Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- While Bundesbank President Nagel suggested he favoured an ECB rate hike by year-end, Bunds made gains as Germany's trade surplus shrank markedly.
- While PM Johnson signalled an end to all English Covid-19 restrictions in February, Gilts followed USTs higher as Chief Economist Pill suggested the BoE might not start active Gilt sales as soon as Bank Rate gets to 1%.
- After UK housing and labour market surveys tomorrow, Friday will bring final German inflation data for January and the first estimate of UK Q4 GDP.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.357	-0.045
OBL 0 04/27	0.024	-0.051
DBR 0 02/32	0.215	-0.045
UKT 0⅞ 01/24	1.279	-0.050
UKT 0⅜ 10/26	1.319	-0.055
UKT 0¼ 07/31	1.427	-0.062

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

Euro area

German goods trade surplus shrinking rapidly despite gradual rise in exports

A quiet couple of days for economic data from the euro area has nevertheless brought some striking figures from the large member states, highlighting the highly adverse terms of trade shock suffered by the region. According to today's preliminary report, Germany's trade surplus on an adjusted basis dropped in December by a much larger-than-expected €4bn – the most in ten months – to just €6.8bn, almost €10bn lower than a year earlier. That represented the second-smallest surplus in more than two decades, only exceeding that following the sudden stop to exports in April 2020 due to the first coronavirus lockdown. On this occasion, exports continued to grow in nominal terms, rising 0.9%M/M and 11.8%Y/Y in December. And while, after adjusting for prices, they were unchanged on the month in volume terms, they were still up 1.7% 3M/3M, albeit 1.4% below the post-pandemic peak in March and 3.2% below the pre-pandemic level in February 2020.

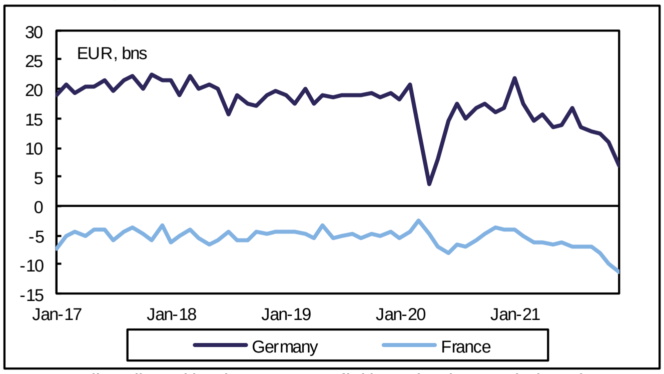
Shrinking German surplus caused by import price shock

So, the marked deterioration in the German trade surplus principally reflects the big increase in the value of imports, which rose 4.7%M/M in December to a new record high up almost 25%Y/Y. That increase from a year earlier almost entirely reflects changes to prices of energy and other goods, with the volume of imports up just 0.7% Y/Y in December. While import volumes were stronger on the month in December, up 4.6%M/M to be 1.4% above the pre-pandemic level, they were also up just 1.5% 3M/3M, slightly less than the equivalent pace of increase of exports. So, with German goods export prices up 10.9%Y/Y but import prices up a whopping 24.0%Y/Y (and even 21.4%Y/Y excluding petroleum and associated products), the massive shifts in relative prices are significantly eroding purchasing power. In volumes terms, net trade appears to have had a minimal direct impact on German GDP growth in Q4. The indirect effect on domestic spending, however, is likely to be substantive for a while yet.

French trade deficit blows out to record high

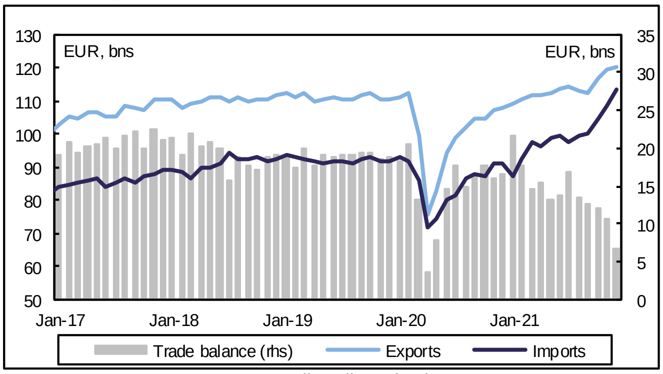
The trade surplus of the euro area as a whole is also bound to have shrunk markedly at the end of 2021. Indeed, France also recorded a notable deterioration in its goods trade balance in December, with the deficit in adjusted terms increasing more than €1.5bn – the most since May 2020 – to a record high of €11.3bn, some €7.1bn larger than a year earlier. That also left the full-year French trade deficit in 2021 at a record high of €84.7bn, just under 3½ of GDP. French import values rose 2.5%M/M in December to be up 33.2%Y/Y, while exports dropped 0.4%M/M to be up 17.7%Y/Y. Some two-thirds of the increase in imports from a year earlier reflected increases in import prices. But firm growth in the volume of imports of capital and intermediate goods, as well as electricity, have also played a role. Indeed, the preliminary French GDP data highlighted

Germany & France: Goods trade balance*



*Seasonally-adjusted basis. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Goods trade*



*Seasonally-adjusted values.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

a negative contribution to French growth in Q4 from net trade of 0.2ppt, as import volumes (up 3.6%Q/Q) outpaced export volumes (3.2%Q/Q) not least due to strong growth in imports of transport equipment (up 8.8%Q/Q).

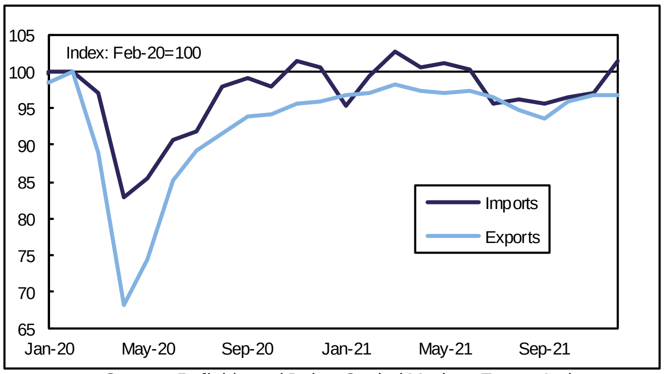
Italian and Spanish IP fell in December

Meanwhile, the latest Italian and Spanish industrial production figures were significantly weaker than the modest declines previously reported in Germany and France at the end of last year. Italian IP fell 1.0%M/M, the most for seven months, while Spanish output dropped 2.6%M/M, the most since April 2020. But the weakness in both countries followed vigorous growth in November (2.1%M/M and 3.9%M/M respectively). And over Q4 as a whole, industrial output in Italy rose a further 0.5%Q/Q to end the quarter 2.0% higher than the pre-pandemic level, while production in Spain was up 1.4%Q/Q to be just 0.1% below the pre-Covid level. Within the detail in Italy, the weakness in December reflected sizeable declines in machinery and metals production (-2.8%M/M and -3.4%M/M respectively). In contrast, production of transport equipment and clothing maintained an upwards trend, albeit from a low level with output still some 7% and 11% below their respective pre-Covid benchmarks. Likewise, autos production in Spain rose again in December although remained more than one fifth lower than the pre-pandemic level. While the weakness in Spain at the end of the year in part reflected a drop of 19%M/M in the pharmaceutical sector following extraordinary growth of 22%M/M previously, it was principally driven by a near-2%M/M drop in energy production. Overall, while the performance varies significantly by subsector, these data on balance still suggest a more advanced recovery in the Italian and Spanish manufacturing sectors than in Germany and France, where supply bottlenecks appear to be more damaging. And while the Italian and Spanish manufacturing PMIs implied a softer performance in January, they remained consistent with ongoing expansion at the start of the year.

Irish output maintains strong upwards trend at year-end

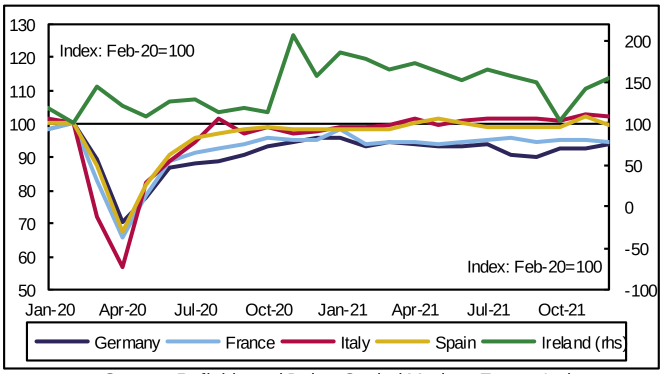
Contrasting with the declines in the large member states, the latest Irish production figures suggested a further notable rebound in output at the end of last year. Indeed, manufacturing production rose 8.0%M/M in December after increasing 38%M/M in November. Admittedly, this followed considerable weakness between August and October and so output was still down by around 15%Q/Q in Q4. Ireland's Central Statistical Office continues to flag technical issues associated with its seasonally adjustment. And this again adds a degree of uncertainty to the euro area aggregate production data (due to be published a week today), which have also been particularly volatile of late. Nevertheless, with manufacturing output having moved broadly sideways in Germany and France in December, and the decline in Spain (-0.4%M/M) also notably smaller than the headline IP figure, we expect euro area manufacturing output to have risen in December. And based on member state figures already published, we expect total euro area industrial output (excluding construction) to have moved broadly sideways at year-end.

Germany: Export and import volumes



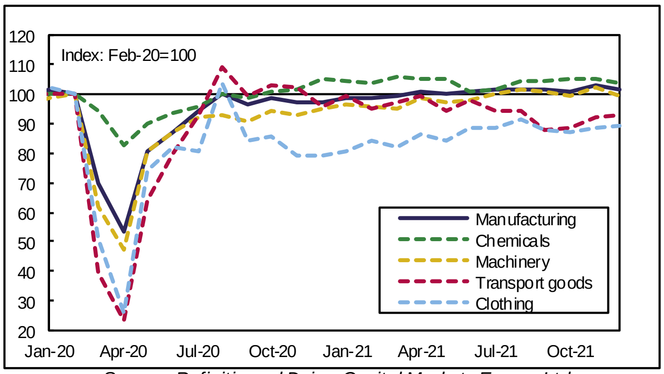
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing production



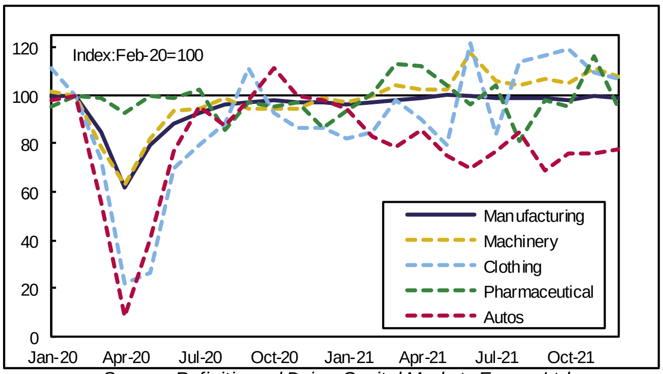
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Italy: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Spain: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The coming two days in the euro area

With no data of note due tomorrow, the focus will be on commentary from various Governing Council members with ECB Chief Economist Lane due to participate in a panel discussion on supply-chain disruptions, while Vice President de Guindos will be speaking about Europe's post-Covid economic recovery. On Friday, Germany will publish final CPI inflation data for January. The preliminary data revealed that German inflation fell back in January as the base effects from past tax changes fell out of the arithmetic. However, the declines in both the HICP EU-harmonised measure (down 0.6ppt to a three-month low of 5.1%Y/Y) and national CPI measure (down 0.4ppt to 4.9%Y/Y) were much smaller than anticipated. Once again, energy was the main culprit, rising on the national measure by more than 2.0ppts to 20.5%Y/Y, due not least to higher prices of gasoline at the pump. However, services inflation declined a very modest 0.1ppt to 3.0%Y/Y, still just the second-highest reading since 1997.

UK

UK spending data provide mixed picture as real disposable incomes are steadily eroded

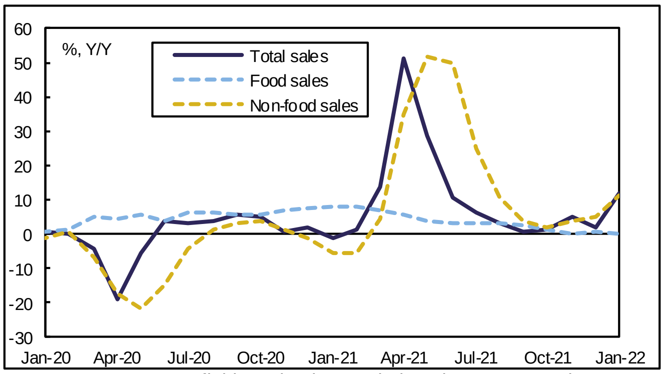
Yesterday's snapshots of spending at the start of the year in the UK were a mixed bag. At face value, the BRC's retail sales survey looked strong, with the measure of total sales up 11.9%Y/Y with like-for-like sales up 8.1%Y/Y. But that figure was flattered by the weakness of sales during the lockdown a year earlier when non-essential stores were shut, as well as higher prices. While food sales were reportedly muted as opportunities for eating out increased, strength in nominal sales was reported in purchases of items for the home, including appliances, electronics and furniture – all categories currently experiencing high rates of inflation. Overall, therefore, we suspect that the official measure of retail sales in January will show that the 3.6%M/M drop in December was by no means fully reversed last month. Indeed, Barclaycard reported that spending on its cards rose 7.4% in January compared to the same month of 2020 just ahead of the pandemic, representing the softest such rise in nine months. The slowdown partly reflected lower spending on fuel and public transport due to increased working from home, an effect likely to reverse in the current month. But spending on tourism and hospitality was also much weaker. And the ongoing significant erosion of real disposable incomes – due to higher inflation, taxes and interest rates – seems bound to weigh on discretionary spending over coming quarters.

The coming two days in the UK

It should be a relatively quiet day for top-tier releases tomorrow, with the RICS residential survey and KPMG/REC report on jobs for January due. A persisting supply-demand imbalance in the housing sector seems bound to have kept house price expectations elevated at the start of the year, while ongoing tightness in the labour market is likely to have maintained upwards pressure on starting salaries. A lot more attention will be on Friday's first estimate of Q4 GDP, which will come alongside the monthly deluge of output and trade numbers for December. GDP looks set to have risen close to the 1.1%Q/Q pace in Q3. But the headline figure will mask a more significant slowing in activity towards the end of the quarter – particularly in consumer-facing services – amid a rise in coronavirus infections and reintroduction of certain restrictions. Indeed, we forecast GDP to have contracted by about 1%M/M in December, with weakness among services, manufacturing and construction alike, with production still impeded by supply bottlenecks.

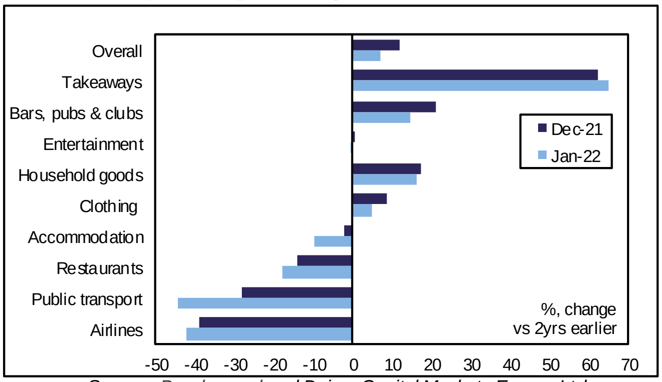
The next edition of the Euro wrap-up will be published on 11 February 2022

UK: BRC retail sales monitor



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Barclaycard spending



Source: Barclaycard and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Trade balance €bn	Dec	**7.0**	11.0	12.0	**11.6**
Italy	Industrial production M/M% (Y/Y%)	Dec	**-1.0 (4.4)**	-0.7 (4.6)	1.9 (6.3)	**2.1 (6.6)**

Auctions

Country	Auction
Germany	sold €1.27bn of 0% 2050 bonds at an average yield of 0.39%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK	00.01	RICS house price balance %	Jan	69	69

Auctions and events

Country	GMT	Event
Euro area	10.00	European Commission publishes Economic Forecasts
	12.30	ECB's Villeroy scheduled to speak
	13.00	ECB's de Guindos scheduled to speak on 'Managing Europe's post-Covid economic recovery'
	14.15	ECB Chief Economist Lane participates in panel discussion - 'The impact of supply chain disruptions on the European economy'
UK	01.01	KPMG/REC report on jobs
	20.15	BoE Governor Bailey scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Final CPI (EU-harmonised CPI) Y/Y%	Jan	4.9 (5.1)	5.3 (5.7)
UK	07.00	Preliminary GDP Q/Q% (Y/Y%)	Q4	*1.0 (6.2)*	1.1 (6.8)
	07.00	GDP M/M%	Dec	-0.5	0.9
	07.00	Industrial production M/M% (Y/Y%)	Dec	0.1 (0.6)	1.0 (0.1)
	07.00	Manufacturing production M/M% (Y/Y%)	Dec	0.2 (1.7)	1.1 (0.4)
	07.00	Construction output M/M% (Y/Y%)	Dec	-0.7 (7.7)	3.5 (6.8)
	07.00	Index of services M/M% (3M/3M%)	Dec	-0.7 (1.2)	0.7 (1.3)
	07.00	Goods trade balance €bn	Dec	-12.5	-11.3

Auctions and events

Country	GMT	Event
Euro area	17.00	ECB publishes Survey of Monetary Analysts
Italy	10.00	Auction: €3bn of 0% 2024 bonds
	10.00	Auction: €3bn of 0.45% 2029 bonds
	10.00	Auction: €1.75bn of 1.8% 2041 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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