Euro wrap-up

Overview

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- Despite a record rise in German producer prices, evidence of broader-based consumer price pressures in the euro area, and a signal from the Governing Council of its readiness to adjust policy this year if needed, Bunds made gains as Christine Lagarde insisted that the ECB would not need to follow the Fed.
- Gilts also made gains despite another strong UK housing market survey.
- Friday will bring updates on euro area and UK consumer confidence and UK retail sales while Christine Lagarde will speak publicly again.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/23	-0.595	-0.008
OBL 0 10/26	-0.304	-0.005
DBR 0 02/32	-0.031	-0.015
UKT 0⅛ 01/24	0.879	-0.009
UKT 0⅜ 10/26	1.004	-0.019
UKT 0¼ 07/31	1.223	-0.031

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

Euro area

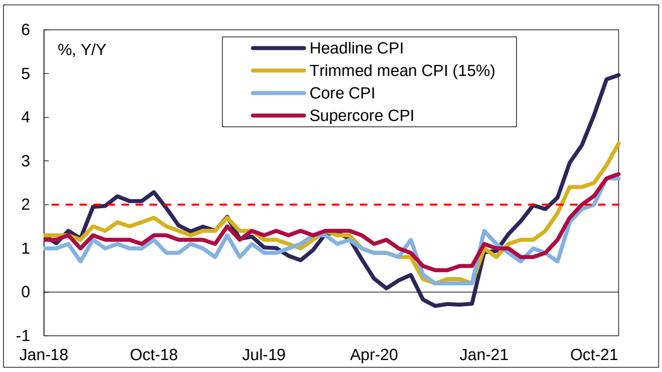
Broader-based price pressures push euro area trimmed mean inflation to series high

The final headline estimates of euro area inflation in December predictably aligned with flash figures. So, confounding the original expectations of a marginal drop, the rise of 0.1ppt to 5.0%Y/Y in the headline HICP rate was confirmed. Extra pressure at the end of 2021 came from non-energy goods, for which the industrial component jumped 0.5ppt to a euro-era high of 2.9%Y/Y and the food component jumped 1.0ppt to 3.2%Y/Y as some increased input costs were passed on to consumers. Today's detail revealed further notable rises in inflation of motor cars, up 0.4ppt to 5.1%Y/Y, and clothing, which doubled to 2.8%Y/Y as prices were discounted less than in December 2020. But those impacts were offset by a drop in services inflation of 0.3ppt to 2.4%Y/Y, perhaps in part weighed by the latest wave of the pandemic which meant that prices of recreation, package tours and transport services rose less this December than a year earlier. Energy still accounted for roughly half of all inflation even as the component fell for the first time in eleven months, down 1.6ppts to 26.0%Y/Y. The decline reflected lower prices of liquid fuels, which offset the impact of higher bills for household energy, particularly electricity. Core inflation (excluding energy, food, alcohol and tobacco) was unchanged at 2.6%Y/Y, so that it averaged just 1.4%Y/Y over the two years since Covid-19 emerged underscoring that much of current high inflation reflects the normalization of prices that had initially weakened due to the pandemic. However, increasingly broad-based price pressures were reflected in the 15% trimmed mean rate, which rose 0.5ppt in December to a series high of 3.4%Y/Y.

German producer prices up the most on record flagging upside risks to CPI outlook

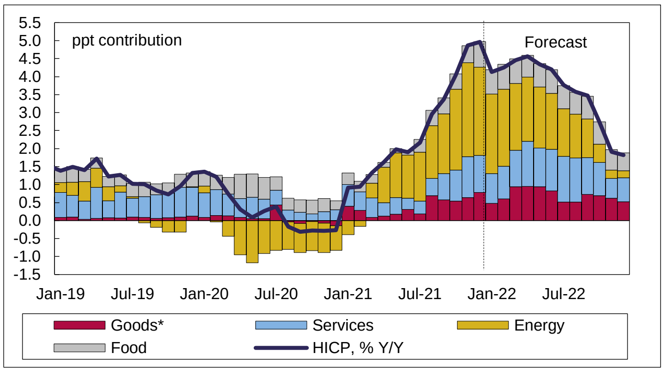
Euro area inflation is expected to weaken by some 0.35ppt in January simply due to the impact of past German tax changes. But today's German producer price inflation data suggest that firms will continue to look to pass on increased pipeline pressures to consumers. Indeed, pressures intensified significantly at the end of last year, with industrial producer prices up an unprecedented 5.0%M/M, more than three times the average monthly increase in 2021, to be up a whopping 24.2%Y/Y. Once again, the culprit was energy, prices of which were up 15.7%M/M to be up 69.0%Y/Y. Natural gas prices were up 121.9%Y/Y with electricity prices up 74.3%Y/Y. Excluding energy, the industrial PPI rose 0.4%M/M to be up 10.4%Y/Y, similarly a series high, with broad-based increases related to supply bottlenecks and higher prices of inputs. Prices of intermediate goods rose 0.9%M/M to be up 19.3%Y/Y with big rises in a wide range of items from metals to wooden goods to fertilisers and animal feeds. Due not least to rising food prices, non-durable consumer goods prices rose 0.8%M/M and 4.7%Y/Y. Prices of durable consumer goods rose 0.8%M/M and 3.7%Y/Y. And while capital goods prices rose 'just' 0.3%M/M, they were still up 3.8%Y/Y pressured not least by prices of computers (up 18.5%Y/Y). With the German ifo business price expectations index down in December by just 0.3pt from the previous month's series high to 44.6, a large share of firms are signalling their intention to raise prices over the coming three months.

Euro area: Headline, core and trimmed mean CPI*



*Supercore CPI includes items most sensitive to the cycle, and excludes energy, food, travel-related items, clothing and footwear. Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to HICP inflation



*Non-energy industrial goods.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

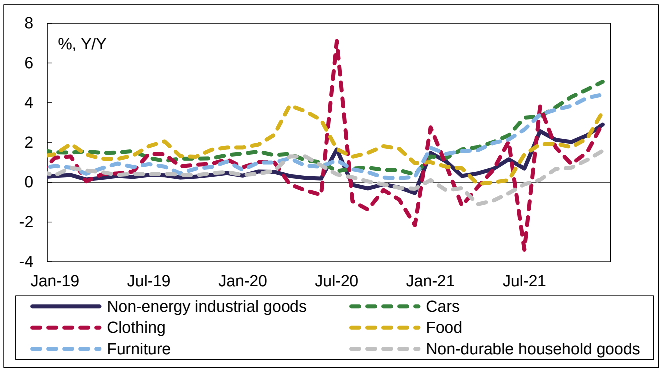
Lagarde flags divergence from Fed but ECB ready to adjust policy path in 2022 if needed

Not least in light of the dominant share of inflation contributed by energy prices, as well as the euro area's less advanced cyclical position, in a radio interview today President Lagarde insisted that the ECB would not need to adjust policy as quickly as the Fed might. She still expected that inflation would stabilise before gradually falling back this year. While we think that recent moves in wholesale energy prices and the continued pass-through of producer price pressures mean that inflation will now exceed the ECB's projection over the near term, we similarly expect euro area inflation to fall back close to the 2.0%Y/Y target by year end and below it in H123. However, the outlook is undeniably extremely uncertain, with any renewed tightening of supply bottlenecks or a further upwards shift in energy prices – that would follow intensification of tensions on the Ukraine-Russia border – likely to increase the probability that inflation remains above target by end-year. The account of the ECB's December monetary policy meeting, published today, noted that a "higher for longer" inflation scenario – whereby inflation continued to exceed 2% in 2023 and 2024 – could not be ruled out. The proposed slowing in QE over the coming few quarters – with net APP purchases of €40bn per month in Q2, €30bn per month in Q3 and €20bn per month from October – was "widely agreed" among Governing Council members to be a "proportionate course of action". However, the account also emphasised the desire of the policymakers to retain flexibility to adjust monetary policy if necessary, in either direction, in line with new data as the year goes on.

INSEE survey reports adverse impact of pandemic wave on French service sector at start of 2022

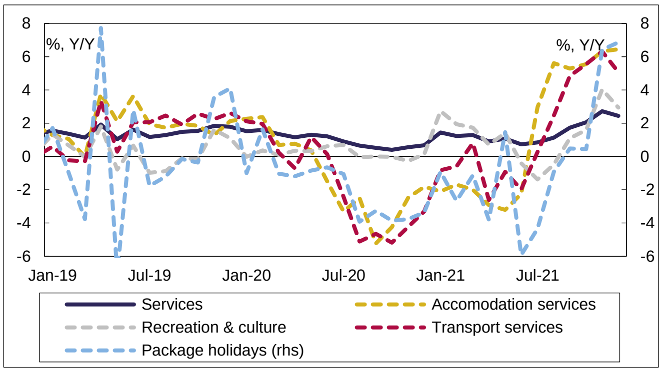
In light of the surge in coronavirus cases over the festive period in France, today's INSEE business survey – which gave an indication of what to expect from next week's flash PMIs – reported a modest decline in overall confidence at the start of the New Year. Indeed, the headline sentiment index fell 2pts in January to 107, its lowest since April but nevertheless still significantly higher than during the first year of the pandemic and comfortably above the long-run average. The slowdown was unsurprisingly driven by services, with a sharp deterioration in activity in the accommodation and food subsectors – the relevant turnover index was down 32pts from November's high to a six-month low. But with conditions in other subsectors holding up relatively well, the overall services sentiment index (105) was still above the long-run average, but down 9pts from November's level. While confidence among construction firms also moderated slightly, it remains at an extremely elevated level (113) and the drop largely reflected ongoing supply constraints. But encouragingly, sentiment among manufacturers bucked the trend, with the respective index rising (up 2pts to 112) to its highest since February 2018 benefitting from strong order books, improved past production and a modest easing in supply difficulties. This improvement principally reflected the transport sector, with the relevant sentiment index rising 14pts on the month to its highest since January 2020 as manufacturers production expectations rose to their highest since 2000, seemingly reflecting more upbeat prospects for resolving supply bottlenecks.

Euro area: Goods inflation



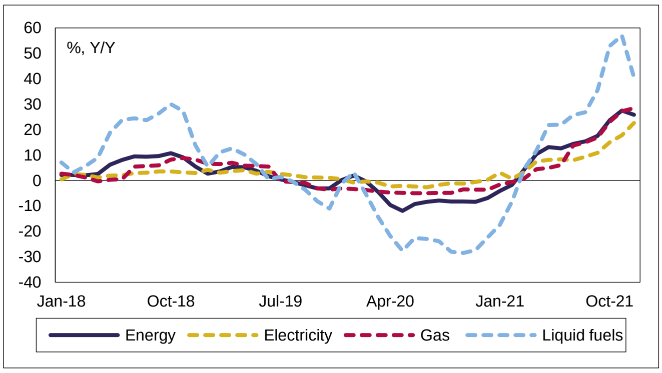
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Services inflation



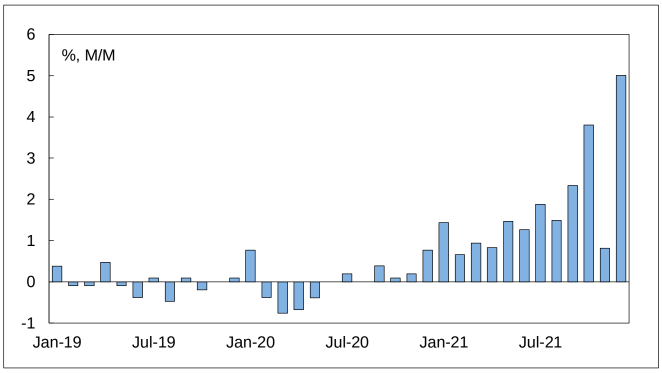
Source:Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Energy inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Producer prices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Tomorrow's data highlight in the euro area will be the Commission's preliminary consumer confidence index for January. After a notable decline in December, sentiment is expected to have weakened further at the start of the year reflecting the adverse impact of the surge in coronavirus cases during the festive period. Indeed, the index is forecast to fall 0.7pt to -9.0, suggesting that consumers were the most downbeat since March. Separately, ECB President Lagarde will take part in a virtual panel discussion at the Davos Agenda discussing the global economic outlook.

UK

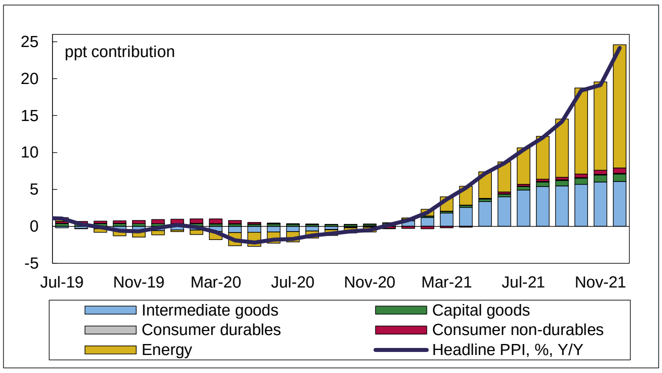
UK RICS survey points to ongoing demand-supply imbalances to keep prices elevated

Today's RICS residential survey signalled that strong UK house price growth had been maintained at the end of last year despite the BoE's decision to raise interest rates and expectations of more hikes to come over the near term. Indeed, the survey's headline price balance (69%) was merely a touch softer than in November and only 13ppts below the peak in June ahead of the start of the tapering of the government's Stamp Duty holiday. There was a further slight easing in the number of new buyer enquiries, although this continued to outpace new properties coming to the market – indeed, inventories on estate agents' books fell to a new series low. Against this backdrop, surveyors remained relatively optimistic about their expectations for house prices over the coming three months, with sales expectations only a touch below the long-run average too. Today's RICS survey broadly tallies with the message of other recent housing market indicators. Yesterday's official HPI data published by the Land Registry showed that the average UK house price rose 10%Y/Y in November, within the recent range, but still well above the historical average. This left the average UK house price at £271k, just below the record high reached in September. And with mortgage approvals in December (67k) broadly in line with the pre-pandemic trend, the latest Nationwide survey indicated that price growth remained above 10%Y/Y at the end of 2021 too.

But housing affordability set to worsen this year for first-time buyers

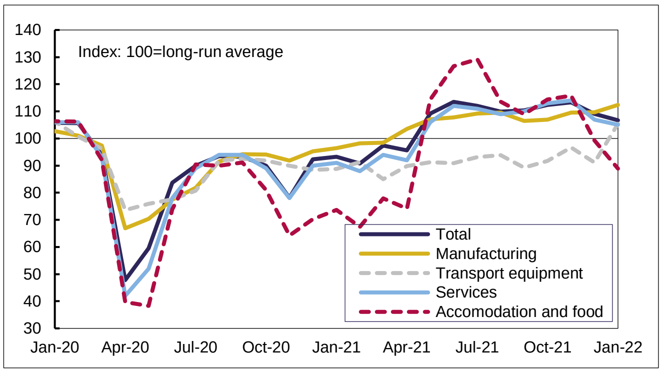
The rise of roughly 16% in the average UK house price since the start of the pandemic (compared with the increase of a little more than 2% in the two years before February 2020) has far outpaced that of earnings during the same period (7½%). So, the ratio of house prices to earnings has steadily risen over recent quarters, to a record high of 6.6x in Q4. And with the exception of London – which despite remaining exceptionally high at 10.6x is down from the pre-Brexit peak – housing affordability has worsened across all regions. With most UK mortgage debt now fixed-rate, only a relatively small share of mortgages will be refinanced this year. And despite higher sterling yields, mortgage holders who do refinance will still typically be able to do so at lower rates when their fixes come to an end. However, according to Nationwide, first-time buyer

Germany: Producer price inflation



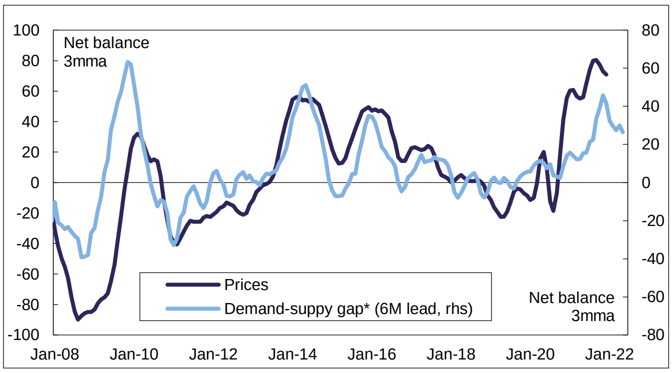
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Business sentiment indicators



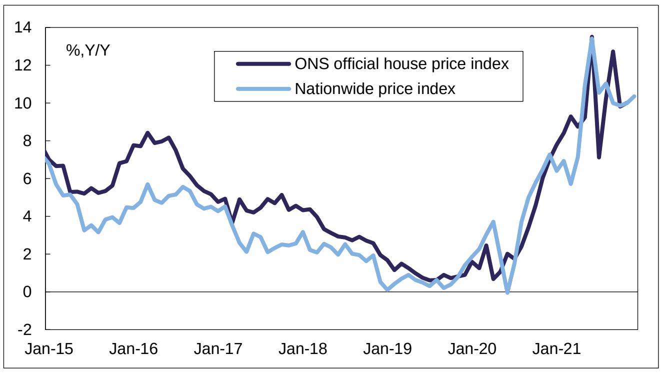
Source: INSEE, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: RICS residential survey



**Buyer enquiries minus new vendor instructions. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: House price growth



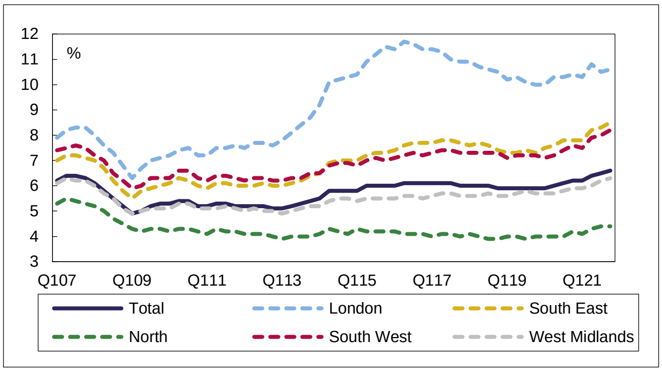
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

mortgage payments rose to roughly 31% of take-home pay in the final quarter of last year. While still significantly lower than levels seen ahead of the global financial crisis (when the equivalent share peaked at 47%), these were nevertheless the highest since 2014. With Bank Rate and sterling yields set to rise further this year (we now expect three hikes in Bank Rate in 2022), interest rates on new mortgages will rise significantly. So, housing affordability for first-time buyers seems bound to worsen further. And with real disposable incomes likely to decline over the year as a whole, this should act as a break on house price growth as the year progresses.

The day ahead in the UK

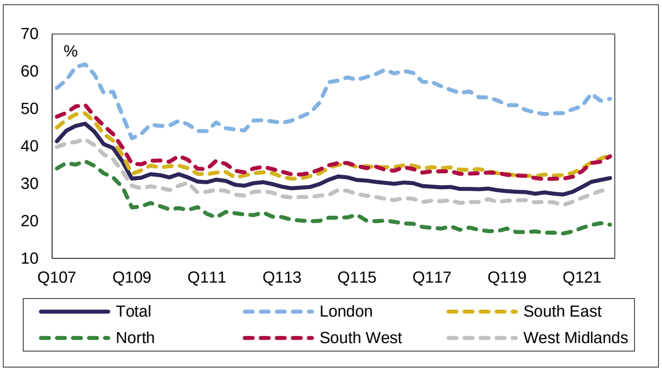
Tomorrow brings the release of the UK's December retail sales data, which are expected to show that, following strong growth in November and weaker consumer confidence amid the surge in coronavirus cases, sales fell back at the end of last year, albeit not fully reversing the near-1½%M/M increase seen in November. The latest Bloomberg consensus is for a fall of 0.6%M/M in December, compared with the average decline of 1%M/M in the five months to September. Tomorrow's GfK consumer confidence survey seems unlikely to point to a substantial improvement in sentiment at the start of the year either. Aside from the data, tomorrow sees MPC member Catherine Mann speak at an event on the economy and monetary policy.

UK: House prices to earnings



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

UK: FTB mortgage payments to take-home pay*



**First-time buyer mortgage payments. Based on 80% LTV mortgage.*
Source: Nationwide, Refinitiv 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	Final CPI (core CPI) Y/Y%	Dec	**5.0 (2.6)**	*5.0 (2.6)*	4.9 (2.6)	-
Germany	PPI M/M% (Y/Y%)	Dec	**5.0 (24.2)**	0.8 (19.3)	0.8 (19.2)	-
France	INSEE business (manufacturing) confidence	Jan	**107 (112)**	109 (112)	110 (111)	**109 (110)**
Spain	Trade balance €bn	Nov	**-4.2**	-	-3.4	-
UK	RICS house price balance %	Dec	**69**	69	71	-

Auctions

Country	Auction
France	sold €4.40bn of 0% 2025 bonds at an average yield of -0.35%
	sold €3.96bn of 0% 2027 bonds at an average yield of -0.15%
	sold €2.14bn of 0.75% 2028 bonds at an average yield of -0.01%
	sold €684mn of 0.1% 2026 inflation-linked bonds at an average yield of -2.08%
	sold €602mn of 0.1% 2031 inflation-linked bonds at an average yield of -1.5%
	sold €460mn of 0.1% 2032 inflation-linked bonds at an average yield of -1.33%
Spain	sold €2.16bn of 0% 2027 bonds at an average yield of 0.088%
	sold €1.39bn of 0.5% 2030 bonds at an average yield of 0.429%
	sold €1.18bn of 1.2% 2040 bonds at an average yield of 1.21%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	15.00	Commission's preliminary consumer confidence	Jan	-9.0	-8.3
UK	00.01	GfK consumer confidence	Jan	-15	-15
	07.00	Retail sales M/M% (Y/Y%)	Dec	-0.6 (3.4)	1.4 (4.7)
	07.00	Retail sales, excluding auto fuel M/M% (Y/Y%)	Dec	-0.8 (1.1)	1.1 (2.7)

Auctions and events

Country	GMT	Event
Euro area	12.30	ECB President Lagarde takes part in a forum on 'The Global Economic Outlook'
UK	13.00	BoE MPC member Mann to speak at an OMFIF event on the economy and monetary policy

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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