Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses as the ECB's account of its December policy meeting confirmed that a large number of Governing Council members had initially preferred a 75bps rate hike, while Lagarde invited the markets to revise up their pricing of the future path of ECB rates.
- Gilts made modest gains as BoE Governor Bailey noted that inflation is likely to fall rapidly thanks to lower energy prices, while a UK survey signalled a marked weakening in the housing market.
- Friday will bring German PPI data, along with UK retail sales figures and consumer confidence indices.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.496	+0.062
OBL 2.2 04/28	2.105	+0.069
DBR 2.3 02/33	2.057	+0.047
UKT 1 04/24	3.467	-0.011
UKT 1¼ 07/27	3.249	-0.015
UKT 4¼ 06/32	3.285	-0.027

*Change from close as at 4:15pm GMT.
Source: Bloomberg

Euro area

A "large number" of Governing Council members initially preferred a 75bps hike in December

The account of the ECB's December Governing Council meeting, published today, underscored that the policy decision – a slowing in the pace of rate hikes to 50bps, accompanied by hawkish signalling that rates would continue to rise "significantly at a steady pace" to restrictive levels, as well as the start to quantitative tightening (QT) in March – was the result of a compromise between the hawks and doves. Indeed, the account noted that a "large number of members initially expressed a preference for increasing …rates by 75bps, as inflation was clearly expected to be too high for too long". Some members also advocated a faster pace of QT, or indeed terminating reinvestments altogether. Among other things, the hawks were concerned about "prevailing market expectations and financial conditions", and so wanted to try to shift up the yield curve, which they judged to be "plainly inconsistent with a timely return to the ECB's 2% inflation target." Nevertheless, a "broad majority" of Governing Council members were ultimately persuaded that, given the strengthened forward guidance and start of QT, the overall package might be considered "broadly equivalent" to a hike of 75bps. Of course, some members would also have preferred a less aggressive policy package. For example, it was noted that a 50bps rate hike might anyway be appropriate given the projected decline in inflation over coming months. And given the downwards shift in wholesale gas prices and easing of some global price pressures over the past couple of months, we expect the ECB's updated projections in March to forecast a faster fall in inflation than was suggested in December.

Lagarde and Knot evidently displeased with downward shift in yield curve since start of 2023

Given the welcome drop in gas prices, ECB President Lagarde today noted in Davos that the euro area economy would perform "a lot better" than had been feared this year. Among other things, she now expected merely a "small contraction" in GDP rather than recession. Nevertheless, consistent with the messaging agreed at the December Governing Council meeting, she reminded that inflation was still "way too high". And while she acknowledged that inflation expectations were not de-anchoring, she also insisted that the ECB would "stay the course" with further significant rate hikes. Indeed, she appeared displeased with the downward adjustment in the yield curve since the start of the year, inviting markets to revise up their pricing of future rate hikes. Before Lagarde's comments, leading Governing Council hawk Klaas Knot also questioned the appropriateness of current market pricing, stating that he expected "more than one half-point increase in interest rates" to come. Of course, a hike of 50bps is nailed on for next month's monetary policy meeting. However, if and when the ECB's inflation forecast is revised down in March, we suspect a majority might agree to slow further the pace of hikes to 25bps, particularly if such a decision is accompanied by a commitment to additional tightening in Q2 and a faster pace of QT from the start of Q3.

The day ahead in the euro area

Looking ahead to tomorrow, ECB President Lagarde will speak publicly again on a panel in Davos. Data-wise, tomorrow will bring the release of German producer price inflation figures for December. Price pressures at the German factory gate are expected to have eased further at the end of last year, driven by lower energy and intermediate goods prices. In particular, prices are forecast to have fallen for the third consecutive month in December, by 1.2%M/M, taking the annual PPI inflation rate down around 7½ppts to 20.7%Y/Y, about 25ppts below August's peak and the lowest reading since November 2021. Friday is also expected to bring the BoF's survey for French retail sales in December.

UK

BoE Governor Bailey acknowledges improvement in the inflation outlook

At next month's monetary policy meeting, the MPC will discuss the BoE's updated macroeconomic projections. In reported comments made in South Wales today, Governor Bailey offered insights into what to expect from those revised forecasts. What he said, however, should not have come as a surprise. In particular, Bailey highlighted the downwards shift in wholesale gas and other energy prices over the winter, which – if sustained – should allow inflation to "fall quite rapidly this year". Lower energy prices would also help to alleviate the current severe shock to real incomes, although he continued to expect recession and "weak activity over a long period". Over the near term, given the "unprecedented and quite unique fall in the labour force" and associated labour market tightness, he remained concerned about upwards pressures on pay growth and risks of second-round effects on inflation. However, he also noted that some forward-looking surveys of pay were not so strong. And so, once again, he did not criticize current market pricing of the outlook for Bank Rate, which foresees a terminal rate of no more than 4.50%, before an eventual pivot to easier policy around the turn of the year.

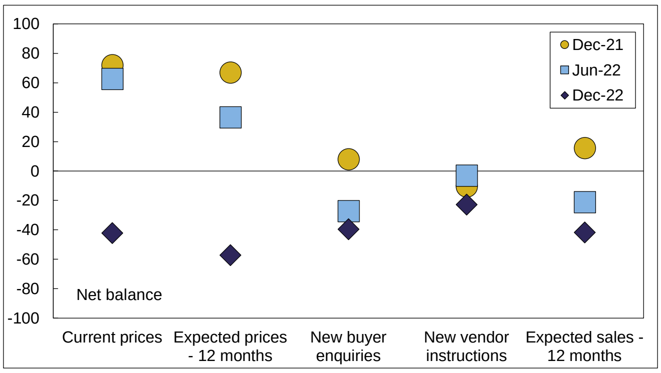
RICS survey illustrates downbeat expectations for the housing market

One further reason for the BoE to be wary of pushing Bank Rate too high is the housing market, which has softened significantly since the summer as higher mortgage rates, falling real incomes and major uncertainty about the economic and market outlook took their toll. Nationwide figures released before year-end reported a fourth successive drop in home prices in December, leaving the index 2.5% below the peak. And today's RICS residential market survey provided plenty more colour, suggesting that downwards momentum on UK house prices increased heading into 2023. A net balance of -42% of respondents saw house prices rising in December, the lowest share since October 2010. In addition, the index of new buyer enquiries weakened to its second lowest level since the first wave of Covid-19, only beating October's reading which had suffered from the marked impact of the Truss crisis on mortgage rates and availability. Judging from the RICS survey, uncertainty has also hit housing market supply, with the balance for new vendor instructions down to a fifteen-month low. And so, the survey index of sales expectations dropped to the lowest on the series apart from the readings during first two months of pandemic lockdown. Perhaps most notably, home price expectations three months ahead (-65.8) were the most negative on the series bar the first wave of Covid and initial aftermath of the collapse of Lehman Brothers in 2008. And while not quite as bad as November's reading, price expectations twelve months ahead remained highly negative (-57.2) at the second-lowest level on the series. Overall, therefore, the RICS survey made for a very downbeat assessment of the UK residential property market, consistent with a peak-to-trough decline in house prices of at least 10%, with significantly more than that required to offset the hit to affordability to first-time buyers caused by the rise in mortgage rates since the summer.

BoE survey signals steep decline in demand and supply of household lending

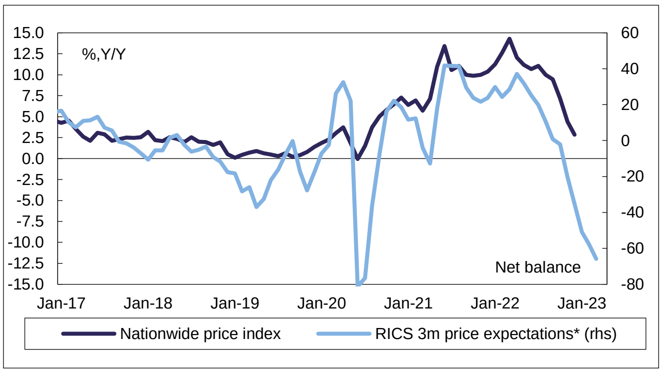
Tallying with the marked deterioration in housing market conditions, today's BoE Credit Conditions Survey results reported a further weakening in both demand and supply of secured credit in the final quarter of last year. Indeed, the net balance of lenders reporting a decline in new mortgage applications in Q4 slumped 39pts to -75.4, the weakest reading on the series dating back to 2007 notwithstanding the collapse at the onset of the pandemic in Q220 (-79.0), and more than 155pts below the peak in Q221 when the government's stamp duty holiday was initially due to conclude. Given the poor economic outlook, lower expectations for house prices, reduced appetite for risk and tightening of wholesale funding conditions, banks were unsurprisingly less willing to lend. The respective net balance of loan supply (-33.6) declined to its second-lowest level since the global financial crisis. And lenders expected the availability of secured credit to fall again in Q123, which would seem likely to compound the challenges in the residential property market.

UK: Selected RICS residential survey indices



Source: RICS, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected house price indices



**RICS index has five-month lead.*
Source: RICS, Refinitiv and Daiwa Capital Markets Europe Ltd.

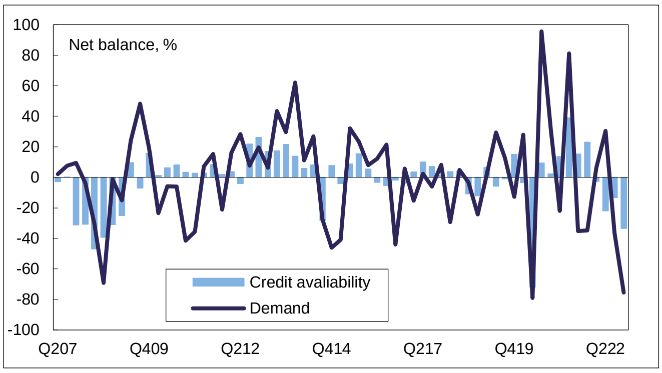
Unsecured credit availability reduced too

Meanwhile, despite diminishing household purchasing power, today's Credit Conditions Survey results also reported the first drop in consumer demand for unsecured lending since Q121, with the respective net balance down 27pts to -22.8, the second-weakest reading for almost a decade. This seems in part to reflect a deterioration in credit availability and terms, with lenders also reporting a notable shortening in the interest-free period on new credit card deals as well as a sharp rise in overall borrowing costs. Overall, the net balance of lenders reporting a rise in the availability of total unsecured lending fell by the most since the start of the pandemic and was anticipated to fall significantly further at the start of 2023 too. So, with consumer credit less readily available and real incomes still falling at a historically rapid pace, and the household savings ratio having already increased sharply (by 2.3ppts to 9.0%) in Q3 in the face of the uncertain outlook, consumer spending seems bound to remain very weak.

The day ahead in the UK

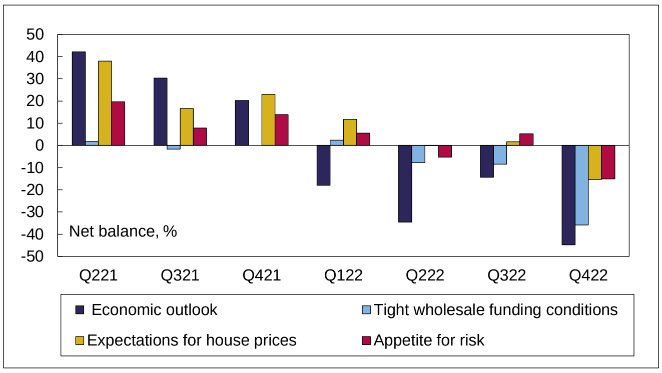
Despite the drop in demand for consumer credit and declining real disposable incomes, tomorrow's retail sales data are forecast to report a rise of 0.5%M/M in December. But this would merely reverse the decline in November (-0.4%M/M), to leave sales down 4.0%Y/Y that month. And it would also leave sales 0.8%Q/Q lower in Q4 following a drop of 1.7%Q/Q in Q3, to mark the sixth successive quarterly decline. Meanwhile, the latest GfK consumer survey is likely to suggest that sentiment remained very weak at the start of 2023, implying that the cautious spending pattern will remain in place for a while to come.

UK: Demand & availability of secured loans



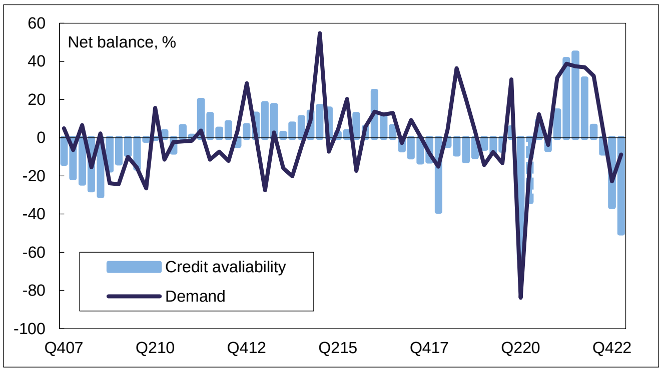
Source: BoE Credit Conditions Survey, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Factors driving supply of secured loans



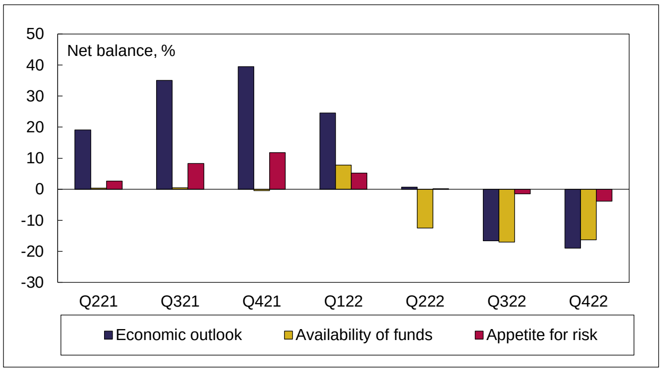
Source: BoE Credit Conditions Survey and Daiwa Capital Markets Europe Ltd.

UK: Demand & availability of unsecured loans*



**Q123 figures are survey expectations. Source: BoE Credit Conditions Survey, Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Factors driving supply of unsecured loans



Source: BoE Credit Conditions Survey and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Current account balance €bn	Nov	**13.6**	-	-0.4	**-0.5**
Spain		Trade balance €bn	Nov	**-33.1**	-	-6.9	**-**
UK		RICS house price balance %	Dec	**-42**	-30	-25	**-26**

Auctions

Country		Auction
France		sold €3.77bn of 0.00% 2025 bonds at an average yield of 2.56%
		sold €3.76bn of 0.75% 2028 bonds at an average yield of 2.32%
		sold €2.47bn of 0.50% 2029 bonds at an average yield of 2.29%
		sold €840mn of 0.10% 2029 index-linked bonds at an average yield of 0.240%
		sold €485mn of 0.10% 2032 index-linked bonds at an average yield of -0.003%
		sold €422mn of 0.10% 2036 index-linked bonds at an average yield of 0.410%
Spain		sold €2.35bn of 0.0% 2028 bonds at an average yield of 2.623%
		sold €1.59bn of 0.5% 2030 bonds at an average yield of 2.701%
		sold €1.40bn of 4.9% 2040 bonds at an average yield of 3.203%
UK		sold £1.10bn of 0.125% 2031 index-linked bonds at an average yield of 0.007%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	PPI M/M% (Y/Y%)	Dec	-1.2 (20.7)	-3.9 (28.2)
France		-	Retail sales* M/M% (Y/Y%)	Dec	-	1.0 (-3.1)
UK		00.01	GfK consumer confidence	Jan	-42	-42
		07.00	Retail sales including auto fuels M/M% (Y/Y%)	Dec	0.5 (-4.0)	-0.4 (-5.9)
		07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Dec	0.4 (-4.4)	-0.3 (-5.9)

Auctions and events

Euro area	12.00	ECB President Lagarde in panel discussion on 'Global economic outlook' at the World Economic Forum in Davos

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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