Euro wrap-up

Overview

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- Bunds made sizeable losses as the ECB announced that banks will significantly increase their TLTRO repayments this month, while reports suggested that ECB hawks might push for an early start to QT in return for a slowing in the pace of rate hikes next week.
- Gilts also made losses as the BoE's Inflation Attitudes Survey suggested an uptick in households' medium-term inflation expectations.
- Thursday will bring ECB and BoE monetary policy announcements, while the flash December PMIs and UK inflation and GDP data are also due.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.120	+0.090
OBL 1.3 10/27	1.924	+0.104
DBR 1.7 08/32	1.915	+0.106
UKT 1 04/24	3.419	+0.075
UKT 1¼ 07/27	3.248	+0.035
UKT 4¼ 06/32	3.177	+0.085

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

Euro area

ECB to revise up its near-term inflation projection

The ECB's monetary policy meeting on Thursday will see the Governing Council agree another substantive rate hike, publish updated macroeconomic projections, and set the principles to guide quantitative tightening (QT) if and when it gets underway in 2023. The key focus will be the magnitude of monetary tightening, with the outcome uncertain and policymakers likely to be split between those favouring a third successive increase of 75bps and those preferring a moderation in the pace of tightening to 50bps. Of course, the hawks have been in the majority since the ECB initially started to raise rates ahead of schedule in July in response to repeated big upside surprises in the inflation data. And while the flash estimate of headline inflation fell a larger-than-expected 0.6ppt in November to 10.0%Y/Y, they will highlight that the average rate over the first two months of Q4 was more than 1ppt above the ECB's most recent forecast. So, the near-term profile of inflation will once again have to be revised up in the updated projections, and the hawks will argue that the peak might well not yet have been reached.

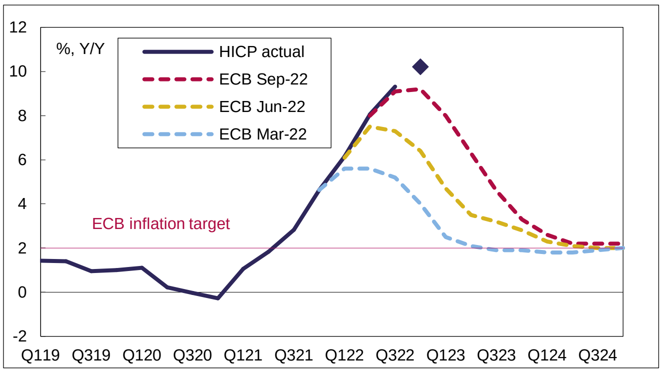
Hawks will flag sticky core inflation and rising risks of second-round effects

As well as fretting about yet another upwards revision to the near-term outlook for headline inflation, the hawks will also point to the continued stickiness of core inflation, which was unchanged in November at the series high of 5.0%Y/Y and is likely to rise again in December. They will also cite evidence of increasing risks of second-round effects on future inflation. For example, given this week's ECB consumer expectations survey results, the hawks will reiterate concerns that inflation expectations are becoming de-anchored. And they will judge that there remains a significant shortfall of supply relative to demand that will also allow firms to continue to pass on increased costs to households. In particular, the hawks will highlight persistent labour market tightness, reflected not least in the drop in the unemployment rate below expectations to a record low of 6.5% in October, as well as an ECB survey this week that suggested that labour shortages were still a bigger concern for businesses than cost pressures. So, with wage growth expected to accelerate in 2023, and workers also likely to want to try to regain purchasing power in 2024, the ECB will revise up its inflation projections for each of the coming two years from 5.5%Y/Y and 2.3%Y/Y respectively. The hawks are unlikely, therefore, to agree to a slowing in the pace of rate hikes without receiving something in return.

Smaller rate hike justified by tightening financial conditions and falling excess liquidity

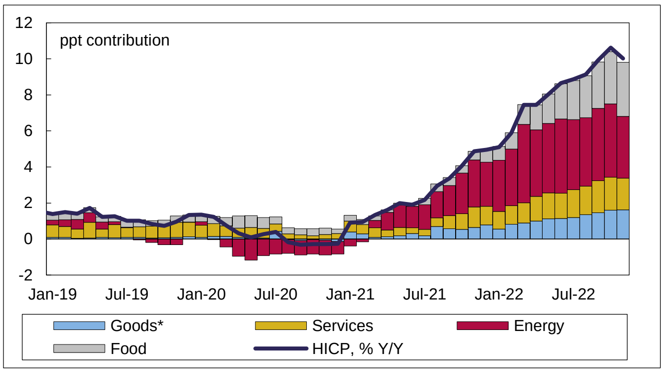
Several members of the Governing Council, however, will advocate a slowing in the pace of rate hikes this month to 50bps, which would still represent a further substantive tightening of monetary policy. As suggested earlier this week by ECB Chief

Euro area: ECB inflation forecasts*



*Diamond represents average in October and November. Source: Refinitiv, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



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

Economist Philip Lane, such a smaller rate hike this month would in part take account of the accumulated 200bps of tightening implemented since July, which has already contributed to a significant tightening of financial conditions and should increasingly restrain economic activity and inflation over the coming 18-24 months. Indeed, a hike of 50bps would take the deposit rate up to 2.0%, arguably representing a neutral monetary stance. And the ongoing tightening of financial conditions will be reinforced by the ECB's efforts to reduce excess liquidity. Data released today confirmed that banks will accelerate their early repayment of TLTRO-iii loans to €447.5bn this month, taking the cumulative repayment of such funds outstanding including maturities to almost €800bn (or 38% of the total) over the last six weeks of 2022. Six further opportunities for early repayments will come in 2023 and three more in 2024, at the end of which all of the remaining €1.32trn TLTRO-iii loans will have matured. And with the Governing Council set next week to agree principles for quantitative tightening – in particular, that it should operate in the background, in a predictable, measured way, most likely setting a limit on monthly reinvestments as the Fed has done – and also likely to start that process soon, excess liquidity will continue to decline steadily over coming quarters.

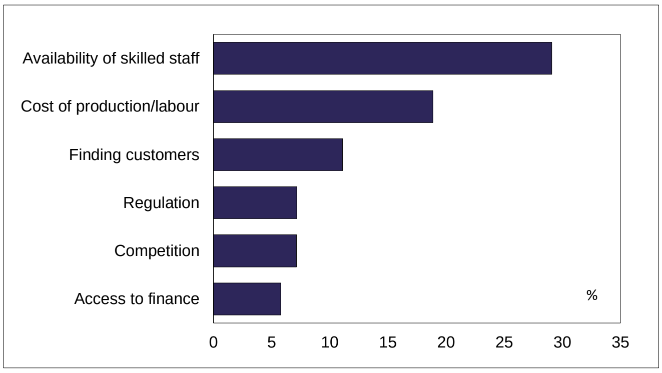
Inflation should be back close to target by the end of the projection horizon

The doves on the Governing Council will also note that, while core inflation remains historically high, half or more of that likely reflects the pass-through of energy, food and other supply-driven costs. Importantly, survey indicators and wholesale market prices suggest that many supply-side challenges and associated price pressures are starting to ease. Moreover, although economic activity remains resilient in some member states such as France, where the national bank's business survey points to growth of 0.1%Q/Q this quarter, euro area GDP is likely to contract in Q4 and Q1. So, the ECB's forecast for GDP growth in 2023 is likely to be revised down from 0.9%Y/Y to about 0.5%Y/Y or less. As such, despite the fears of the hawks, the ECB's projections should suggest that the peak in euro area inflation has been reached this quarter, and that both headline and core measures should decline gradually from Q1 onwards. And despite the upside revisions to the forecasts for 2023 and 2024, the ECB is likely to project that inflation should be back close to target by the end of the horizon, which will be extended to 2025 for the first time.

Expect a 50bps rate hike to be accompanied by a signal of more hikes and QT to come in Q1

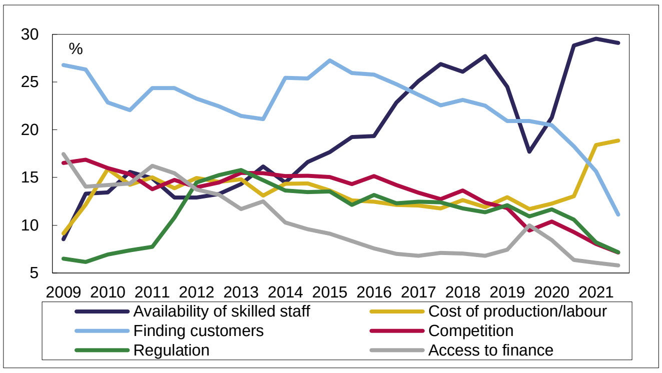
On balance, the updated projection for inflation to be back close to target by the end of the projection horizon should encourage the majority on the Governing Council to back the smaller hike of 50bps. But in return for agreeing to a slower pace of tightening, reports today suggested that the hawks might demand assurances that QT will start no later than the end of Q1. So as not to raise market expectations of a 'pivot' to easier policy and an associated premature easing of financial conditions, the ECB policy statement will also likely signal the likelihood of further hikes in Q123 and possibly beyond. In addition, while she will also make clear that policy decisions will remain data dependent and taken on a meeting-by-meeting basis, we suspect that President Lagarde will try her best to sound hawkish in her press conference, making it clear that the ECB will have no intention to ease policy soon after it eventually takes rates to their terminal levels.

Euro area: Key challenges facing firms*



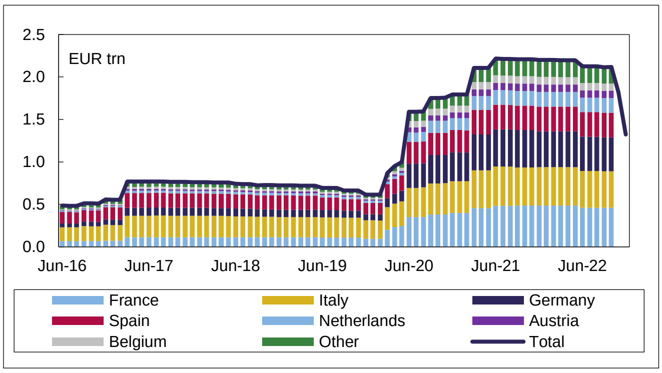
**April-September 2022. Source: ECB Survey on access to finance of euro area enterprises and Daiwa Capital Markets Europe Ltd.*

Euro area: Key challenges facing firms



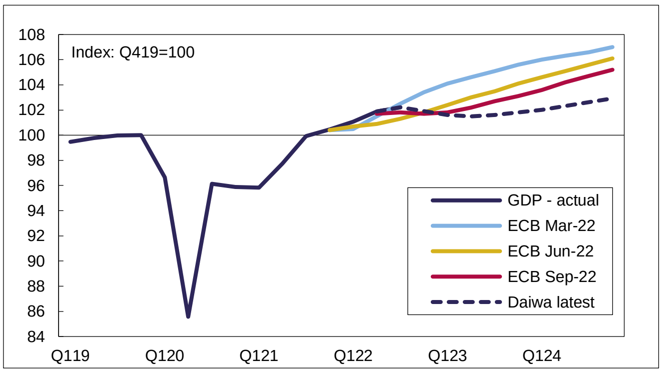
Source: ECB Survey on access to finance of euro area enterprises and Daiwa Capital Markets Europe Ltd.

Euro area: TLTRO loans outstanding*



**Total amount for end-December. Source: ECB and Daiwa Capital Markets Europe Ltd.*

Euro area: ECB GDP forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

The data week ahead in the euro area

On the data front, the main focus might well be December's flash PMIs on Friday. While the euro area composite PMI ticked up in November, at 47.8 it remained firmly consistent with contraction, with the services index the weakest since mid-2013 outside of Covid lockdown periods. Updated consumer price inflation estimates for November are due from Germany (Tuesday), Spain (Wednesday), France (Thursday) and Italy (Friday), concluding with the release on Friday of the final euro area data. The flash release revealed a larger-than-expected drop in the headline rate by 0.6ppt from October's series high to 10.0%Y/Y. The moderation in inflation in part reflected lower energy prices, which declined 1.9%M/M to push the respective annual rate down 6.6ppts to 34.9%Y/Y. Core euro area inflation, however, remained steady at the series high of 5.0%Y/Y. Among other releases due, euro area industrial production data for October come on Wednesday. Based on the figures from the member states, including declines in Germany (-0.4%M/M), France (-2.6%M/M), Spain (-0.4%M/M) and Ireland (-10.7%M/M), aggregate euro area output is likely to fall around 1.5%M/M, although Italy's IP data on Tuesday will also have a bearing. The German ZEW investor sentiment survey for December (Tuesday), euro area new car registrations for November (Thursday) and euro area trade figures for October (Friday) will also offer a guide to Q4 activity.

UK

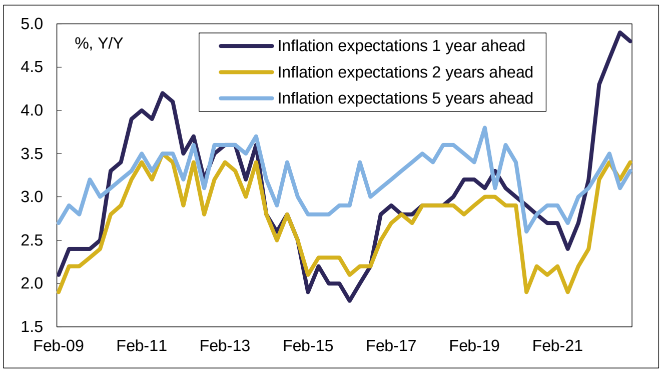
Slower pace of BoE hikes to reflect significant tightening of financial conditions since the summer

When the BoE makes its monetary policy announcement on Thursday, the MPC is bound to raise Bank Rate for the ninth consecutive meeting and will also likely signal further tightening to come. But as for the ECB, we expect the pace of tightening to slow. Following the hike of 75bps at the prior meeting in November, we expect the increase to revert back to 50bps – as in August and September – taking Bank Rate to 3.50%. As in the euro area, the moderation in the pace of tightening will reflect recognition of the lagged dampening effects on growth and inflation still to come from the cumulative 290bps of hikes implemented so far. Indeed, while Gilt market conditions have stabilised after the Truss crisis, financial conditions remain significantly tighter than in the summer, particularly when it comes to secured lending to households. For example, quoted mortgages in November were only marginally lower than the peak in October, to leave the average rate on a 2Y mortgage with a 75% LTV ratio up 180bps from September and almost 450bps higher than a year ago.

Some further tightening ahead as MPC will remain mindful of second-round effects

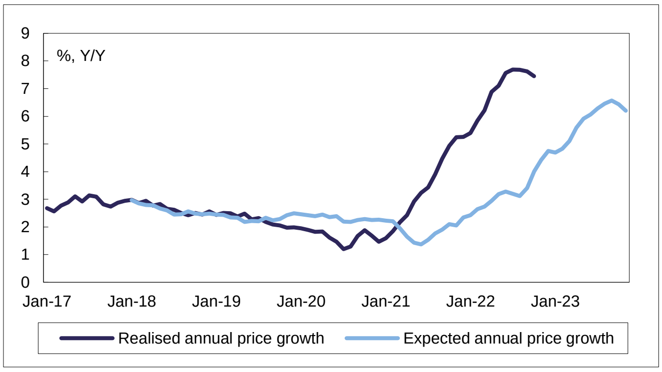
The moderation in the pace of tightening should also reflect the expectation that the jump in headline inflation in October to a 40-year high of 11.1%Y/Y will represent the peak. But with household energy prices set to rise significantly again in April, the MPC will also expect the decline in inflation in the UK to be slower than in the euro area. And the Committee will remain mindful of potential second-round effects to come, justifying further tightening over the near term. Certainly, some MPC

UK: Households' inflation expectations



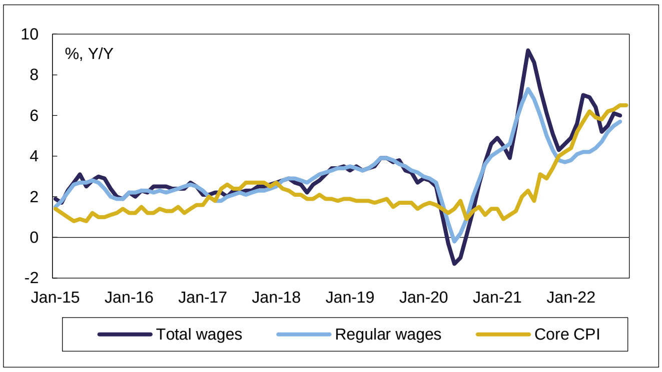
Source: BoE Inflation Attitudes Survey and Daiwa Capital Markets Europe Ltd.

UK: Firms' price expectations



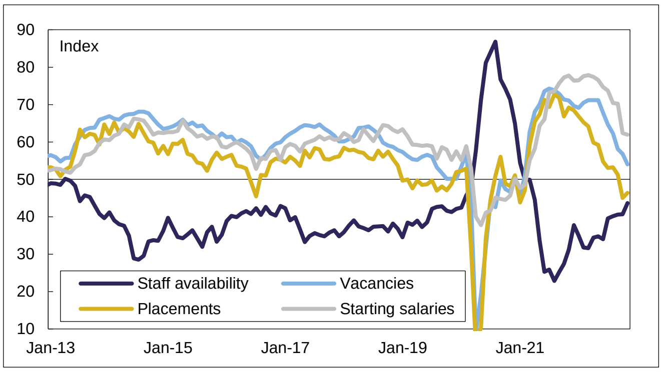
Source: BoE DMP survey and Daiwa Capital Markets Europe Ltd.

UK: Wages and core CPI inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Labour market indicators



Source: Refinitiv, REC/KPMG and Daiwa Capital Markets Europe Ltd.

members will be wary of the uptick in households' medium-term inflation expectations over the past quarter. Today's BoE Inflation Attitudes Survey results for November saw the median expectation of inflation two years ahead rise 0.2ppt to 3.4%Y/Y, just 0.1ppt below the series high recorded in 2011 and 0.7ppt above the long-run average. And expected inflation five years ahead increased 0.2ppt to 3.2%Y/Y, a touch above the long-run average. While the BoE DMP survey measure of business price expectations moderated slightly in November, it too remained extremely elevated. Moreover, the labour market remains very tight, with regular wage growth in September (5.7%3M/Y) the strongest rate outside of the height of the pandemic period and well above levels that the BoE will judge are consistent with inflation returning to target over the medium term. Further, at the margin, the government's fiscal policy plans announced on 17 November – including with respect to the energy price guarantee and a decision to postpone most austerity beyond the end of the monetary policy horizon – were arguably somewhat more generous than had been assumed in the Bank's forecast update at the start of November.

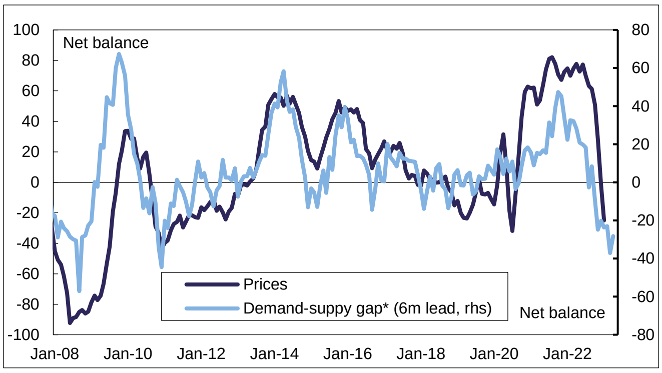
Some MPC members will likely call for a more marked slowdown in the pace of tightening

While the BoE will signal further tightening to come, however, as last month the policy statement is unlikely to be hawkish. With the UK economy now in a recession that is likely to extend through to the middle of 2023 and possibly beyond, there are signs that firms are becoming more reluctant to add to their workforces – yesterday's REC jobs survey suggested that full-time placements fell for the second successive month, job vacancies rose at the softest pace for 21 months and below the long-run trend, and the increase in starting salaries moderated to a 19-month low. In addition, consumer confidence remains very weak. And it might be further dented by ongoing adjustments in the housing market which appear only just to be gaining momentum – yesterday's RICS residential survey implied the steepest decline in house prices since May 2020 and, before that, 2012. Taken together with slowing global demand, the weaker economic backdrop should help to restrain price pressures over coming quarters, with risks that inflation will eventually fall below the 2.0%Y/Y target by the end of the projection horizon. Indeed, while the majority is likely to vote for a hike of 50bps, at least one member will likely prefer a smaller increase or none at all – in November, the newest external member Swati Dhingra voted for a hike of 50bps hike, while long-standing dove Silvana Tenreyro voted for 25bps.

The data week ahead in the UK

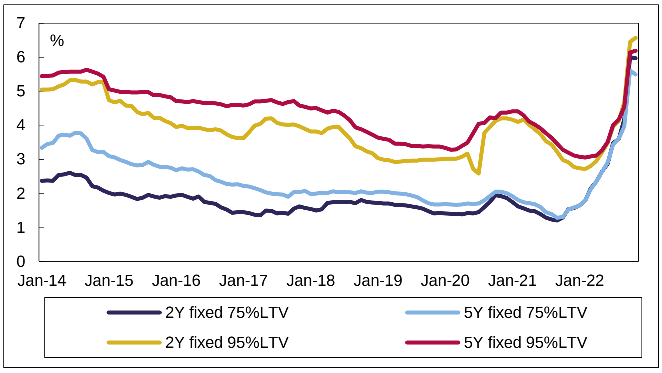
The coming week's data will likely play a role in the MPC's decision-making process, with the latest estimates of GDP (Monday), labour market conditions (Tuesday) and inflation (Wednesday) all due ahead of the monetary policy meeting. Headline CPI inflation is expected to have edged slightly lower in November due principally to an easing in energy inflation. But, in line with the Bloomberg consensus, we forecast inflation to fall only marginally below 11%Y/Y, with core inflation likely to remain sticky at 6.5%Y/Y. Despite expectations of another decline in employment in the three months to October, elevated inactivity and a lack of skilled workers will ensure that the labour market remains extremely tight, therefore maintaining upwards pressure on private sector wages. In terms of economic activity, despite an expected rebound in output in October (0.4%M/M) as trading returned to 'normal' following fewer working days in September due to the Queen's funeral, GDP is still expected to have maintained a downwards trend (-0.4%3M/3M) at the start of Q4. Meanwhile, after the MPC announcement, Friday's release of the December flash PMIs will remain consistent with ongoing contraction after the composite index was unchanged last month at the 22-month low of 48.2. The same day, the November retail sales figures are likely to suggest only modest growth despite Black Friday discounting, while the GfK consumer confidence index is likely to remain near historical lows.

UK: RICS house price balance



*Difference between buyer enquiries and new instruction.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Mortgage interest rates



Source: BoE quoted interest rates and Daiwa Capital Markets Europe Ltd.

Daiwa economic forecasts

	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2022	2023	2024
GDP	%, Q/Q						%, Y/Y		
Euro area	0.8	0.3	-0.3	-0.3	-0.1	0.1	3.3	-0.1	0.8
UK	0.2	-0.2	-0.5	-0.3	-0.5	-0.3	4.3	-1.2	0.1
Inflation, %, Y/Y									
Euro area									
Headline HICP	8.0	9.3	10.2	8.5	6.6	4.9	8.4	5.7	2.0
Core HICP	3.7	4.4	5.1	4.8	4.0	3.3	3.9	3.5	2.0
UK									
Headline CPI	9.2	10.0	10.9	10.1	8.2	7.2	9.2	7.7	3.9
Core CPI	6.0	6.3	6.4	5.8	4.7	4.3	6.0	4.7	3.9
Monetary policy, %									
ECB									
Refi Rate	0.00	1.25	2.50	3.00	3.00	3.00	2.50	3.00	2.25
Deposit Rate	-0.50	0.75	2.00	2.50	2.50	2.50	2.00	2.50	1.75
BoE									
Bank Rate	1.25	2.25	3.50	4.25	4.25	4.25	3.50	4.25	3.25

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain	Industrial production M/M% (Y/Y%)	Oct	**-0.4 (2.5)**	-0.4 (2.8)	-0.3 (3.6)	**-0.1 (-)**
UK	BoE inflation expectations next 12 months Y/Y%	Nov	**4.8**	-	4.9	**-**

Auctions

Country	Auction
Euro area	ECB early TLTRO-iii loan repayment announcement of €447.5bn
UK	BoE sold £1.88bn of gilts under financial stability buying portfolio

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	RICS house price balance %	Nov	**-25**	-10	-2	**-**

Auctions

Country	Auction
UK	BoE sold £749.9mn of 2030-2042 APF gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's data calendar

The coming week's key data releases

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
		Monday 12 December 2022			
UK	00.01	Rightmove house prices M/M% (Y/Y%)	Dec	-	-1.1 (7.2)
	07.00	GDP M/M% (3M/3M%)	Oct	0.4 (-0.4)	-0.6 (-0.3)
	07.00	Industrial production M/M% (Y/Y%)	Oct	0.0 (-2.4)	0.2 (-3.1)
	07.00	Manufacturing production M/M% (Y/Y%)	Oct	0.0 (-5.2)	0.0 (-5.8)
	07.00	Index of services M/M% (3M/3M%)	Oct	0.5 (-0.1)	-0.8 (0.0)
	07.00	Construction output M/M% (Y/Y%)	Oct	0.0 (6.4)	0.4 (5.7)
	07.00	Goods trade balance (excl. precious metals) £bn	Oct	-15.3 (-)	-15.7 (-20.4)
		Tuesday 13 December 2022			
Germany	07.00	Final CPI M/M% (Y/Y%)	Nov	*-0.5 (10.0)*	0.9 (10.4)
	07.00	Final HICP M/M% (Y/Y%)	Nov	*0.0 (11.3)*	1.1 (11.6)
	10.00	ZEW current assessment (expectations)	Dec	-57.0 (-26.4)	-64.5 (-36.7)
Italy	09.00	Industrial production M/M% (Y/Y%)	Oct	-	-1.8 (-0.5)
UK	07.00	Unemployment claimant count rate %, change '000s	Nov	-	3.9 (3.3)
	07.00	ILO unemployment rate %, 3M	Oct	3.7	3.6
	07.00	Employment change '000s, 3M/3M	Oct	-19	-52
	07.00	Average earnings including (excluding) bonuses 3M/Y%	Oct	6.2 (5.9)	6.0 (5.7)
		Wednesday 14 December 2022			
Euro area	10.00	Industrial production M/M% (Y/Y%)	Oct	*-1.5 (3.6)*	0.9 (4.9)
Spain	08.00	Final CPI M/M% (Y/Y%)	Nov	*-0.1 (6.8)*	0.3 (7.3)
	08.00	Final HICP M/M% (Y/Y%)	Nov	*-0.5 (6.6)*	0.1 (7.3)
UK	07.00	CPI M/M% (Y/Y%)	Nov	*0.5 (10.8)*	2.0 (11.1)
	07.00	Core CPI Y/Y%	Nov	*6.5*	6.5
	09.30	House price index Y/Y%	Oct	11.2	9.5
		Thursday 15 December 2022			
Euro area	07.00	EU27 new car registrations Y/Y%	Nov	-	12.2
	13.15	ECB Deposit (Refi) Rate %	Dec	*2.00 (2.50)*	1.50 (2.00)
France	07.45	Final CPI M/M% (Y/Y%)	Nov	*0.4 (6.2)*	1.0 (6.2)
	07.45	Final HICP M/M% (Y/Y%)	Nov	*0.5 (7.1)*	1.2 (7.1)
	07.45	INSEE business (manufacturing) confidence	Dec	101 (100)	102 (101)
UK	12.00	BoE Bank Rate %	Dec	*3.50*	3.00
		Friday 16 December 2022			
Euro area	09.00	Preliminary manufacturing (services) PMI	Dec	47.1 (47.8)	47.1 (47.8)
	09.00	Preliminary composite PMI	Dec	48.0	47.8
	10.00	Final HICP M/M% (Y/Y%)	Nov	-0.1 (10.0)	1.5 (10.6)
	10.00	Final core CPI Y/Y%	Nov	5.0	5.0
	10.00	Trade balance €bn	Oct	-	-37.7
Germany	08.30	Preliminary manufacturing (services) PMI	Dec	46.4 (46.3)	46.2 (46.1)
	08.30	Preliminary composite PMI	Dec	46.5	46.3
France	08.15	Preliminary manufacturing (services) PMI	Dec	48.0 (49.0)	48.3 (49.3)
	08.15	Preliminary composite PMI	Dec	48.7	48.7
Italy	10.00	Final CPI M/M% (Y/Y%)	Nov	0.5 (11.8)	3.4 (11.8)
	10.00	Final HICP M/M% (Y/Y%)	Nov	0.6 (12.5)	3.8 (12.6)
Spain	08.00	Labour costs Y/Y%	Q3	-	3.8
UK	00.01	GfK consumer confidence	Dec	-42	-44
	07.00	Retail sales including auto fuel M/M% (Y/Y%)	Nov	0.3 (-5.8)	0.6 (-6.1)
	07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Nov	0.3 (-5.8)	0.3 (-6.7)
	09.30	Preliminary manufacturing (services) PMI	Dec	46.4 (48.5)	46.5 (48.8)
	09.30	Preliminary composite PMI	Dec	48.0	48.2

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 12 December 2022
			- Nothing scheduled -
			Tuesday 13 December 2022
UK		10.00	Auction: £3bn of 1% 2032 bonds
		10.30	BoE publishes Financial Stability Report
			Wednesday 14 December 2022
			- Nothing scheduled -
			Thursday 15 December 2022
Euro area		13:15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds press conference following the Governing Council meeting
Spain		09.30	Auction: fixed rate bonds
UK		12.00	BoE monetary policy announcement, statement and minutes to be published
		12.00	BoE publishes Agents' summary of business conditions – Q422
			Friday 16 December 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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