Euro wrap-up

Overview

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- As commodity and energy prices remained under intense pressure, Bunds sold off but BTPs outperformed on reports that EU leaders will this week discuss proposals for new common bond issuance to fund energy independence from Russia and defence initiatives.
- Gilts again underperformed as PM Johnson signalled that the UK would phase in a ban on Russian oil over coming months and a retail survey pointed to ongoing growth in sales in February.
- While coming days will be light for new economic data, Thursday will bring the ECB's latest policy announcements and the start of the EU summit.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.647	+0.074
OBL 0 04/27	-0.224	+0.102
DBR 0 02/32	0.103	+0.126
UKT 1 04/24	1.306	+0.155
UKT 1¼ 07/27	1.227	+0.153
UKT 4¼ 06/32	1.440	+0.138

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

Euro area

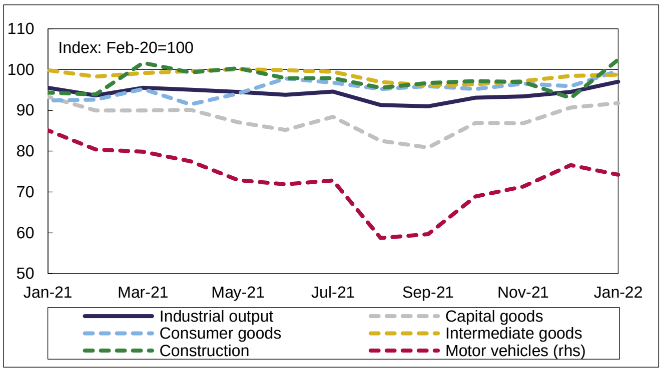
Reports of new EU common bond issuance proposals give BTPs a boost

While global markets continued to respond to extreme pressures in energy and commodity prices – with nickel today's most extreme mover leading to a suspension of trading on the London Metals Exchange – euro area government bonds also responded to reports that the EU's Versailles summit on Thursday and Friday will see leaders discuss a possible new common bond issuance programme to mutualise some of the costs of responding to the war in Ukraine. Among other things, the programme would run as a possible successor to – or in tandem with – the EU's €750bn recovery funds. And along similar lines to the SURE programme of support for Covid-related job programmes, the Commission might issue bonds to fund cheap loans to member states to finance new investments in energy and food independence from Russia and common defence initiatives (i.e. to "Repower" the EU) up to 2030. BTPs responded favourably to the news with spreads to Bunds declining more than 12bps at 10Y maturities. While a European Commissioner subsequently denied that his institution had involvement in the plan, the French Government – as EU Presidency – appears to be leading the charge. And while detailed proposals seem unlikely to be published before the Summit conclusion, and the necessary unanimous agreement of leaders cannot be taken for granted, President Macron's powers of persuasion could well suffice this week to make the scheme a runner.

German industrial production surges in January boosted by construction output

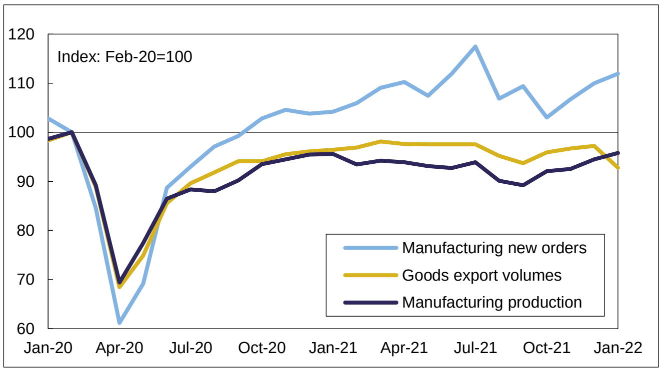
Turning to today's data, as suggested by yesterday's turnover data and various survey indicators, German industrial production grew vigorously at the start of the year as supply bottlenecks appeared to ease somewhat. Indeed, growth of 2.7%M/M was the strongest in fifteen months. Moreover, given favourable revisions to the estimates for prior months, the surge at the start of the year also represented the fourth successive month of industrial sector growth. But while the level was 3.5% above the Q4 average, it was still some 3.0% below the pre-pandemic level in February 2020. Growth in January was relatively broad-based with increases in production of all main categories of goods – capital (1.2%M/M), intermediate (0.3%M/M) and consumer (4.0%M/M) alike, so that manufacturing and mining output was up 1.3%M/M. Nevertheless, production of machinery and equipment (9.9%M/M) stood out as particularly strong, while output of autos fell back for the first month since August (-3.1%M/M). Moreover, the overall growth rate was flattered by an exceptional rebound in construction output, up an extraordinary 10.1%M/M on unseasonably mild weather following a revised drop of 4.0%M/M in December. As we noted yesterday, survey and high-frequency data point to a further increase in factory output in February. And the high level of orders and backlogs, as well as the low level of inventories in the sector, would normally point to ongoing expansion further ahead too. However, the sudden renewed tightening of supply bottlenecks due to the disruption to

Germany: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output, orders and exports



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

supplies of key inputs from Ukraine and Russia is already impeding production in certain sectors, including autos. And given the additional adverse shock to energy and commodity prices, the outlook for Q2 and beyond currently looks weak.

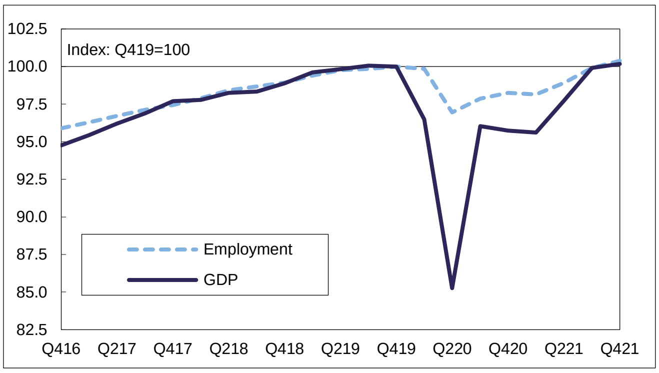
Euro area consumption and net exports contracted in Q4; capex surge likely to prove temporary

As expected, today's national accounts expenditure breakdown confirmed that the slowdown in euro area GDP growth in Q4, by 2ppts to 0.3%Q/Q, partly reflected the reduced opportunities and inclination to spend as the latest pandemic wave swept across the region. Indeed, despite another solid quarter of employment growth (0.5%Q/Q), household consumption fell 0.6%Q/Q, with particular weakness in Germany, where total consumption dropped 1.8%Q/Q and spending on services and durable goods declined by around 3%Q/Q. So, despite having risen by a cumulative 8½%Q/Q over the previous two quarters, euro area household consumption was still some 2½% below the pre-pandemic level. Other components of domestic demand were, however, more encouraging at the end of last year. For example, buoyed by a surge in spending on R&D (12.4%Q/Q), as well as higher capital spending on machinery and equipment (2.1%Q/Q), transport (5.6%Q/Q) and construction (0.6%Q/Q) – in part reflecting an easing in supply bottlenecks – fixed investment increased 3.5%Q/Q, the strongest in five quarters and adding 0.7ppt to GDP growth. This notwithstanding, investment was still around 6½% below the Q419 level, with the most substantial shortfalls in transport (-21%) and R&D (-24%). While stock-building also added 0.3ppt to quarterly GDP growth, there was a sizeable negative contribution from net trade in Q4 (-0.6ppt). Indeed, despite a solid increase in exports (2.9%Q/Q) as both goods shipments and tourism increased, imports were up a stronger 4.6%Q/Q to return to the pre-pandemic level for the first time.

Euro area GDP outlook now highly uncertain, so ECB should avoid premature tightening

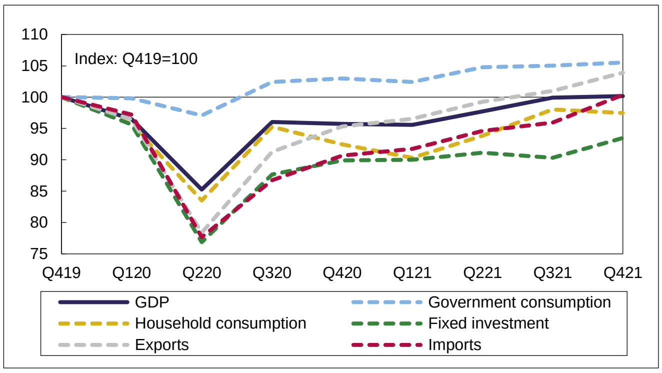
Of course, the near-term outlook for euro area GDP remains extremely uncertain. Ahead of the Russian invasion, we had anticipated another quarter of growth close to that of Q4 before a marked acceleration in Q2 and Q3 thanks to economic reopening as the omicron wave subsided. And so far, the available information for January and February have been consistent with that scenario, with high-frequency data suggestive of a pickup in household expenditure on retail and recreation following Covid-related weakness in December, and production firmer thanks to an easing of supply bottlenecks. However, the invasion represents a shock of immense proportions to inflation and confidence, both of which will significantly weigh heavily on private consumption and investment from now on. And supply-chains are also being disrupted once again. While fiscal policy – including support from the EU recovery funds as well as new initiatives related to energy independence, defence spending and support for Ukrainian refuges – should make a positive contribution, the range of possible outcomes for euro area GDP and inflation is now extremely wide indeed, with non-negligible risks of recession. Much will depend on the response of governments as well as the ECB. The former have scope to cap the rise in household energy bills to reduce

Euro area: GDP and employment



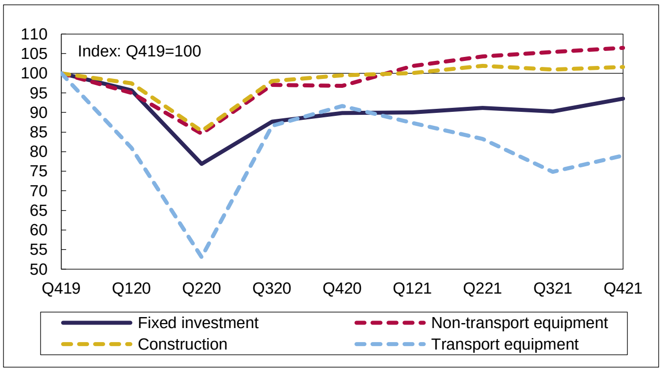
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP expenditure components



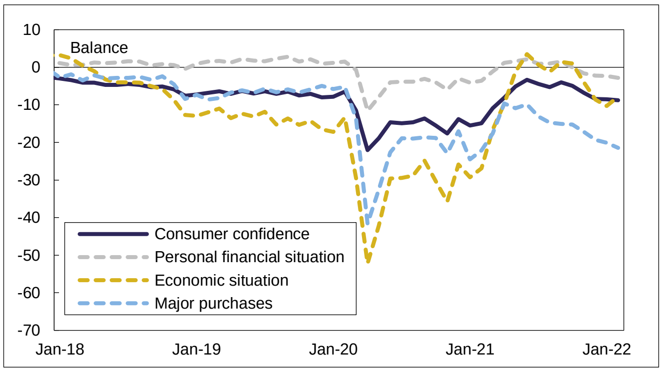
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Fixed investment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer confidence



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

the peak in inflation and soften the hit to household real incomes. And with wage growth still muted, and so risks of second-round effects on inflation in the euro area relatively modest, the latter should for the time being look through the forthcoming inflation surge and seek to avoid any premature tightening of financial conditions that would arise if it phased out its net asset purchases too rapidly.

The coming two days in the euro area

All eyes on Thursday will be on the outcome of the ECB's monetary policy meeting when the Governing Council will have to gauge the likely impact of events in Ukraine on the euro area economic outlook and determine how it should respond. Before the Russian invasion, the Council had looked set to reach a consensus for a much faster reduction in its net asset purchases, providing scope for a rate hike by year-end. That reflected the big upwards surprise to euro area inflation in January, which highlighted the sudden shift in skew of risks to the price outlook. And given the dramatic impact on prices of energy and commodities, as well as the prospect of a marked tightening of supply bottlenecks, inflation is set to accelerate sharply further over the near term, with even a non-negligible possibility of a double-digit rate in the second half of the year. But economic growth momentum is bound to be hit hard by the erosion of real household incomes, much higher business costs, weaker exports, and a marked loss of confidence, as well as the additional supply-side restraints. So, were it not for ongoing economic reopening from the pandemic and the accumulation of a buffer of household savings throughout the pandemic, the near-term economic outlook in the euro area would be very dire, with recession odds-on.

Crucially, however, the duration and precise path of the conflict – as well as the policy responses of the main protagonists, the EU and its member states – is impossible to predict, as are the effects of those events on energy, commodity and financial markets. And that means that the path of euro area GDP and inflation is extremely uncertain too. As such, rather than presenting on Thursday any one set of macroeconomic projections with confidence, we expect the ECB to set out a range of plausible scenarios. And while under certain scenarios, inflation will be expected to remain above the 2%Y/Y target over the horizon, under the most severe scenario inflation would fall back below target and remain there through to the end of the 2024. So, the risks of a monetary policy error are high and the Governing Council will want to move gradually in adjusting its key parameters. For the time being, therefore, we expect it to leave unchanged its plan to reduce its monthly net asset purchases to €40bn in Q2 and €30bn in Q3, while maintaining 'optionality' for more substantive policy adjustments and/or new initiatives (e.g. related to liquidity provision, or net purchases of EU agencies) over coming months as events unfold.

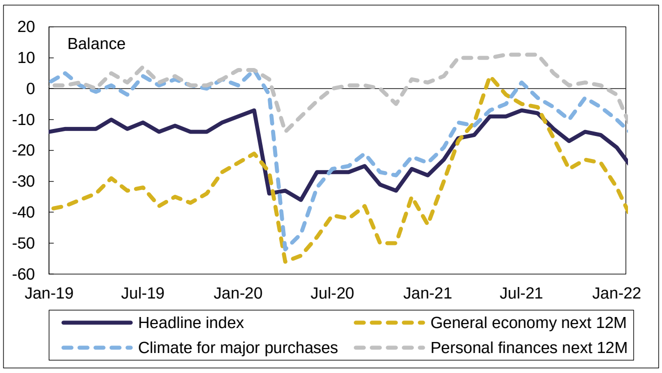
Beyond monetary policy, the EU's informal summit at Versailles will also start on Thursday, with plans to increase energy independence from Russia, and possible new EU borrowing to help fund the required infrastructure as well as common defence initiatives – reports of which today contributed to a sell-off of Bunds but significant narrowing of BTP spreads – to be discussed. Data-wise, the calendar for the coming couple of days is free of top-tier releases, although Italian IP numbers for January are expected to report a modest decline in output at the start of the year.

UK

UK retail sales survey signals ongoing growth in February, but outlook appears gloomy

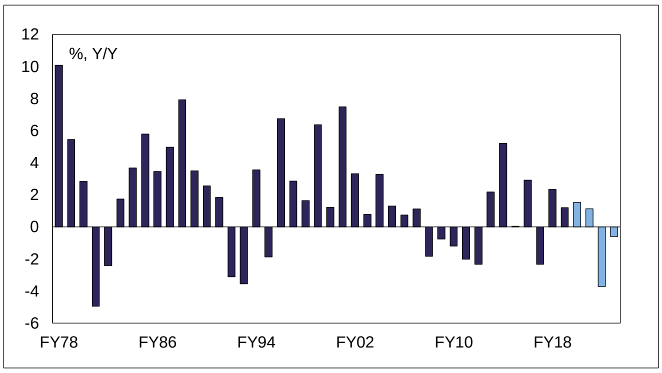
The BRC retail sales monitor published today suggested that the UK high street saw continued sales growth in February, with nominal sales up in February by 6.7% compared to a year earlier, when non-essential stores were closed due to pandemic containment measures. So, while sales were impeded by stormy weather conditions towards the end of the month, they were still some 4½% higher than the pre-pandemic level in February 2020. Within the detail, demand for household-related goods, as well as clothing and jewellery, was reportedly strong. But the BRC survey's measure of sales growth seems bound to have been flattered by the recent surge in prices. And given the further deterioration in the inflation outlook, and National Insurance Contributions set to rise along with household energy bills, the near-term outlook for the UK

UK: Consumer confidence



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Household real disposable income*



**Median equivalised income. Light blue bars based on Resolution Foundation forecasts. Source: ONS and Daiwa Capital Markets Europe Ltd.*

high street looks increasingly gloomy. Indeed, with the GfK consumer confidence indices recently taking a marked turn for the worse, the IGD Shopper Confidence Index has now fallen to its lowest since the series began in 2013. And credible forecasts published by the Resolution Foundation suggested that typical real non-pensioner household incomes in FY22/3 could fall by 4%Y/Y or more, with a further drop of 2% expected in FY23/4, such that the period from FY19/20 to FY24/5 would represent the worst parliament on record for income growth.

The coming two days in the UK

After a quiet day in the UK tomorrow, with no releases scheduled, Thursday brings a couple of second-tier February survey results. The RICS residential market indices will provide an update on housing supply, demand and price expectations. And the KPMG/REC report on jobs will provide an insight into new hiring activity and salary demands ahead of next week's official labour market data.

The next edition of the Euro wrap-up will be published on 10 March 2022

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final GDP Q/Q% (Y/Y%)	Q4	**0.3 (4.6)**	*0.3 (4.6)*	2.3 (3.9)	**- (4.0)**
		Final employment Q/Q% (Y/Y%)	Q4	**0.5 (2.2)**	*0.5 (2.1)*	1.0 (2.1)	**-**
Germany		Industrial production M/M% (Y/Y%)	Jan	**2.7 (1.8)**	0.5 (-1.9)	-0.3 (-4.1)	**1.1 (-2.7)**
Spain		Industrial production M/M% (Y/Y%)	Jan	**-0.1 (1.7)**	1.0 (2.7)	-2.6 (1.3)	**-0.5 -**
UK		BRC retail sales monitor, like-for-like Y/Y%	Feb	**2.7**	-	8.1	**-**

Auctions

Country		Auction
Germany		sold €334mn of 2030 inflation-linked bonds at an average yield of -2.74%
		sold €212mn of 2033 inflation-linked bonds at an average yield of -2.44%
UK		sold £1.5bn of 1.25% 2051 bonds at an average yield of 1.58%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France		06.30	Final total (private sector) payrolls Q/Q%	Q4	0.4 (0.5)	1.1 (0.5)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jan	-0.5 (3.3)	-1.0 (4.4)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		12.45	ECB refinancing rate %	Mar	*0.00*	0.00
		12.45	ECB deposit rate %	Mar	*-0.50*	-0.50
Italy		09.00	PPI M/M% (Y/Y%)	Jan	-	0.9 (27.8)
UK		00.01	RICS house price balance %	Feb	73	74

Auctions and events

Country		GMT	Event
Euro area		12.45	ECB monetary policy announcement
		13.30	ECB President Lagarde speaks at post-Governing Council meeting press conference
		-	Informal Summit of EU leaders
UK		00.01	KPMG/REC report on UK jobs

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.