Euro wrap-up

Overview

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- Euro area govvies made big gains, as the ECB raised rates by 50bps today, stated that it intends to hike by a further 50bps in March, but also judged the inflation outlook to be 'more balanced'.
- Gilts also rallied as the BoE raised rates by a further 50bps but suggested that the end of the tightening cycle might be near.
- The coming week brings new figures for euro area retail sales, German IP and UK GDP.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.458	-0.186
OBL 2.2 04/28	2.083	-0.225
DBR 2.3 02/33	2.067	-0.213
UKT 1 04/24	3.138	-0.246
UKT 1¼ 07/27	2.854	-0.308
UKT 4¼ 06/32	3.000	-0.301

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

Euro area

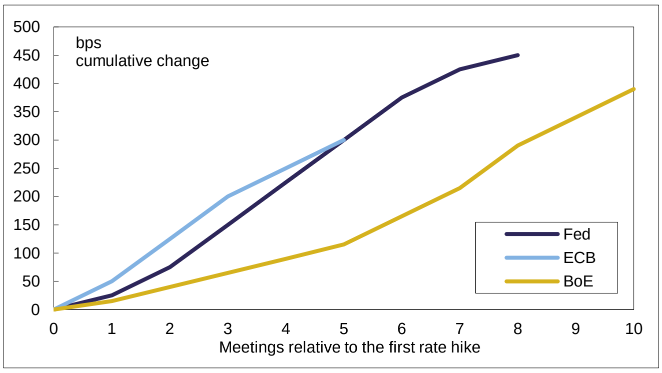
ECB hikes by 50bps today and "intends" to hike by another 50bps in March

As ECB President Lagarde has repeatedly suggested over recent weeks, the Governing Council today stated that it will "stay the course in raising interest rates significantly at a steady pace and in keeping them at levels that are sufficiently restrictive". So, consistent with such recent hawkish communication, and also in light of the ECB's forward guidance issued in December, it was no surprise that the Governing Council hiked rates by 50bps today. That took the deposit rate to 2.50%, and the cumulative tightening this cycle to 300bps. More of a surprise today was that the Governing Council added that it also "intends" to raise rates by a further 50bps in March, after which it insisted that it will evaluate the path for policy. That stated intention for the March meeting appeared to contradict the long-standing commitment – which counterintuitively was retained today – that decisions will be data-dependent and taken on a meeting-by-meeting basis. So, in her press conference, Lagarde conceded that the stated intention to raise rates in March did not represent "an absolute irrevocable unconditional commitment". However, a 50bps hike next month does appear to be all but a done deal. And rather than determine the rate decision in March, the ECB's updated economic projections, which will be finalised ahead of next month's meeting, now seem only likely to have a bearing on the path of policy from Q2 on.

Inflation outlook judged to be "more balanced" but risks still judged to be skewed to the upside

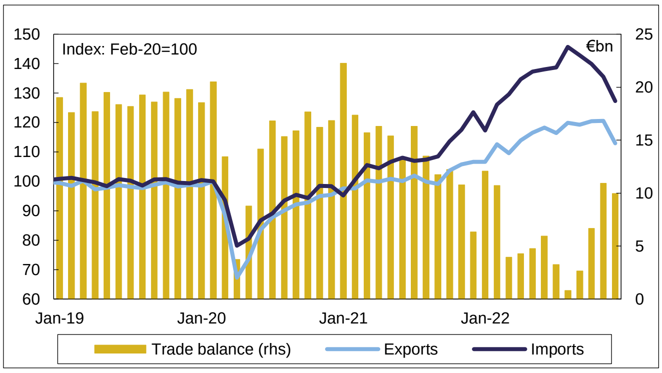
In her press conference, President Lagarde insisted that the decision to reevaluate the outlook in March did not mean that the peak in rates will be reached then. However, the Governing Council's economic assessment today acknowledged that the outlook for economic growth and inflation now looks "more balanced". It acknowledged that supply bottlenecks are gradually easing, the supply of gas has become more secure, and also – of course – energy price pressures have fallen. But the Governing Council also judged that risks to the inflation outlook remain skewed to the upside. In particular, it considered general price pressures to remain strong, not least due to the pass-through of past increases in prices of energy and other goods to other items, as well as pent-up demand on services prices. China's re-opening from its zero-Covid policy was considered a possible new source of additional pressures, not least on commodity prices. And crucially, with labour markets resilient, the policymakers remain concerned about second-round effects on wages, as unions seek compensation for high inflation in wage negotiations. Notably, however, the Governing Council judged that wage growth has been no stronger than expected in December, and that longer-term inflation expectations still do not appear to be de-anchored. In the absence of new evidence of a marked acceleration in wage growth, we continue to expect the ECB to revise down significantly its inflation projection next month, probably to suggest that inflation will be back near target around the middle of next year. And so, also assuming that core inflation has started to decline in the course of next quarter, after the hike of 50bps in March we expect just one further hike of 25bps in May to take the terminal deposit rate for this cycle to 3.25%.

ECB, BoE & Fed: Cumulative rate tightening



Source: ECB, BoE, Fed & Daiwa Capital Markets Europe Ltd.

Germany: Goods trade balance, exports & imports*



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

No surprises from QT; primary market purchases permitted only for greening of corporate holdings

In terms of quantitative tightening, the ECB provided a little more detail today on its plans for quantitative tightening (QT). There were no major surprises, with remaining reinvestments to be conducted broadly in line with current practice, except for its corporate bond holdings which will be "greened". In particular, as stated in December, the portfolio of the regular Asset Purchase Programme (APP) will be reduced by €15bn per month on average from the beginning of March until the end of June, with the subsequent pace of reduction to be determined in due course and regularly reassessed thereafter. The remaining reinvestment amounts will be allocated proportionally to the share of redemptions across each constituent programme of the APP. So, under the public sector purchase programme (PSPP), reinvestments will be allocated proportionally to the share of redemptions of each jurisdiction and across national and supranational issuers. For the private sector programmes (ABSPP, CBPP3 and CSPP), primary market purchases will be phased out by the start of the partial reinvestments. However, for the corporate bond holdings, remaining reinvestments will be tilted more strongly towards issuers with a better climate performance. Moreover, primary market purchases will be permitted for green corporate bonds and non-bank corporate issuers judged to have a better climate performance.

German exports and imports tumbled in December

While euro area GDP growth remained mildly positive in Q4, underlying economic activity looks to have weakened sharply at the end of last year. This is certainly true in the euro area's largest member state, where GDP fell slightly over the quarter (-0.1%Q/Q). Consistent with the sharp drop in German retail sales reported in December, today's goods trade report for that month was equally shocking. While the goods trade surplus narrowed only slightly – by €0.9bn to €10bn – this masked the steepest monthly drop in the value of exports (-6.3%M/M) and imports (-6.1%M/M) since January 2009 when excluding the initial pandemic slump in Q220. The weakness in shipments was broad-based, including a drop to other euro area countries (-3%M/M), and was led by double-digits declines to the US (-10%M/M), China (-14%M/M) and the UK (-24%M/M). And although the fall in trade volumes was no doubt in part due to price developments, when the real-terms data are published around the middle of this month, these are likely to reflect weakness in global demand too.

The week ahead in the euro area

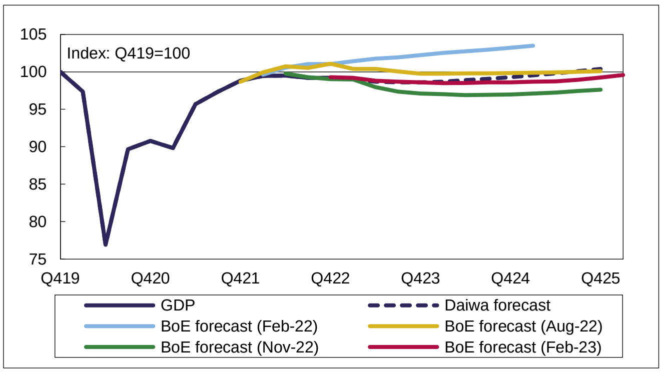
The coming week's euro area economic data calendar should be much quieter, kicking off with December retail sales figures on Monday. While the past week's GDP estimates suggested that the economy posted modest growth in the final quarter of 2022, these are expected to report a marked decline in household spending on goods at the end of the year. Indeed, the past week's German retail sales data recorded the steepest monthly drop (-5.5%M/M) since the consumption tax hike in January 2007 bar pandemic lockdown-related disruption. Meanwhile, Monday will also bring the euro area Sentix investor confidence survey for February, along with the construction PMIs for January. At the country level, German factory orders data (Monday) might well report some positive payback in December for the sharp decline in November (-5.3%M/M). German IP figures (Tuesday) are likely to confirm that the manufacturing sector provided a modest drag on GDP growth in Q4. In addition, the delayed German preliminary inflation estimates for January will be published at some point in the coming week. Separately, Austrian Governing Council hawk Holzmann is scheduled to speak publicly on Monday, while President Lagarde and Executive Board member Schnabel will speak at separate events on Tuesday – expect the main message from today's announcements to be repeated, perhaps with attempted push back against today's rally in euro government bonds.

UK

BoE hikes by 50bps but guidance suggests end to tightening cycle is near

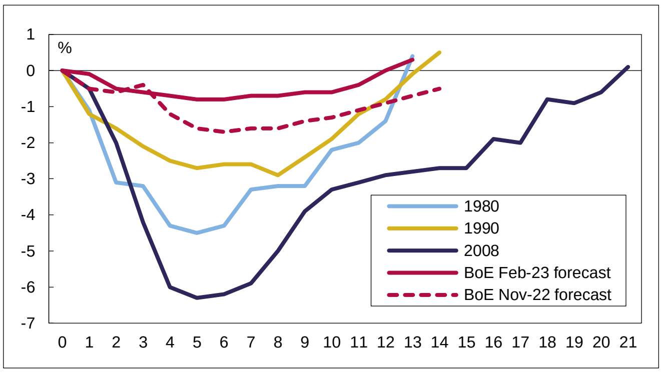
Unlike the ECB, ahead of the BoE's policy announcement, there had been differences of opinion among analysts, reflected in market pricing, about the size of the rate hike likely to come today. While some expected a slowdown in the pace of hikes to 25bps, in line with our (and the consensus) view, the MPC voted 7-2 in favour of another hike of 50bps. That took Bank Rate to 4.00% and the cumulative tightening so far this cycle to 390bps. As at the December meeting, the two dissenters on

UK: BoE GDP forecasts



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

UK: Recession comparisons – path of GDP



Source: BoE and Daiwa Capital Markets Europe Ltd.

the Committee – external members Dhingra and Tenreyro – voted for no change to policy. But more important in suggesting that the end to the tightening cycle is probably near was the MPC's revised forward guidance, which was far more guarded than before about the likely path of rates ahead. Admittedly, the guidance flagged the risk of further tightening to come, if there is "evidence of more persistent pressures". And in the post-meeting press conference, Governor Bailey acknowledged that the probability that the next move in rates will be up remains greater than the probability that the next move in rates will be down. He also clarified that most likely triggers for further hikes would be stronger wage settlements and/or additional pressures in services inflation. And with the labour market still very tight, we suspect the threshold for further tightening will be met next month. So, we maintain our expectation of a further hike of 25bps to 4.25% in March. But we also still think that will represent the peak for the cycle. We also cannot rule out the possibility that there will be no further hikes from here. And rate cuts now look set to be up for discussion by the end of the year.

Recession expected to be shallower than previously expected, but growth potential weaker too

As far as its updated economic projections are concerned, the BoE has become less downbeat about the near-term outlook for GDP, not least due to the resilience of the labour market, the recent marked decline in wholesale energy prices and the resulting impact on private consumption. Indeed, the Bank revised slightly higher its forecast for Q4 to growth of 0.1%Q/Q (from -0.1%Q/Q), and expects the downturn to be significantly shallower than previously feared in November – a peak to trough decline of around 1% compared with its previous forecast of almost 3%. Nevertheless, the BoE still forecasts economic output to contract for five consecutive quarters, and not return to modestly positive growth until Q324. Moreover, GDP is still expected to remain below the pre-pandemic level at the end of the horizon in Q126. However, the Bank's estimate for the UK's supply potential has also fallen below the pre-pandemic level. And it also judges that UK potential GDP growth has weakened considerably, with potential supply growth now estimated to fall to just 0.7% from 2024, a full 1ppt below the pre-pandemic ten-year trend and 2ppts below the decade before the global financial crisis. So, with the recession expected to be milder and labour force participation expected to remain weak, the Bank revised down its expected profile for the unemployment rate over the horizon, by around 1ppt, to reach about 5.3% at the start of 2026. And it also revised its forecast for the negative output gap, which is still expected to emerge from next quarter. In particular, the negative output is anticipated to widen to 2% in two years' time, a full percentage point smaller than previously expected, albeit still large enough to weigh substantively on the outlook for inflation.

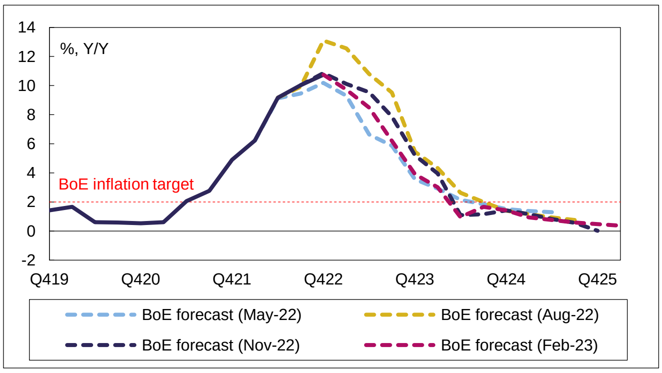
Inflation forecast to fall well below 2% by end of projection horizon

Of course, the inflation outlook will remain the key driver for the BoE's near-term policy decisions. And its near-term profile has improved since the Bank's previous forecasts in November, not least reflecting the government's Energy Price Guarantee from April, as well as the marked fall in wholesale gas prices, which means that household energy bills should fall below the cap implied by the government's EPG from Q3 on. Indeed, the Bank's baseline forecast foresees headline inflation falling to below 4%Y/Y by the end of this year, a little more than 1ppt below the level forecast in November. And inflation is expected to maintain a downwards trend thereafter, as externally-generated supply pressures continue to fade, and increasing economic slack in the UK's economy adds downward pressures. Admittedly, with services inflation and wage settlements having again exceeded its expectations, the Bank still remains concerned about risks of persisting domestically-driven price pressures. However, the Bank's Agents have reported signs that pricing power is starting to fade slightly, and that pay settlements might be a little lower in the second half of this year. So, the BoE's inflation projection for 2024 and 2025 was little changed, with inflation still expected to fall significantly below the 2% target from Q224 on, and to a little less than ½%Y/Y at the end of the forecast horizon – even assuming rates are cut to just over 3¼% in three years' time.

The week ahead in the UK

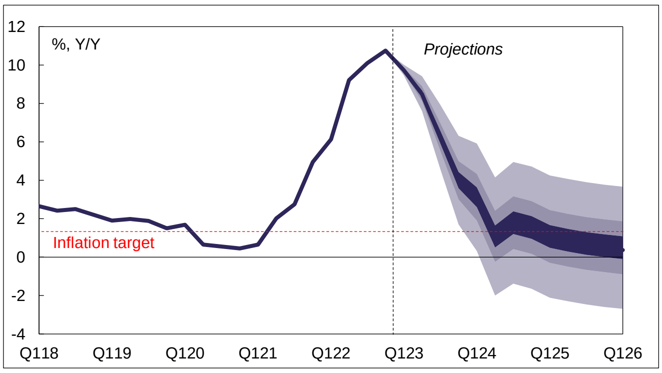
The data highlight from the UK in the coming week will come on Friday in the form of the first estimate of Q4 GDP and associated monthly output and trade figures for December. Not least reflecting the weakening in demand amid high inflation, rising borrowing costs and heightened economic uncertainties, we expect GDP to have fallen moderately in December.

UK: BoE CPI forecast comparison*



Based on market-implied interest rates rising to around 4½% in mid-2023 and falling back to just over 3¼% in three years' time. Source: BoE

UK: BoE CPI forecast – February 2023*



Based on market-implied interest rates rising to around 4½% in mid-2023 and falling back to just over 3¼% in three years' time. Source: BoE

Indeed, we forecast a drop of 0.7%M/M, to leave GDP broadly flat in Q4, with consumer spending subtracting from growth. That would leave the UK as the only G7 economy with output still below the pre-pandemic level. Ahead of the GDP release, January surveys will include the construction PMIs (Monday), BRC retail sales monitor (Tuesday), REC report on jobs (Wednesday) and RICS residential market indicators (Thursday). In terms of BoE-speak, Governor Bailey and external member Mann will present at a conference on Monday, while Chief Economist Pill and Deputy Governor Ramsden will speak at a various events during the week.

The next edition of the Euro wrap-up will be published on 6th February 2023

Daiwa economic forecasts

	2022			2023			2022	2023	2024
	Q2	Q3	Q4	Q1	Q2	Q3			
GDP			%, Q/Q					%, Y/Y	
Euro area	0.9	0.3	0.1	0.0	0.1	0.1	3.5	0.6	1.0
UK	0.1	-0.3	0.0	-0.2	-0.3	-0.1	4.1	-0.7	0.3
Inflation, %, Y/Y									
Euro area									
Headline HICP	8.0	9.3	10.0	7.4	5.4	3.7	8.4	4.6	2.2
Core HICP	3.7	4.4	5.1	5.4	4.1	3.2	3.9	3.7	2.1
UK									
Headline CPI	9.2	10.0	10.7	9.7	7.8	6.4	9.1	6.9	2.5
Core CPI	6.0	6.3	6.4	5.9	4.8	3.9	5.9	4.4	2.5
Monetary policy, %									
ECB									
Refi Rate	0.00	1.25	2.50	3.50	3.75	3.75	2.50	3.75	3.00
Deposit Rate	-0.50	0.75	2.00	3.00	3.25	3.25	2.00	3.25	2.50
BoE									
Bank Rate	1.25	2.25	3.50	4.25	4.25	4.25	3.50	4.25	3.25

Source: Bloomberg, ECB, BoE 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	ECB Deposit (Refi) Rate %	Feb	**2.50 (3.00)**	*2.50 (3.00)*	2.00 (2.50)	-
Germany	Trade balance £bn	Dec	**10.0**	9.3	10.8	**10.9**
UK	BoE Bank Rate %	Feb	**4.00**	*4.00*	3.50	-

Auctions

Country	Auction
France	sold €4.14bn of 0.00% 2031 bonds at an average yield of 2.590%
	sold €4.57bn of 2.00% 2032 bonds at an average yield of 2.680%
	sold €2.77bn of 0.50% 2044 bonds at an average yield of 2.940%
Spain	sold €2.40bn of 2.80% 2026 bonds at an average yield of 2.919%
	sold €1.61bn of 1.40% 2028 bonds at an average yield of 2.887%
	sold €1.98bn of 3.45% 2043 bonds at an average yield of 3.649%
	sold €505mn of 1.00% 2030 index-linked bonds at an average yield of 0.876%

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	Final services (composite) PMI	Jan	_50.7 (50.2)_	49.8 (49.3)
Germany		08.30	Final services (composite) PMI	Jan	_50.4 (49.7)_	49.2 (49.0)
France		07.45	Industrial production M/M% (Y/Y%)	Dec	0.3 (0.8)	2.0 (0.7)
		08.50	Final services (composite) PMI	Jan	_49.2 (49.0)_	49.5 (49.1)
Italy		08.45	Services (composite) PMI	Jan	50.9 (50.2)	49.9 (49.6)
Spain		08.15	Services (composite) PMI	Jan	52.5 (50.5)	51.6 (49.9)
UK		09.30	Final services (composite) PMI	Jan	_48.0 (47.8)_	49.9 (49.0)
Auctions and events						
Euro area		09.00	ECB publishes its survey of professional forecasters			
UK		12.15	BoE Chief Economist Pill to give update on Monetary Policy Report at Bank's Agents briefing			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases						
Country		GMT	Release	Period	Market consensus/ _Daiwa forecast/actual_	Previous
Monday 06 February 2023						
Euro area		08.30	Construction PMI	Jan	-	42.6
		09.30	Sentix investor confidence	Feb	-	-17.5
		10.00	Retail sales M/M% (Y/Y%)	Dec	-	0.8 (-2.8)
Germany		07.00	Factory orders M/M% (Y/Y%)	Dec	2.0 (-11.4)	-5.3 (-11.0)
		07.00	Construction PMI	Jan	-	41.7
		-	Preliminary HICP (CPI)* Y/Y%	Jan	10.1 (9.2)	9.6 (8.6)
France		08.30	Construction PMI	Jan	-	44.3
Italy		08.30	Construction PMI	Jan	-	47.0
UK		09.00	New car registrations Y/Y%	Jan	-	18.0
		09.30	Construction PMI	Jan	-	48.8
Tuesday 07 February 2023						
Germany		07.00	Industrial production M/M% (Y/Y%)	Dec	-2.0 (-1.9)	0.2 (-0.4)
France		07.45	Trade balance €bn	Dec	-	-13.8
Spain		08.00	Industrial production M/M% (Y/Y%)	Dec	-	-0.7 (-1.1)
UK		00.01	BRC retail sales monitor like-for-like Y/Y%	Jan	-	6.5
Wednesday 08 February 2023						
Italy		09.00	Retail sales M/M% (Y/Y%)	Dec	-	0.8 (4.4)
Thursday 09 February 2023						
UK		00.01	RICS house price balance %	Jan	-	-42
Friday 10 February 2023						
Italy		09.00	Industrial production M/M% (Y/Y%)	Dec	-	-0.3 (-3.7)
UK		07.00	GDP Q/Q% (Y/Y%)	Q4	_0.0 (0.4)_	-0.3 (1.9)
		07.00	GDP M/M%	Dec	_-0.7_	0.1
		07.00	Industrial production M/M% (Y/Y%)	Dec	-	-0.2 (-5.1)
		07.00	Manufacturing production M/M% (Y/Y%)	Dec	-	-0.5 (-5.9)
		07.00	Index of services M/M% (Q/Q%)	Dec	-	0.2 (-0.1)
		07.00	Construction output M/M% (Y/Y%)	Dec	-	0.0 (4.0)
		07.00	Goods trade balance (ex precious metals) £bn	Dec	-	-15.6 (-21.0)

**Publication date to be confirmed by Destatis on 3 February. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

The coming week's key events & auctions

Country	GMT	Event / Auction
		Monday 06 February 2023
Euro area	-	ECB's Holzmann, BoE Governor Bailey and MPC member Mann speak at conference on 'central banking in the post-covid era'
UK	17.00	BoE Chief Economist takes part in Q&A on the Monetary Policy Report
		Tuesday 07 February 2023
Euro area	17.00	ECB's Schnabel scheduled to speak
Germany	10.30	Auction: €500mn of 0.1% 2026 index-linked bonds
	10.30	Auction: €200mn of 0.1% 2046 index-linked bonds
UK	09.00	BoE Deputy Governor Ramsden and Chief Economist Pill scheduled to speak
	10.00	Auction: £3.5bn 4.125% 2027 bonds
		Wednesday 08 February 2023
Germany	10.30	Auction: €4bn of 2.1% 2029 bonds
UK	01.01	KPMG/REC report on jobs
	10.00	Auction: 1.125% 2039 bonds
		Thursday 09 February 2023
		- Nothing scheduled -
		Friday 10 February 2023
UK	14.00	BoE Chief Economist Pill scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.