Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Despite a steep decline in German retail sales, Bunds made losses as the euro area unemployment rate fell to a series low and French inflation exceeded expectations.
- Shorter-dated Gilts made losses as UK house prices accelerated while UK mortgage approvals and consumer credit picked up.
- Tomorrow will bring the flash euro area inflation estimate for January, which is expected to have fallen by less than the ECB had forecast in December.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.491	-
OBL 0 04/27	-0.211	+0.022
DBR 0 02/32	0.030	+0.024
UKT $0^{1}/_{8}$ 01/24	1.049	+0.019
UKT $0^{3}/_{8}$ 10/26	1.134	+0.007
UKT $0^{1}/_{4}$ 07/31	1.299	-0.001

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

Euro area

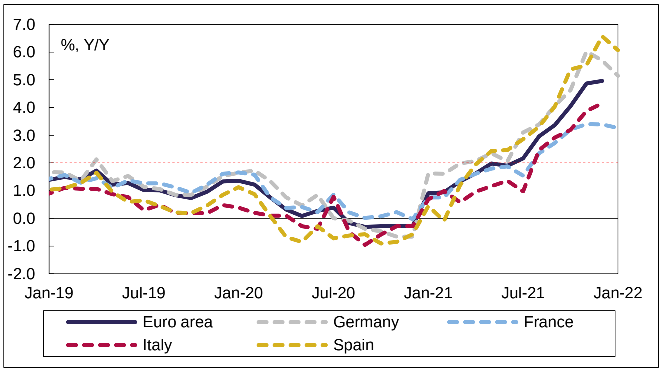
As in Germany and Spain, French inflation exceeds expectations

Following yesterday's significant upside surprises to the January flash inflation estimates from Germany, Spain and Portugal, today's equivalent French data similarly beat expectations. In particular, on the EU-harmonised HICP measure, French inflation dropped just 0.1ppt to 3.3%Y/Y, contrasting with the fall of 0.4ppt on the median forecast from the Bloomberg survey. Moreover, the national CPI measure rose 0.1ppt to 2.9%Y/Y, the highest since 2008. As elsewhere, energy again provided additional impetus, rising more than 2ppts to 19.7%Y/Y on the national measure due to higher petrol prices. And food inflation edged up 0.1ppt to 1.5%Y/Y. But while services inflation rose 0.2ppt to 2.0%Y/Y, inflation of manufactured items fell 0.6ppt to 1.2%Y/Y. While that left our estimate of core inflation up just 0.1ppt at a still-moderate 1.5%Y/Y, the weakness of goods inflation reflected the timing of the winter sales and a rebound might be expected in February. Based on the data released so far, we now anticipate a drop of 0.3ppt in tomorrow's euro area inflation estimate to 4.7%Y/Y (compared to the current Bloomberg median forecast of 4.4%Y/Y). While core inflation should also decline from December's rate of 2.6%Y/Y, it is likely to remain firmly above 2.0%Y/Y. So, the ECB's inflation forecast looks all the more likely again to be revised upwards next month, with implications for its signal on the timing of an end to its net asset purchases and eventual interest rate lift-off.

Unemployment rate falls to series low despite softer GDP growth

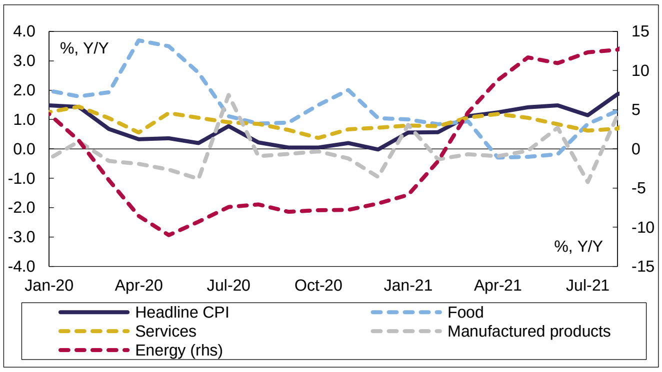
As the contribution from energy prices will be projected to decline steadily, euro area inflation will still be forecast by the ECB to fall back from Q222 and perhaps return to below 2.0%Y/Y by early next year. But labour market developments will be most important in determining the inflation outlook beyond that point. If it remains near current rates, wage growth will be too subdued to generate a big pickup in domestically-generated inflation in 2023. However, given the continued decline in joblessness around the turn of the year despite the slowdown in economic growth, today's labour market data will have provided the ECB with encouragement. The euro area unemployment rate fell for the eighth successive month in December, edging down 0.1ppt from a downwardly revised reading in November to a series low of just 7.0%. The number of people out of work fell a further 185k, only some 43k lower than the average decline since April, to 11.481mn. Among the large member states, the unemployment rate dropped again in France, Italy and in particular Spain (down 0.4ppt to a thirteen-year low of 13.0%). Moreover, German claimant count unemployment fell a bigger-than-expected 48k – the most since August – in January to push the rate down to a 22-month low of 5.1%. And job vacancies rose 21k to a series high suggesting increased tightness in the German labour market despite the contraction in GDP in Q4 and persisting weakness at the start of 2022. But while that points to stronger wage settlements in Germany over coming months, underemployment in other member states – particularly in Southern Europe – remains ample and will weigh on labour costs for several quarters to come.

Euro area: Consumer price inflation by country*



*HICP measure. Flash estimates for January 2022 for Germany, France and Spain. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Consumer price inflation*



*National CPI measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

German retail sales laid low by coronavirus in December

Contrasting with the upbeat data from the labour market, German retail sales plunged at the end of last year as the latest wave of pandemic and associated restrictions saw shoppers stay at home. According to today's preliminary figures, retail turnover fell in December by 5.5%M/M in real terms, the most since April. Sales at all types of stores were hit, with non-food turnover down 7.7%M/M and food items down 1.4%M/M. Online shopping fell too, down a marked 5.7%M/M, suggesting that the pandemic restrictions were only part of the cause of the decline in overall sales. Total real sales were still unchanged from a year earlier and 0.7% above the pre-pandemic level. However, despite growth in October and November, they also fell 0.8%Q/Q in Q4, highlighting the dominant contribution of weak private consumption to the 0.7%Q/Q drop in GDP last quarter. Despite strong inflation, the drop in nominal retail sales was also marked, down 4.9%M/M to be up just 0.1%Q/Q in Q4. We caution that these provisional data are frequently revised significantly. However, given the magnitude of the drop in December, it seems inconceivable that any revisions will alter the picture of marked weakness at the end of the year. And with a range of restrictions in place and hospitalisations moving in the wrong direction, sales have likely remained subdued at the start of 2022.

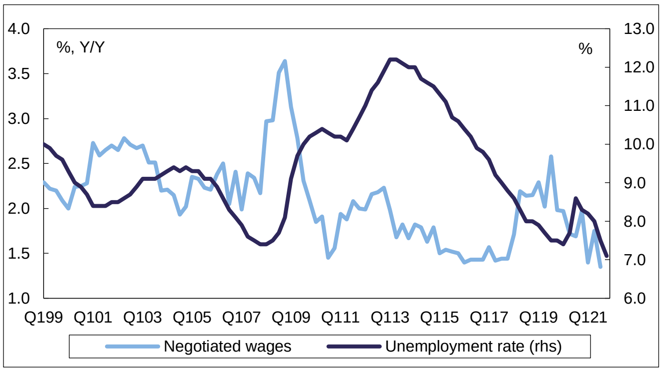
Final manufacturing PMIs suggest pickup in output and demand amid slight easing of bottlenecks

Despite some downwards revisions from the flash estimates, the final euro area manufacturing PMIs still signalled a pickup in growth in the sector at the start of 2022. In particular, the output index rose 1.6pts in January to a four-month high of 55.4 (compared to the flash estimate of 55.8), pointing to moderate growth in production, while the new orders indices implied firmer demand. Other detail on the survey pointed to a slight easing in supply bottlenecks, with delivery times reportedly lengthening at the slowest pace in a year and backlogs rising at the softest pace in eleven months. Nevertheless, while the euro area manufacturing input cost PMI (83.5) was confirmed at the lowest since April, the equivalent index for output prices (72.7) suggested a greater willingness to pass on pressures to customers. At the country level, the downwards revision to the euro area output index reflected the German PMI (57.0), which nevertheless still suggested the best month for production since August. While the French output index (50.9) still suggested minimal manufacturing growth at the start of the year, the equivalent PMIs for Italy (54.5) and Spain (53.1) were consistent with moderate growth albeit with the former the lowest in a year and the latter close to the bottom of the range of the past twelve months.

The day ahead in the euro area

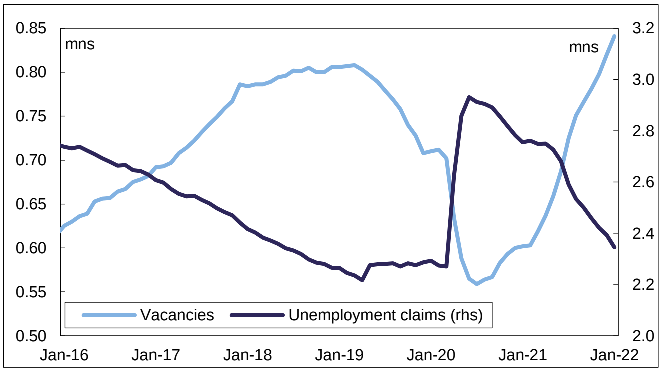
Ahead of Thursday's ECB policy-setting meeting, attention tomorrow will be on the aforementioned euro area flash inflation estimate for January. While this will have declined at the start of the year in part due to the impact of past German tax changes, upside surprises to various national figures so far this week suggest a more modest fall than previously estimated.

Euro area: Unemployment rate and wage growth



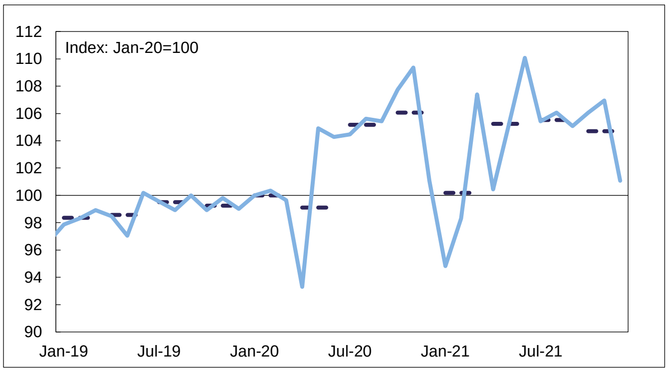
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Jobless claims and vacancies



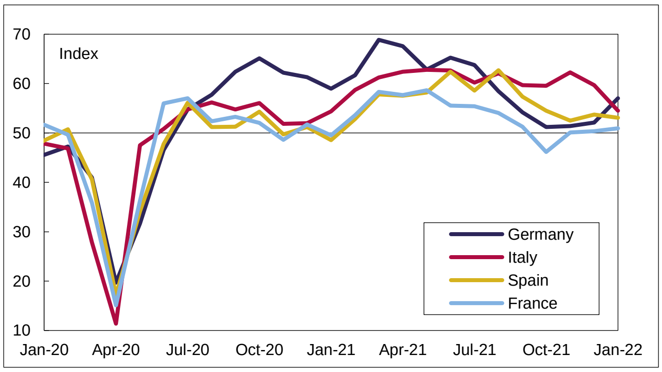
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Retail sales*



**Dashed line represents quarterly average level.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output PMI by country



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

In the absence of a downside surprise from tomorrow's Italian numbers, we now expect the headline CPI rate to have fallen just 0.3ppt to 4.7%Y/Y, with the core measure to have remained firmly above 2%Y/Y but down from 2.6%Y/Y previously.

UK

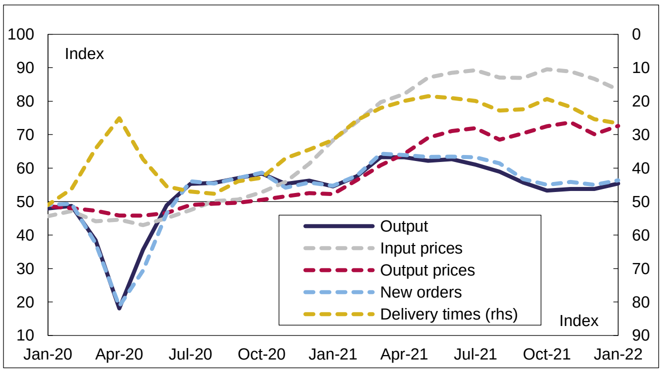
Demand for credit up and household deposits softer as real income are squeezed

While the reintroduction of certain pandemic restrictions in December limited spending on services and retail sales fell sharply that month, today's UK bank lending data suggested that demand for credit increased more than expected and the amount that households saved fell at the end of last year as real disposable incomes were squeezed. In particular, individuals borrowed a net £0.8bn in consumer credit in December, down slightly from November (£1.0bn) but a touch above the average (£0.7bn) in the previous six months. So, growth in the stock of such lending rose 0.6ppt to 1.4%Y/Y, with credit card borrowing up 2%Y/Y. Meanwhile, the amount households deposited with banks in December was notably lower than of late, with the net flow of £2.7bn comparing with an average monthly net flow of £11.1bn in the previous twelve months and below the pre-pandemic ten-year average (£4.0bn) too. Nevertheless, 'excess savings' during the pandemic have risen to about £175bn, equating to roughly 12½% of household consumption. Those accumulated savings should provide a financial cushion for some households. But they are far from equitably distributed. And April alone will bring a further rise in the regulated energy price cap and 1.25ppt increase in National Insurance Contributions. Notwithstanding the possibility of further policy measures to ease the burden, many lower income households will struggle to cope with rising household energy costs, which account for a much larger share of disposable income (7% for households in the lowest 10% income bracket) than the national average (under 4%). So, consumer credit should continue to rise over coming months while household spending growth is likely to remain relatively subdued.

Mortgage approvals above pre-pandemic trend as house prices growth accelerates

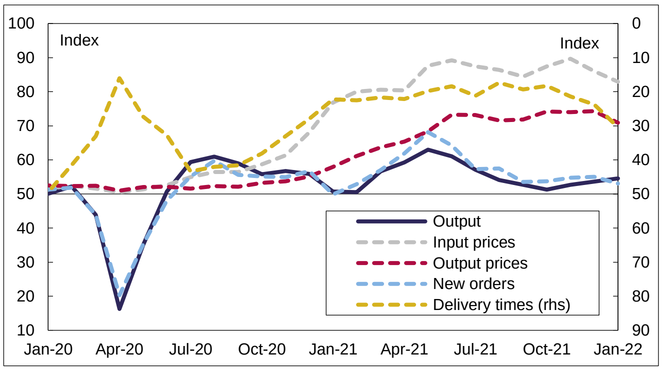
Despite the latest pandemic wave, today's data suggested that mortgage market activity remained relatively firm at the turn of the year. In particular, net secured borrowing increased £3.6bn in December, only a touch below the pre-pandemic twelve-month average (£4.2bn) despite the conclusion of the government's Stamp Duty holiday at the end of September. And the number of mortgages approved in December increased slightly to 71k, above the twelve-month average ahead of the pandemic (67.7k). Admittedly, the effective interest rate on new mortgages ticked slightly higher (8bps) from November's record-low 1.58%, and this will likely increase further as Bank Rate rises over coming quarters. However, the first house price data for January indicated an acceleration at the start of the year as tight supply-demand balance offset concerns

Euro area: Manufacturing PMIs



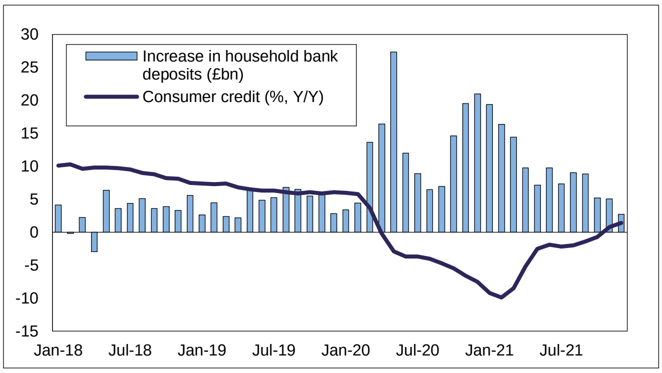
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing PMIs



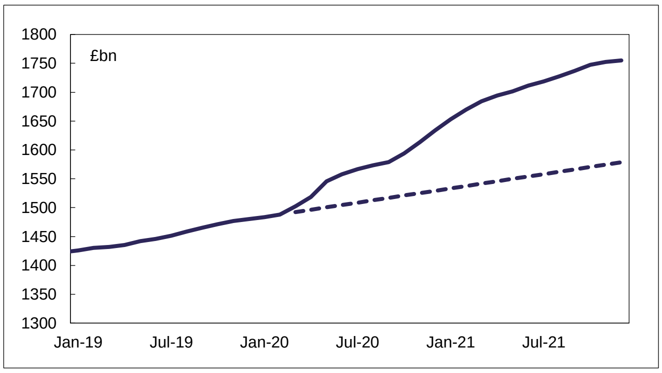
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Household deposits and consumer credit



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Households 'excess savings'*



**Dashed line represents pre-pandemic trend in household deposits in banks.*
Source: BoE and Daiwa Capital Markets Europe Ltd.

about Omicron, rising inflation and falling real incomes. Indeed, the Nationwide house price index rose 0.8%M/M, the strongest monthly increase in January for thirteen years, to take the annual rate up a stronger-than-expected 0.8ppt to a seven-month high of 11.2%Y/Y from 10.4%Y/Y in December.

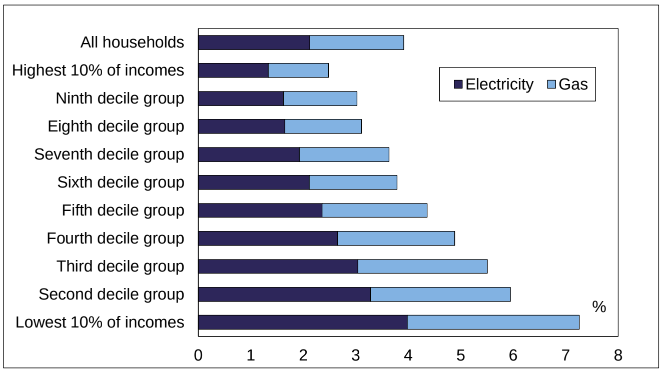
Manufacturing PMI signals solid output growth, but softer orders and still elevated prices

Separately, there were no major surprises from today's final manufacturing PMIs, which suggested that the UK's manufacturing sector has fared relatively well during the latest pandemic wave. For example, the survey's output component rose for the third consecutive month in January to 54.5, a five-month high, with a notable pickup reported in production of intermediate goods as supply bottlenecks appeared to have eased a little further. Indeed, delivery times in the sub-sector lengthened by the least since October 2020. Nevertheless, some firms still noted that supply chain stresses persisted, and, together with staff shortages and slower growth of new work, had continued to limited production capacity. While price pressures had reportedly eased somewhat in line with easing supply bottlenecks, they remained at an historically elevated level. And although the output price PMI fell to an eight-month low, at 70.9 it still remains almost 17pts above the long-run average.

The day ahead in the UK

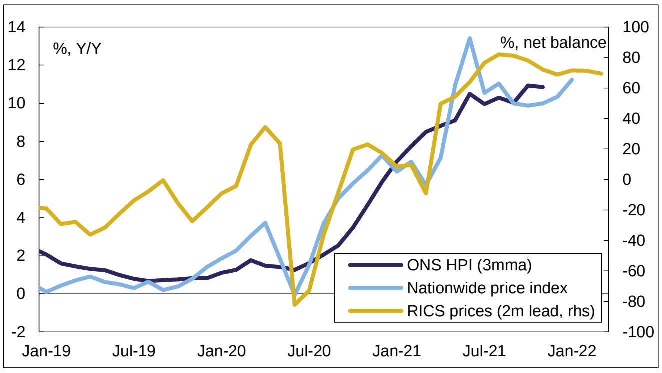
Tomorrow brings the release of the BRC shop price index for January. Despite softer demand amid the latest pandemic wave, this is likely to signal upwards price pressures on the High Street as retailers struggle to absorb the cost pressures arising from rising global energy and food prices, more expensive transportation and storage costs and labour shortages.

UK: Spending as a share of disposable income



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: House price indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Today's results

Economic data						
Country	**Release**	**Period**	**Actual**	**Market consensus/ *Daiwa forecast***	**Previous**	**Revised**
Euro area	Final manufacturing PMI	Jan	**58.7**	59.0	58.0	**-**
	Unemployment rate %	Dec	**7.0**	7.1	7.2	**7.1**
Germany	Retail sales M/M% (Y/Y%)	Dec	**-5.5 (0.0)**	-1.4 (3.4)	0.8 (0.5)	**0.8 (1.1)**
	Unemployment rate % (change '000s)	Jan	**5.1 (-48.0)**	5.2 (-6.0)	5.2 (-23.0)	**- (-29.0)**
	Final manufacturing PMI	Jan	**59.8**	60.5	57.4	**-**
France	Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	**2.9 (3.3)**	2.5 (2.9)	2.8 (3.4)	**-**
	Final manufacturing PMI	Jan	**55.5**	55.5	55.6	**-**
Italy	Manufacturing PMI	Jan	**58.3**	61.2	62.0	**-**
	Unemployment rate %	Dec	**9.0**	9.1	9.2	**9.1**
Spain	Manufacturing PMI	Jan	**56.6**	56.0	56.2	**-**
UK	Nationwide house price index M/M% (Y/Y%)	Jan	**0.8 (11.2)**	0.6 (10.9)	1.0 (10.4)	**1.1 (-)**
	Net consumer credit £bn (Y/Y%)	Dec	**0.8 (1.4)**	0.4 (-)	1.2 (0.4)	**1.0 (0.8)**
	Net mortgage lending £bn (approvals '000s)	Dec	**3.6 (71.0)**	3.5 (66.0)	3.7 (67.0)	**3.8 (67.9)**
	Final manufacturing PMI	Jan	**57.3**	56.9	57.9	**-**

Auctions	
Country	Auction
Germany	sold €4.85bn of 0% 2024 bonds at an average yield of -0.50%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	**GMT**	**Release**	**Period**	**Market consensus/ *Daiwa forecast***	**Previous**
Euro area	10.00	Preliminary CPI (core CPI) Y/Y%	Jan	*4.7 (2.2)*	5.0 (2.6)
Italy	10.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	3.8 (4.0)	3.9 (4.2)
UK	00.01	BRC shop price index Y/Y%	Jan	-	0.8

Auctions and events
- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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