Euro wrap-up

Overview

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- Euro area government bonds followed USTs significantly higher as the drop in the region's headline inflation rate in December was confirmed.
- Gilts made far more modest gains as UK inflation fell in December but the core measure exceeded expectations.
- On Thursday the ECB will publish the account of its December monetary policy meeting, while UK data for bank lending and a housing market survey will also be released.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.429	-0.002
OBL 2.2 04/28	2.025	-0.049
DBR 2.3 02/33	1.986	-0.096
UKT 1 04/24	3.397	-0.013
UKT 1¼ 07/27	3.236	-0.025
UKT 4¼ 06/32	3.282	-0.038

*Change from close as at 4:00pm GMT.
Source: Bloomberg

Euro area

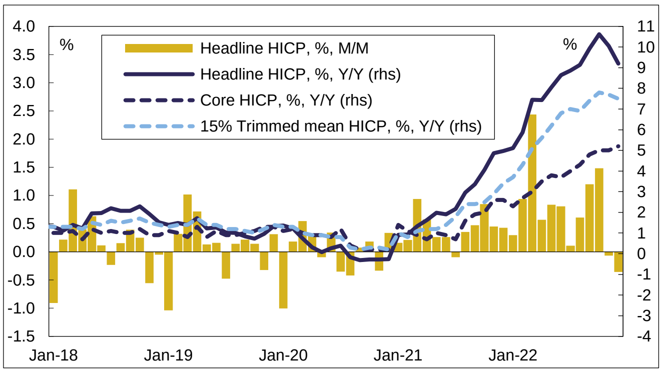
Drop in headline inflation confirmed as gas and petrol prices decline

Today's final euro area inflation figures for December aligned with the flash release, confirming a second successive decline in the headline HICP rate and suggesting that the peak has now passed. The monthly decline in consumer prices was marginally steeper than initially estimated in December at -0.4%M/M, the most since August 2020. But due to rounding, the annual rate was unrevised at 9.2%Y/Y, still marking a drop of 0.9ppt from November to be 1.4ppt below October's peak. The decline was overwhelmingly driven by lower energy inflation, thanks to lower petrol prices as well as government interventions including the German government's special payments towards household bills. Indeed, consumer gas prices fell 9.7%M/M and heating energy prices were down almost 19%M/M, both representing the steepest monthly drops on the series, while petrol prices declined 7.3%M/M. As a result, energy inflation fell 9½ppts to a fourteen-month low of 25.5%Y/Y, with its contribution to headline inflation declining to just 2.5ppts. In contrast, the food, alcohol and tobacco component rose 0.2ppt to a new high of 13.8%Y/Y, accounting for roughly one third of all inflation, a larger share than energy prices for the first time since February 2021. But while the increase in food prices of 0.7%M/M was above the long-run average for the respective month for the fourteenth consecutive time, it was nevertheless the lowest in a year, suggesting that food inflation might well be close to the peak too.

Core inflation rises to record high, but signs underlying price pressures may have peaked

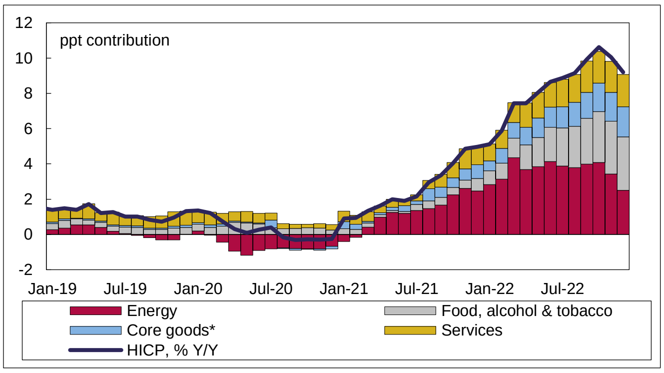
Within the core items, non-energy industrial goods inflation rose 0.3ppt to 6.4%Y/Y, with the monthly increase of 0.4%M/M the biggest in any December on the series as the impact of certain supply-bottlenecks persisted. Indeed, inflation of furniture (9.0%Y/Y), household appliances (8.2%Y/Y), clothing (3.9%Y/Y) and new autos (8.0%Y/Y) all rose in December. In contrast, however, favourable base effects related to significant price rises earlier in the pandemic saw inflation of second-hand vehicles fall to an eight-month low (11.8%Y/Y). And while services inflation also rose, up 0.2ppt to a series high of 4.4%Y/Y, that principally reflected the unusually weak figure in December 2021 related in part to hospitality. Indeed, the monthly increase in services prices of 0.7%M/M was below the long-run average for the respective month for the first time since June. As such, although core inflation rose 0.2ppt to 5.2%Y/Y, a new series high, other measures of underlying price pressures were more encouraging. Indeed, the ECB's estimate of 15% trimmed mean CPI fell for the second successive month, by 0.2ppt to 7.5%Y/Y. Given global developments, we expect non-energy industrial goods inflation to fall back steadily over coming months. And despite the fears of the Governing Council, there is little evidence so far to suggest that the historically tight labour market is feeding through to markedly higher wages in services. Indeed, we expect to see services inflation moderate from the New Year, to allow core inflation to gradually fall back too. And given the ongoing decline in natural gas prices and associated base effects, the anticipated downtrend in energy inflation should ensure that headline

Euro area: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation & contributions



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

inflation falls back over the course of this year. While the headline HICP rate is highly likely to remain above the ECB's 2% target throughout 2023, it is perfectly feasible that it will be back below target in 2024.

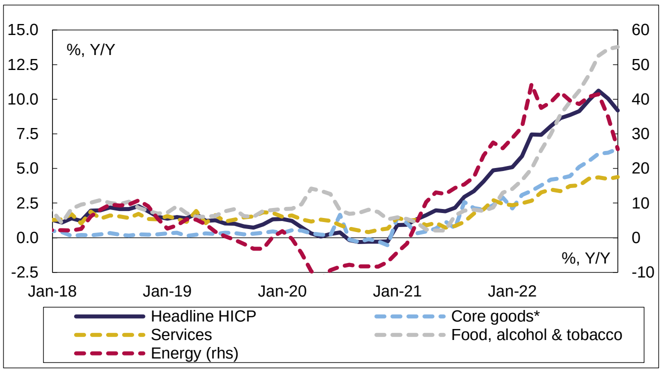
Car registrations accelerate in Q4 amid a fast recovery in Germany

With respect to economic activity, euro area new car registrations figures today suggested that, thanks to a further easing in supply constraints, autos provided a welcome boost to GDP in the final quarter of 2022. Admittedly, the ECB's numbers showed little growth on a seasonally adjusted basis in December in the euro area as a whole. But this reflected weakness in France and Spain, which offset a further acceleration in sales in Germany and Italy – indeed, German registrations rose 10½%M/M in December, to leave them up a whopping 27½%3M/3M in Q4 and at their highest level in two years. And so, while aggregate euro area registrations were still some 13½% below the pre-pandemic level, they rose a sizeable 12.6%Q/Q in Q4, following growth of 12.3%Q/Q in Q3. In contrast, today's euro area construction output data confirmed a contraction in November of 0.8%M/M, following downwardly revised growth in October (1.0%M/M), due to a drop of 0.9%M/M in building activity. Among the larger member states, the weakness was broad-based, with drops in Germany (-2.2%M/M), France (-1.2%M/M) and Spain (-0.8%M/M). Overall, this still left euro area construction activity trending marginally higher in the first two months of Q4 (½%) compared with Q3. However, we suspect that the sector will have provided little if any support to GDP growth last quarter.

The day ahead in the euro area

Focus in the euro area tomorrow will be on the publication of the ECB account from the [December monetary policy meeting]. That saw the Governing Council moderate the pace of tightening to 50bps, taking the deposit rate to a broadly neutral level of 2.00% and the cumulative tightening since July to 250bps. However, the ECB's message regarding the outlook for rates was hawkish, making clear its desire to shift policy into a restrictive stance. In addition, the Governing Council announced that quantitative tightening will start from March onwards, with the APP portfolio to be reduced at a "measured and predictable pace" by limiting the amount of principal payments from maturing bonds that will be reinvested. Following yesterday's Bloomberg report that the ECB staff is now considering the case for slowing the pace of rate hikes in March to 25bps, further details on the debate between the doves and the hawks surrounding last month's decisions will be studied.

Euro area: Consumer price inflation



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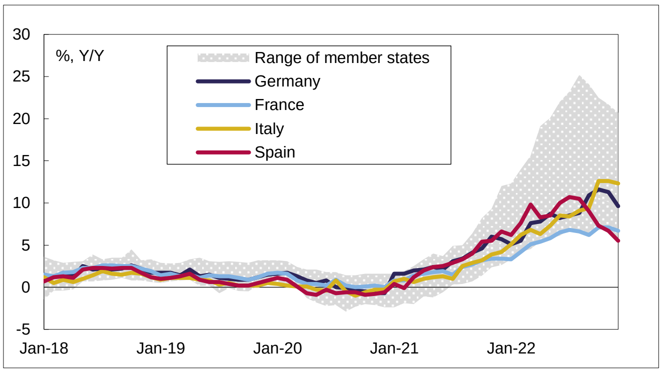
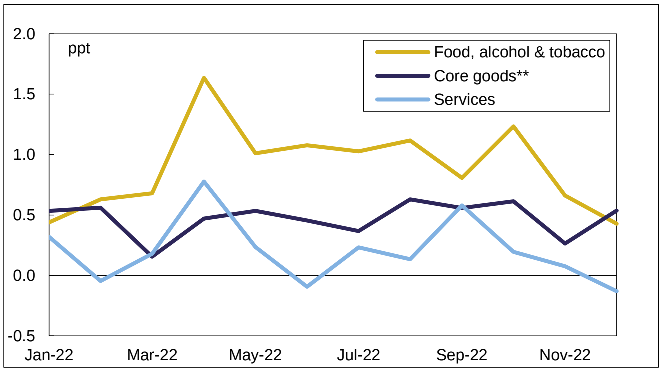
Euro area: Consumer price inflation



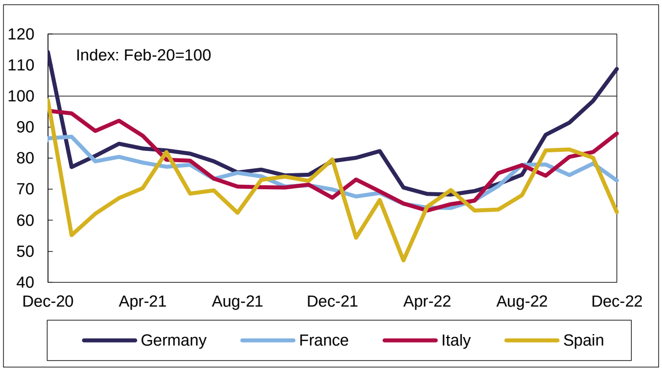
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Deviations from l-r average price change*



*Difference in monthly consumer price change from pre-pandemic long-run average. **Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations*



*Seasonally-adjusted data. Source: ECB and Daiwa Capital Markets Europe Ltd.

UK

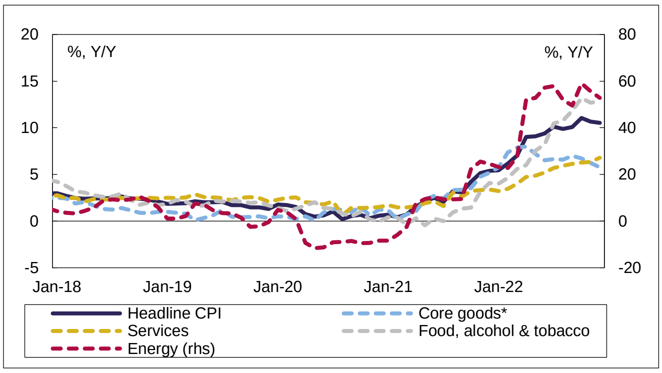
Inflation falls for second successive month but core rate remains sticky

Broadly in line with expectations, UK consumer price inflation moderated a touch for the second successive month in December. In particular, the headline CPI inflation rate fell 0.2ppt to 10.5%Y/Y, to be 0.6ppt below October's multi-decade peak. The main driver of the decline was again motor fuel, inflation of which dropped almost 6ppts to 11.5%Y/Y, more than 30ppts below the summer peak. Inflation of non-energy industrial goods moderated further too, down about ½ppt to 5.8%Y/Y, the lowest since January and 2.2ppts below April's peak, seemingly reflecting an easing of global price pressures in the sector. The fall in that component was driven in particular by lower inflation of clothing and footwear (down to a six-month low of 6.5%Y/Y), as well as recreational goods such as toys and games (down to an eleven-month low of 4.3%Y/Y) and furniture and household equipment (down to a ten-month low of 9.8%Y/Y). However, there were some offsetting increases in inflation in December, including restaurants and hotels (up more than 1ppt to 11.3%Y/Y), which pushed up services inflation by ½ppt to 6.9%Y/Y, the highest on the series dating back to 1997. So, core inflation remained sticky, unchanged at 6.3%Y/Y, contrary to expectations of a decline. And the NIESR estimate of 10% trimmed mean inflation was also unchanged at the series high of 9.0%Y/Y. Meanwhile, inflation of food and drink rose again, up 0.4ppt to another series high of 16.8%Y/Y. However, unlike in the euro area, given the sharper rise in gas and electricity prices, energy inflation, at more than 50%Y/Y in December, continues to account for the largest share (roughly one third) of total inflation in the UK.

Persistent pressure in services further justifies another 50bps hike in Bank Rate next month

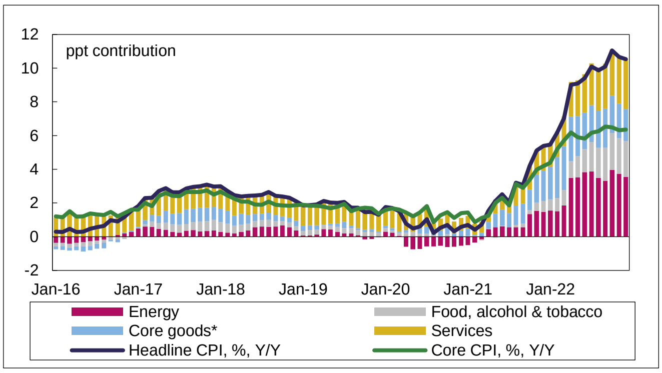
The further drop in headline inflation in December is welcome, and left the quarterly average in Q4 0.2ppt below the BoE's forecast in its November Monetary Policy Report. And thanks to base effects related not least to energy prices, inflation should continue to decline over coming months and quarters. Indeed, we expect the headline CPI rate to fall below 9%Y/Y in April. And with scope for cuts to household energy bills from October, inflation could well be firmly below the BoE's baseline forecast of 5.2%Y/Y in Q423. Nevertheless, the MPC will remain concerned about the stickiness of core inflation. Indeed, just as they did in every month of last year, the increases in prices of core goods and services both exceeded the respective long-run average increments in December. Notably too, while in part it reflects continued pass-through of increases in energy and food prices, the acceleration in services inflation also tallies with continued labour market tightness and associated wage pressures, which the BoE will fear risk persistence of domestically generated inflation even as the initial shock to the terms of trade fades. In addition, the Bank's DMP survey suggested that firms last month revised up their own expectations for CPI inflation one year ahead by 0.2ppt to a new high of 7.4%Y/Y. Added also to yesterday's stronger-than-expected wage data, overall, today's inflation figures underscore the likelihood of another 50bp hike in Bank Rate to 4.00% on 2 February.

UK: Consumer price inflation



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

UK: Consumer price inflation & contributions



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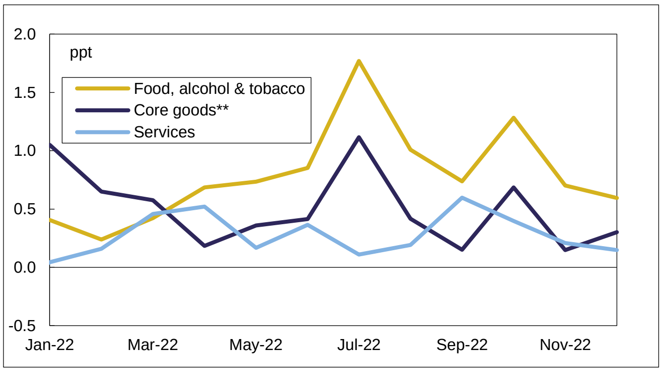

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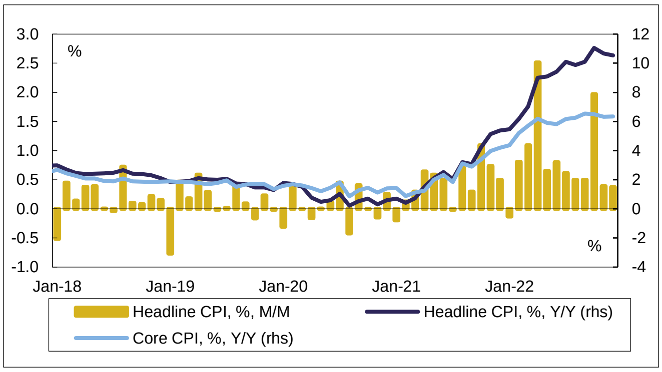

Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

In the UK, the data flow on Thursday will focus on the housing market and bank lending conditions. While mortgage interest rates fell back further in December from October's peak, the RICS residential survey is likely to report a further deterioration in housing market conditions with the headline house price balance forecast to fall to its most negative since May 2020. Meanwhile, the BoE credit conditions survey seems bound to report a marked tightening of financial conditions last quarter, while the supply of available consumer credit is likely to have declined amid ongoing economic uncertainties while demand for secured lending is likely to have fallen for a second-successive quarter.

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%	Dec	**12.8**	-	16.3	-
	Final HICP M/M% (Y/Y%)	Dec	**-0.4 (9.2)**	*-0.3 (9.2)*	-0.1 (10.1)	-
	Final core HICP Y/Y%	Dec	**5.2**	*5.2*	5.0	-
	Construction output M/M% (Y/Y%)	Nov	**-0.8 (1.3)**	-	1.3 (2.2)	**1.0 (1.9)**
Italy	Trade balance €bn	Nov	**1.4**	-	-2.1	-
UK	CPI M/M% (Y/Y%)	Dec	**0.4 (10.5)**	*0.3 (10.4)*	0.4 (10.7)	-
	Core CPI Y/Y%	Dec	**6.3**	*6.2*	6.3	-
	House price index Y/Y%	Nov	**10.3**	10.3	12.6	**12.4**

Auctions

Country	Auction
Germany	sold €1.21bn of 1.8% 2053 bonds at an average yield of 2.05%
	sold €805mn of 0% 2050 bonds at an average yield of 1.97%

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	Current account balance €bn	Nov	-	-0.4
Spain	09.00	Trade balance €bn	Nov	-	-6.9
UK	00.01	RICS house price balance %	Dec	-30	-25

Auctions and events

Country	GMT	Event
Euro area	12.30	ECB publishes account of 14-15th December monetary policy meeting
	12.30	ECB President Lagarde in panel discussion 'Finding Europe's new growth' at the World Economic Forum in Davos
	14.00	ECB's Knot scheduled to speak on "Digital currencies"
	17.00	ECB's Schnabel scheduled to speak on "Monetary policy in times of pandemic and war"
France	09.50	Auction: 0.00% 2025 bonds
	09.50	Auction: 0.75% 2028 bonds
	09.50	Auction: 0.50% 2029 bonds
	10.50	Auction: 0.10% 2029 index-linked bonds
	10.50	Auction: 0.10% 2032 index-linked bonds
	10.50	Auction: 0.10% 2036 index-linked bonds
Spain	09.30	Auction: 0.0% 2028 bonds
	09.30	Auction: 0.5% 2030 bonds
	09.30	Auction: 4.9% 2040 bonds
UK	09.30	BoE to publish credit conditions survey results for Q422
	11.30	Auction: £1.1bn of 0.125% 2031 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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