Euro wrap-up

Overview

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- Euro area government bonds followed USTs higher even as the ECB left its forward rate guidance unchanged and announced an early end to full reinvestment of proceeds of its maturing PEPP bond-holdings.
- Gilts also made gains even as the BoE maintained a tightening bias and three MPC members vote for a rate hike.
- Friday's economic focus will be the flash December PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.545	-0.087
OBL 2.4 10/28	2.080	-0.075
DBR 2.6 08/33	2.124	-0.045
UKT 3½ 10/25	4.316	-0.032
UKT 4½ 06/28	3.813	-0.059
UKT 3¼ 01/33	3.796	-0.029

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

Euro area

ECB inevitably leaves rates & 'higher for longer' guidance unchanged

Inevitably, the ECB left its policy interest rates unchanged today. So, for example, the Deposit Rate was maintained at the record high of 4.0%, 450bps above the trough in place until July last year and a level that is undeniably consistent with a tight monetary stance. The Governing Council also left unchanged its forward guidance. So, while it implied that rates are unlikely to be hiked any further, it also insisted again that rates will be left at a sufficiently restrictive level for as long as necessary, maintaining the "higher for longer" message of previous policy meetings. In her press conference, President Lagarde predictably added that the timing of rate cuts was not discussed at all this week. Instead, she implied that rates would now be unchanged for a while to come. But she reiterated that policy would be data-dependent, and the Governing Council would take a meeting-by-meeting approach, with decisions based on the staff macroeconomic projections, and an assessment of various measures of underlying inflation pressures, and the extent of transmission of its past rate hikes to the real economy.

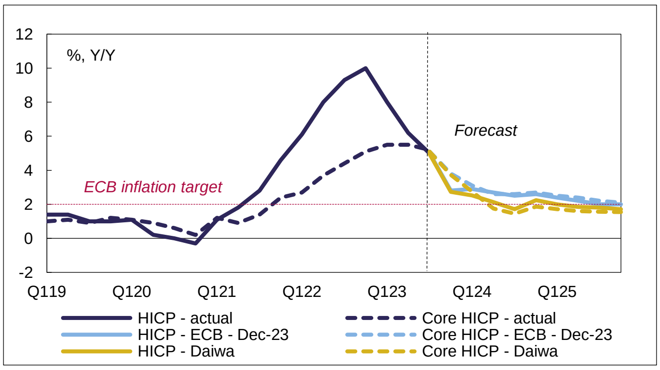
Quantitative tightening to be accelerated from July 2024 via halving of PEPP reinvestments

While it left its main interest rates unchanged today, the ECB did change policy with respect to its balance sheet. The Governing Council took advantage of the recent sovereign bond market rally to announce an acceleration in the pace of quantitative tightening (QT) over the second half of 2024. In particular, given no pressures for bond market fragmentation, it decided to bring forward the termination of full reinvestments of its PEPP bond holdings from end-2024 to next June. It now intends to halve those reinvestments, reducing the PEPP portfolio by €7.5bn per month, from July until December 2024, on top of its reduction in its APP portfolio which currently averages about €27bn per month. The remaining PEPP reinvestments, however, will continue to be conducted on a flexible basis, giving (admittedly somewhat smaller) scope to support periphery bond markets if necessary. And the overall additional reduction in the balance sheet planned for the second half of next year will still be modest in the context of the €1.67trn PEPP portfolio and excess liquidity of about €3.5trn. Certainly, the impact on bond yields is expected to be modest, and BTPs still outperformed all euro area government bonds bar Greece today despite the decision to accelerate QT.

Eurosystem projects core inflation to remain above target across the horizon

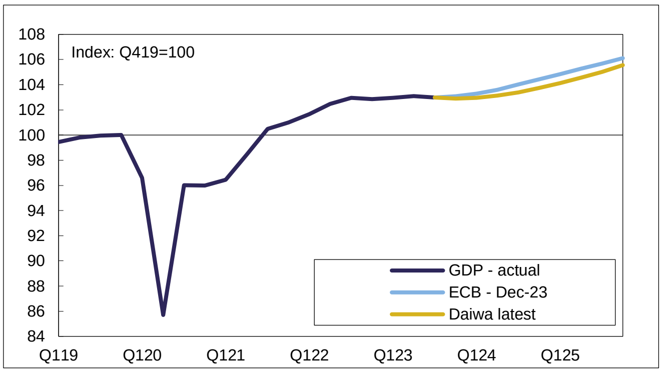
The updated Eurosystem macroeconomic projections, also published today, had to acknowledge that economic growth and inflation has recently been weaker than the ECB staff had anticipated in September. While the baseline GDP projection still failed to forecast recession, and a gradual consumption-driven recovery was anticipated over coming quarters thanks to

Euro area: Inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: GDP forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

rising real incomes, the growth forecasts for 2023 and 2024 were revised down by 0.1ppt and 0.2ppt respectively to 0.6%Y/Y and 0.8%Y/Y with the risks to that outlook judged to be skewed to the downside. The growth projection for 2025 was left unchanged at 1.5%Y/Y, however. Moreover, despite inflation's broad-based drop in November, the Eurosystem staff rightly expect it to tick higher over the near term due to German energy price base effects. And it also anticipates only a gradual renewed decline throughout 2024 and thereafter as base effects largely turn less favourable and government energy bill support is steadily withdrawn. So, while the forecast for headline inflation in 2024 was revised down by 0.5ppt to 2.7%Y/Y, the 2025 projection was left unchanged at 2.1%Y/Y. And a first projection for 2026 was only marginally below target at 1.9%Y/Y. Moreover, seemingly reflecting a judgement that wage growth and domestically-generated inflation remained too high for comfort, the forecast for core inflation in 2025 was revised up 0.1ppt to 2.3%Y/Y, with that for 2026 still above target too. As such, Lagarde insisted that it was still too soon for the ECB to "relax its guard" against inflation.

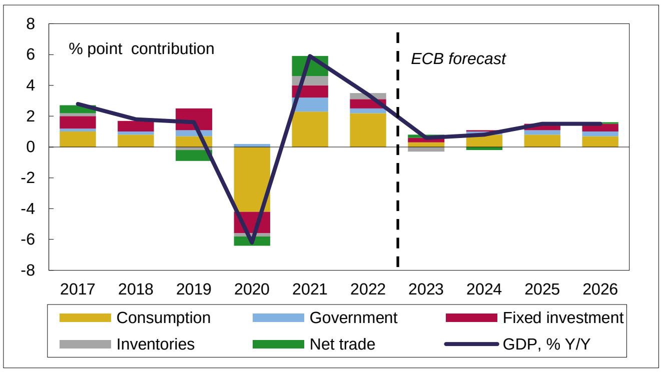
ECB in March could well forecast sub-target inflation at Q425 to justify a rate cut

In her press conference, Lagarde noted that the end-2025 inflation projections were now probably most important for determining monetary policy. Currently, those suggest that headline inflation will be bang on target at 2.0%Y/Y at that point, while core inflation will be marginally above target at 2.1%Y/Y. Those projections were conditioned on market rates up to 23 November, representing materially tighter financial conditions than at present. So, the recent big downwards shift in market rates, as well as certain other factors including the German government's decision this week to increase electricity and carbon prices, might point to upside risks to the inflation outlook when the projections are next updated in three months' time. However, we note that the next forecasts will be produced by the (relatively balanced) ECB staff rather than the instinctively hawkish Eurosystem. As such, also given our somewhat more downbeat near-term GDP forecast, we see scope for a non-negligible downwards revision to the Q425 inflation projections in March to below target, which could justify a first rate cut at that policy meeting. Indeed, while we think that the full quantum of ECB loosening in 2024 currently priced by the markets is excessive, we now expect cuts of 25bps apiece every three months from March on.

The day ahead in the euro area

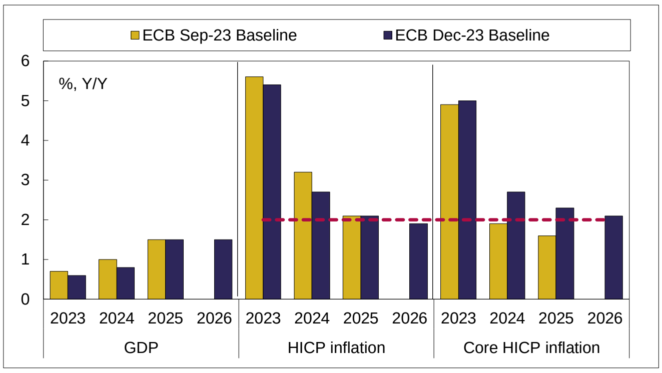
Tomorrow's focus will be the preliminary PMIs for December. While we expect to see a second successive rise in the euro area composite output PMI from October's three-year low, it is likely to remain firmly below 50, suggesting ongoing contraction. The weakness will be led by the manufacturing sector but the survey is also likely to suggest that services remain subdued. An unchanged reading in the composite PMI from 47.6 in November would leave the Q4 average down 0.6pt from Q3 when GDP declined 0.1%Q/Q. Survey results from the two largest member states will likely point to a

ECB: Euro area GDP & expenditure forecast



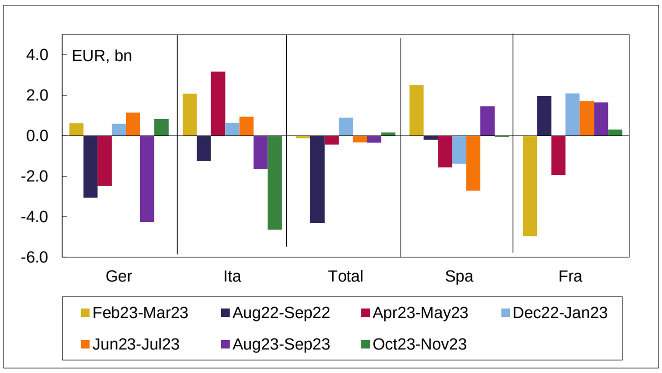
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation and GDP forecasts



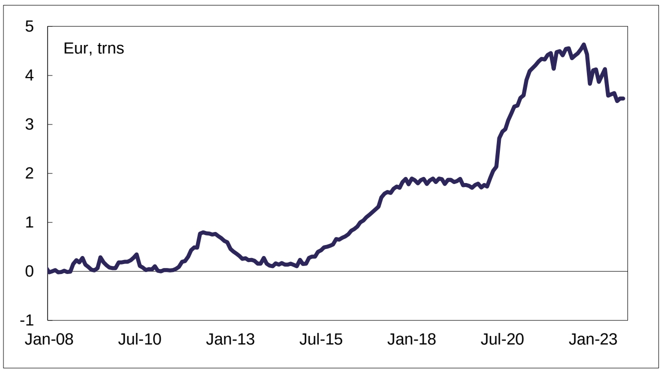
Source: ECB and Daiwa Capital Markets Europe Ltd.

ECB: PEPP net asset purchases by country



Source: ECB and Daiwa Capital Markets Europe Ltd.

ECB: Excess liquidity



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

contraction in activity across both Germany and France, with the composite PMIs expected to come in at 48.2 and 45.0 respectively, only marginally firmer than in November. The price PMIs will also be watched closely for any further evidence of inflationary persistence in the services sector, with both the input and output price indices having ticked slightly higher in November. Meanwhile, updated euro area unit labour costs data for Q3 will confirm a record growth rate in Q3 illustrating some of the concerns of the ECB hawks. Friday will also bring final French and Italian HICP figures for November, as well as euro area goods trade figures for October, which are expected to see the surplus rise slightly on the month, but remain a touch below the 2-year high reached in August.

UK

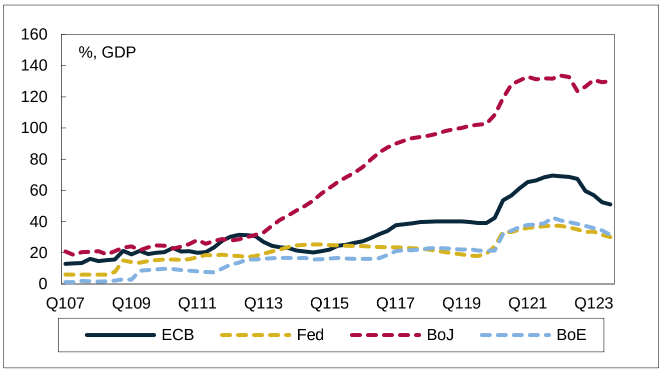
BoE keeps Bank Rate unchanged, but maintains a tightening bias

As expected, today's BoE policy announcement saw the MPC leave Bank Rate unchanged at 5.25% for a third successive meeting. Also, as we anticipated, the vote was again split, with six MPC members voting for no change, while three external members – Greene, Haskel and Mann – voted for a hike of 25bps. And while the BoE revised down its assessment of GDP in Q4, and acknowledged that the latest CPI and wage prints had come in softer than it expected at the time of the previous meeting, it continued to assess that the risks to the inflation outlook remained skewed to the upside. As such, contrasting with the dovish signals from the Fed yesterday evening, the MPC's forward guidance and subsequent comments from Governor Bailey sought to downplay the possibility that rates might soon be cut. Indeed, for a third successive meeting, the MPC stated that "Monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term". Moreover, it retained a tightening policy bias, reiterating that "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures".

BoE still view risks to the inflation and wage outlook to be skewed to the upside

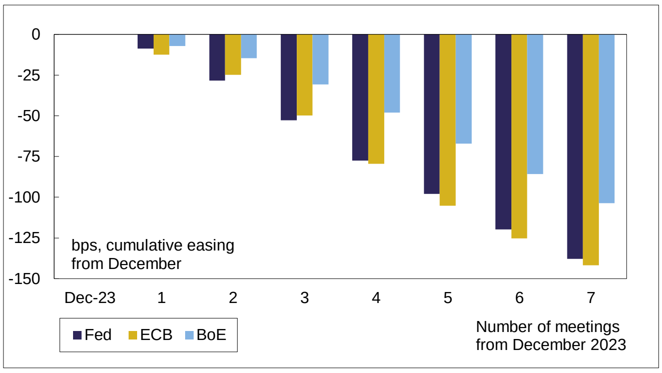
Although certain key variables in the MPC's reaction function – services inflation and private regular pay growth – have come in on the soft side compared with the Bank's November projections, the MPC judged the downside surprises to have been relatively limited overall. Furthermore, it noted that the shortfall in services inflation largely reflected components that are typically more volatile and seasonally-driven, such as accommodation and airfares, and non-private rents. Indeed, when excluding such items, the Bank estimated that services inflation had been broadly stable in November at an elevated level in line with the average over the previous six months. And so, with risks to both services inflation and pay growth still judged to be skewed to the upside, the MPC insisted that it was still too early to conclude that they were on a firmly downwards path.

Major central banks: Balance sheets



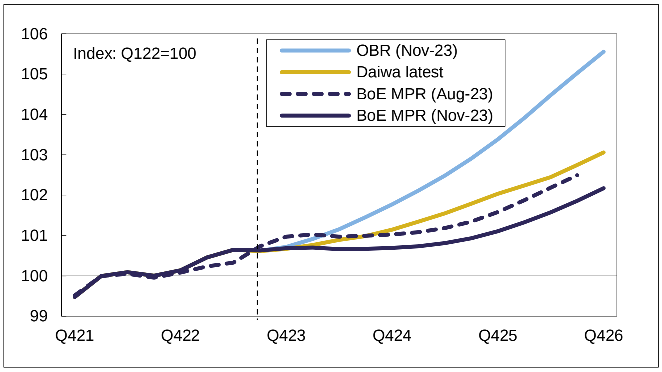
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Major central banks: Market-implied rate path*



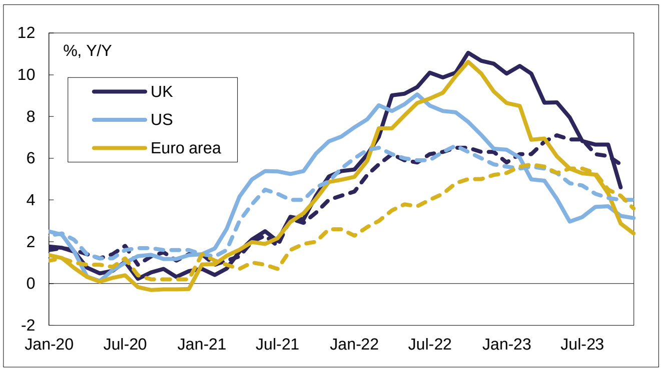
**Path for key policy rates implied by swap markets. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

UK: GDP forecasts



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

Major economies: Headline and core CPI inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The meeting minutes also highlighted that inflation and wage growth remained above their equivalent rates in the US and euro area. And despite downwardly revising slightly its growth forecast for Q4 (from 0.1%Q/Q to flat), the Bank estimated that the additional fiscal measures announced in November's Autumn Statement could increase the level of GDP by around ¼% over coming years. So, while one MPC member (presumably Dhingra) saw the risks of overtightening policy having continued to build, Bailey reiterated after the meeting that in his view "it's really still too early to start speculating about cutting interest rates". The other MPC members will undoubtedly agree. And so, while the swaps market continues to price the first rate cut in May next year, on balance we still think it is more likely to come in August by when core inflation should finally be moving below 3.0%Y/Y and heading back towards target.

The day ahead in the UK

Like in the euro area, the main UK focus tomorrow will be the preliminary PMIs for December. Having risen 2pts to a four-month high of 50.7 in November, the composite PMI is again expected to be consistent with stagnation or modest growth rather than recession. Also due tomorrow is the GfK consumer confidence survey for December, which we expect to be consistent with cautious household spending, albeit likely reporting a further modest rise close to September's 20-month high.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB Deposit Rate %	Dec	**4.00**	*4.00*	4.00	
Spain	Final HICP (CPI) Y/Y%	Nov	**3.3 (4.5)**	*3.2 (4.5)*	3.5 (5.2)	-
UK	RICS house price balance %	Nov	**-43**	-57	-63	-61
	BoE Bank Rate %	Dec	**5.25**	*5.25*	5.25	

Auctions

Country	Auction
- Nothing to report -	

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	Preliminary manufacturing (services) PMI	Dec	44.6 (49.0)	44.2 (48.7)
	09.00	Preliminary composite PMI	Dec	48.0	47.6
	10.00	Labour costs Y/Y%	Q3	-	4.5
	10.00	Trade balance €bn	Oct	10.0	9.2
Germany	08.30	Preliminary manufacturing (services) PMI	Dec	43.2 (49.8)	42.6 (49.6)
	08.30	Preliminary composite PMI	Dec	48.2	47.8
France	07.45	Final HICP (CPI) Y/Y%	Nov	*3.8 (3.4)*	4.5 (4.0)
	08.15	Preliminary manufacturing (services) PMI	Dec	43.3 (46.0)	42.9 (45.4)
	08.15	Preliminary composite PMI	Dec	45.0	44.6
Italy	09.00	Final HICP (CPI) Y/Y%	Nov	*0.7 (0.8)*	1.8 (1.7)
UK	00.01	GfK consumer confidence	Dec	-22	-24
	09.30	Preliminary manufacturing (services) PMI	Dec	47.5 (51.0)	47.2 (50.9)
	09.30	Preliminary composite PMI	Dec	51.0	50.7

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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