

Euro wrap-up

Overview

- Despite an unexpected drop in euro area consumer confidence, Bunds made losses as the ECB's Q4 Bank Lending Survey suggested that credit standards tightened only moderately further and loan demand declined at a softer pace than in Q3.
- Gilts also made losses as the latest UK public finances data underscored the likelihood that substantive tax cuts will be announced in March.
- Wednesday will bring the flash PMIs for January.

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Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.702	+0.023
OBL 2.1 04/29	2.259	+0.039
DBR 2.2 02/34	2.347	+0.059
UKT 3½ 10/25	4.354	+0.075
UKT 4½ 06/28	3.926	+0.089
UKT 3¼ 01/33	3.987	+0.087

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

Euro area

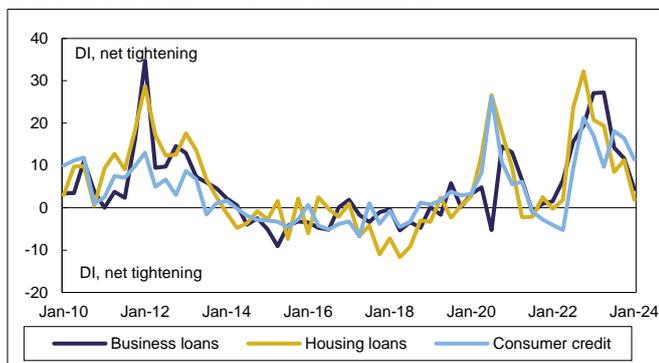
ECB bank lending survey suggests lending conditions less alarming than previously feared

Ahead of the start of the Governing Council's policy meeting, the results of the ECB's Bank Lending Survey (BLS) for Q4 illustrated the ongoing transmission of the ECB's aggressive tightening cycle that began in summer 2022. But while the account of the December policy meeting had noted the assessment that the transmission of rate hikes had arguably been more powerful than originally anticipated, the results were perhaps not as alarming as feared. So, in line with President Lagarde's commentary last week, the majority of policymakers will still not feel the need to rush into the first rate cut, with a summer rate cut instead still most likely. Nevertheless, despite having concluded its rate hiking cycle in September, the BLS reported a further moderate tightening of credit standards on loans to both firms and households last quarter, adding to the marked tightening over the course of the preceding year and a half. Among other things, increased risk aversion of banks in their lending was reflected in a further net rise in rejected loan applications, with the share for SMEs the highest at 15%. And banks signalled the likelihood of a further (and more significant) squeeze on loan supply in Q1 too.

Drop in demand for corporate and household loans moderates in Q4

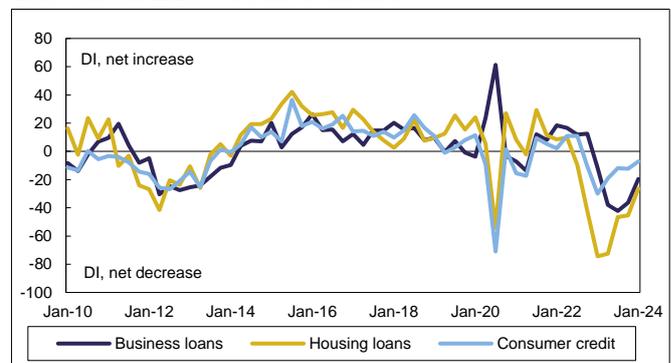
Perhaps more reassuringly for policymakers was the marked moderation in the pace of decline in loan demand in Q4 and expected improvement (albeit modest) in Q1. Admittedly, the net percentage of banks reporting a decline in corporate loan demand (-20%) was still well below the long-run average (-1%), and the weakest since the euro crisis in 2012 aside from the previous three quarters. Moreover, banks suggested that the improvement in part reflected increased need for funds amid a drop in firms' equity issuance last quarter. At the same time, higher interest rates and reduced fixed investment plans remained key drivers of lower loan demand, with the latter tallying with the recent lull in longer-term borrowing. Banks also reported a softer-than-expected drop in demand for consumer credit in Q4, reportedly reflecting smaller drags from consumer confidence, high interest rates and lower spending on durable goods. There was also an easing in the pace of decline in demand for housing loans, which banks expected to return to positive growth in Q1 for the first quarter in two years. But this recovery was principally underpinned by higher demand in Italy amid continued growth in construction. Overall, however, lenders suggested that loan demand remained hindered by high borrowing costs, the housing market slump and low consumer confidence. And today's survey reinforced the likelihood of continued subdued loan growth ahead, consistent with a still-lacklustre near-term growth outlook.

Euro area: BLS – credit standards



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

Euro area: BLS – loan demand



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

Euro area consumer confidence unexpectedly drops at the start of the year

The fragile economic backdrop was also illustrated by the Commission's flash consumer confidence indicator. Contrasting with expectations, this suggested a slight worsening in sentiment at the start of the year, with the headline index down 1pt to -16.1 in January. Admittedly, having reached a 22-month high in December, this still left the index some ½pt above the Q4 average, which itself was the highest since Russia's invasion of Ukraine in Q122. While we will have to await the final survey results (30 January) for the detailed breakdown, the equivalent survey from Belgium implied perceptions of a worsening in the general economic outlook at the start of the year – with the respective index down to a five-month low – while consumers in the Netherlands reported little improvement in their willingness to spend on durable goods. So, with euro area retail sales currently on track for a second successive quarterly decline in Q4, today's survey suggests that consumer spending will provide limited impetus to economic momentum in Q1 too, despite the pickup in real disposable incomes.

The day ahead in the euro area

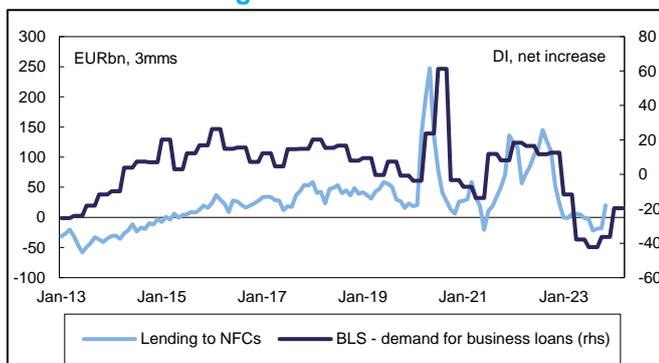
The euro area data focus tomorrow will be the publication of the January flash PMIs. After the composite PMI moved sideways at 47.6 in December, we expect to see a modest improvement in January to a six-month high, albeit remaining in contractionary territory. The services PMI, which edged up marginally in December to a four-month high of 48.8, will likely point to only modest contraction. The manufacturing output PMI is likely to remain much weaker at less than 45 for an eight successive month. And the composite PMIs will be consistent with negative growth in both Germany and France.

UK

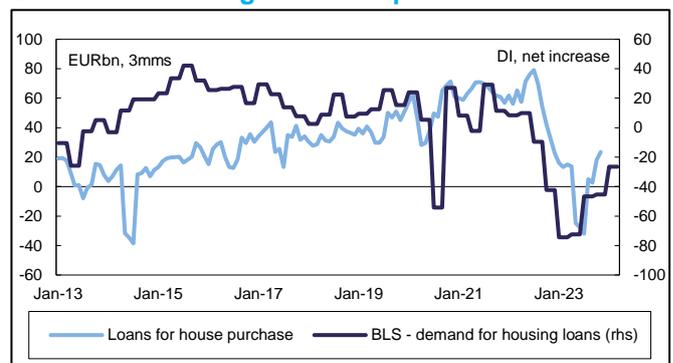
Lower public borrowing provides extra political cover for new tax cuts in March

Given the Conservative party's dire poll ratings, the prospect of personal tax cuts in the spring Budget has long seemed an inevitability. Fortuitously for the Government, today's public finances data appeared to give a little extra cover for such a politically motivated giveaway. In particular, public sector net borrowing excluding public sector banks (PSNB ex) in December was £7.8bn, a little less than half the amount borrowed a year earlier, about one third the record for borrowing for the month which was reached during the first year of pandemic in 2020, and the lowest borrowing for the month since 2019. Despite the lower figure for December, cumulative public borrowing in the first nine months of financial year FY23/4 of £119.1 billion was still £11.1bn more than in the same period of FY22/3. However, it was £5.0bn less than the OBR had forecast at the time of the autumn statement – when the Government cut personal and business taxation by almost £20bn by FY27/8 – arguably suggesting additional headroom for tax cuts in March. The improvement came from lower central government

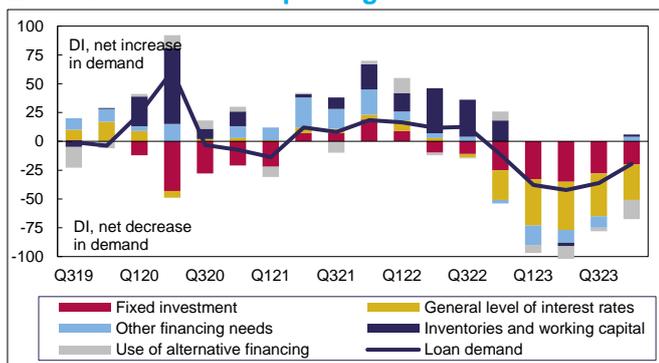
Euro area: Lending to NFCs



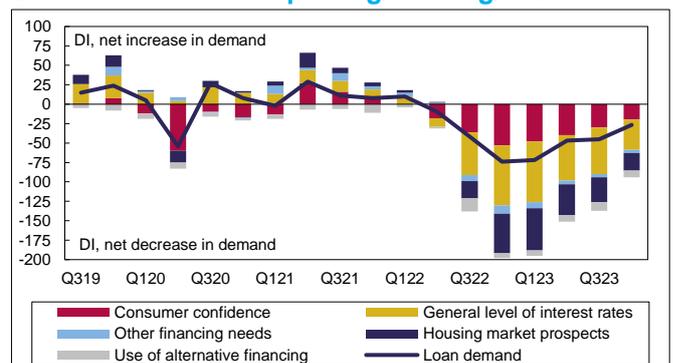
Euro area: Lending for house purchase



Euro area: Factors impacting NFC loan demand



Euro area: Factors impacting housing loan demand

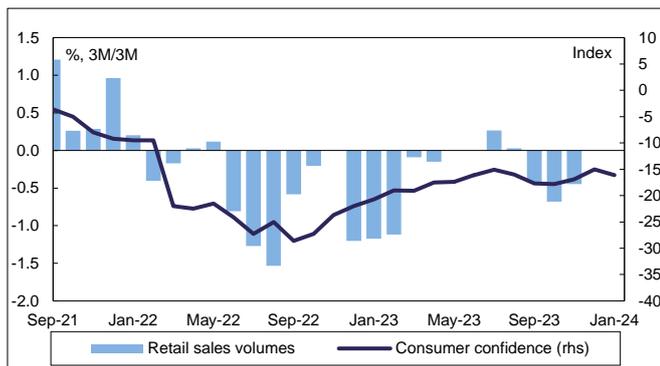


expenditure. And that reflected lower central government debt interest, which at £4.0bn was a marked £14.1bn less than a year earlier, principally thanks to the impact of the decline in RPI inflation on payments related to index-linked gilts. Indeed, RPI inflation averaged 5.5%Y/Y in Q4, 1.2ppts below the OBR's forecast. In contrast, central government receipts undershot the OBR's forecast.

But next Government's fiscal inheritance will be dire

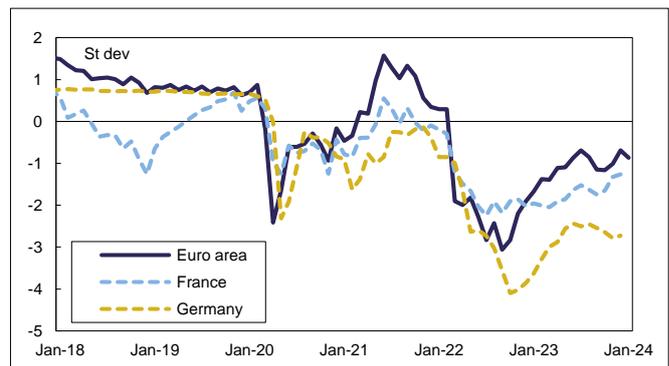
The OBR's projections suggested in November that the Government still had some £13.0bn of headroom available for tax cuts without jeopardising meeting its objective that the ratio of government debt to GDP should be falling in five years' time. But over the near term, inflation is set to continue to fall further than the OBR anticipated in November, suggesting an additional drop in net borrowing relative to forecast. And thanks to the recent market decline in market forward interest rates over the horizon, debt interest payments should undershoot significantly the OBR's projection further ahead too. So, depending on the other assumptions made by the OBR, including with respect to potential GDP growth and wages, the headroom for fiscal loosening in the Budget in March could reach £20bn or more. But while the tax burden as a share of GDP is on track to rise to the highest level since the 1940s, tax cuts of that magnitude would be imprudent. Public sector net debt excluding public sector banks was about 97.7% of GDP in December, up 1.9 ppts from a year earlier and the highest since the early 1960s. Moreover, the Government's plans for real-terms current public expenditure are unrealistic, particularly in light of the evident severe existing strains on public services. Its plans for public investment are also inadequate in light of the current woeful state of the UK's public capital stock. Moreover, the higher the tax cuts to come in March, the greater the chance that the BoE will keep interest rates higher for longer. Notably too, recent opinion polls, such as last week's poll by YouGov for the Times, strongly suggest that such tax cuts will have little impact on the election outcome, with a majority of voters of all major parties preferring to spend more on public services even if it means not cutting taxes. With the Conservatives looking to hamper the Labour Party when it almost certainly takes the reins of the next Government, however, such polling is unlikely to make a difference. Certainly, personal tax cuts worth ½% of GDP or more is our base case for the March Budget.

Euro area: Retail sales & consumer confidence



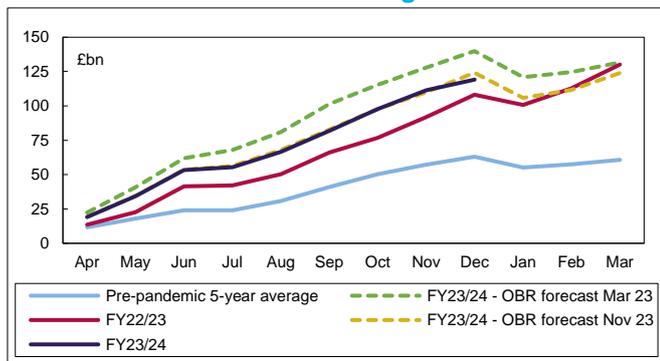
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer confidence



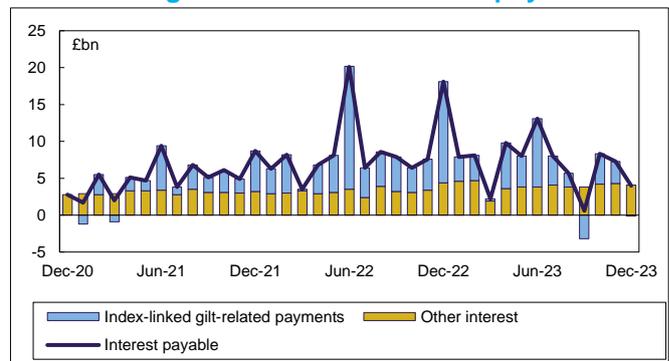
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



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

UK: Central government debt interest payable

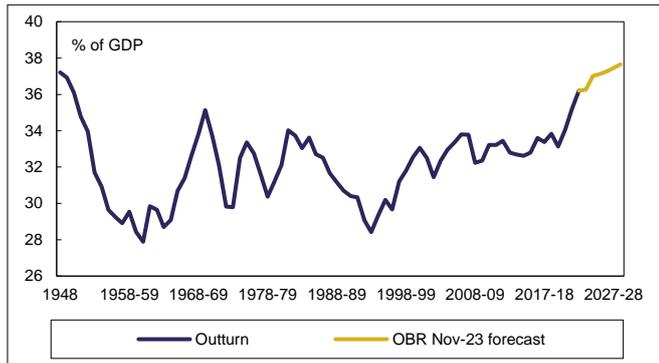


Source: ONS and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

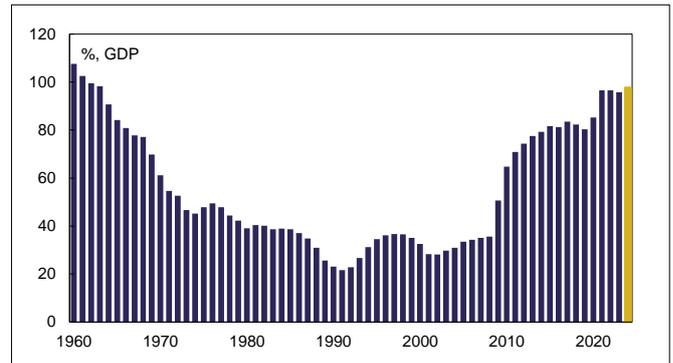
Like in the euro area, the data highlight tomorrow will be the flash January PMIs. Following a very surprising rebound at the end of last year to a seven-month high (52.1), the composite output PMI is expected to be little changed at the start of the New Year consistent with a modest recovery in economic momentum. This will largely reflect a signal of ongoing growth in the services (excluding retail), while the pace of contraction in manufacturing production is expected to ease slightly. The CBI's industrial trends survey (Wednesday) will also provide insight into manufacturing conditions, and will likely underscore that new orders in the sector remain very subdued.

UK: Tax revenues



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt*



*Gold bar is latest figure as of December 2023. Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 European Commission's preliminary consumer confidence index	Jan	-16.1	-14.3	-15.0	-15.1
UK	 Public sector net borrowing (excl. banks) £bn	Dec	6.8 (7.8)	11.4 (13.4)	13.4 (14.3)	12.8 (13.7)

Auctions

Country	Auction
Germany	 sold €954mn of 1.3% 2027 green bonds at an average yield of 2.21%
	 sold €954mn of 1.8% 2053 green bonds at an average yield of 2.47%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
France	 Bank of France retail sales Y/Y%	Dec	-2.4	-	-3.8	-3.7

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/ <i>Daiwa forecast</i>	Previous
Euro area		09.00 Preliminary manufacturing (services) PMI	Jan	44.8 (49.0)	44.4 (48.8)
		09.00 Preliminary composite PMI	Jan	48.0	47.6
Germany		08.30 Preliminary manufacturing (services) PMI	Jan	43.5 (49.3)	43.3 (49.3)
		08.30 Preliminary composite PMI	Jan	47.8	47.4
France		08.15 Preliminary manufacturing (services) PMI	Jan	42.4 (46.0)	42.1 (45.7)
		08.15 Composite PMI	Jan	45.2	44.8
UK		09.30 Preliminary manufacturing (services) PMI	Jan	46.8 (53.5)	46.2 (53.4)
		09.30 Preliminary composite PMI	Jan	52.5	52.1
		11.00 CBI industrial trends, total orders (selling prices)	Jan	-	-23 (7)

Auctions and events

Germany		10.30 Auction: €1.5bn of 1.0% 2038 bonds
		10.30 Auction: €1.0bn of 2.5% 2046 bonds
UK		10.00 Auction: £4bn of 4.5% 2028 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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