Euro wrap-up

Overview

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- Bunds made gains as the final estimates of euro area inflation in November confirmed a broad-based easing of price pressures.
- Gilts also made gains despite a slightly improved UK industrial sector survey.
- Wednesday will bring updates on euro area consumer confidence and construction output and UK inflation.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.507	-0.035
OBL 2.4 10/28	1.998	-0.048
DBR 2.6 08/33	2.017	-0.059
UKT 3½ 10/25	4.234	-0.039
UKT 4½ 06/28	3.669	-0.077
UKT 3¼ 01/33	3.641	-0.053

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

Euro area

Broad-based easing of inflation in November confirmed with drop in services most welcome

Today's final consumer price inflation data for November confirmed the flash estimates, which had originally reported a much steeper drop than anticipated, and underscored that the moderation in price pressures last month was broad-based. So, for example, today's figures reaffirmed the 0.5ppt drop in the headline HICP rate to just 2.4%Y/Y, the lowest since July 2021. More encouragingly perhaps, they also reaffirmed the 0.6ppt decline in the core rate to 3.6%Y/Y, the lowest since April 2022. Of most importance for the ECB, inflation of services fell a similar 0.6ppt, to a 15-month low of 4.0%Y/Y, 1.6ppts below the series high reached just four months ago. In part that reflected a sharp drop in airfares, which meant that transport services inflation fell 3.9%Y/Y, the most since 2020. In addition, the components for accommodation and restaurants slowed to the lowest since 2021 and mid-2022 respectively. And the drop in services inflation would have been steeper still had it not been for a sharp 6.6ppt jump in the highly volatile package holiday component, to 16.7%Y/Y, the second-highest rate this decade, which we expect to reverse in December.

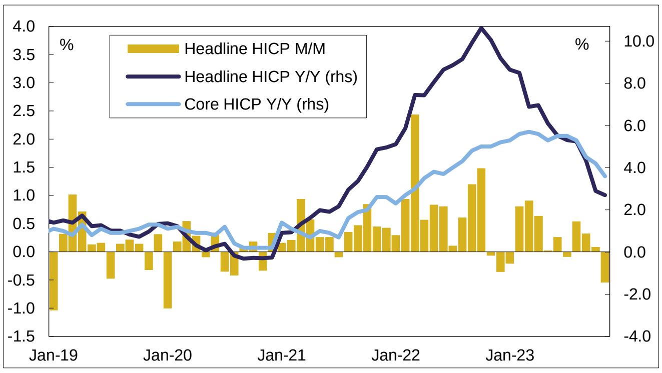
Goods inflation continues to fall thanks to shift in balance between supply and demand

Beyond services, given weak demand, an ongoing easing of supply constraints and diminished cost pressures in the industrial sector, inflation of non-energy industrial goods also fell 0.6ppt to 2.9%Y/Y, the lowest since January 2022 and almost 4ppts below February's peak. Among other items, inflation of major household appliances slowed to a crawl (just 0.3%Y/Y), the lowest since July 2021, as prices fell for the fourth month in the past five. The rate for furniture and furnishings (3.0%Y/Y) was also the softest since that date. Inflation of new and second-hand cars also moderated to the softest since 2021, with the clothes component the weakest in fifteen months. Meanwhile, beyond the core components, inflation of food, alcohol and tobacco fell 0.5ppt to 6.9%Y/Y, the lowest since April 2022 and 8.6ppts below the summer peak, despite a pickup in unprocessed prices. And with prices of auto fuels, electricity and gas all falling, energy inflation edged down 0.3ppt to -11.5%Y/Y, the weakest since the first wave of Covid-19.

Underlying inflation moderating on a wide range of measures

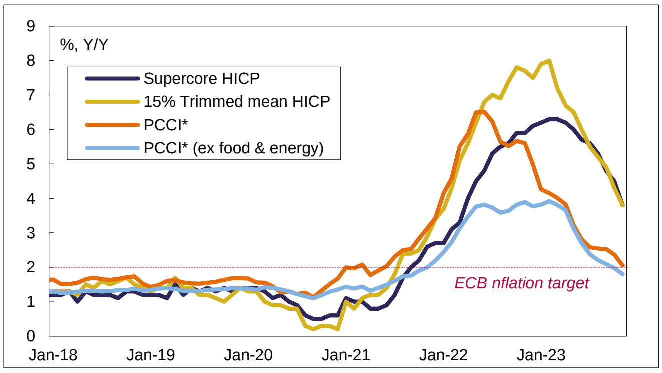
Notably, prices of services and non-energy industrial goods fell on a month-on-month basis far more than the pre-pandemic norm for November. Indeed, in seasonally-adjusted terms, prices of both major core components fell last month. So, core inflation momentum also continues to improve significantly. On a seasonally-adjusted basis, prices of non-energy industrialised goods were up just 0.6%3M/3M annualised, down 1.5ppts from October and the least since June 2021. Services price momentum slowed 0.8ppt to 3.0%3M/3M annualised, the least since April 2022. And as a result, the 3M/3M

Euro area: Headline and core inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



**Persistent and Common Component of Inflation. Source: ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

annualised rate of all core prices fell 1.0ppt to a 29-month low of just 2.1%, only marginally above the ECB's target. Other measures of underlying price pressures published as part of today's release showed further improvement too. For example, the share of items in the HICP basket with slowing inflation rose to a new high of 73.7% while the share with negative inflation rose 3.5ppts to 12.8%, the most since July 2021. Having dropped 0.6ppt in October, the 15% trimmed mean HICP rate fell a further 0.5ppt to a 22-month low of 3.8%Y/Y. The ECB's supercore measure of items most sensitive to economic slack slowed 0.7ppt to a 20-month low of 3.8%Y/Y. Moreover, the ECB's model-based measure of persistent and common component of inflation (PCCI), which the Governing Council believes can provide one of the more reliable guides to future inflation, fell to its lowest rate (2.0%Y/Y) since July 2021. And the core PCCI (excluding energy and food) rate declined below 2.0%Y/Y for the first time in almost two years.

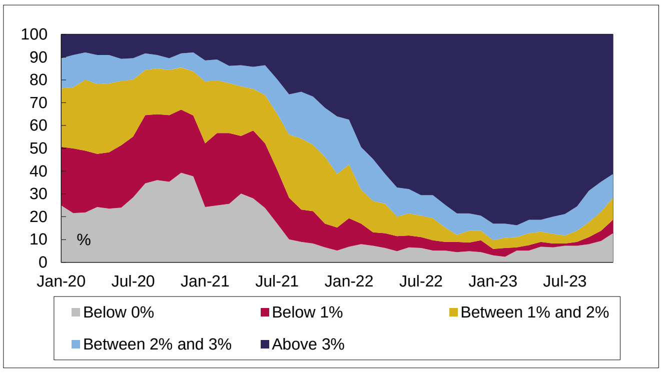
Headline inflation to rebound in December but slowing core trend should persist into New Year

Looking ahead, inflation seems bound to rise significantly in December, if only due to a highly adverse base effect. Indeed, a year earlier, energy prices saw their sharpest monthly drop on the series (-6.6%M/M) thanks to a one-off government subsidy to household energy bills in Germany. With petrol prices also seemingly now subject to upside risks due to the attacks on shipping in the Red Sea by Yemeni Houthi rebels, we currently forecast headline inflation to fully reverse November's drop and rise 0.5ppt back to 2.9%Y/Y this month. Headline inflation could well remain sticky near that level in January, in part due to the further withdrawal of energy support measures and adjustments to utility bills. However, thanks to easing pressures in services, we also anticipate a drop of 0.2ppt in core inflation to 3.4%Y/Y in December, before taking a more substantial step-down in the New Year and falling back to 2% or below in Q224. If, as we expect, core inflation does moderate significantly to below 3.0%Y/Y in Q1, the ECB will need to revise down its own projection in March. And that could provide the green light for the start to its rate-cutting cycle too.

German ifo survey tallies with flash PMIs to signal further contraction in Q4

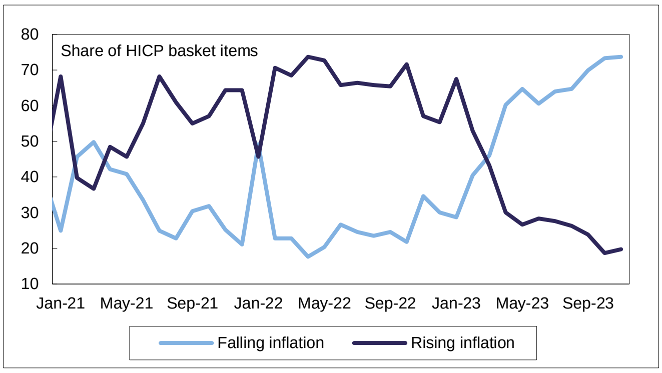
One of the reasons for the recent significant moderation in underlying inflation is the stagnation in economic activity over the past year. And notably perhaps, yesterday's ifo business survey results reinforced the message of Friday's flash PMIs for December, i.e. that the German economy has probably contracted for a second successive quarter in Q4. Contrary to expectations of a second successive monthly improvement, the headline business climate index dropped 0.8pt in December to a three-month low of 86.4 with the survey detail reporting a broad-based deterioration. Indeed, the ifo survey reported a downgrade in businesses' assessments of current conditions to the worst since July 2020. Firms in manufacturing, retail and construction all judged that conditions had deteriorated over the past month. In particular, firms in the factory sector judged the business climate to be the least favourable since November 2020 with order books reportedly continuing to shrink and

Euro area: Share of HICP basket by inflation rate



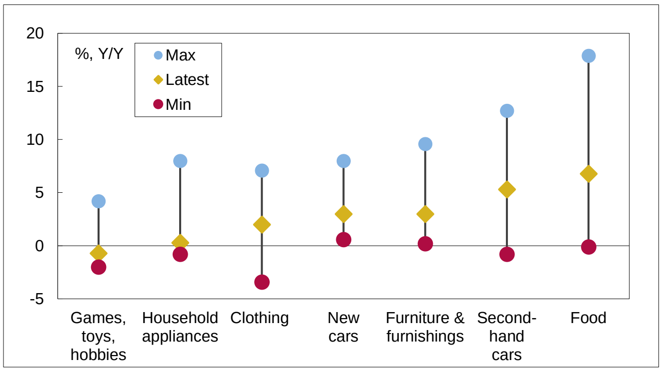
Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Share of HICP with falling/rising inflation



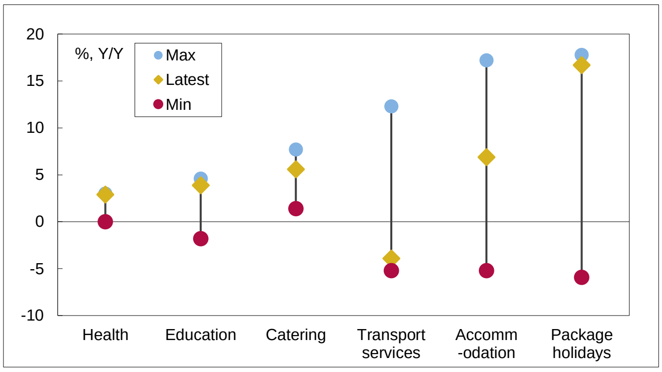
Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods inflation*



**Based on data since January 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Euro area: Selected services inflation*



**Based on data since January 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

energy-intensive firms particularly struggling. In addition, retailers bemoaned a disappointing festive period for sales. Meanwhile, expectations for the coming six months improved only in services. Within that sector, the ifo institute reported a marked deterioration in perceptions of the outlook for restaurants and catering. And beyond services, pessimism in construction dropped to a fourteen-month low with roughly half of all firms in that sector anticipating a worsening of conditions over the first half of 2024.

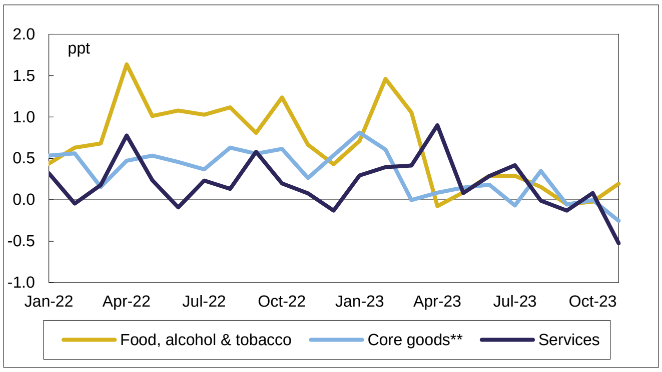
Unwelcome further fiscal tightening likely to weigh on German economic activity in 2024

We suspect that concerns with respect to fiscal policy, following the Constitutional Court's ruling on the use of the government's climate and transformation funds, played a role in the deterioration of the PMIs and ifo indices in December. Perhaps reassuringly, uncertainty has lifted following last week's agreement between the parties making up the ruling coalition. However, an additional net tightening of the fiscal stance in 2024 will be the result, including via reduced subsidies for solar energy and consumers who buy an electric car, as well as higher prices for electricity and carbon. And that more restrictive fiscal policy risks weighing further on economic activity in 2024, restraining any eventual recovery that might otherwise have emerged.

The day ahead in the euro area

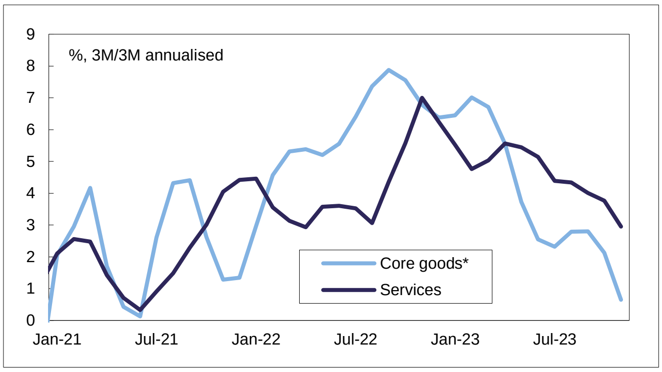
Wednesday will bring an update on consumer confidence, with the flash Commission euro area indicator for December due along with the equivalent GfK German survey results. Most notably, benefiting from the ongoing decline in inflation, the euro area index is expected to rise for a second successive month to a four-month high of -16.3. That would still be more than 1pt down from July's seventeen-month high, albeit more than 12pts above the series low reached in September 2022. German producer price inflation data for November are expected to report an eleventh monthly drop in factory-gate prices in the past thirteen. Euro area construction output and balance of payments figures for October are also due along with the region's new car registration data for November.

Euro area: Deviations from long-run price change*



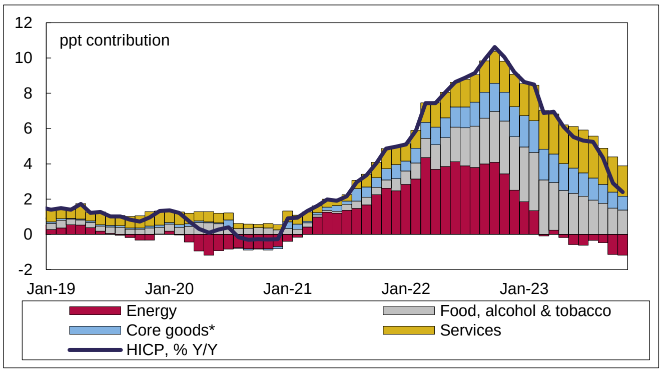
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Services & core goods* momentum



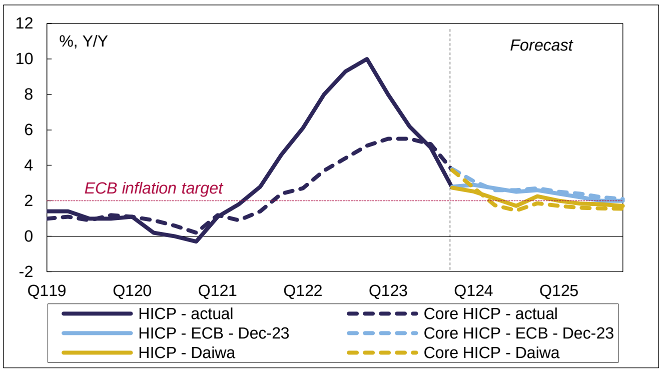
*Non-energy industrial goods. Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to inflation



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

Euro area: Headline & core inflation forecasts



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

UK

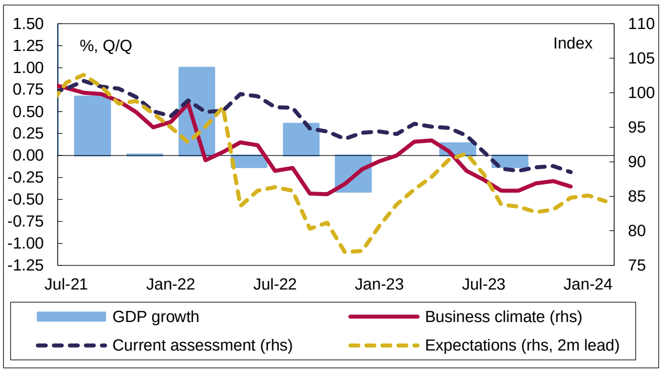
CBI survey signals some stabilisation at year-end, but points to lacklustre output growth outlook

Contrasting with the steeper pace of contraction reported in last week's flash December manufacturing PMIs, today's CBI industrial trends survey suggested that conditions in the sector stabilised somewhat heading into year-end. Indeed, having reported a decline in each of the previous four months, on balance, firms suggested that output in the three months to December was unchanged compared with a year earlier. And roughly one-third of firms signalled an increase in output, the highest share in thirteen months. But this improvement appears to have been relatively narrowly based, with just six out of the seventeen sub-sectors reporting a rise in output. Although firms expected a return to modest growth over the coming three months, the respective balance (+5%) was only marginally higher than in the previous twelve months. Persisting weakness was reported by producers of investment (-14%) and intermediate goods (-13%), largely offsetting greater optimism in the consumer goods sector (+43%), which was the highest for 2½ years. Other detail from today's survey also pointed to lacklustre output over the near term. For example, despite an improvement from November, firms – whether it be in the investment, intermediate or consumer goods subsectors – still considered order books to be slimmer than normal for the time of the year, while also considering current stocks of finished goods to be more than adequate. Given diminished pricing power, manufacturers' selling-price expectations edged slightly lower in December, with the respective balance (+7%) at its joint-lowest level since February 2021, down 73ppts from the peak in March 2022 and bang in line with the long-run average. As such, we continue to expect core goods CPI inflation to maintain a downwards trend over coming quarters.

The day ahead in the UK

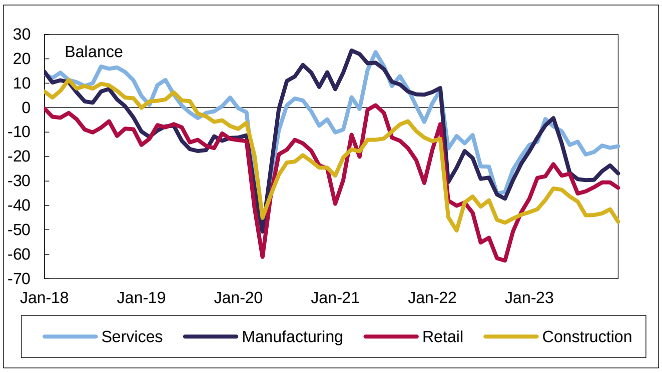
The UK focus on Wednesday will be inflation data for November. Having taken a significant step down in October due to the cut in the regulated household energy price cap, we expect the headline CPI inflation rate to have moderated slightly further last month, by 0.2ppt to 4.4%Y/Y, the lowest since October 2021 and 6.7ppts below last year's peak. The easing will again in part reflect a larger drag from energy thanks to a drop in petrol prices. But while we expect services inflation to have moved sideways, a further decline in non-energy industrial goods inflation will likely see core inflation ease for a fourth consecutive month, by 0.1ppt to a 21-month low of 5.6%Y/Y.

Germany: ifo business climate indices & GDP



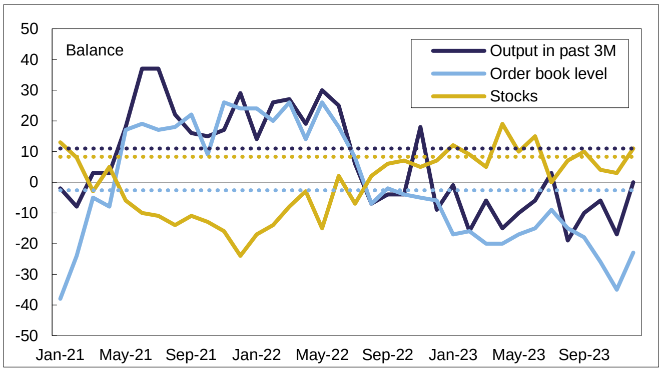
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ifo business expectations indices



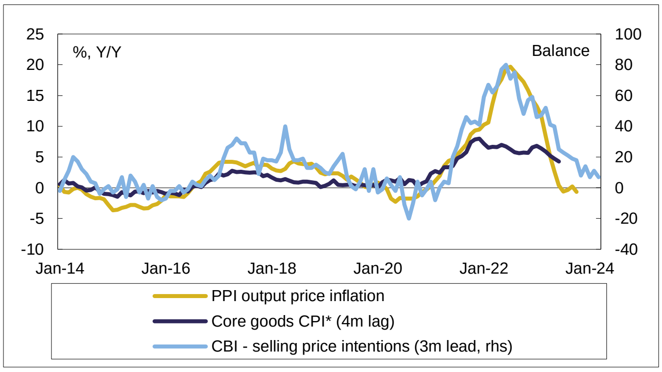
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends survey indices*



**Dotted lines are the average in the five years before the pandemic. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Goods price indices



**Non-energy industrial goods. Source: Macrobond 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	Final headline (core) HICP Y/Y%	Nov	**2.4 (3.6)**	*2.4 (3.6)*	2.9 (4.2)	-
UK	CBI industrial trends, total orders (selling prices) balance	Dec	**-23 (7)**	-30 (-)	-35 (11)	-

Auctions

Country	Auction
UK	sold £3bn of 4.625% 2034 bonds at an average yield of 3.739%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Ifo business climate indicator	Dec	**86.4**	87.8	87.3	87.2
	Ifo current assessment (expectations) balance	Dec	**88.5 (84.3)**	89.5 (86.0)	89.4 (85.2)	- (85.1)

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	07.00	EU27 new car registrations Y/Y%	Nov	-	14.6
	15.00	Preliminary consumer confidence index	Dec	-16.3	-16.9
	10.00	Construction output M/M% (Y/Y%)	Oct	-	0.4 (-0.3)
Germany	07.00	PPI Y/Y%	Nov	-7.5	-11.0
	07.00	GfK consumer confidence index	Jan	-27.0	-27.8
UK	07.00	Headline CPI (core CPI) Y/Y%	Nov	*4.4 (5.6)*	4.6 (5.7)
	07.00	PPI output (input) Y/Y%	Nov	-0.5 (-3.0)	-0.6 (-2.6)
	09.30	House price index Y/Y%	Oct	-	-0.1

Auctions and events

Country	GMT	Event
Euro area	14.00	ECB Chief Economist Lane scheduled to give a speech – 'The euro area outlook'

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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