

Euro wrap-up

Overview

- While euro area core inflation fell further and German retail sales dropped sharply, Bunds made losses as euro area headline inflation in December reversed the prior month's drop.
- Gilts also made losses despite a weak UK construction sector survey.
- The coming week brings updates on UK GDP, euro area retail sales and unemployment, and German industrial production in November, as well as the results of the Commission sentiment survey for December.

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Daily bond market movements

| Bond | Yield | Change |
|---------------|-------|--------|
| BKO 3.1 12/25 | 2.551 | +0.039 |
| OBL 2.4 10/28 | 2.083 | +0.028 |
| DBR 2.6 08/33 | 2.138 | +0.017 |
| UKT 3½ 10/25 | 4.190 | +0.028 |
| UKT 4½ 06/28 | 3.729 | +0.052 |
| UKT 3¼ 01/33 | 3.764 | +0.043 |

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

Source: Bloomberg

Euro area

Consumer price inflation reverses big November drop but core rate maintains downtrend

Broadly in line with expectations, the flash estimate of euro area consumer price inflation in December fully reversed the drop in November to rise 0.5ppt back to 2.9%Y/Y. The increase was driven by energy inflation, which jumped almost 5ppts to -6.7%Y/Y, largely reflecting the base effect associated with one-off German government payments to reduce household utility bills which explained the record monthly drop in such prices a year earlier. The other major components were well-behaved. With prices of food, alcohol and tobacco declining on the month for the first time in more than two years, the respective inflation component dropped 0.8ppt to a 21-month low of 6.1%Y/Y. With prices of non-energy industrial goods unchanged on the month, the respective annual inflation rate slowed 0.4ppt to 2.5%Y/Y, the lowest since January 2022. And with services prices rising by less than the long-run average for the time of year for the third out of the past four months, following a steeper than expected decline in November, the respective inflation component was steady at 4.0%Y/Y, matching the lowest since August 2022. So, core inflation (excluding energy, food, alcohol and tobacco) maintained its downtrend, dropping for the fifth successive month and by 0.2ppt to a 21-month low of 3.4%Y/Y.

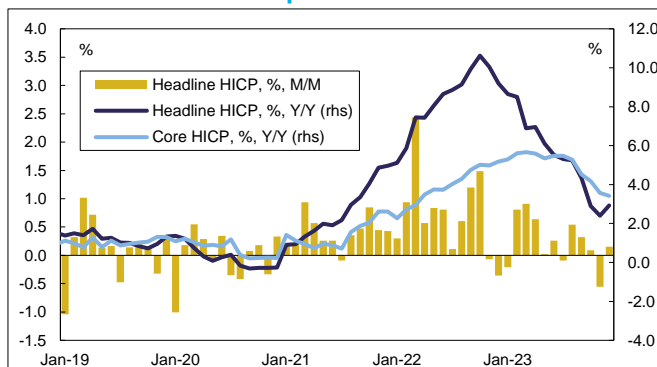
Inflation momentum continues to slow ahead of ECB expectations

Despite the pickup in December, the average headline inflation rate in Q4 of 2.7%Y/Y was 0.1ppt below the ECB's projection published just last month. More importantly perhaps, core inflation in Q4 also came in 0.1ppt below the ECB's projection at 3.7%Y/Y. Moreover, inflation momentum, which ECB policymakers have flagged as important in guiding policy, continues to slow. In seasonally-adjusted terms, core goods prices were unchanged on a three-month annualised basis in Q4, the softest such rate in three years. And the equivalent rate of increase in services prices slowed to just 2.3%3M/3M annualised, the lowest since Q321. As a result, core inflation momentum slowed more than 2ppts over the quarter to just 1.4%3M/3M annualised, the softest since Q221, and a rate that if sustained would clearly be consistent with undershooting the ECB's inflation target over the medium term.

Uncertain near-term outlook but inflation on track to return to target or below in Q2

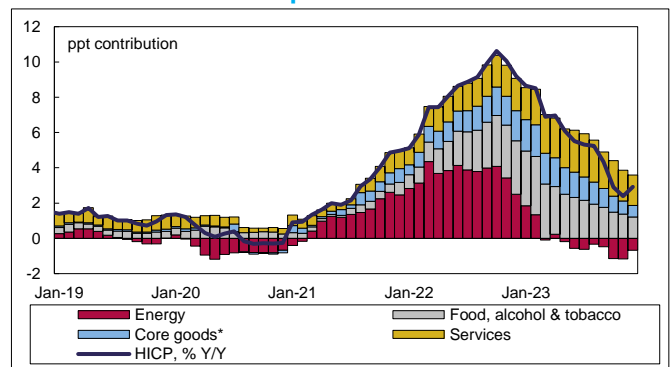
The near-term inflation outlook remains highly uncertain, and indeed perhaps more so than usual. In part, that uncertainty relates to the reweighting of the inflation basket in the New Year as well as the continued withdrawal of government support for household utility bills, which will cause a further rise in energy inflation over coming months. Some ECB policymakers will also be wary of possible disruption to supply due to events in the Red Sea, which risk a further new impulse to prices too. However, wholesale energy forward prices are currently undershooting significantly the assumptions used in the ECB's

Euro area: Consumer price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation & contributions



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

December projections. And with weakness in intermediate and consumer items, non-energy producer output goods prices fell for the eighth successive month in November to be down 0.5%Y/Y, the most since the first wave of Covid-19 in June 2020, to suggest that core HICP goods inflation will remain subdued over coming months. Of course, services inflation will remain most important for the ECB. But with wage settlement growth seemingly having peaked, other cost pressures in the sector having eased, and soft demand restraining pricing power, this component should continue to subside over coming months. We think that services inflation will fall to 2.0%Y/Y or less in the course of Q2. Indeed, by March, headline inflation could well have fallen to 2.0%Y/Y with core inflation down to 2.5%Y/Y or less. In the absence of new shocks, both rates might be below 2.0%Y/Y in Q2 and Q3. So, the ECB is highly likely to have to revise down its inflation projection in March. And the extent of that downwards revision should mean that a rate cut is up for discussion that month too.

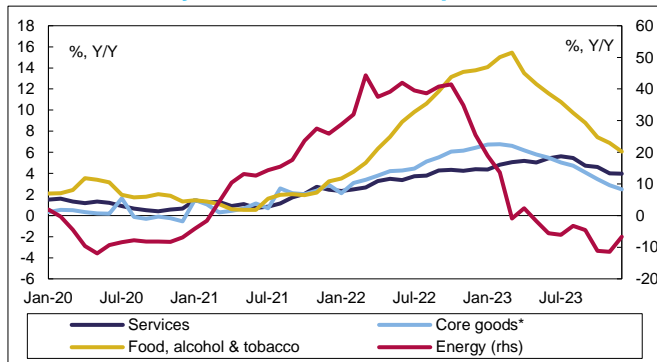
German retail sales slump in November to extend steady downtrend

Despite the recent easing in consumer goods inflation and special promotional events such as Black Friday and Cyber Monday deals, German retail sales surprised significantly to the downside in November, suggesting that household consumption of goods provided a meaningful drag on GDP growth in Q4. Indeed, the 2.5%M/M decline in sales volumes was the steepest since April 2022 when consumer confidence slumped after Russia's invasion of Ukraine. And while monthly German retail data are notoriously volatile, and the extent of weakness in November likely in part reflected payback for a firm outturn in October – with sales growth that month upwardly revised by 0.2ppt to 1.3%M/M – the steady downtrend in volumes clearly continues. Indeed, sales fell to the lowest level since February 2021 to be down 0.8%3M/3M, just 0.1ppt above the equivalent rate of the prior two months. Within the detail, sales of auto fuel (+4.0%M/M) benefitted from lower petrol prices that month, while clothing sales rose for a second successive month to be trending notably higher than in Q3. But food sales fell for a second successive month to maintain the broadly sideways trend of the past year. And sales of furniture, furnishings and recreational goods fell to the lowest levels since early 2021. Although the GfK survey suggested that consumer confidence ticked higher around the turn of the year and households' willingness to buy increased to the highest level since March 2022, it also merely pointed to a stabilisation rather than resurgence in spending over coming months.

Construction PMIs consistent with recession at year-end

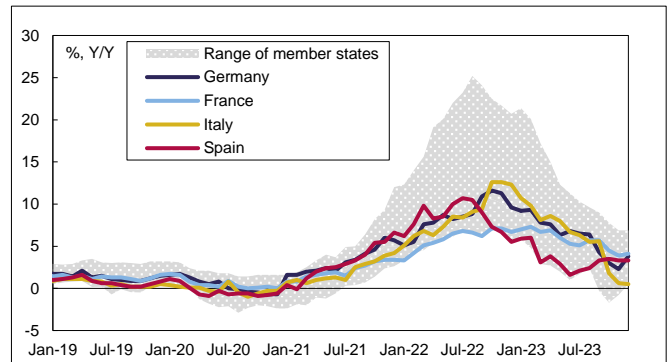
The December construction PMIs were also predictably weak, flagging the ongoing retrenchment in the sector in response to higher interest rates and their inevitable negative impact on real estate demand and prices. While the German headline construction activity PMI edged up slightly from November, at 37.0 it was still the second-lowest reading since the first Covid lockdown in April 2020 and the euro crisis in 2012 before that. The downturn in German house-building remained particularly acute, with the respective index (28.7) well below levels recorded during the first wave of the pandemic. Moreover, the

Euro area: Key HICP inflation components



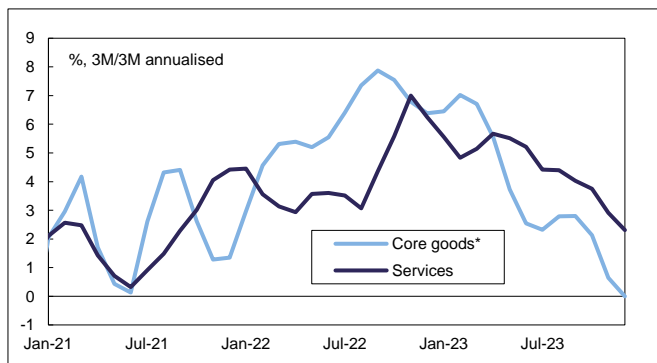
*Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation



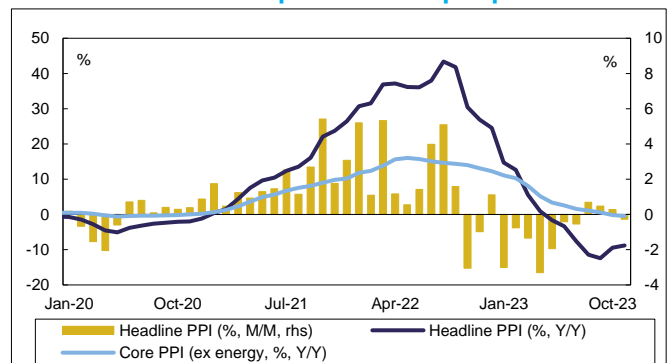
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum



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

Euro area: Industrial producer output price inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

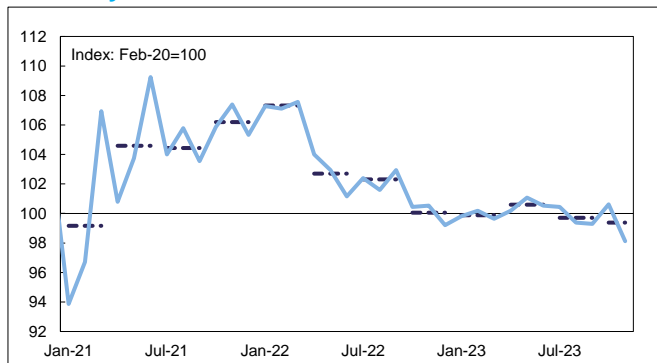
reported rate of contraction in commercial building (40.3) and civil engineering activity (39.5) deteriorated further. And with new orders declining sharply and building permits down almost 38% from last year's peak despite a second successive monthly rise in October, the outlook for German construction remains exceptionally weak. Indeed, the German PMI for business expectations for the coming twelve months was stuck at a historically low level (26.7). Elsewhere, the malaise in the French construction sector appeared to increase at the end of last year, with the respective activity PMI down 2pts to 42.6, with only civil engineering holding up. In contrast, the survey reported ongoing growth in the construction sector in Italy, where the construction PMI rose for a fourth successive month to a buoyant 55.2, the highest level since May 2022.

Overall, the euro area headline activity index ticked up just 0.2pt from November to 43.6, in line with the downbeat average over the prior six months and still close to the bottom of the range since the first wave of Covid-19. All major subsectors at the euro area level reported contraction, with house-building still leading the downturn but commercial activity deteriorating back to the bottom of the range of the past year. While the index for new orders edged up for a third successive month, it remained very low by historical standards. With input costs reportedly rising at an eight-month high, business expectations for the coming twelve months were the most pessimistic since November 2022. And firms in the sector reportedly cut headcount for the tenth month in a row. Overall, the construction PMIs remained consistent with recession.

The week ahead in the euro area

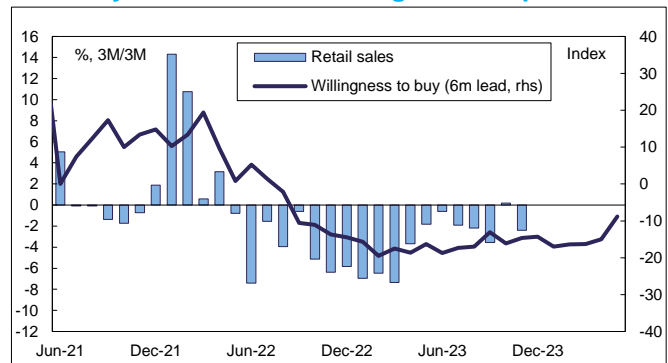
The coming week's data calendar kicks off Monday with arguably the most noteworthy release of the week from the euro area, with the European Commission's survey for December set to provide an update on economic momentum into year-end. But like the [PMIs](#), these are likely to report little improvement in business conditions amid subdued demand. So, despite the improvement in the flash consumer confidence index, the headline economic sentiment index will remain below the long-run average and at a level consistent with a modest contraction in GDP in Q4. Euro area retail sales data for November – also due Monday – look set to report a marked decline in November, led by the aforementioned drop in Germany as well as ongoing weakness in France (-0.8%M/M). Among other data releases, euro area jobless figures (Tuesday) are expected to see the unemployment rate tick slightly higher from October's joint-record low (6.5%). The coming week also brings the publication of German factory orders and trade data for November (Monday), followed by German and Irish industrial production figures (Tuesday), and equivalent numbers from France (Wednesday), Italy and Spain (Thursday).

Germany: Retail sales volumes*



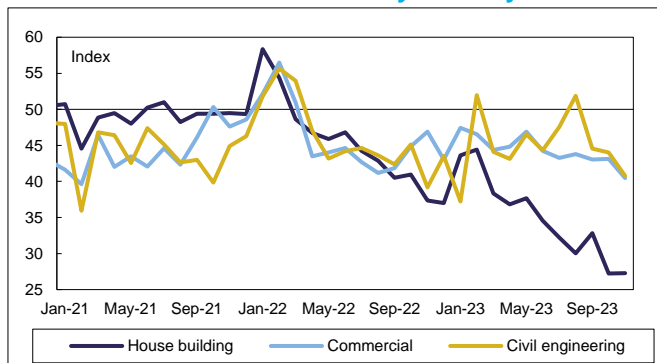
*Dashed dark blue lines are quarterly averages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Retail sales & willingness to spend



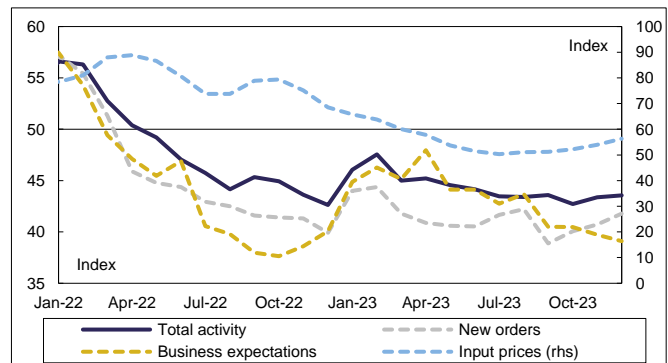
Source: Macrobond, GfK and Daiwa Capital Markets Europe Ltd.

Euro area: Construction activity PMIs by subsector



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

Euro area: Selected construction PMIs



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

UK

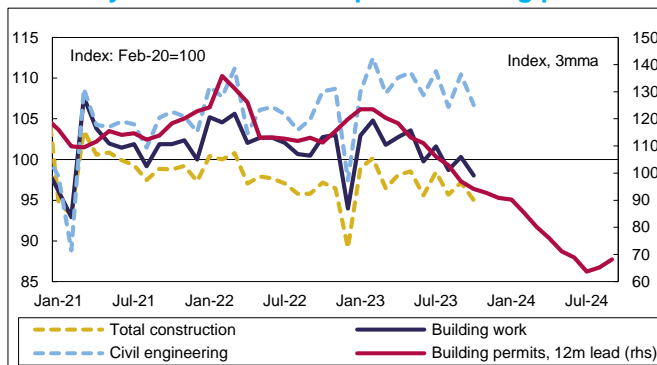
Construction PMIs consistent with contraction despite rising in December

While the UK's December PMIs suggested that growth momentum picked up in services at the end of last year, like the manufacturing indices, today's construction survey results signalled substantive contraction in the sector. Admittedly, the headline activity index rose for the second month out of the past five in December, by 1.3pt, but it remained low at 46.8. The improvement principally reflected a smaller decline in civil engineering (47.0). But while the survey suggested that commercial activity was the strongest performing of the subsectors, the relevant index (47.6) nevertheless fell to its lowest level since January 2021. And while the implied pace of contraction in housing was the least pronounced since July, at 41.1, the index was markedly weaker than the other subsectors, with activity weighed by high borrowing costs and dim perceptions of the residential market outlook. Despite rising to a five-month high, the new orders component (47.9) offered little encouragement about the near-term construction outlook, with respondents citing in particular persisting subdued demand for house building. As such, firms reduced purchasing activity for a fourth successive month. More happily, however, the survey suggested that input costs fell for a third consecutive month reflecting falling prices of raw materials and increased competition amid spare capacity among suppliers. And rates charged by subcontractors remained broadly stable.

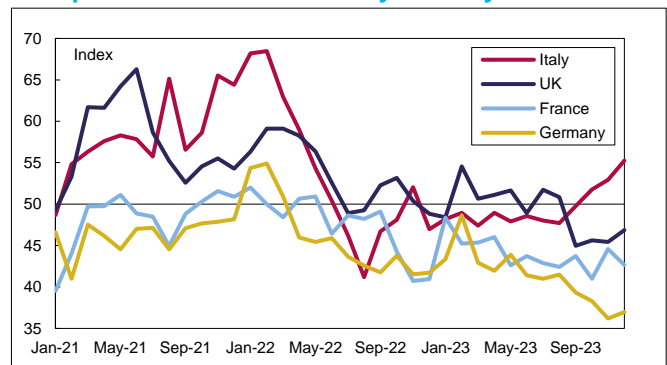
The day ahead in the UK

Looking ahead, a key focus in the UK in the coming week will be Friday's release of the November GDP report, including the monthly services, industrial, construction and trade figures. Retail sales came in much stronger than expected in November (1.3%M/M), while the ONS's business insights survey suggested that the share of firms affected by strikes was the lowest since June 2022. Taken together with a rebound in the composite PMI that month to a four-month high (50.7), we expect GDP growth in November to be a touch firmer than the Bloomberg survey consensus of 0.2%M/M to fully reverse the 0.3%M/M contraction recorded in October. Ahead of the GDP report, the REC report on jobs for December will be published on Monday, with the results to be more closely watched given the temporary suspension of the official labour force survey. Meanwhile, the BRC retail sales monitor for December is also due Tuesday.

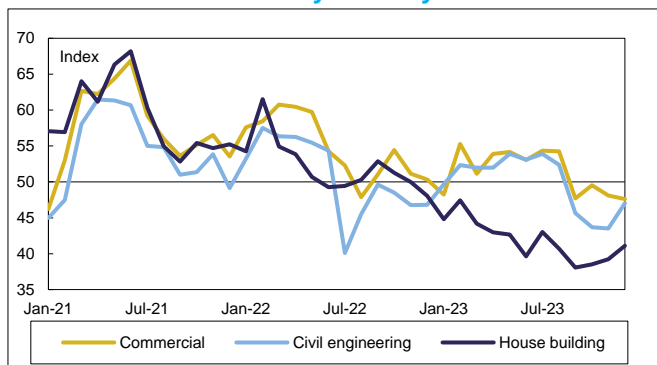
Germany: Construction output & building permits



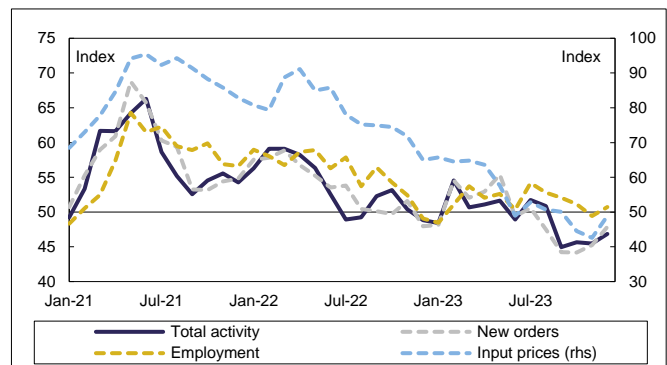
Europe: Construction PMIs by country












UK: Construction activity PMIs by subsector



UK: Selected construction PMIs








Daiwa economic forecasts

| | 2023 | | 2024 | | | | 2023 | 2024 | 2025 |
|---|------|------|------|------|------|------|------|------|------|
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| GDP | | | | | | | | | |
| %, Y/Y | | | | | | | | | |
| Euro area  | -0.1 | -0.1 | 0.1 | 0.2 | 0.3 | 0.3 | 0.5 | 0.3 | 1.4 |
| UK  | -0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 | 0.3 | 0.3 | 0.7 |
| Inflation, %, Y/Y | | | | | | | | | |
| Euro area | | | | | | | | | |
| Headline HICP  | 5.0 | 2.7 | 2.2 | 1.8 | 1.4 | 2.0 | 5.4 | 1.9 | 1.8 |
| Core HICP  | 5.1 | 3.7 | 2.7 | 1.7 | 1.4 | 1.8 | 4.9 | 1.9 | 1.6 |
| UK | | | | | | | | | |
| Headline CPI  | 6.7 | 4.2 | 3.7 | 1.9 | 2.1 | 2.5 | 7.3 | 2.5 | 2.1 |
| Core CPI  | 6.4 | 5.3 | 4.5 | 2.8 | 2.4 | 2.6 | 6.2 | 3.0 | 2.1 |
| Monetary policy, % | | | | | | | | | |
| ECB | | | | | | | | | |
| Refi Rate  | 4.50 | 4.50 | 4.25 | 4.00 | 3.75 | 3.50 | 4.50 | 3.50 | 2.75 |
| Deposit Rate  | 4.00 | 4.00 | 3.75 | 3.50 | 3.25 | 3.00 | 4.00 | 3.00 | 2.25 |
| BoE | | | | | | | | | |
| Bank Rate  | 5.25 | 5.25 | 5.25 | 5.00 | 4.50 | 4.00 | 5.25 | 4.00 | 2.50 |

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  | Construction PMI | Dec | 43.6 | - | 43.4 | - | |
| | Preliminary headline HICP (core HICP) Y/Y% | Dec | 2.9 (3.4) | <u>2.8 (3.4)</u> | 2.4 (3.6) | - | |
| | PPI Y/Y% | Nov | --8.8) | -8.6 | -9.4 | - | |
| Germany  | Retail sales M/M% (Y/Y%) | Nov | -2.5 (-2.0) | -0.5 (-0.5) | 1.2 (0.1) | 1.3 (0.2) | |
| | Construction PMI | Dec | 37.0 | - | 36.2 | - | |
| France  | Construction PMI | Dec | 42.6 | - | 44.6 | - | |
| Italy  | Preliminary HICP (CPI) Y/Y% | Dec | 0.5 (0.6) | 0.5 (0.7) | 0.6 (0.7) | - | |
| | Construction PMI | Dec | 55.2 | - | 52.9 | - | |
| UK  | New car registrations Y/Y% | Dec | 9.8 | - | 9.5 | - | |
| | Construction PMI | Dec | 46.8 | - | 45.5 | - | |
| Auctions | | | | | | | |
| Country | Auction | - Nothing to report - | | | | | |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming weeks' data calendar

The coming few week's key data releases

| Country | GMT | Release | Period | Market consensus/ <i>Daiwa</i> <i>forecast/actual</i> | Previous |
|----------------------------------|-------|--|--------|---|--------------|
| Monday 08 January 2024 | | | | | |
| Euro area | 09.30 | Sentix investor confidence | Jan | -15.8 | -16.8 |
| | 10.00 | Retail sales M/M% (Y/Y%) | Nov | <u>-1.3 (-2.0)</u> | 0.1 (-1.2) |
| | 10.00 | European Commission's Economic Sentiment Indicator | Dec | 94.1 | 93.8 |
| | 10.00 | European Commission's final consumer confidence index | Dec | -15.1 | -16.9 |
| | 10.00 | European Commission's industrial (services) confidence index | Dec | -9.5 (5.2) | -9.5 (4.9) |
| Germany | 07.00 | Factory orders M/M% (Y/Y%) | Nov | 1.0 (-3.4) | -3.7 (-7.3) |
| | 07.00 | Trade balance €bn | Nov | 18.0 | 17.7 |
| Tuesday 09 January 2024 | | | | | |
| Euro area | 10.00 | Unemployment rate % | Nov | 6.6 | 6.5 |
| Germany | 07.00 | Industrial production M/M% (Y/Y%) | Nov | 0.3 (-3.9) | -0.4 (-3.5) |
| France | 07.45 | Trade balance €bn | Nov | - | -8.6 |
| UK | 00.01 | BRC retail sales monitor, like-for-like sales Y/Y% | Dec | - | 2.6 |
| Wednesday 10 January 2024 | | | | | |
| France | 07.45 | Industrial production M/M% (Y/Y%) | Nov | 0.1 (0.7) | -0.3 (1.8) |
| Italy | 09.00 | Retail sales M/M% (Y/Y%) | Nov | - | 0.4 (0.3) |
| Thursday 11 January 2024 | | | | | |
| Italy | 09.00 | Industrial production M/M% (Y/Y%) | Nov | - | -0.2 (-1.1) |
| Spain | 08.00 | Industrial production M/M% (Y/Y%) | Nov | - | -0.5 (-1.5) |
| Friday 12 January 2024 | | | | | |
| France | 07.45 | Final HICP (CPI) Y/Y% | Dec | 4.1 (3.7) | 3.9 (3.5) |
| | 07.45 | Consumer spending M/M% (Y/Y%) | Nov | 0.0 (-1.4) | -0.9 (-1.3) |
| Spain | 08.00 | Final HICP (CPI) Y/Y% | Dec | 3.3 (3.1) | 3.3 (3.2) |
| UK | 07.00 | GDP M/M% (3M/3M%) | Nov | <u>0.3 (0.0)</u> | -0.3 (0.0) |
| | 07.00 | Industrial production M/M% (Y/Y%) | Nov | 0.3 (0.8) | -0.8 (0.4) |
| | 07.00 | Index of services M/M% (Y/Y%) | Nov | 0.2 (0.4) | -0.2 (0.1) |
| | 07.00 | Construction output M/M% (Y/Y%) | Nov | 0.4 (1.5) | -0.5 (1.1) |
| | 07.00 | Trade balance (goods trade balance) £bn | Nov | - (-15.7) | -4.7 (-17.0) |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

| Country | GMT | Event / Auction |
|----------------------------------|-------|--|
| Monday 08 January 2024 | | |
| UK | 00.01 | REC report on jobs |
| Tuesday 09 January 2024 | | |
| Euro area | 17.30 | ECB's Villeroy scheduled to speak |
| UK | 10.00 | Auction: £2.25bn of 4.75% 2043 bonds |
| Wednesday 10 January 2024 | | |
| Euro area | 08.00 | ECB's de Guindos scheduled to speak |
| Germany | 10.30 | Auction: €5bn of 2034 bonds |
| UK | 10.00 | Auction: £4bn of 3.75% 2027 bonds |
| Thursday 11 January 2024 | | |
| Euro area | 09.00 | ECB publishes Economic Bulletin |
| Italy | 10.00 | Auction: 3Y and 7Y bonds |
| Friday 12 January 2024 | | |
| Euro area | 12.30 | ECB Chief Economist Lane scheduled to speak at conference on post-pandemic governance and Next Generation EU |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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