Euro wrap-up

Overview

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- Bunds made modest losses at the short end as the flash estimate of euro area inflation in January smashed expectations to rise to a new series high.
- Gilts followed USTs higher despite a strong survey of UK high-street prices.
- Thursday is likely to see the BoE's MPC raise Bank Rate by 25bps and confirm the start of quantitative tightening, but the ECB should leave its monetary policy settings unchanged while acknowledging the need for flexibility.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.479	+0.010
OBL 0 04/27	-0.196	+0.012
DBR 0 02/32	0.030	-0.003
UKT 0⅛ 01/24	1.008	-0.039
UKT 0⅜ 10/26	1.094	-0.037
UKT 0¼ 07/31	1.245	-0.052

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

Euro area

Flash inflation smashes expectations due principally to accelerating energy prices

Today's flash estimate of euro area inflation in January smashed all expectations to increase somewhat the probability that the ECB might raise rates as soon as this year. Contrary to universal expectations of a drop – which, despite their own upside surprises, had still been strongly suggested by the national data published earlier this week – the headline HICP rate edged up 0.1ppt to a new series high of 5.1%Y/Y. The largest pressures once again came from energy prices, which rose 6.0%M/M – the most in any single month since the introduction of the euro – to take the respective annual rate to a new record of 28.6%Y/Y. In part that reflected higher prices of auto fuel driven by the renewed uptrend in global crude oil prices. But it also reflected a steep jump in household energy bills in Italy – where regulated energy prices rose 93.5%Y/Y – the full extent of which was also revealed today and contributed to a massive upside surprise in overall inflation in that country (up 1.1ppts to 5.3%Y/Y on the HICP measure). Given the increase in the share of the euro area inflation basket taken by energy from the start of this year, its impact was all the larger. Indeed, excluding energy, inflation fell 0.2ppt to 2.6%Y/Y.

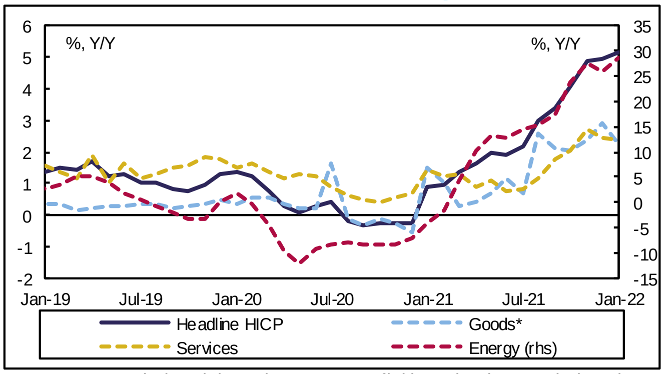
Core inflation declines, but only due to timing of German tax changes and French discounting

Despite the dominant role of energy prices, the other detail in today's inflation data provided plenty for the ECB to worry about. In part due to global factors as well as higher oil prices, there were clear additional pressures from inflation of food, alcohol and tobacco, which rose 0.4ppt to 3.6%Y/Y, the highest since panic-buying during the first wave of the pandemic. In contrast, services inflation was unchanged at 2.4%Y/Y, and inflation of non-energy industrial goods fell 0.6ppt to a three-month low of 2.3%Y/Y. As a result, core inflation fell 0.3ppt to 2.3%Y/Y. But having been expected to slip back below 2.0%Y/Y, that decline in core inflation was a disappointment. And it principally reflected base effects associated with German tax changes and French New Year discounting – adjusting for those impacts core inflation would have accelerated.

Core inflation set to move significantly higher over coming months

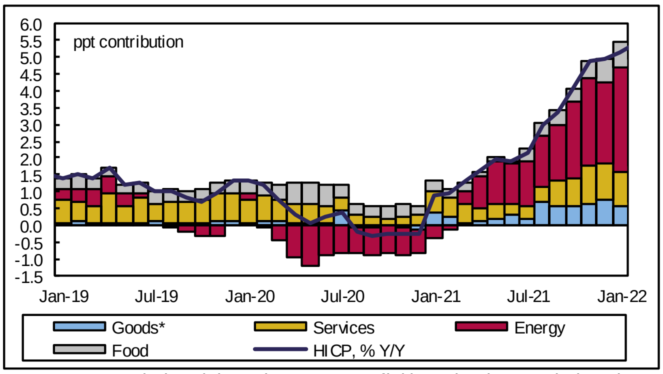
Today's data are a big headache for the ECB. Headline inflation vastly exceeded the path set out in its forecast published seven weeks ago, when it expected it to drop to an average of 4.1%Y/Y in Q1 and fall steadily further over the remainder of the year. Of course, the ECB is not alone in misjudging this pressure – indeed, the difference between the flash estimate and the consensus forecast was the largest on the series. The recent rise in oil prices, to above $88bbl from an average near $75 in December, has provided new impetus. There is set to be additional pass-through of natural gas prices to household energy bills in some member states. And with base effects set to become less favourable, and further pass-through of pipeline costs to prices of services and goods to come, core inflation is set to rise above 3.0%Y/Y in Q2 and Q3.

Euro area: HICP inflation and components



*Non-energy industrial goods. Source: 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.

ECB's March forecasts could signal likelihood of rate hike by year-end

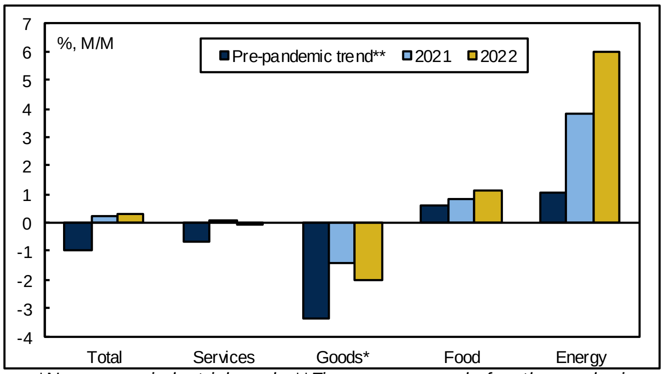
Therefore, the ECB will have to revise up its inflation projection significantly next month. The upwards revisions will be largest for the coming couple of quarters, not least as forecasting conventions will continue to weigh on the projection for inflation next year. And still-subdued wage growth will continue to contain the forecast for the services component in 2023 and 2024. Nevertheless, with the previous forecasts having anticipated average inflation of 1.8% Y/Y in both 2023 and 2024, it is perfectly feasible that the updated forecasts will nudge up these figures to 2.0% Y/Y or so, suggesting that the conditions required for rate lift-off might now be met. At tomorrow's Governing Council press conference Christine Lagarde will no doubt emphasise the dominant but temporary role of energy prices in driving inflation higher. And she will insist on the need to await the ECB's updated projections before jumping to conclusions about the appropriate policy response. But she will also have to acknowledge that the near-term inflation outlook appears to have deteriorated. And as such, she should also repeat that the Governing Council is prepared to be flexible, and amend policy this year if necessary. If only by implication, that would underscore the possibility that a faster pace of decline in the ECB's net asset purchases over coming quarters, as well as a first ECB hike before year-end, might eventually be agreed by the Governing Council.

The day ahead in the euro area

While they at one stage appeared likely to be relatively uneventful after the significant policy amendments at the previous meeting, tomorrow's ECB monetary policy statement and press conference will therefore be closely watched. While recent data suggest that the ECB's assessment of the most likely path ahead for GDP remains broadly unchanged, the near-term inflation outlook appears to have deteriorated, clouding the monetary policy outlook. In the absence of updated projections, however, the Governing Council will reaffirm the expected profile for QE up to October. Net PEPP purchases will certainly still conclude at the end of March. And net APP purchases will still be expected to double to €40bn per month in Q2, before slowing to €30bn per month in Q3 and further to €20bn per month in October. But in her press conference, President Lagarde will acknowledge the significant uncertainty with respect to the likely path of inflation and thus repeat that the Governing Council stands ready to adjust policy if and when necessary. Nevertheless, she will likely reiterate that economic conditions in the euro area differ markedly from those in the US, and that – based on the December projections – the preconditions for rate hikes set out in the ECB's forward guidance were unlikely to be met before the end of the year.

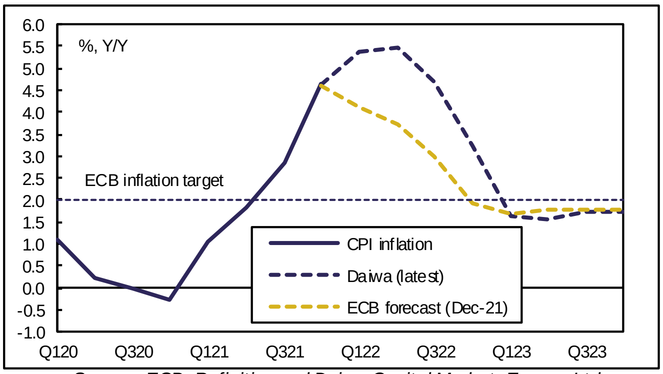
On the data front, tomorrow sees the release of final January services and composite PMIs. The flash PMIs suggested that euro area economic activity slowed for a second successive month in January as the latest wave of coronavirus weighed on services activity. In particular, the euro area composite output PMI dropped 0.9pt in January to an eleven-month low of 52.4

Euro area: Consumer price inflation



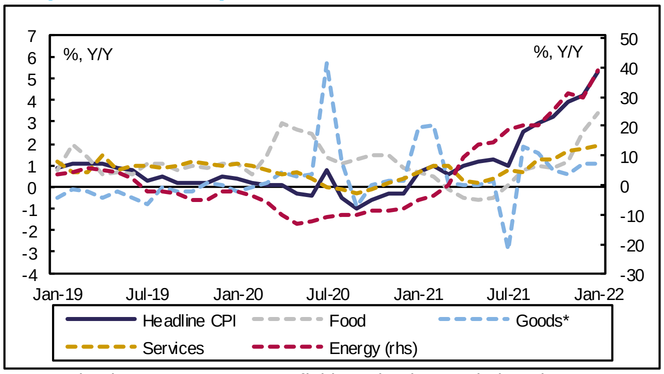
*Non-energy industrial goods. **Five-year average before the pandemic. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



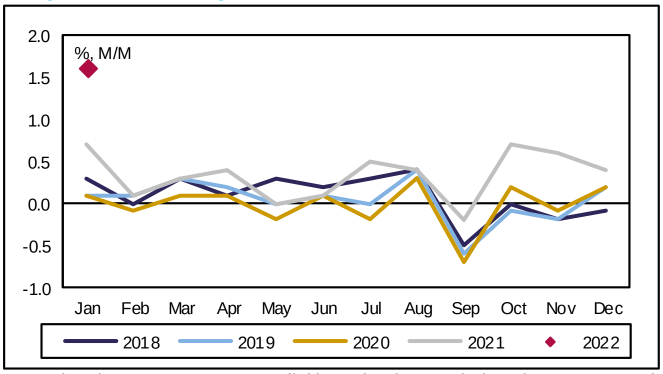
Source: ECB, Refinitive and Daiwa Capital Markets Europe Ltd.

Italy: Consumer price inflation*



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

Italy: Consumer price inflation*



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

with the fall entirely due to a near-2pt decline in the services activity index to a nine-month low of 51.2. Among the member states, the flash German survey pointed to a return to growth in services at the start of the year, but a much weaker performance in France. And while no detailed data were published for Italy and Spain, Markit suggested that growth in both countries had ground almost to a halt.

UK

Survey signals strongest inflation on the high street since 2012

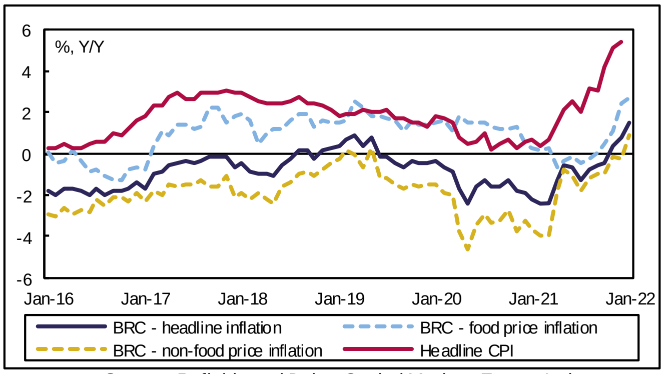
High inflation in the wider economy has finally started to show up in prices on the UK high street. According to the BRC's latest survey, shop price inflation accelerated 0.7ppt in January to 1.5%Y/Y as retailers sought to pass on to consumers the increased costs of shipping, energy and other items. The latest reading compared with an average pace of decline in shop prices of 0.9%Y/Y in 2021, an even steeper fall in 2020, and a minimal average rise of just 0.1%Y/Y in 2019 ahead of the pandemic. Indeed, with the high street having been characterized by intense competition for a decade, the BRC measure of shop price inflation was the highest since December 2012. The pickup was most marked for non-food items, for which the survey index rose 0.7ppt to 1.5%Y/Y, the highest since November 2011. Prices of furniture (for which output producer price inflation rose to 5.1%Y/Y in December) and flooring reportedly rose very significantly. Despite a slight slowing in the fresh component, food inflation rose 0.3ppt to 2.7%Y/Y, the highest since October 2013. Of course, with CPI inflation already up to 5.4%Y/Y in December, and the RPI measure eye-wateringly high at 7.5%Y/Y, the BRC measure of shop price inflation still appears remarkably subdued. However, the survey results raise the prospect of a further notable rise in goods CPI inflation at the start of the year, which would increase the likelihood that overall CPI inflation will soon exceed 6.0%Y/Y. The peak will likely come in April, when household energy bills will rise in response to the increase in Ofgem's regulated price cap, to be announced tomorrow. Reports today suggested that the government is now ready to announce new policy measures to reduce the impact of that rise on households. But the net increase in bills still seems likely to be very substantive indeed.

The day ahead in the UK

Unlike the ECB, tomorrow's BoE MPC meeting looks firmly set to bring a change in policy. Bank Rate is highly likely to be hiked by 25bps to 0.50%. And assuming that threshold for Bank Rate is reached, the BoE's guidance means that policymakers should also agree to start quantitative tightening, ceasing reinvestments of the proceeds of maturing bonds from its holdings starting with the redemption of £25bn of Gilts in March. The MPC will justify its decision to raise rates on the basis of its updated projections. Admittedly, the BoE's forecasts for GDP in Q4 and Q1 will be revised down on account of the latest wave of coronavirus and associated restrictions in place over the festive period. And the Bank will be wary about the downside risks to private consumption growth over coming quarters from declines in real disposable incomes. But the MPC will continue to judge that there remains excess demand and that a period of softer demand growth is not inappropriate, particularly given that the labour market is very tight due to a drop in labour force participation and inflation has continued significantly to exceed expectations.

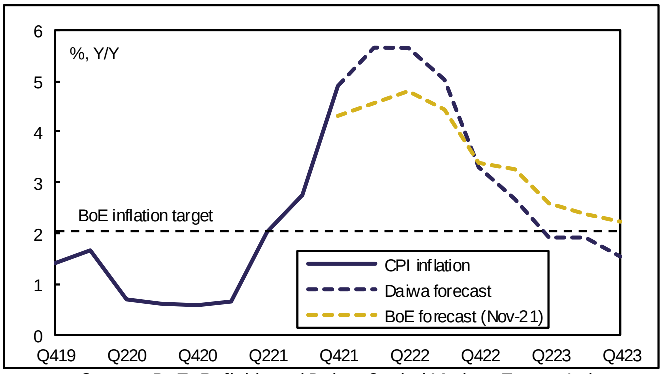
Data-wise, the final UK services and composite PMIs for January will likely align with the flash release to indicate some stabilisation in activity at the start of the year. The preliminary composite output PMI fell just 0.2pt in January to 53.4, a level still consistent with expansion.

UK: BRC shop price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Inflation forecasts



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

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary CPI (core CPI) Y/Y%	Jan	**5.1 (2.3)**	*4.7 (2.3)*	5.0 (2.6)	-
Italy	Preliminary CPI (EU-harmonised CPI) Y/Y%	Jan	**4.8 (5.3)**	3.5 (3.6)	3.9 (4.2)	-
UK	BRC shop price index Y/Y%	Jan	**1.5**	-	0.8	-

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	09.00	Final services (composite) PMI	Jan	51.2 (52.4)	53.1 (53.3)
	10.00	PPI M/M% (Y/Y%)	Dec	2.4 (26.1)	1.8 (23.7)
	12.45	ECB refinancing rate %	Dec	*0.00*	0.00
	12.45	ECB deposit rate %	Dec	*-0.50*	-0.50
Germany	08.55	Final services (composite) PMI	Jan	52.2 (54.3)	48.7 (49.9)
France	08.50	Final services (composite) PMI	Jan	53.1 (52.7)	57.0 (55.8)
	08.45	Services (composite) PMI	Jan	50.0 (52.3)	53.0 (54.7)
Spain	08.15	Services (composite) PMI	Jan	51.9 (52.7)	55.8 (55.4)
UK	09.30	Final services (composite) PMI	Jan	53.3 (53.4)	53.6 (53.6)
	12.00	BoE Bank Rate %	Feb	*0.50*	0.25

Auctions and events

Country	GMT	Release
Euro area	12.45	ECB monetary policy announcement
	13.30	ECB President Lagarde speaks at post-Governing Council press conference
France	09.50	Auction: 0% 2030 bonds
	09.50	Auction: 0% 2032 bonds
	09.50	Auction: 0.5% 2044 bonds
	09.50	Auction: 0.75% 2053 bonds
UK	12.00	BoE monetary policy announcement, publication of MPC meeting summary, minutes and Monetary Policy Report (MPR)
	12.30	BoE Governor Bailey speaks at post-MPC press conference to discuss the MPR
	-	BoE publishes monthly Decision Maker Panel data for January 2022

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.