebted after previous waves of Covid 19 – who now face a particularly troubling festive season and start to 2022.

Euro area: Services PMIs – demand side



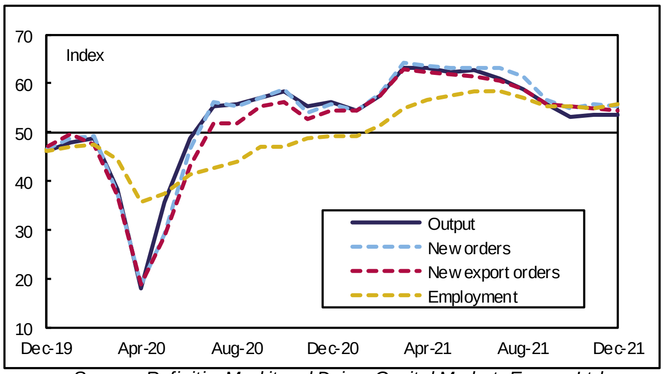
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs – supply side



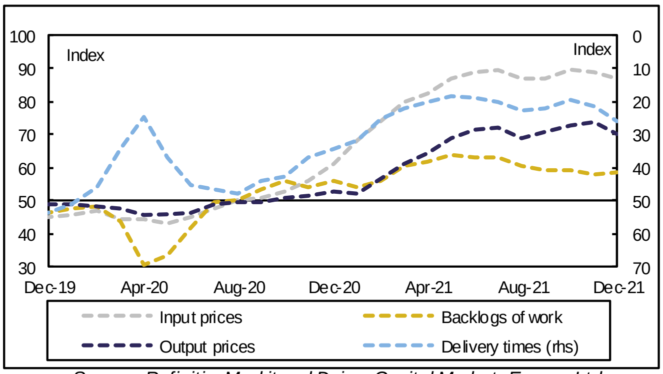
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing PMIs – demand side



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

Euro area: Manufacturing PMIs – supply side



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

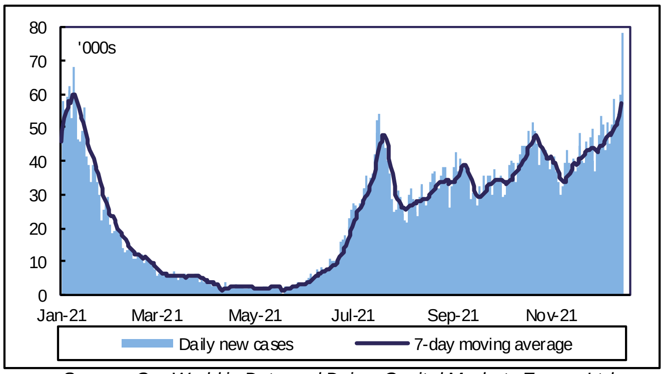
Flash PMIs imply a hit to services due to Omicron strain

Today's flash PMI surveys suggested a hit to the economic recovery heading towards Christmas as the emergence of the Omicron strain and more stringent pandemic restrictions took their toll on services. Certainly, the decline in headline services PMI was more striking than had been expected, with the 5.3pts drop the largest since January to leave the index at 53.2, down more than 9½pts from the summer peak. And consumer-facing firms were notably more downbeat about the near-term outlook, as new orders were dented by weaker consumer demand and tighter international travel restrictions – the new export orders PMI fell a hefty 7.8pts, the most since April 2020, to 46.4, the lowest since March. In contrast, manufacturers appeared to report limited additional impact from the emergence of Omicron. Moreover, there were signs that the supply chain crisis had started to stabilise somewhat, with supplier delivery times the shortest this year (admittedly still significantly longer than the pre-pandemic norm) and therefore allowing a further increase in output, with the respective component up by 0.6pt to 53.3, a four-month high. But new domestic orders remained relatively subdued, and those from overseas continued to fall. And with factories across Asia disrupted by Omicron, supply-chain challenges may become more acute once again over the near term. Overall, the composite output PMI (53.2, the lowest since February) signalled a marked slowdown in the pace of recovery at the end of the year, with heightened uncertainties about the near-term outlook too. The survey also suggested a modest easing in inflationary pressures, with the input price PMI down 5½pts but still historically elevated at 77.8, and the output price PMI down almost 2pts to 62.3, a four-month low.

The day ahead in the UK

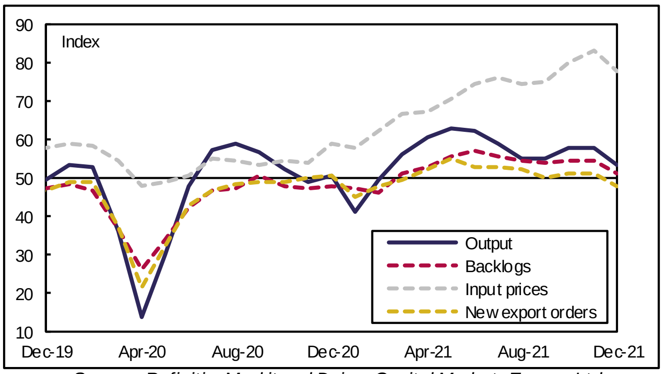
Tomorrow's release of November's retail sales data is expected to report another month of solid growth as consumers brought forward festive spending to take advantage of early Black Friday deals and avoid potential shortages associated with persistent supply bottlenecks. Excluding fuel, sales are expected to have risen 0.8%M/M following growth of 1.6%M/M in October. But not least reflecting the increase in coronavirus cases and tighter restrictions, the latest consumer confidence survey is likely to report a further notable deterioration in sentiment this month and reduced willingness to spending on durable goods, tallying with the findings from today's PMIs.

UK: New coronavirus cases



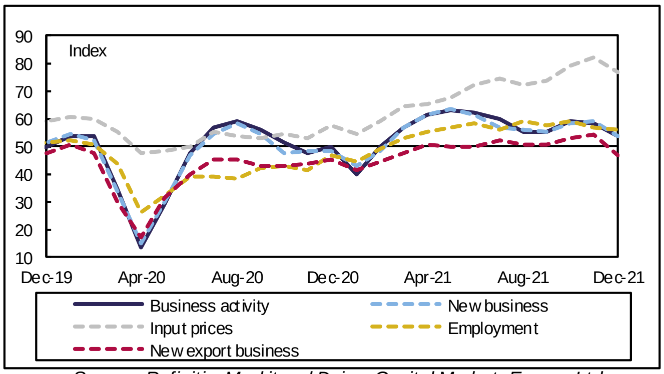
Source: Our World in Data and Daiwa Capital Markets Europe Ltd.

UK: Composite PMIs



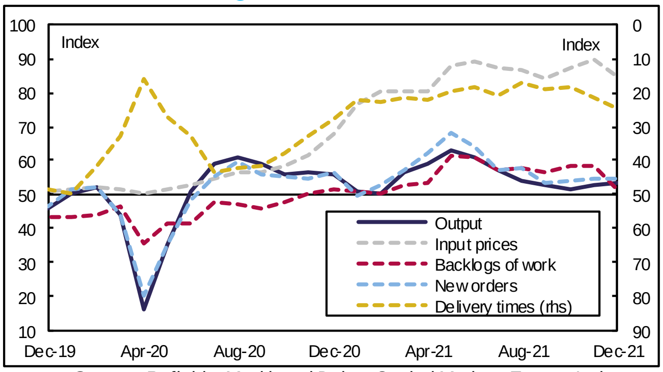
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs



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

UK: Manufacturing PMIs



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

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary manufacturing (services) PMI	Dec	**58.0 (53.3)**	57.8 (54.3)	58.4 (55.9)	-
		Preliminary composite PMI	Dec	**53.4**	54.2	55.4	-
		Trade balance €bn	Oct	**2.4**	5.8	6.1	-
		Labour costs Y/Y%	Q3	**2.5**	-	-0.1	-
		ECB refinancing rate %	Dec	**0.00**	*0.00*	0.00	-
		ECB marginal lending facility rate %	Dec	**0.25**	*0.25*	0.25	-
		ECB deposit rate %	Dec	**-0.50**	*-0.50*	-0.50	-
Germany		Preliminary manufacturing (services) PMI	Dec	**57.9 (48.4)**	56.9 (51.0)	57.4 (52.7)	-
		Preliminary composite PMI	Dec	**50.0**	51.1	52.2	-
France		INSEE business confidence	Dec	**110**	113	114	**113**
		INSEE manufacturing confidence (production outlook)	Dec	**111 (21)**	109 (15)	109 (20)	**110 (19)**
		Preliminary manufacturing (services) PMI	Dec	**54.9 (57.1)**	55.4 (56.0)	55.9 (57.4)	-
		Preliminary composite PMI	Dec	**55.6**	55.0	56.1	-
UK		Preliminary manufacturing (services) PMI	Dec	**57.6 (53.2)**	57.6 (57.0)	58.1 (58.5)	-
		Preliminary composite PMI	Dec	**53.2**	56.3	57.6	-
		BoE Bank Rate %	Dec	**0.25**	*0.10*	0.10	-
		BoE Gilt purchase target £bn	Dec	**875**	*875*	875	-
		BoE Corporate bond target £bn	Dec	**20**	*20*	20	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		07.00	EU27 new car registrations Y/Y%	Nov	-	-30.3
		10.00	Final CPI (core CPI) Y/Y%	Nov	*4.8 (2.6)*	4.1 (2.0)
		10.00	Construction output M/M% (Y/Y%)	Oct	-	0.9 (1.5)
Germany		07.00	PPI Y/Y%	Nov	20.0	18.4
		09.00	Ifo business climate	Dec	95.3	96.5
		09.00	Ifo current assessment (expectations)	Dec	97.5 (93.6)	99.0 (94.2)
UK		00.01	GfK consumer confidence	Dec	-17	-14
		07.00	Retail sales incl. auto fuels M/M% (Y/Y%)	Nov	0.8 (4.2)	0.8 (-1.3)
		07.00	Retail sales excl. auto fuels M/M% (Y/Y%)	Nov	0.8 (2.3)	1.6 (-1.9)

Auctions and events

Country		GMT	Event
UK		12.00	BoE publishes Q4 Quarterly Bulletin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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