Euro wrap-up

Overview

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- Shorter-dated Bunds made gains as euro area IP fell more than expected at the start of Q4 as energy-intensive output continued to be aggressively cut back.
- Shorter-dated Gilts made big gains as UK CPI inflation fell by more than expectations in November, with underlying price pressures easing too.
- Thursday will bring ECB and BoE monetary policy announcements, with both likely to slow the pace of tightening to 50bps, and the former set to confirm the principles which will in due course guide its QT programme.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.112	-0.011
OBL 1.3 10/27	1.918	-0.010
DBR 1.7 08/32	1.930	+0.015
UKT 1 04/24	3.378	-0.079
UKT 1¼ 07/27	3.258	-0.061
UKT 4¼ 06/32	3.312	+0.022

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

Euro area

Euro area IP starts Q4 on the back foot

Consistent with gloomy signals from various business surveys, including the PMIs and the Commission's sentiment indices, today's euro area industrial production data confirmed that the manufacturing sector started the fourth quarter on the back foot. In particular, output fell in October for the first month in three and by a slightly steeper-than-expected 2.0%M/M, with monthly declines in all but four member states. These were particularly striking in Ireland (-10.7%), Germany (-0.9%), France (-2.6%) and Italy (-1.0). And with growth having been revised lower in September (to 0.8%M/M), the level of euro area IP was almost 1% below the Q3 average. Within the detail, the steep decline in energy production (-3.9%M/M), to a series low with the exception of April 2020, partly reflected lower demand due to unseasonably warm weather as well as strike action at French refineries, where energy output slumped 7.6%M/M. But manufacturing was also notably weaker, down 2.2%M/M to leave the level of output more than ½% below the Q3 average.

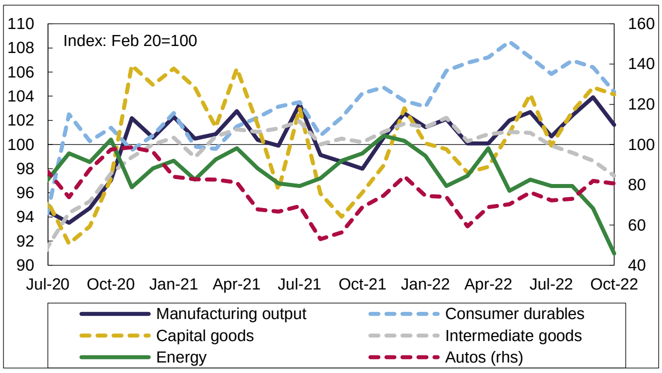
Energy-intensive production continues to be reduced aggressively

Admittedly, there was a modest increase in production of consumer non-durables (0.3%M/M) thanks to a further surge in pharmaceuticals output. But otherwise the weakness was widespread. Output of consumer durables fell for the second successive month (-1.9%M/M), with capital goods down for the first month in three (-0.6%M/M), not least reflecting a partial reversal in autos production. And once again the decline in intermediate goods, where output fell for the fifth consecutive month (-1.3%M/M), was driven by ongoing struggles within energy-intensive subsectors. For example, chemicals production fell for the tenth consecutive month to be 15% lower than at the end of last year. And production in energy-intensive sectors in aggregate was down more than 2½%M/M in October, to be more than 3½% below the Q3 average. Moreover, it was almost 9% below the level ahead of Russia's invasion of Ukraine, compared with an equivalent drop of around 1% in total IP. Given ongoing concerns about energy supply, production in these subsectors seems likely to maintain a downtrend into the New Year, with manufacturing output as a whole highly likely to be a drag on GDP growth in Q4.

Spanish inflation falls to lowest in ten months amid fall in electricity prices

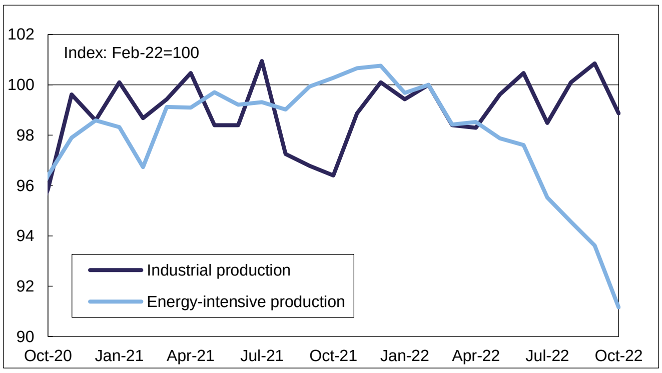
Contrasting with yesterday's German figures, updated November consumer price inflation estimates from Spain brought a modest upwards revision to the EU-harmonised measure, by 0.1ppt to 6.7%Y/Y. But this still represented a drop of 0.6ppt on the month and the lowest reading since January. On the national measure, consumer prices fell 0.1%M/M in November, to leave the annual rate down 0.5ppt to 6.8%Y/Y. The decline was principally due to household utilities, where prices fell

Euro area: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

3½%M/M amid the third consecutive double-digit drop in electricity prices (-14.6%M/M) reflecting the faster pass-through of developments in wholesale markets to consumers in Spain. Strikingly, electricity inflation was down more than 22%Y/Y, with overall prices of household utilities up just 1.0%Y/Y. So, having contributed roughly 4½ppts to headline CPI inflation at the peak in March, household utilities accounted for just 0.1ppt in November. But while food still accounted for a hefty 3½ppts of total inflation, the year-on-year rise in such prices moderated very slightly, suggesting that pressures in this component might have peaked too. While Spain's national measure of core CPI moved sideways at 6.3%Y/Y, core inflation on the EU equivalent basis appear to have fallen back in November.

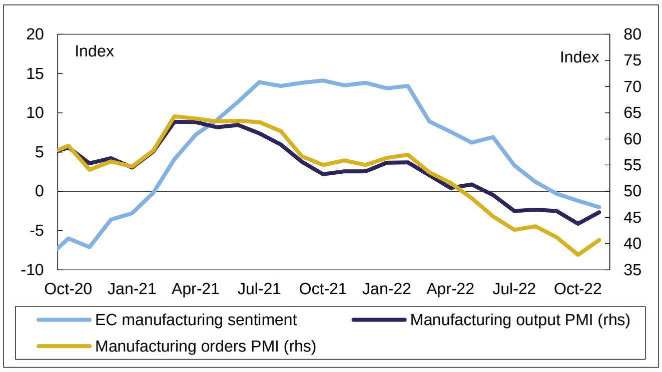
The day ahead in the euro area

The main event in the euro area tomorrow will be the conclusion of the ECB's monetary policy meeting, which 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. While the flash estimate of headline inflation fell a larger-than-expected 0.6ppt in November to 10.0%Y/Y, the hawks will highlight that the average rate over the first two months of Q4 was more than 1ppt above the ECB's most recent forecast, requiring an upward revision to the inflation outlook in the updated projections. They 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 they will cite tentative evidence of increasing risks of second-round effects on future inflation via higher inflation expectations and wage settlements.

So, the hawks are unlikely to agree to a slowing in the pace of tightening to 50bps without receiving something in return. In particular, we expect the policy statement again to state that the Governing Council "expects to raise rates further" in the New Year. 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. And the hawks might also demand assurances that quantitative tightening will start no later than the end of Q1. The principles for that QT programme will make clear that it should operate in the background, in a predictable, measured way, most likely setting a limit on monthly reinvestments (perhaps about €20bn per month) as the Fed has done.

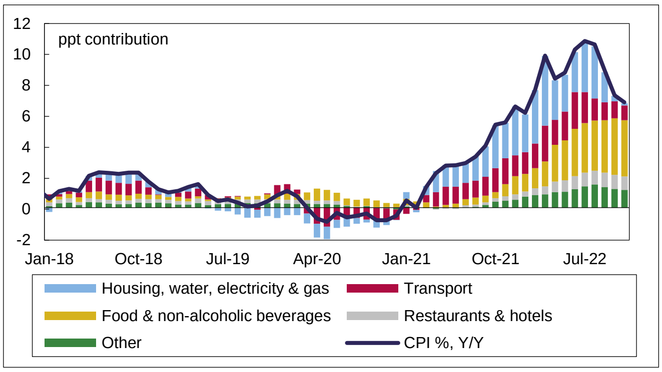
In terms of the detail of the economic projections, the ECB's forecast for GDP growth in 2023 is likely to be revised down from 0.9%Y/Y to about 0.5%Y/Y or less. And they should also suggest that the peak in euro area inflation has been reached this quarter, and that both headline and core measures should decline gradually from Q1 onwards. So, despite the upside

Euro area: Manufacturing survey indices



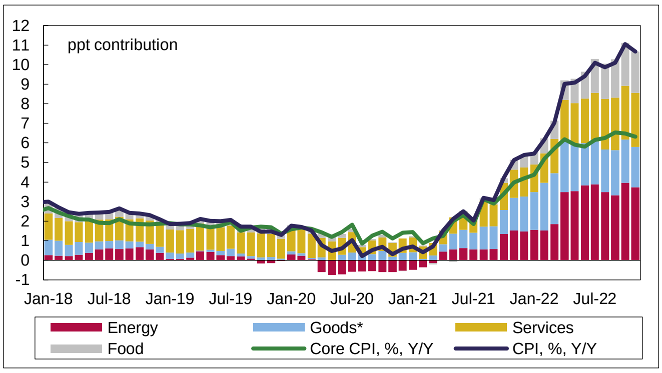
Source: Refinitiv S&P Global and Daiwa Capital Markets Europe Ltd.

Spain: CPI inflation and contributions*



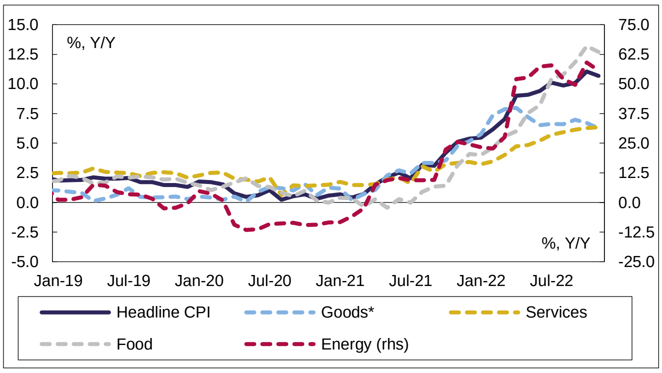
**National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: CPI inflation and contributions



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

UK: CPI inflation – major components



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

revisions to the inflation 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.

More prosaically, the flow of final inflation figures for November continues tomorrow with the French numbers due. The preliminary data suggested that the headline CPI rate moved sideways at 6.2%Y/Y, as the moderation in energy and fresh food prices was offset by an increase in prices of processed food. The core rate also moved sideways at 3.5%Y/Y, with higher goods prices balanced out by an easing in services. And the HICP measure was unchanged at 6.2%Y/Y, still well below the euro area figure of 10.0%Y/Y. Tomorrow also sees the release of EU27 new car registrations for November. Data from the member states suggest that pent-up demand and the recent easing of supply strains is likely to have driven car sales higher. In particular, German car sales rose 31.4%Y/Y, with Italy (14.7%Y/Y), Spain (+10.3%Y/Y) and France (+9.8%Y/Y) also posting solid growth compared to a year earlier. With respect to economic sentiment, the INSEE French business confidence survey for December will also be published.

UK

Drop in inflation in November partly reflects favourable base effects in energy and tobacco

Ahead of tomorrow's monetary policy announcement from the BoE, today's UK inflation figures provided some rare good news, falling back more than had been expected, albeit remaining very high by historical standards. In particular, the headline CPI rate moderated 0.4ppt from October's peak to 10.7%Y/Y, 0.2ppt below the median forecast on the Bloomberg survey. Given the upside surprise at the start of the quarter, however, average inflation in Q4 so far is tracking only marginally below the BoE's baseline forecast of 10.9%3M/Y. The drop in inflation in November was in part thanks to base effects with respect to petrol prices, which were unchanged on the month in contrast to the big rise over the same period a year ago. As a result, energy inflation slowed almost 3½ppts, albeit remaining eye-wateringly high at 55.6%Y/Y. Inflation of food, energy and tobacco moderated slightly too, down ½ppt to 12.7%Y/Y, again thanks to base effects, as last year's big increase in tobacco duty was not repeated.

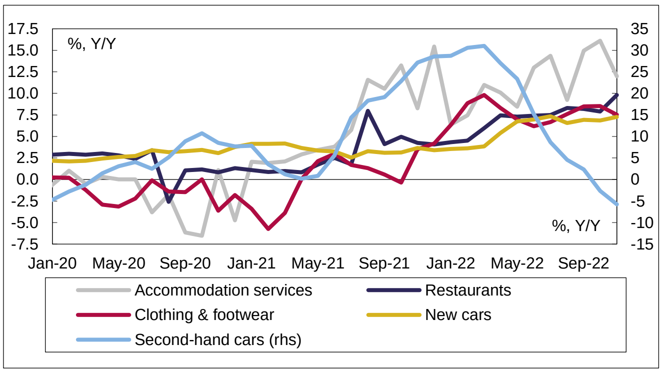
Core inflation moderates due to second-hand cars and clothing

While energy and tobacco accounted for about half of the decline in headline inflation last month, the core measure also slowed, down 0.2ppt from the series peak reached in each of the prior two months, to 6.3%Y/Y, also 0.2ppt below the consensus forecast. The monthly increase in core prices compared to the norm for the month was the lowest so far this year. In part, that reflected a further easing in second-hand car prices, which are now down 5.8%Y/Y having been up more than 30%Y/Y at their peak in March. And with inflation of clothing and footwear moderating 1ppt to 7.5%Y/Y as retailers largely eschewed their usual November price increases, overall inflation of non-energy industrial goods slowed for a second successive month to a ten-month low of 6.3%Y/Y. In contrast, services inflation was unchanged at 6.3%Y/Y, with increased pressures in restaurants broadly offset by an easing in hotels, and transport and recreational services.

Downtrend in price pressures should be clear by end-Q1 allowing BoE to cease tightening cycle

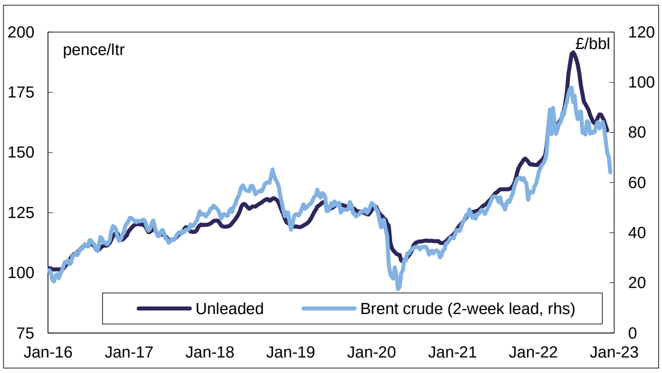
The downside surprise to inflation in November means that the MPC need not panic when it makes its policy decision, and we reaffirm our expectation for a moderation in the pace of tightening tomorrow via a 50bps increase in Bank Rate to 3.50%. Looking ahead, overall CPI inflation should edge slightly lower over the near term thanks not least to weaker petrol prices, which are benefiting from stronger sterling as well as lower dollar-denominated crude prices. The easing in supply-driven pipeline pressures, reflected not least in wholesale and producer prices, as well as an inventory overhang, should also help keep goods inflation better contained, and allow the headline CPI rate to fall back below 10%Y/Y in February. Admittedly, strong wage growth and indexation of certain charges poses upside risks, particularly to services prices in particular. And household energy prices will be hiked again in April, while the government will also scale back its energy support for businesses, to keep headline inflation in the UK significantly higher than in other major industrialised economies through to spring 2023. However, given the likely persistent weakness of domestic demand, we expect a steady downwards trend in the

UK: CPI inflation – selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Petrol and crude oil prices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

core component to be established from the first quarter of 2023, enabling the BoE to cease its tightening cycle at the March MPC meeting.

The day ahead in the UK

All eyes in the UK tomorrow will be on the aforementioned BoE announcement. Not least given the restoration of confidence in UK economic management following the autumn Gilt crisis, the downside surprise to November's CPI inflation data, and the cumulative tightening of 290bps over the past year, the MPC is expected to revert back to an increase of 50bps – as in August and September – taking Bank Rate to 3.50%. However, the vote on the Committee is highly likely to be split again, perhaps three or four ways. With inflation expected to moderate next year somewhat more gradually than in the US and euro area, and the Committee still mindful of second-round effects, the hawks (including external members Catherine Mann and Jonathan Haskel) might vote for another hike of 75bps. In contrast, with the UK economy probably now in recession, the doves will likely call for a more marked slowing in the pace of tightening this month – in November, the newest external member Swati Dhingra voted for a hike of 50bps hike, while long-standing dove Silvana Tenreyro voted for 25bps.

Meanwhile, it will be a quiet day data-wise tomorrow in the UK, with no key releases scheduled to distract from the monetary policy announcement.

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%)	Oct	**-2.0 (3.4)**	*-1.5 (3.6)*	0.9 (4.9)	**0.8 (5.1)**
Spain	Final CPI M/M% (Y/Y%)	Nov	**-0.1 (6.8)**	*-0.1 (6.8)*	0.3 (7.3)	-
	Final HICP M/M% (Y/Y%)	Nov	**-0.3 (6.7)**	*-0.5 (6.6)*	0.1 (7.3)	-
UK	CPI M/M% (Y/Y%)	Nov	**0.4 (10.7)**	*0.5 (10.8)*	2.0 (11.1)	-
	Core CPI Y/Y%	Nov	**6.3**	*6.5*	6.5	-
	House price index Y/Y%	Oct	**12.6**	11.2	9.5	-

Auctions

Country	Auction
UK	BoE sold £3.84bn gilts in sale of financial stability portfolio holdings

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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

Auctions and events

Country	GMT	Event
Euro area	13:15	ECB monetary policy announcement
	13.45	ECB President Lagarde holds press conference following the Governing Council meeting
UK	12.00	BoE monetary policy announcement, statement and minutes to be published
	12.00	BoE publishes Agents' summary of business conditions – Q422

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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