Euro wrap-up

Overview

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- Despite a downside surprise to euro area headline inflation and a second successive increase in unemployment, Bunds made modest losses as core inflation remained sticky at the series high.
- Gilts made very minimal gains as a survey signalled an acceleration in UK shop price inflation, but Nationwide reported the longest losing streak in house prices since the global financial crisis.
- All eyes tomorrow will be on the ECB and BoE announcements: on balance we expect both central banks to hike by 50bps, but also expect the former to be more hawkish in its forward guidance than the latter.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.643	+0.020
OBL 2.2 04/28	2.315	+0.012
DBR 2.3 02/33	2.287	+0.007
UKT 1 04/24	3.395	-0.003
UKT 1¼ 07/27	3.179	-0.025
UKT 4¼ 06/32	3.319	-0.008

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

Euro area

A downside surprise to inflation in January

The euro area's flash estimate of inflation in January surprised on the downside, falling 0.7ppt from December to 8.5%Y/Y. That was 0.4ppt lower than the consensus forecast on the Bloomberg survey, while Monday's big upside surprise to the Spanish figure, as well as uncertainty about the impact of the reweighting of the basket, had even this week raised speculation of a possible increase. Today's estimate also meant that the headline inflation rate has now fallen for three successive months to 2.1ppts below the October level. Certainly, inflation in the euro area – as elsewhere – now looks to be past the peak. Among the member states, inflation fell in January in thirteen of the eighteen member states to publish figures. And today's data reported sizable declines in Italy (down 1.4ppts to 10.9%Y/Y) and the Netherlands (down 2.6ppts to 8.4%Y/Y), which helped more than to offset the impact of the modest increases already reported in France and Spain. With the German figures only to be published next week, however, there will be doubts about the robustness of today's data, and there will be speculation in due course about possible revisions to be made when the final estimates are published on 23 February.

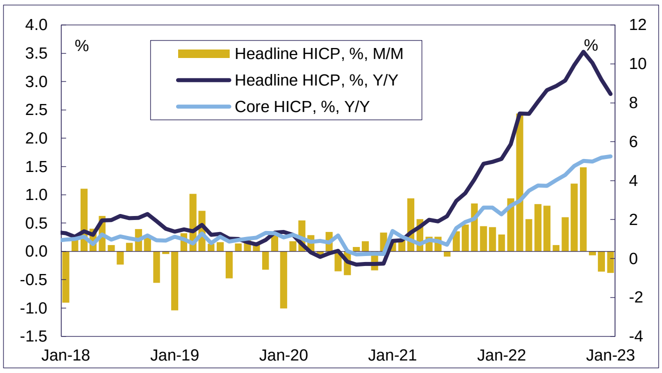
Energy and services components fall

The detail of today's release confirmed that the decline in inflation was principally caused by a third successive drop in the energy component, which fell more than 8ppts to 17.2%Y/Y, the lowest in seventeen months. Encouragingly perhaps, services inflation also moderated, falling 0.2ppt from December's series high to 4.2%Y/Y. However, despite evidence of an easing of supply-chain strains, that impact was offset by a pickup in inflation of non-energy industrial goods of 0.5ppt to a new high of 6.9%Y/Y. So, despite the drop in headline euro area inflation, the core measure (excluding energy, food, alcohol and tobacco) remained unchanged at the series high of 5.2%Y/Y. Moreover, despite a first easing in the unprocessed component, inflation of food, alcohol and tobacco continued to rise, up 0.3ppt to 14.1%Y/Y. As a result, its contribution to overall inflation is now more than 1ppt above that of energy.

Stickiness of core inflation will keep the hawks in the majority at the ECB tomorrow

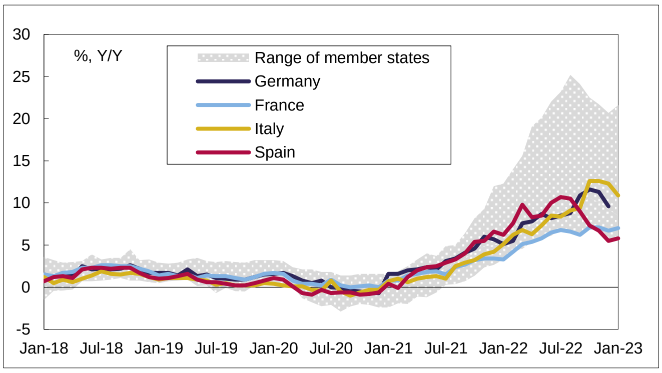
The drop in headline inflation in January took it firmly below the ECB's baseline forecast for Q1 (9.1%Y/Y). Looking ahead, while food inflation might yet rise a little further over the near term, energy inflation should continue to decline, and very sharply from March onwards due to base effects and recent developments in wholesale markets. And given improvements in global goods pressures, and no evidence of substantive lasting second-round effects on inflation via wages, we expect core inflation to take a step down in the second quarter. Nevertheless, the stickiness of core inflation will be more than sufficient

Euro area: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation*



**January-23 flash estimates are absent from Germany and Slovenia.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

for the hawks to maintain the majority on the Governing Council tomorrow. But as the ECB's updated forecasts next month should revise down the expected profile for inflation, and bring forward to the second half of next year the point at which the inflation target is expected to be met, there should soon be a shift in the balance of power on the Governing Council between the hawks and doves.

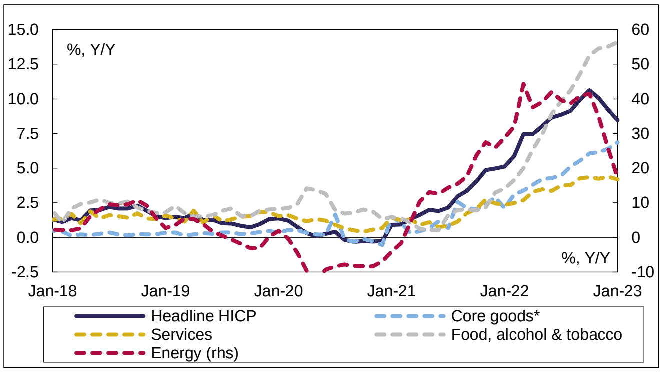
Jobless rate remains at a series low despite a second successive increase in unemployment

Consistent with the slowdown in GDP growth in Q4, today's labour market numbers from the euro area hinted at a slight softening in the jobs market at the end of last year. Having previously been estimated to have declined by 2k in November, the number of people in unemployment is now estimated to have risen by 59k that month, principally due to a significant revision in Spain. As a result, the unemployment rate that month was also revised up, by 0.1ppt to 6.6%. And today's figures reported a further increase in joblessness of 23k in December to 11.048mn. Admittedly, the level of unemployment remains almost ½mn lower than a year earlier and almost 2.9mn below the post-pandemic peak. The increase in December was again lead by Spain (+24k), taking the jobless rate in that country up a further 0.1ppt to 13.1%, a nine-month high. There was also an increase in unemployment in France (+19k) taking the respective rate also 0.1ppt higher from November's series low to 7.0%, while in Italy the unemployment rate moved sideways at 7.8%. However, Germany bucked the trend, reporting the fourth consecutive monthly drop and taking the jobless rate on the ILO measure down 0.1ppt to 2.9%, a post-reunification low. So, overall, the euro area unemployment rate moved sideways in December at 6.6%, the new (slightly higher) series low, which is nevertheless likely to remain consistent with a tight labour market.

Manufacturers report an easing in challenges, while Italian PMI signals a return to growth

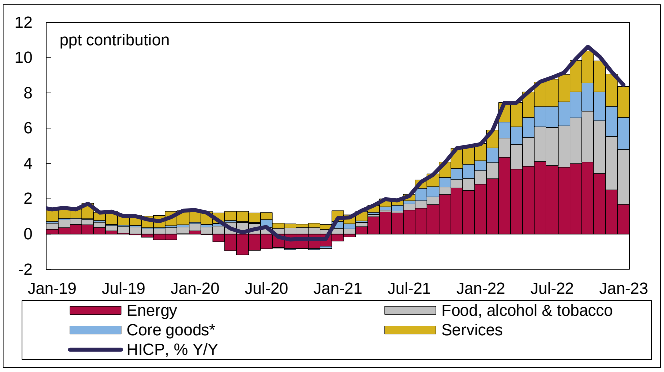
The final euro area manufacturing PMIs were broadly consistent with the flash surveys, which had suggested that supply challenges in the sector eased further at the start of the New Year. Indeed, despite a modest downwards revision, they implied a softer pace of decline in output in January, for which the respective index rose for the third consecutive month, by 1.1pts to an eight-month high of 48.9. Within the country breakdown, the German output PMI (48.4) was unchanged in January suggesting a continued modest contraction in the sector, while the equivalent French index (47.5) edged slightly lower last month to be the joint-weakest of the member states. In marked contrast, the Italian output PMI (51.0) rose more than 2pts in January to imply a return to growth for the first month since June. And the largest improvement was seen in Spain, where the output index rose 4pts to an admittedly still-contractionary 47.5, nevertheless suggesting the softest pace of decline since September. Firms also reported a less marked drop in new orders, while supply-side constraints seemingly broadly eased further on aggregate with supplier delivery times seemingly no longer rising. And so, manufacturers signalled

Euro area: Consumer price inflation



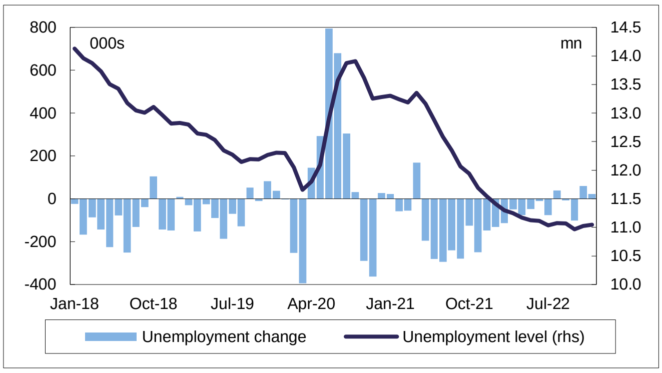
*Goods excluding food & energy.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



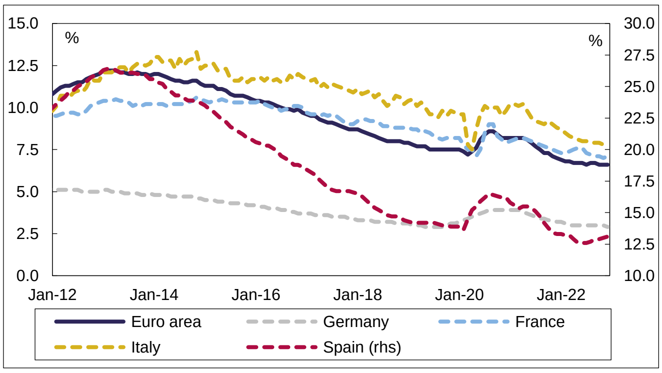
*Goods excluding food & energy.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

a further significant easing in input cost pressures at the start of the year, with the respective PMI for the euro area falling a cumulative 20pts since October to 56.3, the lowest reading for more than two years, some 32pts below the peak and bang in line with the pre-pandemic average. While the output price PMI (61.6) remained some 10pts above the pre-pandemic average, it was almost 16pts below April's peak and seems highly likely to fall further over coming months.

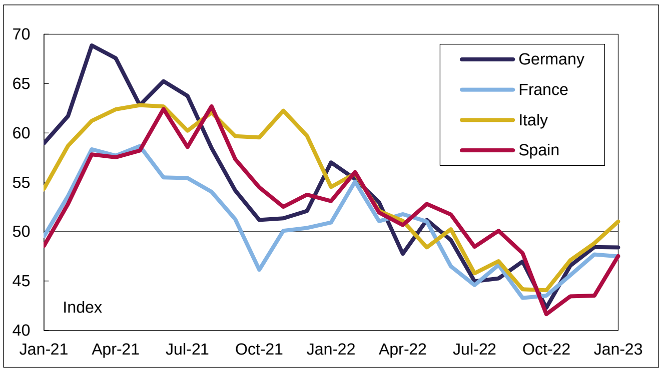
The day ahead in the euro area

Tomorrow's ECB interest rate policy decision is easy to predict. After the December policy statement made clear that "interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive", the main policy interest rates will be hiked again by 50bps. That will take the deposit rate to 2.50% – a level that could reasonably be considered to be restrictive – and the cumulative tightening since July to a hefty 300bps. Meanwhile, the policy statement will probably repeat that "future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach". Apart from that, however, the Council's updated forward policy guidance, which will have an important bearing on the market mood, is uncertain.

In our view, the Governing Council would be wise this month not to pre-commit to a particular path of tightening before considering the updated economic projections due in March. GDP was firmer than feared in Q4, rising 0.1%Q/Q compared to the ECB's baseline forecast of -0.2%Q/Q. The labour market still appears tight too. However, growth in Q4 was more than fully explained by multinational corporations based in Ireland for tax purposes, and underlying economic activity is likely to have been softer. In addition, while the full impact of recent tightening has yet to be fully felt, the ECB's credit conditions survey results yesterday reported the most stringent net tightening in credit standards on loans to non-financial corporations since the euro crisis in 2011 as well as falling demand for loans by firms and households. Moreover, the significant drop in wholesale gas prices to well below levels a year ago, as well as a cooling of global goods inflation and shipping costs, the associated reduction in supply-chain challenges, and ongoing strengthening of the euro exchange rate, all means that the inflation outlook has improved since the December meeting. Bank of France Governor Villeroy recently suggested that inflation could be back to target before the end of 2024, compared to the current baseline projection that it will not reach that point before Q325. And we think 2% inflation could be reached sooner still.

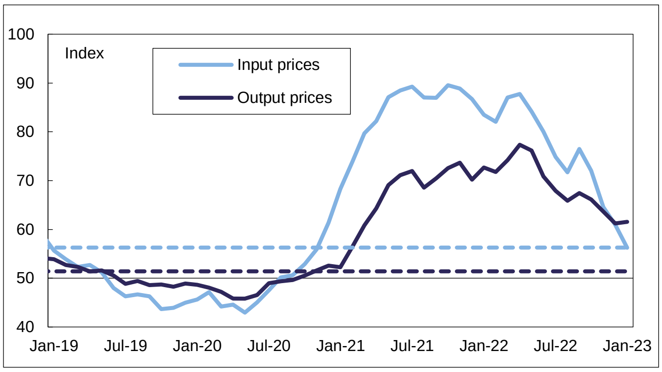
However, while some of the doves on the Governing Council (such as Executive Board member Panetta and Bank of Italy Governor Visco) have argued that the ECB should avoid prejudging the appropriate policy decision in March, last week also some of the typically more balanced members of the Governing Council (such as Irish Governor Makhlouf) support the hawks in signalling their desire for a further 50bps hike in March. So, we see a significant risk that tomorrow will similarly

Euro area: Manufacturing output PMIs



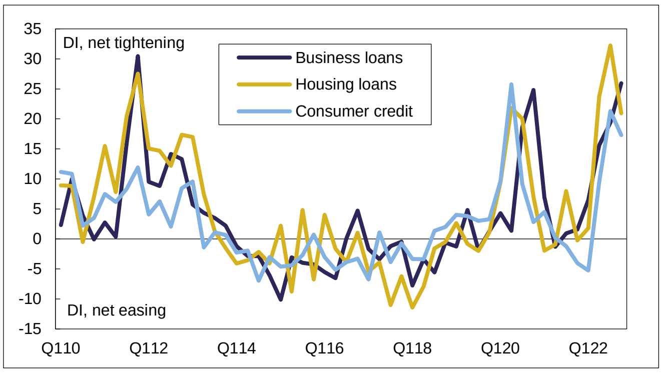
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing price PMIs*



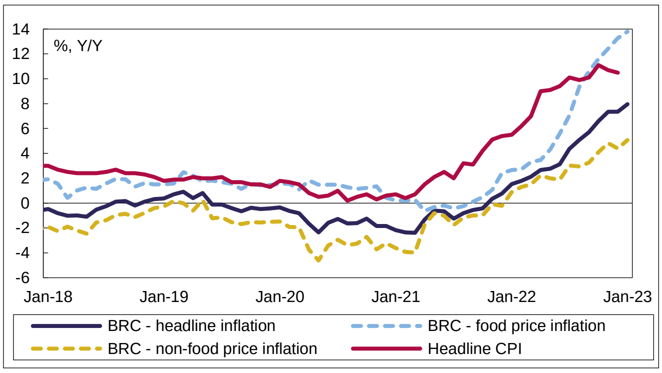
**Dashed lines are pre-pandemic averages. Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area: Changes in loan credit standards



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

UK: Consumer and shop price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

signal the likelihood of further "significant" tightening to come at the end of the quarter and perhaps beyond. And President Lagarde might also comment again on the appropriateness (or not) of the current market-implied path of rates.

Aside from the decision and updated guidance on rates, tomorrow the Governing Council will provide more detail on how, from March, it plans to reduce its portfolio holdings under its regular Asset Purchase Programme (APP). We already know from the last policy announcement that the APP portfolio will shrink by €15bn per month on average until the end of Q2. Tomorrow the ECB should provide information related to the future composition of the portfolio, including with respect to the balance between various asset classes, and plans to "green" the remaining bond holdings. Among other things, the ECB's portfolio of private sector securities might be unwound at a faster pace than its holdings of government bonds. At the same time, however, an excessively rigid or aggressive plan to unwind government bonds might pose a particular risk to periphery government bond prices.

UK

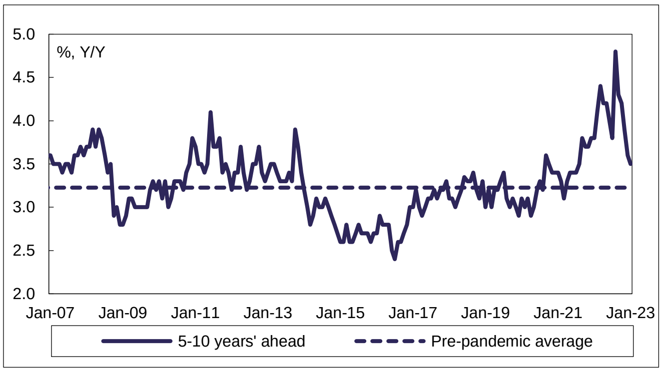
UK shop price inflation accelerates to a series high in January

Despite weak demand and historically low consumer confidence, as well as some signs of easing input cost burdens, the latest BRC shop price survey suggested that many UK retailers ramped up their prices at the start of the year as festive discounting faded. According to the BRC, shop price inflation accelerated to a new series high of 8.0%Y/Y in January, from 7.3%Y/Y in December. Food price inflation maintained a steady upwards trend, rising 0.5ppt to 13.8%Y/Y, while prices at non-food stores were also up a record-high 5.1%Y/Y. But with households purchasing power continuing to be eroded and spending to remain weak, we expect to see retailers resort to renewed discounting over the near term, and price pressures to ease over coming months, not least as food prices and energy costs level off. But there have been further encouraging signs with respect to household inflation expectations, with yesterday's Citi/YouGov survey reporting that the average expectation for inflation over the coming twelve months declined 0.3ppt to 5.4%Y/Y, the lowest in a year, while expectations for inflation in 5-10 years' time declined a further 0.1ppt in January to 3.5%Y/Y, only marginally higher than the pre-pandemic average of 3.2%Y/Y.

UK house prices drop for fifth month, the longest declining streak since global financial crisis

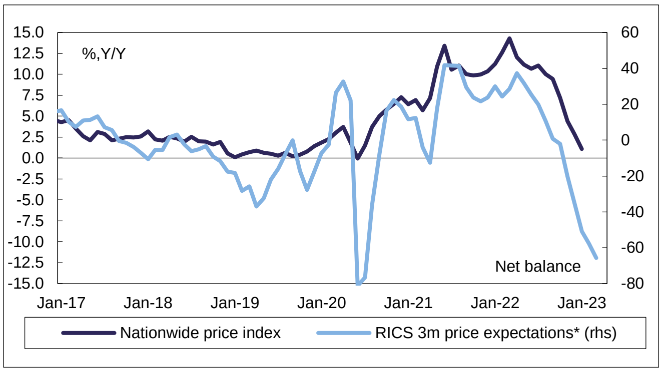
Certainly, the deterioration in the housing market will do nothing to ease households' concerns about the economic outlook and loosen the purse strings. Indeed, the Nationwide house price index fell for the fifth consecutive month in January

UK: Households' inflation expectations



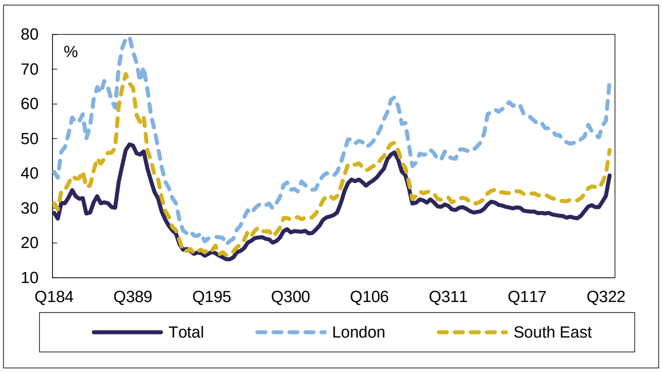
Source: Refinitiv, Citi/YouGov and Daiwa Capital Markets Europe Ltd.

UK: House price indices



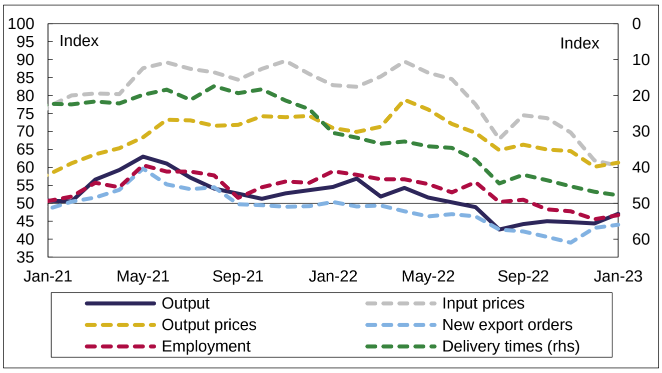
**Three-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Mortgage payments as a share of net pay*



**First-time buyer mortgage payments based on an 80% LTV mortgage. Source: Refinitiv, Nationwide and Daiwa Capital Markets Europe Ltd.*

UK: Manufacturing PMIs



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

(-0.6%M/M), the longest declining streak since February 2009, to leave them more than 3% below August's peak. This left the annual rate down 1.7ppt at 1.1%Y/Y, well below the high of more than 14%Y/Y in March 2022. While mortgage rates have fallen back somewhat from their peak in October, they still remain significantly higher than before the Truss-related blow-out. Indeed, while the average rate on a 2Y fixed 75% LTV mortgage in December had fallen 57bps since October, at 5.43% it was still some 180bps higher than in August and more than four times the low in September 2021. And the easing in rates on higher LTV loans has been more modest, down just 26bps on 2Y fixed 90% LTV mortgage still close to 6.00%, And so, Nationwide continued to flag persisting challenges in overall affordability, with, for example, the average mortgage payment as a share of take-home pay for first-time buyers with an 80% LTV mortgage having risen in Q4 by 5.5ppts to 39%, close to levels seen in the run up the global financial crisis. Taken together with the slump in mortgage approvals in December, and the extremely downbeat expectations of future sales and prices in the latest RICS survey, we expect to see a further fall in house prices over coming months, perhaps eventually taking the peak-to-trough decline to as much as 10%.

Final manufacturing PMI revised higher, but still consistent with contraction

The final UK manufacturing PMIs flagged again the weakness in activity in the factory at the start of the year. Admittedly, the output index was upwardly revised from the flash by 0.5pt to leave it 2.7pts higher in January and at its firmest level since July, with a similar improvement in the new orders component too. But at 47.0 and 44.4 respectively, they remain consistent with contraction in the sector, with firms citing weak demand amid squeezed budgets, heightened uncertainties and ongoing Brexit and port-related disruption. Taken together with ongoing skilled labour shortages, manufacturers reportedly scaled back their workforces for the fourth consecutive month. This notwithstanding, firms were less downbeat about expectations for the coming twelve months, perhaps reflecting to some extent an easing in input cost burdens. Indeed, while still above the pre-pandemic average, the input price PMI (60.4) fell for the eighth month out of the past nine to its lowest level since October 2020 and some 29pts below the peak in April. So while the respective output price index ticked slightly higher in January (61.3), it too was 17½pts below last year's high.

The day ahead in the UK

The BoE's MPC is widely expected tomorrow to raise Bank Rate for the tenth consecutive meeting. But the decision is likely again to be split at least three ways, with external members Silvana Tenreyro and Swati Dhingra likely to vote once again for no change to policy. And the size of the rate hike is difficult to predict with confidence. The BoE's updated projections to be presented this week in its latest Monetary Policy Report (MPR) will play an important role in guiding the policy judgement. Overall, given the tight labour market, still relatively high business inflation expectations, and a likely pessimistic revision by the Bank to its estimates of the equilibrium unemployment rate, potential growth and spare capacity, we expect the majority on the Committee to favour a 50bps increase in Bank Rate this month. But we also recognise the non-negligible risk of a smaller hike. And while the Bank might well signal the likelihood of some additional tightening ahead, the forward guidance might be more equivocal than before.

Encouragingly, GDP in Q4 appears to have been a little more resilient than feared in November, albeit likely still down modestly from Q3. But the very tight labour market will remain a concern for the majority of MPC members. Indeed, the acceleration in wage growth in the three months to November (6.4%3M/Y), and jump in services inflation in December (6.8%Y/Y), will continue to stoke fears of second-round effects on future prices. Nevertheless, headline inflation in Q4 (10.7%Y/Y) came in a touch softer than the Bank's previous forecast (10.9%Y/Y). And BoE staff estimated in December that the revised Energy Price Guarantee would reduce the forecast for inflation in Q2 by ¾ppt. Since then we have also seen a further marked decline in wholesale natural gas prices, which in the fifteen-day period used to set the respective assumption in the BoE's February forecasts were more than 60% lower than in the equivalent period before the November MPR. Futures imply a significantly lower profile for gas prices across the forecast horizon too.

Reflecting the developments in energy markets, Governor Bailey suggested last week that inflation is now on track to fall rapidly from the spring as supply-side pressures recede. Indeed, the BoE's November forecast for 2024-25 was already extremely weak, with headline CPI expected to fall below 1%Y/Y at the end of the horizon even in the event that Bank Rate had been unchanged at 3.00%. Of course, this weakness also reflected the Bank's expectation that demand would fall steadily due to the record decline in household real disposable incomes. But while the anticipated downturn over the coming quarters might not be as deep as the November MPR baseline forecast suggested, recent indicators – including the flash January PMIs and ongoing deterioration in housing market conditions – suggest that economic activity weakened at the start of the year. And recession through the first half of 2023, if not beyond, will likely remain in the BoE's baseline projection.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area	Final manufacturing PMI	Jan	**48.8**	_48.8_	47.8	-
	Preliminary HICP (core HICP) Y/Y%	Jan	**8.4 (5.2)**	9.0 (5.1)	9.2 (5.2)	-
	Unemployment rate %	Dec	**6.6**	6.5	6.5	**6.6**
Germany	Final manufacturing PMI	Jan	**47.3**	_47.0_	47.1	-
France	Final manufacturing PMI	Jan	**50.5**	_50.8_	49.2	-
Italy	Manufacturing PMI	Jan	**50.4**	49.6	48.5	-
	Preliminary HICP (CPI) Y/Y%	Jan	**10.9 (10.1)**	10.7 (10.1)	12.3 (11.6)	-
Spain	Manufacturing PMI	Jan	**48.4**	48.0	46.4	-
UK	BRC shop price index Y/Y%	Jan	**8.0**	-	7.3	-
	Nationwide house price index M/M% (Y/Y%)	Jan	**-0.6 (1.1)**	-0.5 (1.8)	-0.1 (2.8)	**-0.3 (-)**
	Final manufacturing PMI	Jan	**47.0**	46.7	45.3	-

Auctions

Country	Auction
Germany	sold €4.02bn of 2.3% 2033 bonds at an average yield of 2.27%
UK	sold £3bn of 0.875% 2033 Green bonds at an average yield of 3.428%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ _Daiwa forecast_	Previous
Euro area	13.15	ECB Deposit (Refi) Rate %	Feb	_2.50 (3.00)_	2.00 (2.50)
Germany	07.00	Trade balance £bn	Dec	8.0	10.9
Spain	08.00	Unemployment change 000s	Jan	-	-43.7
UK	12.00	BoE Bank Rate %	Feb	_4.00_	3.50

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
France	09.50	Auction: 0.00% 2031 bonds
	09.50	Auction: 2.00% 2032 bonds
	09.50	Auction: 0.50% 2044 bonds
Spain	09.30	Auction: 2.80% 2026 bonds
	09.30	Auction: 1.40% 2028 bonds
	09.30	Auction: 1.00% 2030 bonds
	09.30	Auction: 3.45% 2043 bonds
UK	12.00	BoE monetary policy announcement, statement, minutes and Monetary Policy Report to be published
	12.30	BoE Governor Bailey holds press conference on the BoE's latest Monetary Policy Report
	-	BoE publishes monthly decision maker panel data

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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