Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- While wholesale energy prices leapt, Bunds made gains and BTPs outperformed as Russia's invasion of Ukraine raised the prospect of a slower phasing out of ECB monetary policy stimulus than had been anticipated.
- While a survey pointed to growth in UK retail sales in February, Gilts also made gains.
- Friday will bring the flash estimate of French inflation in February, the Commission's latest sentiment indices, and the expenditure breakdown of German GDP in Q4.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.433	-0.058
OBL 0 04/27	-0.075	-0.072
DBR 0 02/32	0.170	-0.054
UKT 0¹/₈ 01/24	1.254	-0.045
UKT 0³/₈ 10/26	1.292	-0.040
UKT 0¼ 07/31	1.444	-0.036

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

Euro area

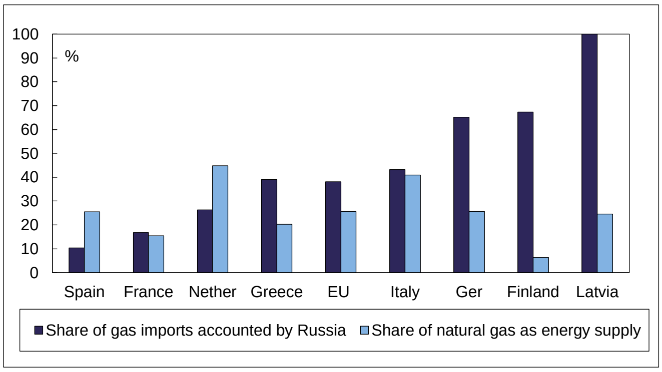
Risk aversion returns and energy prices leap as Russia launches invasion

So, after weeks of uncertainty about Putin's intentions, Russia finally launched a broad-based invasion of Ukraine, with troops attacking from the eastern Donbas region, Belarus to the north, and Crimea and the Black Sea in the south. Explosions were reported across Ukraine's major cities, including Kyiv. Confusion remained about the likely next steps. But Putin was expected to try to dislodge Ukraine's government and replace it with a puppet pro-Russian administration, while more stringent sanctions were expected to be unveiled against Russian interests. After yesterday's equivocation, the market response today was emphatic. With heightened risk aversion, equities fell with shares of euro area banks most exposed to Russia particularly affected (RBI down more than 20%, and Unicredit and SocGen down more than 12%). Major government bonds rallied, with BTPs significantly outperforming. And prices of wholesale energy and certain other commodities leapt, with Brent crude oil up more than 6% to above $103bbl, some 35% more than assumed in the ECB's December projections, and benchmark Dutch natural gas prices up about 50% to above €140/MWh, albeit still down from December's peak. But while some market-implied measures of inflation expectations increased – e.g. 10Y break-evens on German inflation-linked bonds rose above 2.10% for the first time in more than a decade – the 5Y5Y inflation forward swap rate fell back highlighting expectations that the inflation hit will be front-loaded.

ECB's March policy discussion will weigh boost to inflation against hit to growth

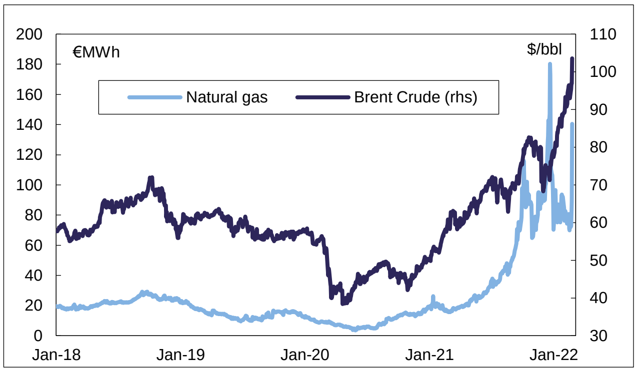
While its Governing Council was set to meet for an informal discussion later today, the ECB issued a statement in the morning insisting that it was closely monitoring the impact of events in Ukraine and will conduct a comprehensive assessment of the economic outlook at the March policy meeting. So, it won't preempt the outcome of next month's discussion on policy, when the Governing Council will have to weigh the additional inflationary impact against the adverse shock to confidence and GDP growth. Indeed, should today's shifts in energy prices persist, euro area inflation could peak above 7%Y/Y in April, and remain well above 4%Y/Y at year-end. Given the consequential impact on real disposable incomes, that could also push private consumption and GDP into contraction territory even though the impact on net trade volumes will be modest and supply of natural gas into the euro area – more than 40% of which comes from Russia – might not necessarily be impeded. And if economic output does weaken markedly, inflation would in due course be expected to fall back well below the 2% target in the course 2023 and 2024 – the horizon when monetary policy changes over coming months will impact prices.

Europe: Reliance on Russian natural gas*



*2020 data. Source: Eurostat, IEA and Daiwa Capital Markets Europe Ltd.

Netherlands natural gas and Brent crude futures



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

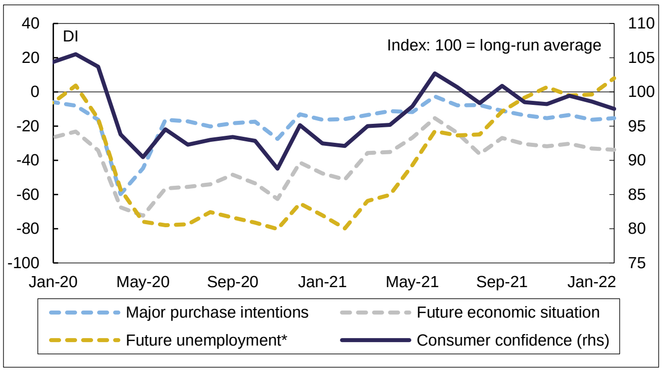
ECB divisions appear to widen again, but rate hikes should be parked until 2023

So, while on 10 March it will likely decide a slower pace of net asset purchases in Q2, we think the Governing Council will remain flexible about the path of policy further ahead, retaining ‘optionality’ for various scenarios as events and data unfold. Nevertheless, having seemingly narrowed over recent weeks, the range of views on the Governing Council might have widened again in response to the latest shock. Despite Russia’s invasion this morning, Irish central bank governor Makhlouf stated that the Governing Council may yet announce next month an end to net asset purchases, possibly as soon as Q2 (which seems far too soon to us), and if not Q3 (which has been our baseline assumption but is also now likely to be premature). We doubt that his views will be shared by the majority. Indeed, no doubt alert to his country’s reliance on Russian energy, Greek governor Stournaras argued that net purchases should now continue at least through to the end of 2022 and be kept open-ended, and that possible rate hikes should be taken off the table. Perhaps mindful that his home country’s banks are particularly exposed to Central and Eastern Europe, Austrian Governor Holzmann, who earlier this week proposed two hikes this year, stated today that the ECB’s exit from stimulus might need to be delayed. And Executive Board member Schnabel, who has otherwise been relatively hawkish over recent weeks, repeated that the uncertainty merited a gradual and data-dependent approach to normalization, with rate hikes not to come before net purchases had come to an end. Certainly, in our view, the phasing out of stimulus will now unfold more slowly than had events in Ukraine not escalated so gravely over the past few days. And rate hikes seem more likely to wait until the negative impact on confidence and growth has passed, which might not be before mid-2023.

French consumer confidence falls back as inflation erodes living standards

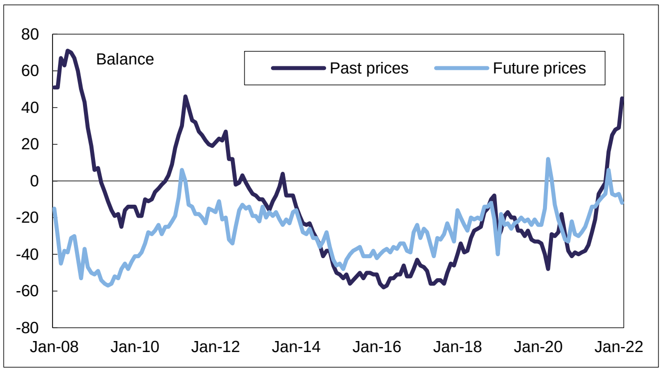
While the latest economic data were clearly of secondary importance, like in Germany’s equivalent survey yesterday, today’s French consumer confidence survey results published by INSEE reported an unexpected decline in sentiment in February. The headline confidence index fell 1pt to 98, matching the level seen in November but still the second-lowest reading of the past year and below the long-run average (100). Within the detail, households assessed their standard of living to have deteriorated by the most since August, due principally to the recent marked increase in inflation, with the respective index jumping 16pts to its highest since April 2011. However, despite signals that firms intend to continue to pass on rising cost burdens to consumers – e.g. the flash composite output price PMI rose to its highest since the series began two decades ago and yesterday’s INSEE survey reported a rise in expected selling prices in the services sector to the highest since 1990 – today’s survey reported a decline in consumers’ expectations for prices over the coming twelve months, although the relevant index remained above the long-run average. So, while consumers were their least concerned about unemployment since 2007, the share of households assessing it to be a good time make major purchases was only very marginally

France: Consumer confidence indices



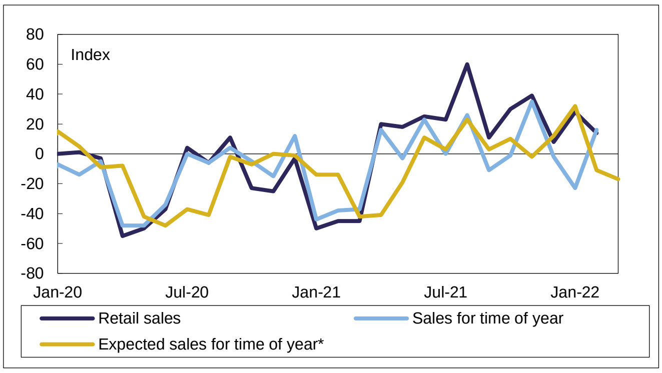
*Scale inversed. Source: Refinitiv, INSEE and Daiwa Capital Markets Europe Ltd.

France: Consumer price expectations



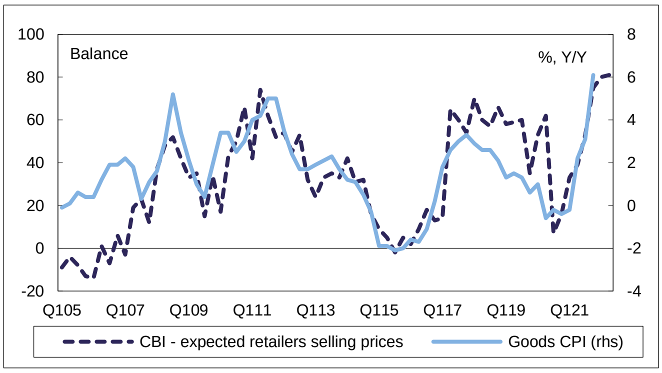
Source: Refinitiv, INSEE and Daiwa Capital Markets Europe Ltd.

UK: CBI distributive trades survey indices



*One-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Retailers selling prices and goods inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

improved from January – indeed, while the respective index was broadly in line with its long-run average, it was still some 12pts lower than last summer's peak.

The day ahead in the euro area

Politics will continue to dominate the news flow tomorrow and data will remain something of an afterthought. Nevertheless, Friday will bring the first CPI inflation data for February, from France. Having fallen back slightly in January due not least to New Year discounting, headline HICP inflation is expected to have risen to its highest rate since mid-2008. Tomorrow will also bring the European Commission's detailed economic sentiment indicators, which like the flash PMIs, likely suggested a pickup in activity thanks not least to the drop in new coronavirus cases across the region. Other releases tomorrow include an update on Germany's Q4 GDP which will bring the first official expenditure breakdown that will likely confirm the decline of 0.7%Q/Q in overall economic output was caused by declines in private consumption and construction investment. The euro area's latest bank lending numbers are also due.

UK

Retail sales reportedly above seasonal trend in February, but price pressures remain high

At face value, today's CBI retail sector survey implied a weakening in sales momentum in February. Indeed, the headline sales balance fell a larger-than-expected 14pts to +14, the third-lowest reading since restrictions were lifted last April. But as this measure reflects the share of retailers assessing the level of sales compared with a year earlier, it remains distorted by base effects. Perhaps of more relevance is the gauge of sales for the time of the year, which rebounded in February – by 39pts to 16 – implying an above-norm rate of sales growth. But despite the further lifting of pandemic restrictions, the outlook for sales was less positive, with retailers expecting them to be well below the seasonal trend next month. This would be consistent with the expectation that retailers' selling prices would rise further over the coming three months – the relevant balance rose 1pt to 81, the highest since 1990 – while disposable incomes will be further squeezed by higher mortgage payments, a further increase in household energy bills in April and an increase in national income contributions. Indeed, given today's shifts in wholesale energy prices, CPI inflation might well peak above 8%Y/Y in April and remain above 6%Y/Y by year-end, risking a contraction in private consumption over coming quarters.

The day ahead in the UK

The week's UK data flow will end with the latest GfK consumer confidence survey. Notwithstanding the likely boost to confidence from the decline in new coronavirus cases and easing of containment measures, given tighter household budgets, consumers seem unlikely to signal a notable improvement in sentiment and spending intentions this month. Elsewhere, BoE Chief Economist Pill will give closing remarks of the BoE's two-day research conference.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France		INSEE consumer confidence index	Feb	**98**	100	99	-
UK		CBI distributive sales survey, total retailing sales	Feb	**14**	25	28	-
Auctions							
Country		Auction					
- Nothing to report -							

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	M3 money supply Y/Y%	Jan	6.7	6.9
		10.00	Commission's Economic Sentiment Indicator	Feb	113.0	112.7
		10.00	Commission's industrial (services) index	Feb	14.1 (10.0)	13.9 (9.1)
		10.00	Commission's final consumer confidence	Feb	-8.8	-8.5
Germany		07.00	GDP – second estimate Q/Q% (Y/Y%)	Q4	-0.7 (1.4)	1.7 (2.9)
France		07.45	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	-	2.9 (3.3)
		07.45	PPI M/M% (Y/Y%)	Jan	-	1.0 (17.7)
		07.45	GDP – second estimate Q/Q% (Y/Y%)	Q4	0.7 (5.4)	3.1 (5.4)
		07.45	Consumer spending M/M% (Y/Y%)	Jan	-0.8 (-1.8)	0.2 (-5.1)
Italy		09.00	ISTAT business (manufacturing) confidence index	Feb	- (113.5)	105.4 (113.9)
		09.00	ISTAT consumer confidence index	Feb	114.4	114.2
UK		00.01	GfK consumer confidence	Feb	-18	-19

Auctions and events

Euro area		-	ECB President Lagarde and Board Member Panetta participate in Eurogroup meeting
Italy		10.00	Auction: €4bn of 1.1% 2027 bonds
		10.00	Auction: €3bn of 0.95% 2032 bonds
		10.00	Auction: €1.25bn of 2026 floating rate bonds
		18.00	BoE Chief Economist Pill gives closing remarks at the BoE's research conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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