Euro wrap-up

Overview

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- Bunds made gains despite hawkish commentary from certain ECB Governing Council members, while euro area industrial production data for December beat expectations.
- Gilts made more significant gains even as UK headline and core inflation rates rose to thirty-year highs.
- Focus tomorrow will remain on speeches from influential ECB Executive Board members, while Friday will bring the Commission's flash consumer confidence estimate and UK retail sales figures.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.387	-0.027
OBL 0 04/27	0.024	-0.024
DBR 0 02/32	0.267	-0.037
UKT 0⅛ 01/24	1.390	-0.131
UKT 0⅜ 10/26	1.408	-0.112
UKT 0¼ 07/31	1.517	-0.062

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

Euro area

Kazaks expects rate hike this year, Schnabel suggests QE costs now outweigh the benefits

Ahead of next month's key ECB monetary policy meeting, Governing Council members continue to express views about the outlook. Yesterday, Bank of France Governor Villeroy noted that the ECB could decide to end its net asset purchases in Q3, leaving room for a rate hike by year-end, a scenario which is our base case. Latvian Governor Kazaks today went further, stating that an interest rate hike this year is "quite likely". And while she was not so explicit, in a largely hawkish interview with the FT, Executive Board member Isabel Schnabel opined that "the benefits of further net asset purchases may not justify the additional costs". She wouldn't preempt the ECB's inflation forecasts, but judged it "increasingly likely that inflation is going to stabilise around our 2 per cent target over the medium term", implying that the conditions for rate liftoff will soon be reached. Schnabel was also mindful of upside risks to the inflation outlook from the labour market, where slack has been absorbed faster than anticipated. And she was concerned about the housing market too. Indeed, Schnabel recalled that the ECB aimed to take account of owner-occupied housing costs in its decision-making. Not least given strong residential property price growth, those costs rose 6.7%Y/Y in Q321, far in excess of the increase in rents of 1.1%Y/Y at the end of last year. So, Schnabel noted staff estimates that their inclusion in the HICP index in Q2 and Q3 would have added 0.4-0.6ppt to core inflation. If that persists, it could be a decisive factor when the ECB decides whether or not to raise rates.

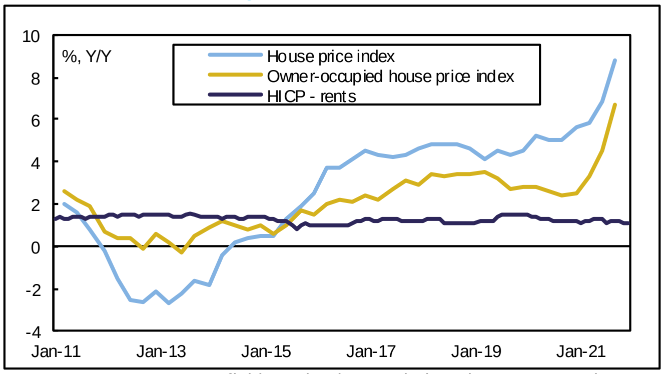
Lane highly likely to be more dovish tomorrow

Schnabel was not hawkish about all matters. For example, she judged that a Russian invasion of Ukraine would argue against an acceleration of policy normalization, as the hit to GDP growth and confidence might outweigh the boost to energy prices and inflation. She was also mindful of widening periphery spreads, insisting that the ECB would be ready to counter "severe market dislocations that lead to fragmentation". But she also noted that, even if bond yields pick up further, average interest rates on member states' government debt will stay low for an extended period of time, suggesting that, for the time being, she is not overly concerned about market developments. So, the overall impression from the interview was that Schnabel might be a persuasive advocate for a swift phasing out of net bond purchases and eventual rate hikes at coming meetings. Of course, other Executive Board members will prefer a more cautious approach. Among them, Chief Economist Lane, who is responsible for the ECB's inflation forecasts and policy recommendation, will speak publicly tomorrow.

Industrial production beats expectations in December but down again in Q4 as a whole

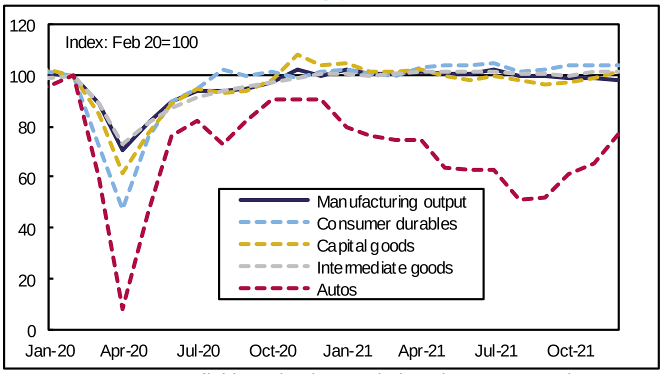
Industrial production (excluding construction) beat expectations in December, rising 1.2%M/M to be 1.0% above the pre-pandemic level in February 2020. While that followed upwardly revised growth of 2.4%M/M in November, industrial

Euro area: Housing cost indicators



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

Euro area: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

production fell in Q4 by 0.5%Q/Q to mark the third successive quarterly decline. On the Eurostat measure, only Germany (1.1%M/M) of the large member states managed positive growth in December. However, another exceptionally strong expansion in Ireland (10.3%M/M) and certain other small member states ensured the stronger-than-expected end to the year. By item, growth was led by output of motor vehicles, which rose for the fourth successive month and by 17.7%M/M to be up 22.7%Q/Q in Q3 but still some 23% below the pre-pandemic level. That helped drive growth in capital goods production of 2.6%M/M, while output of intermediate items rose 0.5%M/M, with both categories rising 1.5% above the pre-pandemic level. In contrast, output of consumer durables fell back at the end of 2021 but was still 3.9% above the level in February 2020.

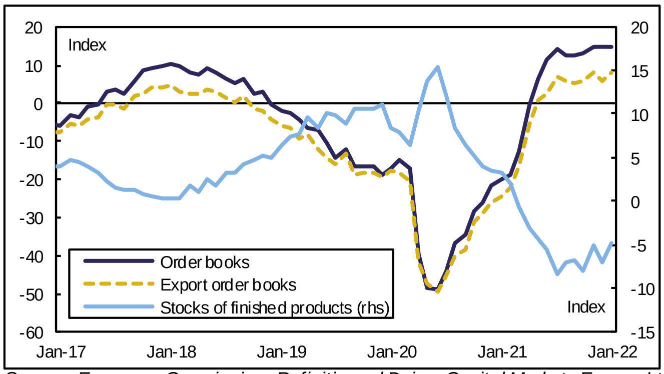
Survey indicators point to industrial expansion in Q1, supply bottlenecks permitting

Most survey indicators point to continued growth in the manufacturing sector at the start of 2022. For example, the euro area manufacturing output PMI rose last month to a four-month high of 55.4 with the equivalent German index up almost 5pts to 57.0, the best since August. And with hints of further gradual easing of supply bottlenecks, the elevated level of new orders, record level of backlogs in some countries (including Germany), and low level of inventories points to a resumption of production growth over coming quarters despite intense cost pressures. However, some high-frequency data softened, e.g. Germany's truck-toll index dropped 1.4%M/M last month. And German car output failed to accelerate at the start of the year. So, whether or not the measure of aggregate euro area production will post a further gain in January will be determined in large part by the Irish figures, which are due a setback after cumulative growth of 48% over the last two months of 2021.

French retail sales slip back at the start of the year, euro area IP data to come

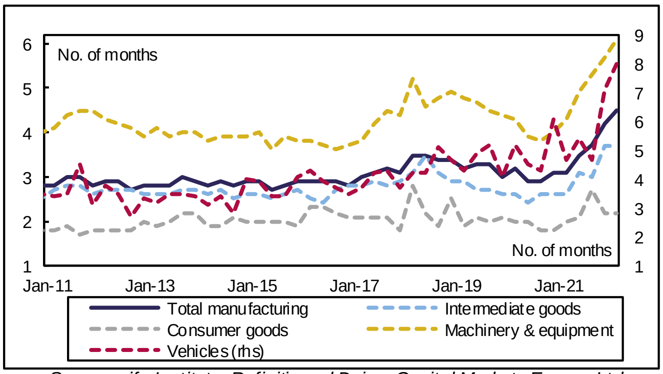
Given the accelerated spread of coronavirus, tighter pandemic restrictions and a drop in consumer confidence, today's Bank of France estimate of French retail sales in January was inevitably subdued. Indeed, the Bank's survey suggested that sales fell for the third month out of the past four in January (-1.4%M/M), albeit following strong growth (1.8%M/M) in December. In light of the latest pandemic hit to consumer-facing services and hospitality in particular, food sales were surprisingly weak in January (-1.7%M/M). And there were sizeable declines in spending on clothing (-8.1%M/M), sports equipment (-9.9%M/M) and autos equipment (-11.4%M/M). However, the BoF measure did suggest a further modest increase in vehicle sales as well as a jump in spending on consumer electronics (10.7%M/M). Overall, retail sales in January were some 5% lower than the pre-pandemic level, but just 0.6% lower than the Q4 average suggesting only a modest drag on growth at the start of the year.

Euro area: New orders and inventories



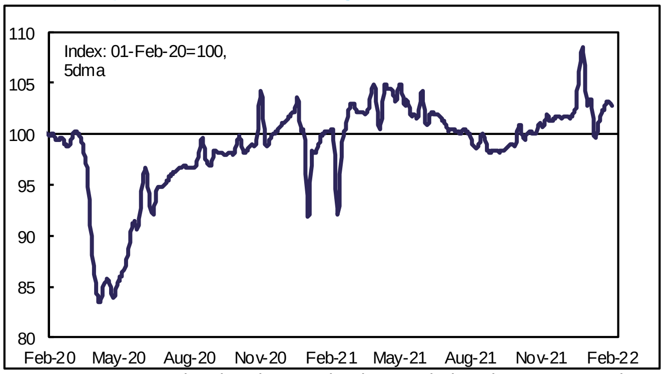
Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing backlogs



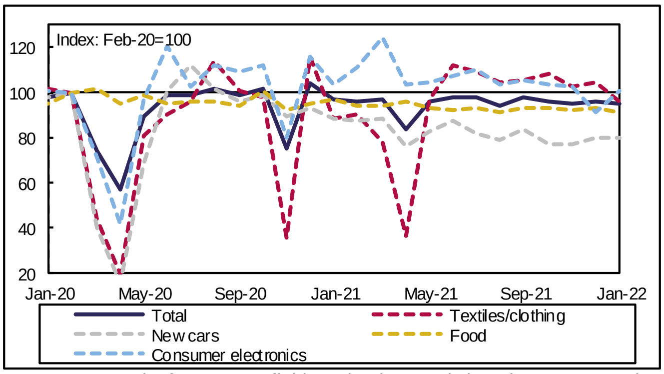
Source: ifo Institute, Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Truck toll mileage index



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

France: Retail sales



Source: Bank of France, Refinitiv and Daiwa Capital Markets Europe Ltd.

The coming two days in the euro area

The focus tomorrow will be on further commentary from influential ECB policymakers, including President Lagarde, Vice-President de Guindos, Chief Economist Lane and Executive Board member Schnabel. Data-wise, a quiet day tomorrow brings only euro area new car registration data for January. National releases showed that autos sales were mixed at the start of the year, with annual increases in Germany (+8.0%) and Spain (+1.0%) contrasting with still sizeable declines in France (-18.6%Y/Y) and Italy (-19.7%Y/Y). On Friday, the European Commission will publish its preliminary consumer confidence index for February, which may well show a modest improvement to reflect the easing in the latest wave of coronavirus across the region. Meanwhile, euro area construction output data are expected to have dropped in December, reflecting steep declines in both Germany and France, with the sector seemingly disproportionately impaired by supply bottlenecks and labour shortages. Friday also sees France publish final CPI inflation figures for January.

UK

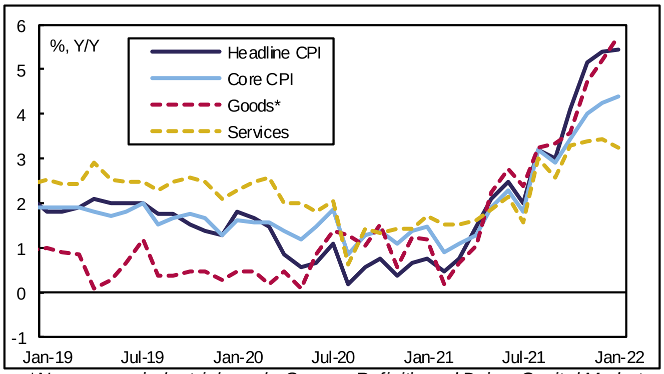
Consumer price inflation up again on limited New Year discounting

Contrasting the consensus (and our) expectation of no change, UK CPI inflation edged up again in January, rising 0.1ppt to 5.5%Y/Y, the highest rate since March 1992. The increase was caused by non-energy industrial goods prices, which accelerated 0.6ppt to 5.8%Y/Y, as retailers sought to pass on cost pressures to consumers and so limited the extent of their usual New Year discounting. So, for example, clothing and footwear inflation rose 2.1ppts to 6.3%Y/Y as prices were cut the least in any January on the series dating back to 1990. Prices of furniture and other household items accelerated 1.1ppt to 8.4%Y/Y, similarly a series high. In addition, supply bottlenecks kept prices of motor vehicles under upwards pressure, with inflation of new and used cars up 0.1ppt apiece to 3.5%Y/Y and a record 28.7%Y/Y.

Core rate up despite easing of services inflation on Omicron

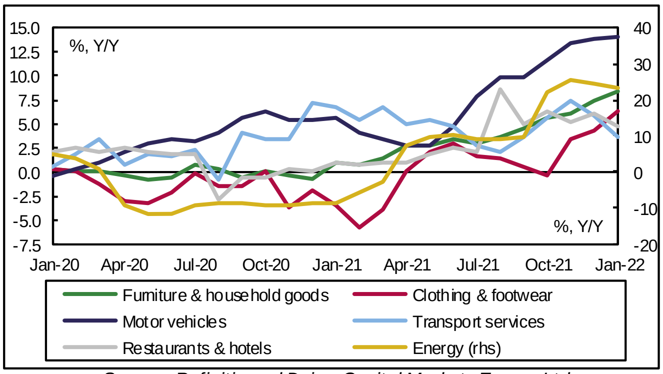
Those pressures in goods prices more than offset the impact of a slight easing of inflation in services, which fell 0.1ppt to 3.3%Y/Y in January, in large part seemingly reflecting the spread of the Omicron variant. Inflation in restaurants and hotels slowed 1.3ppts to a six-month low of 4.7%Y/Y while inflation of recreation and cultural services moderated 0.2ppt to 2.1%Y/Y. And inflation of transport services slowed 2.3ppts to 3.6%Y/Y, reflecting a moderation in air, rail and bus fares. Services inflation did receive a boost from housing rents, up 0.3ppt to 2.3%Y/Y, which nevertheless still pales by comparison with house price inflation of 10.8%Y/Y at the end of 2021. Overall, core CPI inflation rose a further 0.2ppt to 4.4%Y/Y, also the highest since 1992. Meanwhile, among non-core items, energy inflation slowed for a second month, down 1.2ppts on lower petrol prices. But inflation of food and non-alcoholic beverages edged up 0.1ppt to 4.3%Y/Y, the highest since April 2013.

UK: CPI inflation – headline components



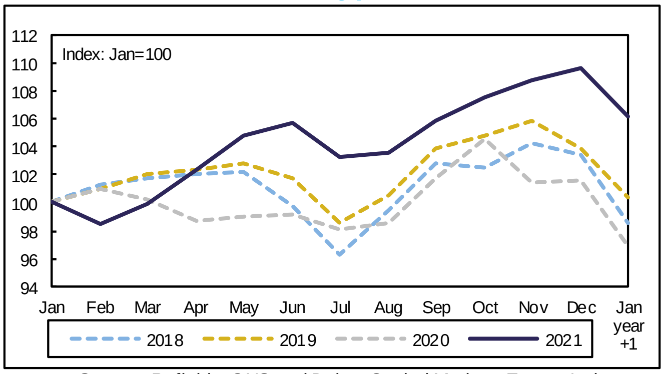
*Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation – selected components



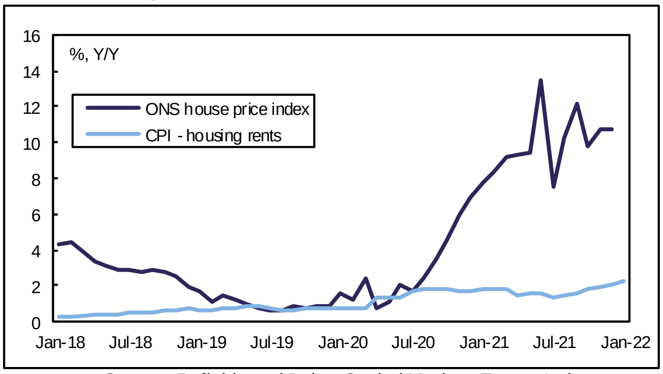
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation - clothing price indices



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

UK: House prices and rents



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Inflation to peak around 7½%Y/Y in April before gradually falling back

Consumer price inflation will continue to rise over the near term, not least on further pass-through of cost pressures further up the supply chain to prices of non-energy goods. Indeed, output PPI inflation accelerated a further 0.5ppt to 9.9%Y/Y in January while the input PPI rate moderated just 0.2ppt to 13.6%Y/Y. Moreover, with household energy prices set to rise more than 50% in April, we expect headline consumer price inflation to peak at around 7½%Y/Y in April. Thereafter, inflation should decline gradually. But we expect it to remain above 4.0%Y/Y at year-end. Assuming that second-round effects on wages remain relatively well contained, whether or not inflation falls further to below the BoE's 2.0% target in 2023 will likely depend in large part on the profile for energy prices. Nevertheless, following yesterday's data which illustrated the tightness of the labour market, this morning's inflation figures reinforce the inevitability of a further BoE rate hike at next month's MPC meeting. However, given the highly adverse impact of inflation on real disposable incomes and hence demand, we continue to see a measured path for further tightening ahead. We expect hikes of 25bps apiece in March and May, with the latter triggering the eventual launch of active Gilt sales. But then we would expect just one further increase in Bank Rate to 1.25% in H222, well below the implied year-end rate of 2.0% currently priced by the swaps market.

The coming two days in the UK

With no UK economic data due tomorrow, the focus turns to Friday's retail sales report for January, which is expected to see total sales up around 1%M/M, relatively modest compared with December's sizeable drop of 3.7%M/M. While that would leave retail sales almost 4% higher than the pre-pandemic level, they would be roughly 1% below the quarterly average in Q4.

The next edition of the Euro wrap-up will be published on 18 February 2022

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Industrial production M/M% (Y/Y%)	Dec	**1.2 (1.6)**	0.3 (-0.7)	2.3 (-1.5)	**2.4 (-1.4)**
France	BoF retail sales M/M%	Jan	**-1.4**	-	2.2	**1.8**
UK	CPI (core CPI) Y/Y%	Jan	**5.5 (4.4)**	*5.4 (4.2)*	5.4 (4.2)	**-**
	PPI input prices M/M% (Y/Y%)	Jan	**0.9 (13.6)**	1.0 (13.4)	-0.2 (13.5)	**0.1 (13.8)**
	PPI output prices M/M% (Y/Y%)	Jan	**1.2 (9.9)**	0.6 (9.1)	0.3 (9.3)	**-**
	House price index Y/Y%	Dec	**10.8**	9.4	10.0	**10.7**

Auctions

Country	Auction
Germany	sold €3.27bn of 0% 2032 bonds at an average yield of 0.31%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		07.00	EU27 new car registrations Y/Y%	Jan	-	-22.8
Auctions and events						
Euro area		07.00	ECB's Schnabel scheduled to speak			
		08.45	ECB Vice President de Guindos to speak on fiscal rules and the ECB's new monetary strategy at a Bruegel event			
		09.00	ECB publishes Economic Bulletin			
		09.00	ECB Chief Economist Lane to speak on the euro area economy and ECB policy			
		11.05	ECB President Lagarde participates in G20 meeting of finance ministers and central bank governors			
France		09.50	Auction: 0% 2025 bonds			
		09.50	Auction: 0% 2027 bonds			
		09.50	Auction: 0.75% 2028 bonds			
		10.50	Auction: 0.1% 2031 inflation-linked bonds			
		10.50	Auction: 0.1% 2032 inflation-linked bonds			
		10.50	Auction: 0.1% 2036 inflation-linked bonds			
Spain		09.30	Auction: 0% 2027 bonds			
		09.30	Auction: 0.7% 2032 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		10.00	Construction output M/M% (Y/Y%)	Dec	-	-0.2 (0.5)
		15.00	Commission's preliminary consumer confidence	Feb	-8.0	-8.5
France		07.45	Final CPI (EU-harmonised CPI) Y/Y%	Jan	2.9 (3.3)	2.8 (3.4)
UK		07.00	Retail sales including autos fuel M/M% (Y/Y%)	Jan	1.1 (9.3)	-3.7 (-0.9)
		07.00	Retail sales excluding autos fuel M/M% (Y/Y%)	Jan	1.0 (7.6)	-3.6 (-3.0)
Auctions and events						
Euro area		11.05	ECB President Lagarde participates in G20 meeting of finance ministers and central bank governors			
		18.30	ECB Panetta participates in a panel discussion on central bank digital currencies			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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