Daiwa Capital Markets

Euro wrap-up

Overview

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- While the ZEW survey signalled much improved expectations for German economic activity and inflation, euro area government bonds made significant gains as a Bloomberg report suggested the ECB would consider a slowing in the pace of rate hikes in March.
- Gilts made smaller gains as UK pay accelerated amid a still-tight labour market.
- Wednesday will bring updates on inflation in the UK and euro area in December, as well as data on euro area construction output and car registrations.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.434	-0.119
OBL 2.2 04/28	2.078	-
DBR 1.7 08/32	2.083	-0.085
UKT 1 04/24	3.416	-0.036
UKT 1¼ 07/27	3.269	-0.029
UKT 4¼ 06/32	3.331	-0.049

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

Euro area

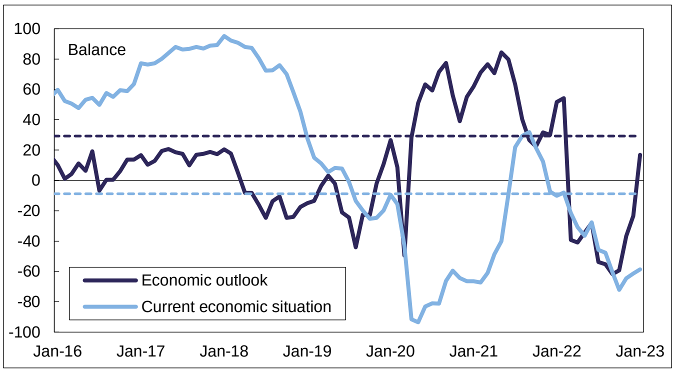
German ZEW survey signals marked improvement in optimism at the start of 2023

Euro area economic activity undoubtedly weakened heading into the final quarter of last year as spending was restrained by high inflation, rising borrowing costs, concerns about energy supply and the uncertain outlook. However, survey indicators suggest an improvement in conditions towards year-end, perhaps supported by easing concerns about adequacy of energy supply and associated falling gas prices. In addition, last week's full-year German GDP figures beat expectations to suggest the possibility that the euro area's largest member state might have avoided contraction in Q4, likely assisted in part by a rebound in auto production and sales as supply challenges eased. And Portugal's National Bank Governor Centeno today suggested that he expected euro area GDP growth still to be positive in Q4. On balance, we think that euro area GDP broadly stagnated last quarter. But there are growing signs that the downturn will be much shorter and less severe than initially feared. And that was reflected in today's results from the January ZEW survey of investors. Admittedly, the improvement in current German economic conditions was judged to be relatively modest, with the respective indicator rising 2.8pts to -58.6, still roughly 50pts below the long-run average. But reflecting a marked improvement in inflation expectations – the respective index fell to its lowest since 1994 (-85.5) – the government's support for energy bills, and greater confidence in energy supply, investors expected a marked improvement in economic conditions over the coming six months. Indeed, the outlook balance rose 40pts to 16.9, the first positive reading since last February. While the ZEW survey indices typically provides a less accurate guide to German GDP growth than others such as those produced by the ifo institute, they nevertheless suggest that the weakest point of the downturn might well have now passed.

Bloomberg report suggests ECB is considering slowing pace of rate hikes in March

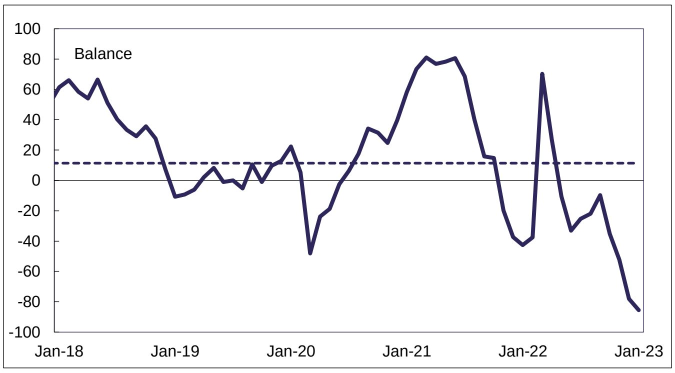
In an interview published today in the FT, the oft-dovish ECB Chief Economist Philip Lane flagged the need for ongoing tightening over coming months. While he judged that rates were now back in the "ballpark of neutral", he also acknowledged that risks to the inflation outlook remained skewed to the upside and were likely to remain that way for the "next year or two", requiring a shift into "restrictive territory". Nevertheless, he also emphasised the uncertainty of the economic outlook. And he made a clear distinction between economic conditions in the US and euro area, noting "declining real incomes and falling real wages, and a big supply component to inflation" this side of the Atlantic, which "means that the scale of monetary policy tightening needed to adjust inflation to target is smaller in the euro area than in the US". He also insisted that the ECB would continue to take a data-dependant, meeting-by-meeting approach. And he suggested that it would maintain "flexibility in both directions, to make sure policy is adjusted in a timely manner, rather than a fixed view of the world for too long". So, if the inflation outlook cools, Lane would seem likely to be keen to pivot. Indeed, a Bloomberg report today suggested that ECB officials were starting to consider the appropriateness of a slowing in the pace of rate hikes to 25bps in March following

Germany: ZEW economic sentiment indices*



Dashed lines represent long-run averages. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: ZEW inflation expectations index*



Dashed line represents long-run average. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

another 50bps hike next month. With wholesale gas prices today still below their levels a year ago, and the global inflation backdrop, particularly in goods markets, improved too, that smaller rate in March aligns with our own current view on the outlook for ECB monetary policy.

The day ahead in the euro area

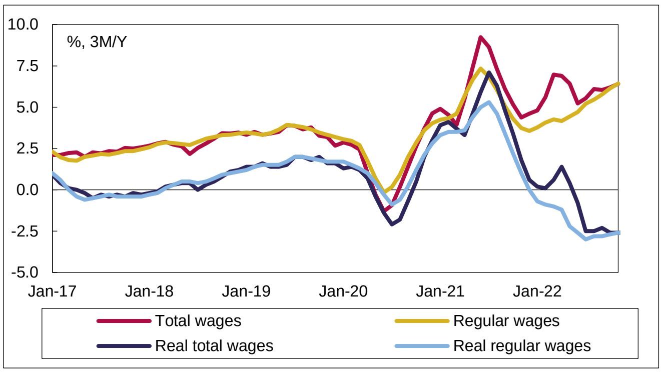
Looking ahead, tomorrow brings the release of final euro area inflation figures for December, new car registration numbers for the same month, and construction output data for November. According to the flash release, euro area consumer price inflation slowed 0.9ppt in December to a four-month low of 9.2%Y/Y. The detail confirmed that the drop in inflation was driven by lower energy inflation, thanks to government interventions including the German government's special payments towards household bills – indeed, Destatis today showed that German gas prices fell a whopping 39.1%M/M in December, to leave the annual rate down 86ppts at 26.1%Y/Y. But core inflation ticked higher last month, to a new record 5.2%Y/Y, as core goods and services inflation rose. Meanwhile, new car registrations figures are likely to report a further sizeable improvement at the end of last year. Indeed, despite a drop in Spain (-14%Y/Y) and stagnant sales in France, solid growth in Germany (38.0%YY) and Italy (21%YY) should see aggregate euro area registrations rise around 16%Y/Y. Finally, consistent with the latest construction PMIs and following declines in activity in Germany (-2.2%M/M) and France (-1.2%M/M), euro area construction output is likely to have contracted in November.

UK

Wages accelerate towards year-end but remain in reverse in real terms

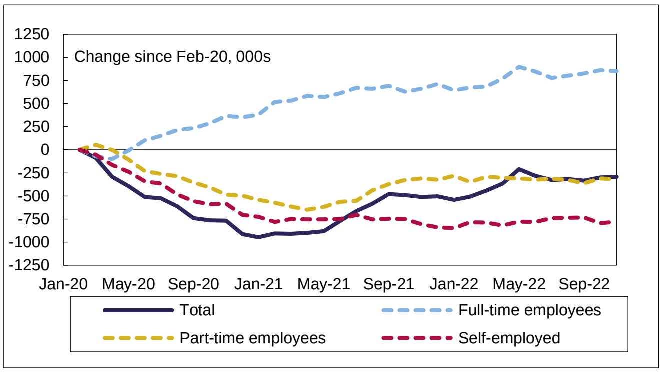
Ahead of tomorrow's CPI inflation data, today's labour market figures were a mixed bag. Most concerning for the BoE will be the stronger-than-expected pickup in the annual rate of average pay growth, which accelerated 0.2ppt in total and 0.3ppt excluding bonuses, with both rates up to 6.4%3M/Y in the three months to November. The rate of total pay growth represented a six-month high with the figure excluding bonuses the highest in sixteen months. Average regular pay in private sector rose 7.2%3M/Y, led by finance and business (7.6%3M/Y) and construction (6.3%3M/Y), far exceeding the pace of 3.3%3M/Y in the public sector. However, the recent trend for private sector regular pay remained steady at 1.8%3M/3M, admittedly the top of the range since the end of 2020. And the equivalent three-month rate for public sector regular pay jumped 0.5ppt to 1.7%3M/3M, the most since July 2020, against the backdrop of ongoing staff shortages and industrial action in the sector. Indeed, 467k working days were lost to strikes in November, the most in more than a decade. Given high rates of inflation, real pay continued to decline sharply in the three months to November in private and public sectors alike.

UK: Wage growth*



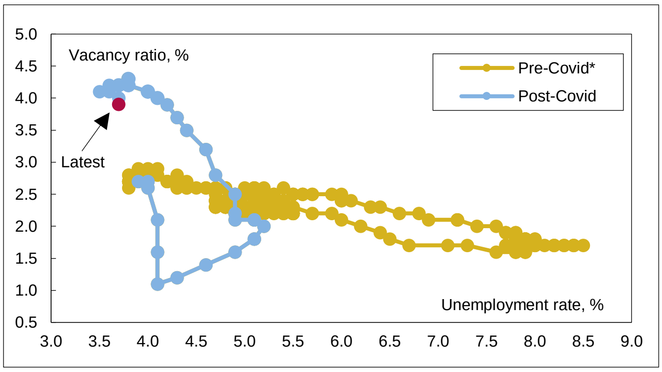
**Real wages deflated by the CPI.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Employment



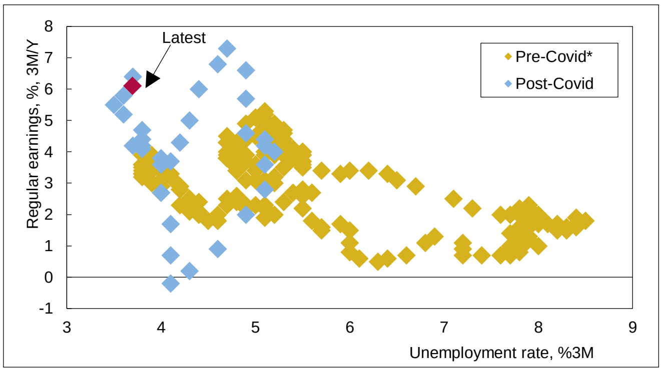
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Beveridge curve



**Pre-Covid period represents data between 2001 and 2019. Red circle represents November 2022 observation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Phillips curve



**Pre-Covid period represents data between 2001 and 2019. Red diamond represents November 2022 observation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

Indeed, total pay in real terms deflated by the ONS's preferred CPIH measure fell 2.6%3M/Y, one of the sharpest declines on the series. And total pay in real terms deflated by the CPI fell a record 4.2%3M/Y, an obvious cause of recent weak spending growth.

Unemployment rate up as inactivity drops slightly

The strong rate of nominal pay growth in part reflects the balance of supply and demand in the labour market, which evidently remained tight in the fourth quarter even as weak economic activity continued to weigh. The unemployment rate for the three months to November 2022 came in at 3.7%, up 0.2ppt (or 56k workers) from the prior three months but still 0.3ppt (120k) below the level ahead of the arrival of the coronavirus. The employment rate was unchanged over that same period at 75.6%, still 1.0ppt (or 292k workers) below the level just ahead of the pandemic. So, the rise in the unemployment rate reflected a small pickup in participation, perhaps in part as the increased cost of living attracted some older workers back into the labour market. Nevertheless, the inactivity rate remained some 1.3ppt (575k) above the pre-pandemic level, highlighting a persistent structural weakness of the UK economy.

Vacancies decline but remain elevated by historical standards

Among some of the other labour market data released today, total weekly hours worked dropped slightly over the three months to November, a further reflection of the weakness of economic activity. The redundancy rate continued to drift up to the highest in just over a year, albeit remaining low by historical standards. And for the sixth successive month, the number of vacancies edged lower, to be down 6.1% or 75k in the three months December with declines in 14 out of 18 sectors. But while the number of vacancies was 85k below the level a year earlier, it was still 365k above the pre-pandemic level. And while the ratio of unemployed people to vacancies edged back up in the three months to November, at 1.0 it remained consistent with a very tight labour market.

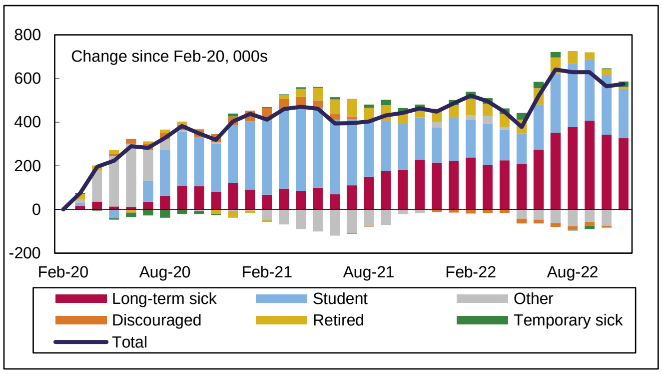
Labour market clearly still very tight so BoE to remain wary of persistent strong wage growth

Indeed, at 3.7% in the three months to November, the unemployment rate was still roughly ½ppt below the BoE's most recent estimate of the equilibrium level (or NAIRU) judged to be consistent with achievement of the inflation target over the longer term. And, as recently suggested by Chief Economist Pill, due to the current adverse terms of trade and inflation shock, the BoE is likely to revise up its estimate of the NAIRU in next month's Monetary Policy Report when it publishes the results of its annual stock-take of the UK's supply capacity. Indeed, the trade-off between unemployment and inflation is likely to have been significantly adversely affected by Brexit, with a loss of labour market flexibility due to the end of freedom of movement steepening the Phillips curve. Of course, various indicators – including the sub-50 composite employment PMI and declining REC survey indices – point to a softening of labour market conditions at the end of last year. And the BoE's own most recent baseline projection suggests that the unemployment rate will eventually rise to 6½% in 2025, a level that would seem bound to place significant downwards pressure on wage growth and help to return inflation back to target. However, the Bank's December Decision-Maker Panel survey reported a further pickup in business wage growth expectations for this year, up 0.5ppt to 6.3%Y/Y, still well above rates that might be considered consistent with the achievement of the inflation target. And for the time being, the MPC will remain concerned about risks of persistent wage pressures. Indeed, today's pay data probably guarantee a hike in Bank Rate of 50bps to 4.0% at the next monetary policy meeting on 2 February.

The day ahead in the UK

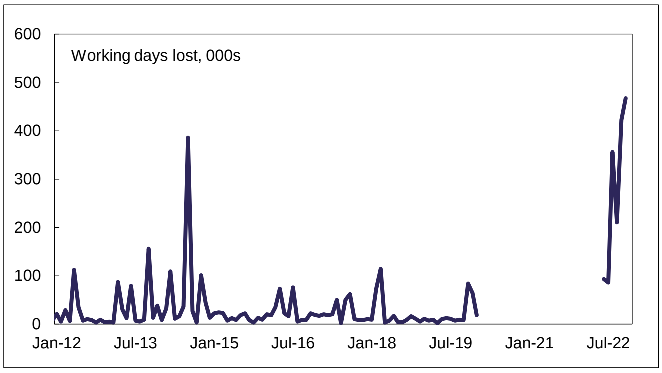
Focus in the UK tomorrow turns to the latest consumer price inflation data. Like in the euro area, we expect inflation to have eased further in the UK in December, with the headline CPI rate down 0.3ppt to 10.4%Y/Y – a touch below the Bloomberg survey consensus – due principally to declining energy prices. But core inflation is likely to remain stickier, with our expectation for a drop of just 0.1ppt to 6.2%Y/Y. In addition, tomorrow will bring the ONS house price index for November.

UK: Economically inactive workers



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Working days lost to strike action



Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ <u>*Daiwa forecast*</u>	Previous	Revised
Germany		Final CPI M/M% (Y/Y%)	Dec	**-0.8 (8.6)**	<u>*-0.8 (8.6)*</u>	-0.5 (10.0)	-
		Final HICP M/M% (Y/Y%	Dec	**-1.2 (9.6)**	<u>*-1.2 (9.6)*</u>	0.0 (11.3)	-
		ZEW current situation (expectations) balance	Jan	**-58.6 (16.9)**	-58.5 (-15.0)	-61.4 (-23.3)	-
Italy		Final CPI M/M% (Y/Y%)	Dec	**0.3 (11.6)**	<u>*0.3 (11.6)*</u>	0.5 (11.8)	-
		Final HICP M/M% (Y/Y%	Dec	**0.2 (12.3)**	<u>*0.2 (12.3)*</u>	0.7 (12.6)	-
UK		Unemployment claimant count rate % (change '000s)	Dec	**4.0 (19.7)**	-	3.9 (30.5)	**- (16.1)**
		Payrolled employees, change '000s	Dec	**60**	63	107	**70**
		ILO unemployment rate %, 3M	Nov	**3.7**	3.7	3.7	-
		Employment change, 3M/3M '000s	Nov	**27**	5	27	-
		Average weekly earnings (excluding bonuses) 3M/Y%	Nov	**6.4 (6.4)**	6.1 (6.3)	6.1 (6.1)	**6.2 (-)**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ <u>*Daiwa forecast*</u>	Previous	Revised
			- Nothing to report -			

Auctions

Country		Auction
UK		BoE sold £649.9mn of 2030-2035 gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ <u>*Daiwa forecast*</u>	Previous
Euro area		07.00	EU27 new car registrations Y/Y%	Dec	-	16.3
		10.00	Final CPI M/M% (Y/Y%)	Dec	<u>*-0.3 (9.2)*</u>	-0.1 (10.1)
		10.00	Final core CPI Y/Y%	Dec	<u>*5.2*</u>	5.0
		10.00	Construction output M/M% (Y/Y%)	Nov	-	1.3 (2.2)
Italy		09.00	Trade balance €bn	Nov	-	-2.1
UK		07.00	CPI M/M% (Y/Y%)	Dec	<u>*0.3 (10.4)*</u>	0.4 (10.7)
		07.00	Core CPI Y/Y%	Dec	<u>*6.2*</u>	6.3
		09.30	House price index Y/Y%	Nov	-	12.6
		09.30	Final output per hour Y/Y%	Q3	1.4	0.4

Auctions and events

Country		GMT	Event
Germany		10.30	Auction: €1.5bn of 1.8% 2053 bonds
		10.30	Auction: €1.0bn of 2050 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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