Euro wrap-up

Overview

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- While the euro area flash PMIs reported a slight easing of the economic downturn and a pickup in service sector cost pressures, Bunds made modest gains as the German and French surveys suggested a deterioration in momentum.
- Gilts made relatively modest losses as the UK flash PMIs pointed to a pickup in growth momentum at the start of the year.
- Thursday's focus will be the conclusion of the ECB's latest monetary policy meeting while the German ifo and French INSEE business survey results are also due.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.702	-0.002
OBL 2.1 04/29	2.251	-0.010
DBR 2.2 02/34	2.334	-0.014
UKT 3½ 10/25	4.369	+0.020
UKT 4½ 06/28	3.938	+0.017
UKT 3¼ 01/33	3.993	+0.011

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

Euro area

Flash PMIs suggest slight easing of downturn despite deterioration in core countries

Overall, the flash PMIs for January suggested a very slight easing of the euro area's economic downturn at the start of 2024. Broadly in line with expectations, and having moved sideways in December, the euro area composite output PMI edged up 0.3pt in January to a six-month high of 47.9, some 0.7pt above the Q4 average. Before the pandemic, however, that level would still have been consistent with a non-negligible contraction in GDP of 0.3%Q/Q. And the headline euro area figure masked significant differences in conditions across the region. In particular, the composite output PMIs for both Germany (down 0.3pt to a three-month low of 47.1) and France (down 0.6pt to a four-month low of 44.2) pointed to a slightly more marked decline in activity in the euro area's core countries. In contrast, the equivalent indicator for the rest of the euro area rose 1.4pts – the most since March – to an eight-month high of 50.9, pointing to slight pickup in economic output in the periphery.

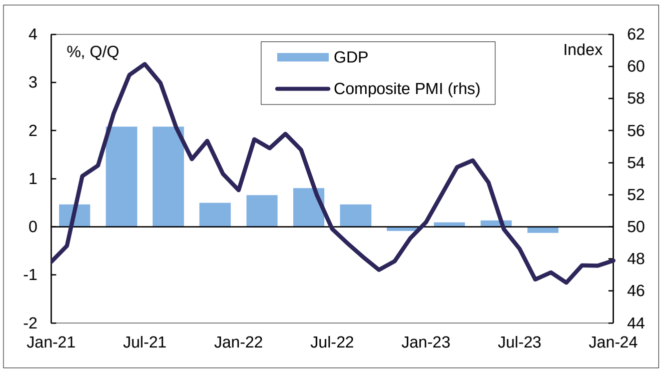
Pace of deterioration in manufacturing moderating as firms continue to run down inventories

The slight pickup in the euro area headline index reflected improvement in manufacturing, for which the output PMI rose 2.2pts – the most in almost three years – to a nine-month high of 46.6. While the equivalent indices pointed to a steeper drop in production in France, those for Germany and the rest of the region signalled improvement. After four successive quarters of declines in production, however, the PMIs still implied ongoing manufacturing contraction across the euro area at the start of the year, albeit not quite as marked as over recent months. The less downbeat picture for manufacturing output was matched by improvements in new orders, both domestic and from abroad, for which the respective indices were similarly the least downbeat since Q223, while work backlogs declined at a slower pace. And with stocks of finished goods reportedly falling further, the survey's ratio of new orders to inventories was the lowest since mid-2022 pointing to the prospect of progress towards expansion in the sector over coming months in the absence of significant new adverse shocks. Unfortunately, however, the marked deterioration in the manufacturing suppliers' delivery times PMI to its worst in fourteen months suggests that disruption to shipping freight via the Red Sea might scupper hopes of imminent recovery in the manufacturing sector.

Services weakened in Germany and France at the start of the year

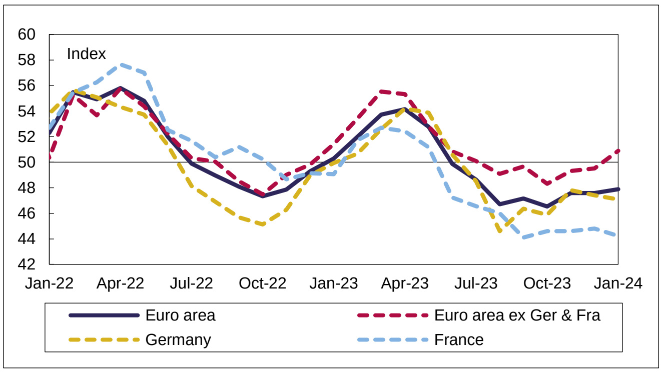
While, on average in the euro area, conditions in the manufacturing might no longer be deteriorating quite so markedly, the PMIs unexpectedly suggested that services activity declined at a faster pace at the start of the year. Indeed, the respective euro area PMI dropped 0.4pt in January to a three-month low of 48.4. The deterioration reflected Germany and France for

Euro area: GDP & Composite output PMI



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

Euro area: Composite output PMIs by country



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

which the service PMIs declined to the lowest levels in five and four months respectively. In contrast, the services activity PMI for the rest of the euro area rose 0.9pt to a six-month high of 51.6, suggesting expansion in the sector at the euro area's periphery at the start of 2024. Looking ahead, however, with signs of a moderation in the pace of decline in new work, and many firms in the sector expecting to benefit from a gradual turn for the better in manufacturing, services firms overall were the most upbeat about the outlook for the coming twelve months since May.

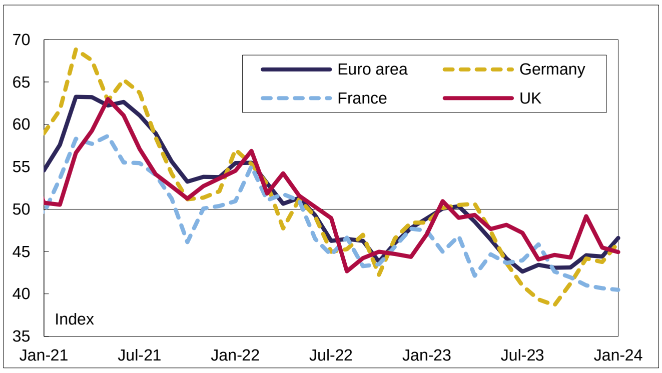
Signs of additional cost pressures strengthen case for ECB intransigence over rates

While the output PMIs suggest that economic activity remains in reverse, many members of the ECB will be more perturbed by signs of increased cost pressure at the start of the year, particularly in services. While the manufacturing input cost PMI remained consistent with disinflation in the sector, it still rose to an eight-month high, perhaps in part reflecting additional costs associated with events in the Red Sea. And seemingly also pressured by above-average wage settlement growth amid still-firm demand for workers in the sector, the services input cost PMI also rose to an eight-month high, in this instance well above the long-run norm. As a result, while manufacturers reported that their selling prices fell for a ninth successive month, services output prices rose the most since June and at a pace consistent with persistent above-target inflation. In defending her insistence that it remains too early for the Governing Council to discuss rate cuts, we would not be surprised if ECB President Lagarde tomorrow cites in her press conference such survey-based evidence of strong input cost growth and risks of high-inflation persistence in services.

The day ahead in the euro area

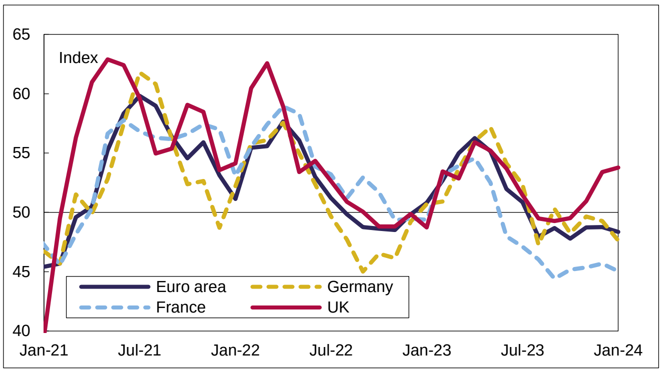
The main event tomorrow will be the conclusion of the ECB's Governing Council meeting, although the policy decision will be uneventful, with the ECB expected to leave its key interest rates unchanged, and the forward guidance will likely to retain its "higher for longer" message. As such, most interest will be in the press conference, where the likely timing of the first rate cut seems bound to be a focus of questions. Lagarde seems bound to reiterate that the ECB's rate decisions will remain data dependent. And despite the likelihood that the ECB's inflation projections will be revised significantly lower in March, she will push back on suggestions that rates could be cut as early as that month. Indeed, consistent with the concerns reported last week in the account of the December Governing Council meeting, Lagarde recently stated in a Bloomberg interview that "it is not helping our fight against inflation if the anticipation [of future rate cuts] is such that they are way too high compared with what's likely to happen". This notwithstanding, Chief Economist Lane last week suggested that sufficient evidence might in due course be available to justify a first rate cut in June. And Lagarde also acknowledged to Bloomberg last week that a first cut by or in the summer looks "likely" to her, a comment that she seems likely to be asked to clarify further tomorrow.

Europe: Manufacturing output PMIs



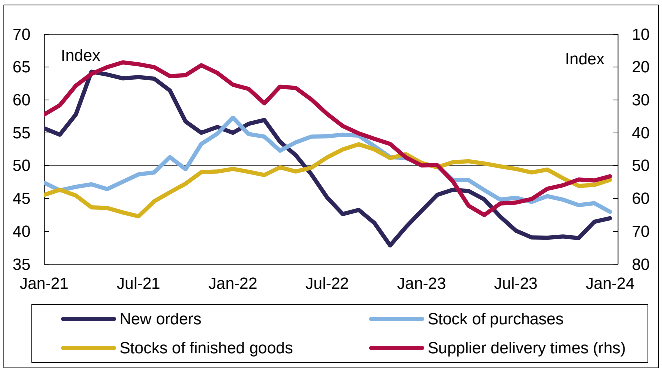
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Services activity PMIs



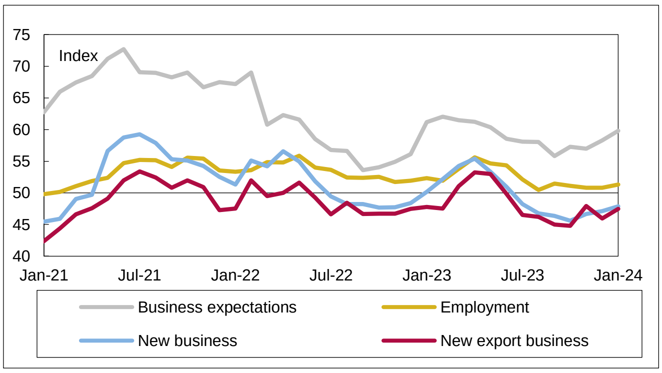
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Selected manufacturing PMIs*



**Supplier delivery times on an inverse scale. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area: Selected services PMIs



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

In terms of tomorrow's data-flow, the German ifo and French INSEE business surveys will offer a cross-check on the findings of today's flash PMIs, with developments in the construction and retail subsectors also incorporated. We note that the INSEE survey has been markedly less downbeat than the PMIs over the recent period and arguably proved to be a more reliable guide to GDP growth.

UK

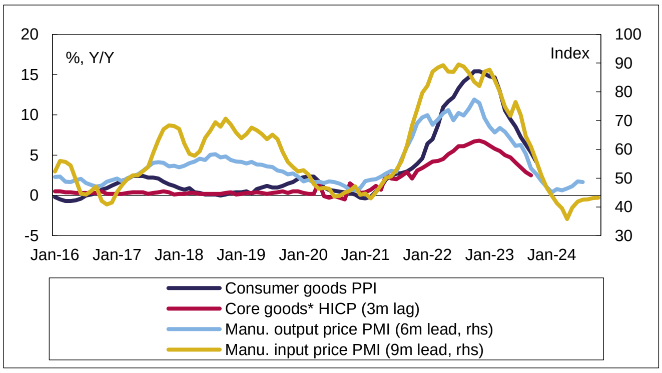
UK flash PMIs signal a boost to services activity at the start of the year

Following a surprising rebound at the end of last year, the flash UK PMIs also beat expectations in January, suggesting that UK recovery momentum picked up at the start of 2024. In particular, the composite output PMI rose for a fourth consecutive month, by 0.3pt to a seven-month high of 52.5, some 2.0pts above the Q4 average. Before the pandemic, that level would have been consistent with GDP growth of between 0.1-0.2%Q/Q. The improvement was again led by the services sector, where the activity index rose 0.4pt to an eight-month high of 53.8, with survey respondents citing a pickup in demand amid improved confidence and an easing in borrowing costs. In contrast, the manufacturing output PMI fell 0.5pt to a three-month low of 45.0, marking the eighteenth sub-50 "contractionary" reading out of the past nineteen months, and leaving the index some 1.3pts below the Q4 average. Moreover, the flash PMIs suggested that the near-term production outlook was clouded by a further decline in domestic orders as well as weakening export demand, which tallied with the findings of today's CBI industrial trends survey. Possible disruptions to trade from the imposition of new Brexit-related import checks from the end of this month will also likely be further weighing on sentiment in certain subsectors. And, as in the euro area, the start of the year has also brought a rise in supply-side challenges arising from longer freight times related to the rerouting of vessels away from the Suez Canal. Indeed, today's survey suggested that supplier delivery times lengthened by the most in sixteen months. At the same time, inventories of input materials fell by the greatest extent since August and manufacturers cut headcount for a sixteenth consecutive month. The impact on employment is likely to have been offset by services, which reported a return to moderate jobs growth.

Supply disruptions pushing up manufacturing costs

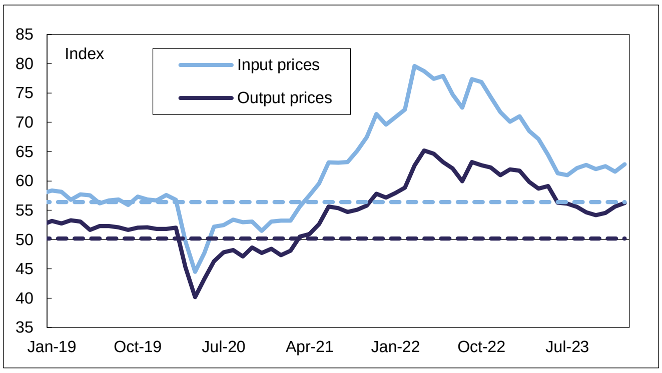
Having accelerated towards the end of last year, BoE policymakers will be encouraged to see the survey's services price indices resume a modest downtrend at the start of the year. In particular, the input price index (63.4) eased to its second-lowest level in almost three years, while the output price component (57.3) similarly fell to second-weakest in almost 2½ years. Admittedly, both indices remain well above their respective long-run averages, implying an ongoing inflationary impulse in the sector. As in the euro area, UK services firms cited the ongoing pass-through of strong wage growth to their

Euro area: Goods price indicators



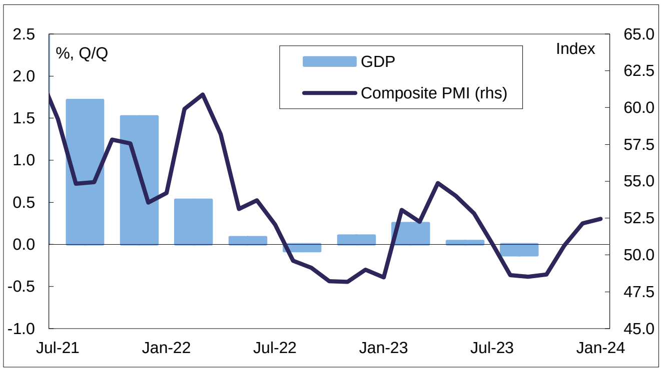
*Non-energy industrial goods. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Services price PMIs*



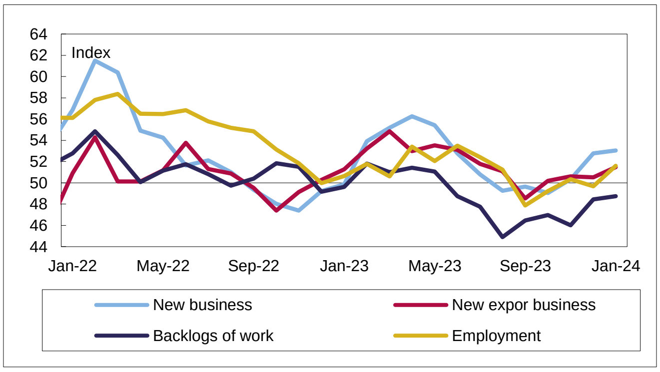
*Dashed lines represent pre-pandemic averages. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: GDP & composite output PMI



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

UK: Selected services PMIs



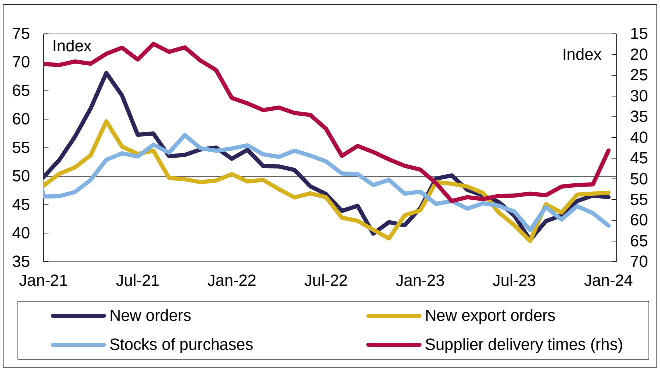
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

selling prices. Today’s survey also flagged a rise in cost burdens facing the factory sector, likely at least in part due to events in the Red Sea, with the manufacturing input price PMI jumping 6pts in January – the most since September 2022 – to a ten-month high of 53.5. The output price index also edged up to a four-month high (51.5), albeit remaining comfortably below the long-run average. And while manufacturers in certain food processing industries will face additional costs associated with the introduction of new import rules from the end of this month, manufacturers’ pricing power will remain constrained to some extent by lacklustre demand for goods.

The day ahead in the UK

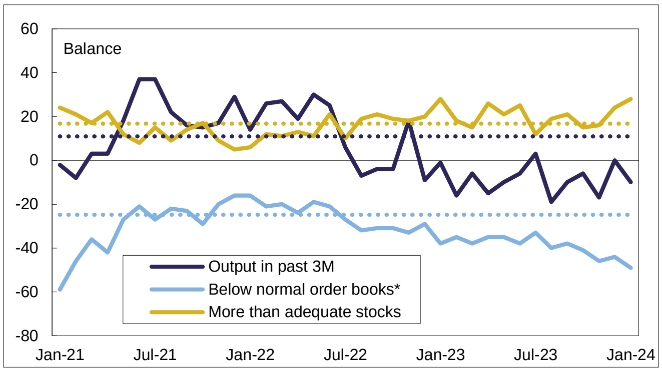
Thursday’s release of the CBI distributive trade survey will offer some insight into retail conditions at the start of the year. While household disposable incomes are benefiting from the cut to National Insurance Contributions at the start of the year, they have also been squeezed by the 5% increase in the regulated cap on household utility tariffs, which will likely restrain any rebound in consumer spending in January.

UK: Selected manufacturing PMIs*



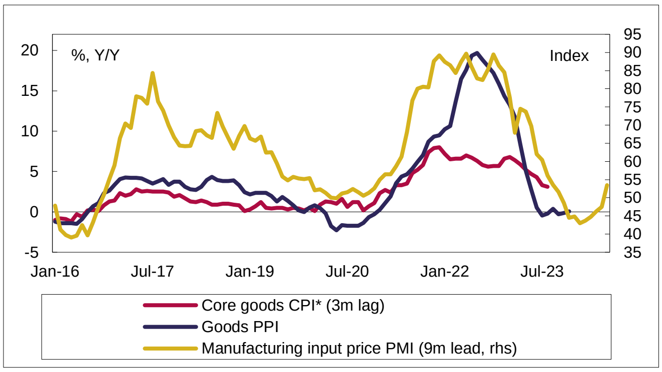
*Supplier delivery times index on an inverse scale. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: CBI manufacturing indices



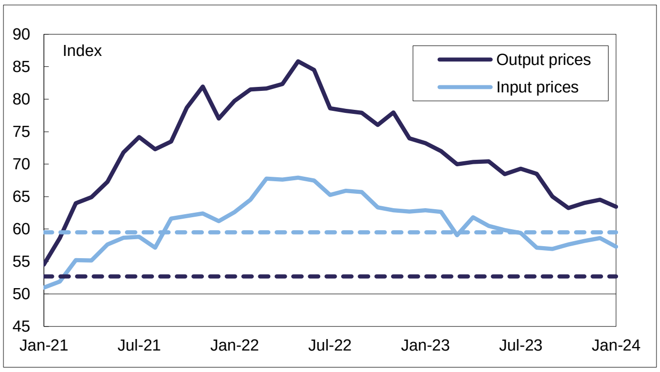
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Goods manufacturing price indices



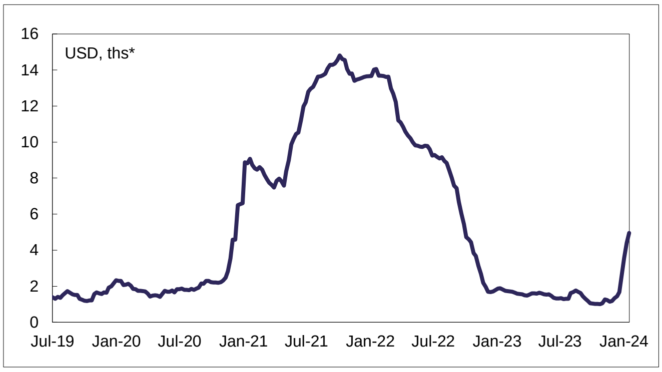
*Non-energy industrial goods. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services price PMIs*



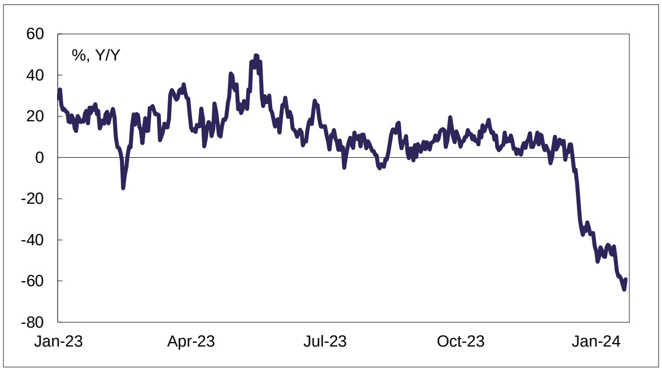
*Dashed lines represent pre-pandemic averages. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Shanghai to Rotterdam shipping freight price index



*Rate per 40ft box. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Transit trade volume via Bab el-Mandeb Strait



Source: IMF PortWatch 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		Preliminary manufacturing (services) PMI	Jan	**46.6 (48.4)**	44.8 (49.0)	44.4 (48.8)	-
		Preliminary composite PMI	Jan	**47.9**	48.0	47.6	-
Germany		Preliminary manufacturing (services) PMI	Jan	**45.4 (47.6)**	43.5 (49.3)	43.3 (49.3)	-
		Preliminary composite PMI	Jan	**47.1**	47.8	47.4	-
France		Preliminary manufacturing (services) PMI	Jan	**43.2 (45.0)**	42.4 (46.0)	42.1 (45.7)	-
		Preliminary composite PMI	Jan	**44.2**	45.2	44.8	-
UK		Preliminary manufacturing (services) PMI	Jan	**47.3 (53.8)**	46.8 (53.5)	46.2 (53.4)	-
		Preliminary composite PMI	Jan	**52.5**	52.5	52.1	-
		CBI industrial trends, total orders (selling prices)	Jan	**-30 (9)**	-	-23 (7)	-
Auctions							
Country		Auction					
Germany		sold €1.0bn of 1.0% 2038 bonds at an average yield of 2.51%					
		sold €603mn of 2.5% 2046 bonds at an average yield of 2.53%					
UK		sold £4.0bn of 4.5% 2028 bonds at an average yield of 3.946%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data						
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		13.15	ECB deposit rate %	Jan	*4.00*	4.00
Germany		09.00	Ifo business climate index	Jan	86.6	86.4
		09.00	Ifo current assessment (expectations) index	Jan	88.5 (84.8)	88.5 (84.3)
France		07.45	INSEE business (manufacturing) confidence index	Jan	98 (100)	98 (100)
Spain		08.00	PPI Y/Y%	Dec	-	-7.4
UK		11.00	CBI distributive trades survey, reported retail sales balance	Jan	-20	-32
Auctions and events						
Euro area		13.15	ECB monetary policy announcement			
		13.45	ECB President Lagarde holds post-meeting press conference			
Italy		10.00	Auction: €2.5bn of 3.6% 2025 bonds			
		10.00	Auction: €1.0bn of 1.5% 2029 index-linked bonds			
		10.00	Auction: €1.5bn of 2.4% 2039 index-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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