Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds made huge losses and BTPs badly underperformed as the ECB raised rates by 50bps but signalled its desire for significant further tightening in the New Year and announced that QT will start in March.
- Gilts made gains while the BoE raised Bank Rate by 50bps and signalled the likelihood of more tightening to come, but two external members voted to keep policy unchanged.
- Friday will bring the flash December PMIs, as well as UK retail sales figures for November.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.346	+0.232
OBL 1.3 10/27	2.150	+0.197
DBR 1.7 08/32	2.084	+0.151
UKT 1 04/24	3.411	-0.039
UKT 1¼ 07/27	3.241	-0.041
UKT 4¼ 06/32	3.259	-0.050

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

Euro area

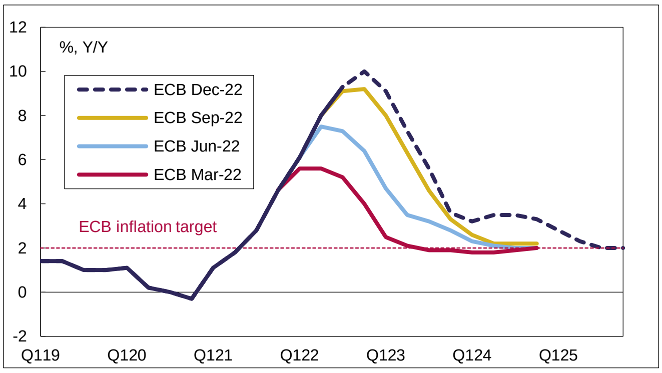
A hawkish 50bp rate hike from the ECB

As expected, the ECB's Governing Council today raised all of its main policy rates by 50bps, taking the deposit rate to a broadly neutral level of 2.00% and the cumulative tightening since July to 250bps. However, despite that moderation in the pace of tightening after two successive hikes of 75bps, the ECB's message was unambiguously hawkish, hitting euro area government bonds and stocks hard. In particular, the policymakers signalled further tightening in the New Year, stating that it "judges that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive". And it made the case for "Keeping interest rates at restrictive levels over time" to "reduce inflation by dampening demand and … guard against the risk of a persistent upward shift in inflation expectations". So, the Governing Council's statement implied that another 50bps hike is likely to come at the next monetary policy meeting in February and perhaps also in March and even maybe in Q2 too. And it made clear that, when the terminal rate for the hiking cycle is eventually reached, there will be no intention to pivot to easier monetary policy for some time thereafter. In her press conference, President Lagarde acknowledged that there were differences of view among the policymakers, with the hawkish guidance clearly a concession to appease the reportedly one-third of policymakers who had preferred another 75bps hike. But she stated that a broad majority agreed that the ECB "should show perseverance" and continue to tighten at the current pace. Indeed, to underscore that point, she argued that the ECB had much more ground to catch up than the Fed in returning rates to a level consistent with 2.0% inflation target over the medium term.

Quantitative tightening to start in March

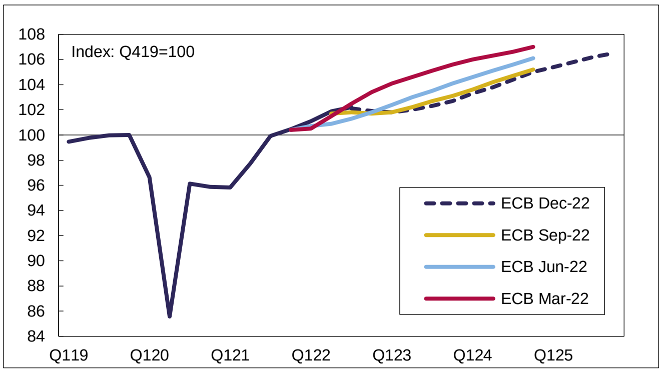
As well as raising rates and signalling further hikes in the New Year, the Governing Council announced the start of quantitative tightening from March onwards. In particular, it confirmed that the asset purchase programme (APP) portfolio will be reduced at a "measured and predictable pace", limiting the amount of principal payments from maturing bonds that will be reinvested. While detailed parameters for reducing the APP holdings will be confirmed in February, the initial pace of decline was set at €15bn per month on average until the end of Q223. That rate was within the expected range, with President Lagarde suggesting that the amount would represent roughly half of all redemptions due over that period. The decision to calibrate the subsequent balance sheet reduction in February might suggest that the monthly pace will be stepped up from Q3 on, as long as the bond market appears able then to withstand it. However, Lagarde insisted that interest rates would remain the primary monetary policy tool and that the pace of balance sheet reduction need not have a significant impact on the overall policy stance. Given the nature of the euro area with its multiple member states, however, that assumption seems a brave one, as illustrated by today's disproportionately large sell off in BTPs.

Euro area: HICP inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: GDP forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

ECB's hawkishness due to upwards revision to its inflation outlook…

The decision to tighten monetary policy further, and the desire to push rates firmly into restrictive territory, reflected the ECB's updated macroeconomic projections. In terms of economic output, the Governing Council acknowledged that GDP might contract in Q422 and Q123. But it also judged that recession would be relatively short-lived and shallow, and revised down the baseline forecast for GDP growth in 2023 by just 0.4ppt to 0.5%. And GDP growth is expected to rebound in 2024 to 1.9% (an unchanged forecast from September) and 1.8% in 2025. With inflation in Q4 on track to average 10.0%Y/Y – some 0.8ppt more than the ECB expected three months ago – the inflation outlook was always bound to be revised up. But given concerns about increased household energy tariffs in some member states at the start of 2023, ongoing rises in food prices, and an assessment that underlying price pressures were stronger and more persistent, the revisions were large. In particular, the projections for average headline inflation in 2023 and 2024 were revised up 0.8ppt and 1.1ppts respectively to 6.3% and 3.4%. Average core inflation was revised up 0.8ppt and 0.5ppt in 2023 and 2024 respectively to 4.2% and 2.8%. And average headline inflation in 2025 – for which a projection was published for the first time – is expected to be 2.3%.

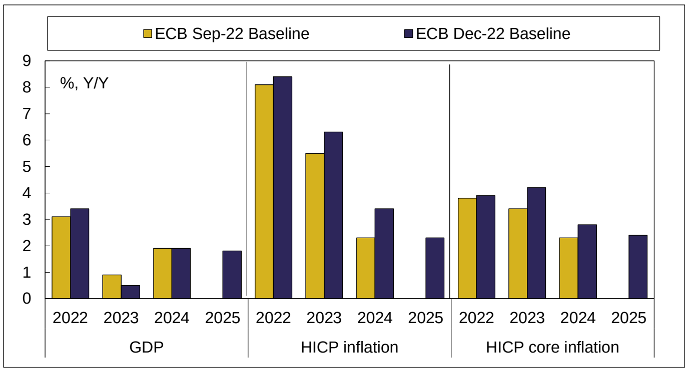
…but inflation projected to be back on target from Q325

With the ECB's updated projections based on a market-implied path for rates, and considered by the Governing Council not to be consistent with the return of inflation to target in a timely manner, Lagarde suggested that market interest rate expectations should be revised up. That would imply a terminal rate of 3.00% or more. We note, however, that the projections still envisage a return to the 2.0% target from Q325 on. Moreover, there seem good reasons to believe that the upwards revision to the ECB's inflation outlook, particularly for 2024, was excessive, and that the risks for 2024 and 2025 should be judged to be skewed to the downside. So, we also expect the ECB's next inflation projections in March – which will be produced by the ECB staff and not (as for the current projections) the national central banks of the Eurosystem – to be revised down. And so, while we now expect a hike of 50bps in February to match Lagarde's steer, we maintain our view that rates will only be hiked by 25bps in March, which would take the terminal rate to 2.75%. Given that the hawks appear to remain in control of the Governing Council, however, we acknowledge that the risks to that view are skewed to the upside.

Faster euro area new car sales driven by pent-up demand and easing supply strains

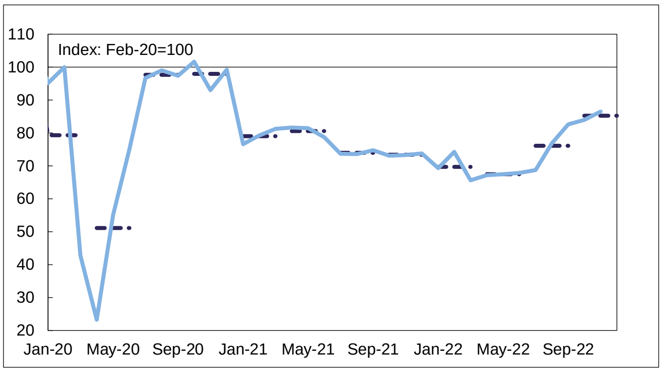
Admittedly, today's data suggested that economic activity is holding up relatively well in the face of the current economic headwinds. For example, the euro area new car registrations figures suggested that pent-up demand and the recent easing of supply strains drove car sales notably higher in November. According to ECB estimates, euro area car registrations rose a further 2.9%M/M, to be up 18%Y/Y, with strong growth in Germany (7.6%M/M), France (4.9%M/M) and Italy (2.0%M/M).

Euro area: ECB forecasts



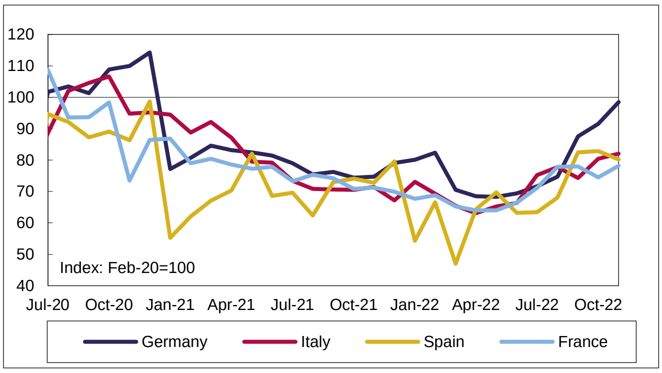
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations*



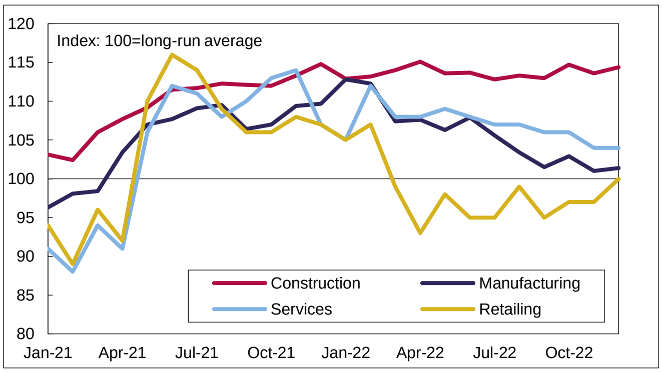
**Dashed dark blue lines represent quarterly averages. Source: ECB and Daiwa Capital Markets Europe Ltd.*

Euro area: New car registrations by country



Source: ECB and Daiwa Capital Markets Europe Ltd.

France: INSEE business indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Given the recent monthly profile, this left new car sales in the euro area trending 12% above the Q3 average, with a striking increase in Germany of almost 22% on an equivalent basis, suggesting a welcome boost to spending and overall GDP growth in the final quarter of the year. However, the level of registrations was still roughly 20% below the pre-pandemic level in November 2019, with year-to-date sales down by more than 40% compared with the equivalent period that year. And with consumer confidence still historically low and household purchasing power continuing to decline, we expect to see demand for new cars moderate over coming quarters once pent-up demand has been exhausted.

French business sentiment resilient in December according to INSEE survey

Ahead of tomorrow's flash December PMIs, the French INSEE business survey suggested that conditions were broadly stable and confidence resilient heading towards the end of year despite ongoing concerns of disruption to energy supply. In particular, the headline sentiment index stood at an above-average 102 for the fourth consecutive month in December. Having underperformed in recent months, there was an improvement in retail sentiment back to the long-run average (100), while the respective indices were unchanged in manufacturing (101), services (104) and construction (114). Admittedly, with the exception of construction, these figures remain well down on levels seen earlier in the year, with the average indices for manufacturing and services in the fourth quarter some 2pts below the Q3 average too, suggesting perhaps unsurprisingly that the French economy slowed (if not contracted) in the final quarter of the year. Nevertheless, with the headline business indicator down just 0.4pt in Q4 at a still respectable 102, consistent with the BoF's most recent estimate, we continue to expect French GDP growth of at least 0.1%Q/Q in Q4.

The day ahead in the euro area

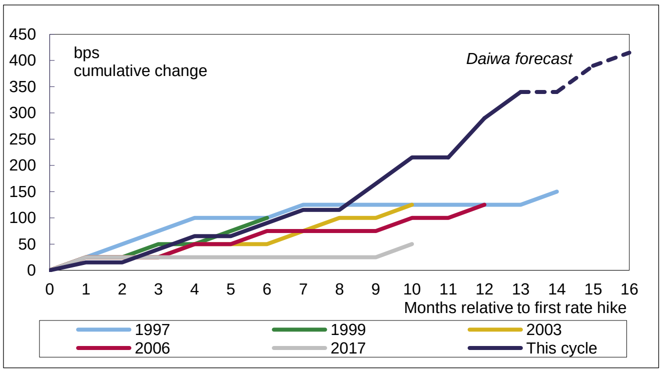
Focus in the euro area tomorrow will be on December's flash PMIs. While the euro area composite PMI ticked up in November, at 47.8 it remained firmly consistent with contraction, with the services index the weakest since mid-2013 outside of Covid lockdown periods. The German composite PMI – which in November stood at 46.3 – is expected to remain the worst performing of the member states, while the French composite index is forecast to move sideways at a contractionary 48.7. We note, however, that the PMIs typically provide a less accurate guide to the French economy than other national surveys. In terms of activity, Friday will also bring October's goods trade figures. But attention will also turn to final euro area consumer price inflation figures for November. Equivalent figures from Germany (11.3%Y/Y) and France (7.1%Y/Y) were unrevised, while there was a modest downwards revision in Spain (by 0.1ppt to 6.7%Y/Y). As such, we expect the euro area headline inflation rate to be confirmed at 10.0%Y/Y, down 0.4%ppt from October's series high. Core euro area inflation, however, remained steady at the series high of 5.0%Y/Y. Of course, the full detailed breakdown will be of interest, allowing calculation of trimmed means, for further insight into underlying price pressures.

UK

MPC hikes by 50bps, with most members favouring additional tightening in the New Year

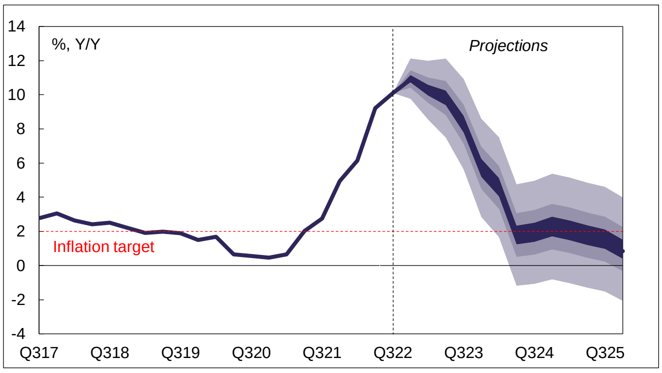
Having hiked by 75bps in November, as expected the BoE's MPC today reverted back to raising rates by 50bps – as in August and September – taking Bank Rate to 3.50%. That took the cumulative increase in rates over the past twelve months to 340bps, extending significantly further the BoE's most aggressive tightening cycle since independence in 1997. Also as expected, the statement signalled the likelihood of additional tightening in the New Year, noting that "The majority of the Committee judged that, should the economy evolve broadly in line with the November Monetary Policy Report projections, further increases in Bank Rate might be required for a sustainable return of inflation to target." But, also as expected, the vote on the Committee was split again three ways. Six members of the MPC backed the 50bps hike, citing evidence of inflationary pressures in domestic prices and wages that could indicate greater persistence. Given her even greater concerns about that evidence, one member (the external hawk Catherine Mann) preferred an increase of 75bps. But more notably perhaps, two external members (Silvana Tenreyro and Swati Dhingra) voted for no change to policy. They thought that the economic downturn was starting to affect the labour market adversely, and were concerned that the lagged effects from past

UK: BoE tightening cycles compared



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: BoE CPI forecast, constant Bank Rate at 3%*



Source: BoE November 2022 Monetary Policy Report and Daiwa Capital Markets Europe Ltd.

rate increases were still to be fully felt. As such, they judged that Bank Rate was already more than high enough to bring inflation back to target.

Economic outlook extremely uncertain, but inflation expectations starting to ease

The differences of opinion on the MPC regarding the appropriate monetary policy stance reflect the UK's extremely uncertain economic outlook. Among other things, the meeting's minutes noted that the economy had recently been a little more resilient than feared, with Bank staff now expecting GDP to decline just 0.1%Q/Q in Q4, 0.2ppt less than forecast just last month. However, they also judged that the government's updated fiscal policy plans would increase the level of GDP by 0.4% at a one-year horizon, leave it broadly unchanged at a two-year horizon, but reduce the level of GDP by 0.5% in three years' time, relative to what had previously been projected. The revised Energy Price Guarantee was estimated to reduce the MPC's forecast for inflation in Q223 by around ¾ppt, although overall the net effect of all fiscal policy measures on inflation was judged to be small. While the labour market was considered still to be historically tight, it was also judged to be "past its peak tightness". And although household and business inflation expectations remained elevated, it was noted that most measures had started to fall back. Moreover, according to a BoE survey, market participants had revised down significantly their expectation for inflation three and five years ahead to 2%, from 3% and 2.5% last month.

Bank Rate set to rise further, but risks to the terminal rate arguably skewed to the downside

While recent economic activity was considered to be somewhat more resilient than previously expected, the Bank's GDP growth outlook remains downbeat. Even assuming a constant Bank Rate at just 3.00%, GDP growth was not expected to return to positive territory on a sustained basis before 2024. And so, while inflation was expected to fall only gradually in 2023 to remain above 5½%Y/Y at the end of the year, on the same conservative Bank Rate assumption, the profile saw a marked decline thereafter, falling to 2.2%Y/Y in Q424 and to 0.8%Y/Y in Q425. As such, the decisions by Tenreyro and Dhingra to vote for Bank Rate to be kept unchanged this month were arguably justifiable. This notwithstanding, given the ongoing tightness in the labour market, we continue to expect the majority on the Committee to want to press ahead with additional tightening at the start of the New Year. As such, we maintain our expectation for a further hike of 50bps in February and a final 25bps increase in March, taking Bank Rate to 4.25%, in line with the median expectation in the Bank's latest market participants survey. But while the market-implied terminal Bank Rate is a touch higher than that, at 4.50% and reached by the middle of next year, we consider risks to our forecast on balance to be skewed slightly to the downside.

The day ahead in the UK

A busy end to the week for top-tier UK releases will include the flash December PMIs. Like in the euro area, these will remain consistent with ongoing contraction after the composite index was unchanged last month at the 22-month low of 48.2, suggesting that manufacturing and services activity is likely contracting. November retail sales figures are also likely to suggest only modest growth despite Black Friday discounting, while the GfK consumer confidence index is likely to remain near historical lows and indicate that willingness (or ability) to spend on big-ticket items remains extremely weak as households' disposable income continues to decline. In addition, the BoE is due to announce its bond sales plan for Q123, which will be based on a decision taken by the BoE Executive rather than the MPC. Most notably, we expect the Bank to confirm the start of sales of long-dated Gilts from the APP portfolio.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	EU27 new car registrations Y/Y%	Nov	**16.3**	-	12.2	-
	ECB Deposit (Refi) Rate %	Dec	**2.00 (2.50)**	*2.00 (2.50)*	1.50 (2.00)	-
France	Final CPI M/M% (Y/Y%)	Nov	**0.3 (6.2)**	*0.4 (6.2)*	1.0 (6.2)	-
	Final HICP M/M% (Y/Y%)	Nov	**0.4 (7.1)**	*0.5 (7.1)*	1.2 (7.1)	-
	INSEE business (manufacturing) confidence	Dec	**102 (101)**	101 (100)	102 (101)	-
UK	BoE Bank Rate %	Dec	**3.50**	*3.50*	3.00	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Preliminary manufacturing (services) PMI	Dec	47.1 (48.5)	47.1 (47.8)
		09.00	Preliminary composite PMI	Dec	47.9	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	46.3 (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	-43	-44
		07.00	Retail sales including auto fuel M/M% (Y/Y%)	Nov	0.3 (-5.6)	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	46.5 (48.5)	46.5 (48.8)
		09.30	Preliminary composite PMI	Dec	48.0	48.2

Auctions and events

Country		GMT	Event
UK		-	BoE to publish schedule for APP Gilt sales in Q123

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs