Euro wrap-up

Overview

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- Shorter-dated Bunds made losses, while longer-dated Bunds made gains as the flash estimates for euro area inflation edged lower in January to extend the disinflationary trend but unemployment remained at a series low.
- Gilts made gains as the BoE removed the tightening bias from its policy statement, but suggested more evidence was required before cutting rates as it forecast only a gradual return to its inflation target.
- The coming week will bring data for euro area retail sales, German IP and UK unemployment, and various euro area and UK sentiment surveys.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/26	2.436	+0.033
OBL 2.1 04/29	2.046	-0.001
DBR 2.2 02/34	2.144	-0.020
UKT 3½ 10/25	4.198	-0.022
UKT 4½ 06/28	3.689	-0.046
UKT 3¼ 01/33	3.741	-0.048

*Change from close as at 5.00pm GMT.
Source: Bloomberg

Euro area

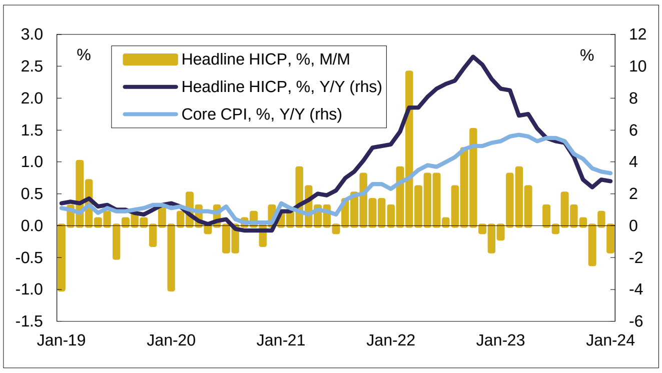
Headline and core inflation edge lower in January to extend disinflationary trend

According to today's flash estimate, euro area consumer price inflation edged lower in January. Having jumped 0.5ppt in December, the headline HICP rate fell 0.1ppt in January to 2.8%Y/Y. That was 0.1ppt above our forecast and the median forecast on the Bloomberg survey. And while yesterday's German and French data came in slightly below expectations, today's HICP figures from Italy (up 0.4ppt to 0.9%Y/Y) and in particular the Netherlands (up 2.1ppts to 3.1%Y/Y) were stronger than expected. However, to two decimal places, headline euro area inflation came in at 2.75%Y/Y, negligibly above the consensus forecast, and so we certainly do not consider this to be a significant upside surprise. Indeed, inflation appears to be continuing to undershoot the ECB's projection. And despite the additional inflationary impulse from the further withdrawal of government policy support at the start of the year, the underlying disinflationary trend appears to remain intact. The impact of reduced subsidies and tax changes to lower household utility bills was reflected in the further rise of energy inflation, up 0.4ppt to a four-month high of -6.3%Y/Y. However, that was more than offset by the ongoing decline in inflation of food, alcohol and tobacco, which eased by 0.4ppt to 5.7%Y/Y, the lowest since March 2022. The easing of pressures in the global factory sector similarly allowed the core goods component to decline for an eleventh successive month, dropping 0.5ppt to 2.0%Y/Y, the lowest since October 2021. And despite new government measures such as the German increase in VAT on restaurants, services inflation was steady at 4.0%Y/Y for a third successive month. So, in line with our forecast, core inflation fell for a sixth successive month in January, by 0.1ppt to 3.3%Y/Y, the lowest since March 2022.

Inflation should decline at a faster pace over rest of Q1, opening the door fully to a Q2 rate cut

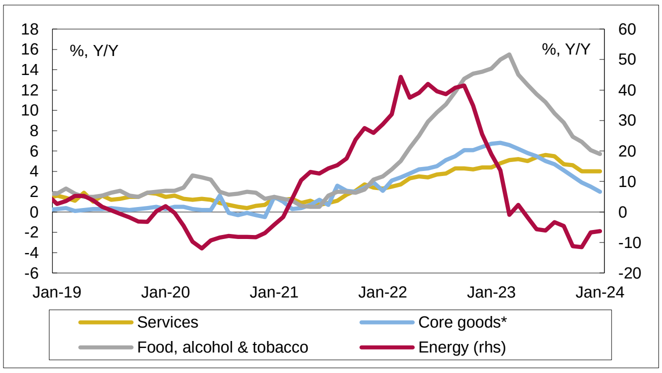
Despite the decline in core inflation, the hawks on the Governing Council might be wary that the month-on-month increases in prices of services, core goods and food were all above their respective long-run averages for January. However, inflation momentum, which ECB policymakers have flagged as important in guiding policy, probably continues to slow. In seasonally-adjusted terms, core goods prices were again unchanged on a three-month annualised basis in January, matching the softest such rate in three years. Unfortunately, the equivalent cyclically adjusted price data for services were not estimated by the ECB. But with some of the increase in prices on the month attributed to tax measures, and the reweighting of the basket likely also to have played a role, the easing in underlying momentum in this category likely persisted. And we think that core inflation momentum will have remained below 2.0%3M/3M annualised, a rate that if sustained would clearly be consistent with undershooting the ECB's inflation target over the medium term. Indeed, while the near-term inflation profile remains difficult to forecast with confidence, we expect new pressures – whether from wages or increased freight costs related to events in the Red Sea – to be largely absorbed by profits margins. And we expect headline and core inflation both to decline about ½ppt in February and further over the subsequent months to average about 2.0%Y/Y in Q2 and less than

Euro area: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key inflation components



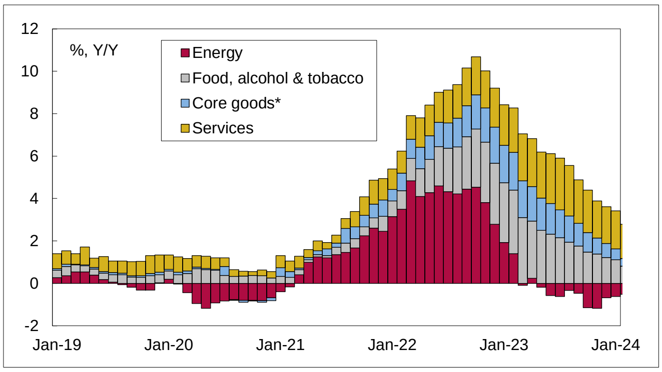
**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

that in Q3. Given recent outturns as well as the downwards shift in wholesale energy prices over recent months – the ECB will have to revise down significantly its inflation projection in March to suggest the likelihood that the target will be reached on a sustained basis in 2025. And so, we maintain our expectation that the first rate cut will come in the second quarter.

Euro area unemployment rate at series low as firms continue to hoard labour

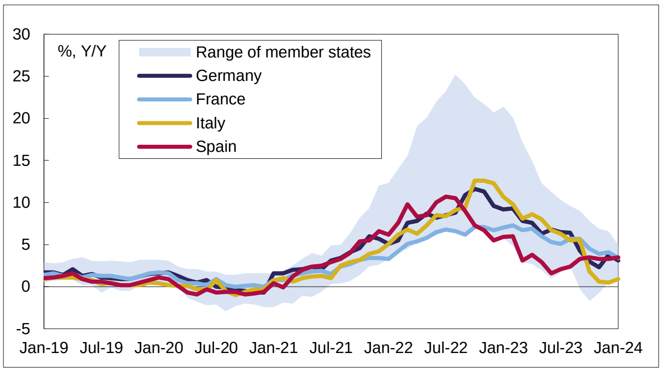
Despite the weakness in GDP growth, the euro area's labour market remains remarkably resilient as firms appear willing still to hoard rather than lay off workers. Indeed, based on December's unemployment figures, also published today, the labour market seemingly remained tight, with the number of unemployed people falling for a third consecutive month and by a further 17k to a record-low 10.909mn, some 369k lower than a year ago and 2.6mn below the pandemic peak. This left the jobless rate in December unchanged at a series-low 6.4%. The improvements were again concentrated in southern Europe, where economic growth momentum is more positive. Indeed, the drop in unemployment was once again largest in Italy (-51k), taking the jobless rate down 0.2ppt to 7.2%, the lowest for fifteen years. There was also another decline in Spain (-17k), where the unemployment rate eased 0.1ppt to 11.7%, the lowest since mid-2008, while the Greek rate dropped 0.2ppt to 9.2%, similarly the lowest since the global financial crisis. In contrast, the number of people out of work in Germany rose for the ninth consecutive month in December, while French unemployment increased for a second successive month, albeit leaving the respective unemployment rates unchanged at 3.1% and 7.3%. While the number of job vacancies fell gradually last year, the latest Commission survey suggested that, with the exception of Germany, firms were more upbeat about employment expectations at the start of the year. The share of firms willing to hoard labour rose further above the long-run average in January (12%), with the share highest in Germany and France, suggesting that the labour market should remain broadly stable over coming months. Of course, the more hawkish members on the Governing Council might remain concerned about the implications for pay growth. But while the Indeed euro area wage tracker rose to a four-month high of 3.9%Y/Y in December, it remains almost 1½ppts below the peak. German negotiated wage growth slowed to just 1.4%Y/Y in January. And with the profit share of non-financial corporations already back down to its long-run average in Q323, we expect the impact of any substantive pressures on pay in other member states to be primarily absorbed by margins amid the subdued demand environment rather than passed on to consumer prices.

Euro area: Contributions to consumer price inflation



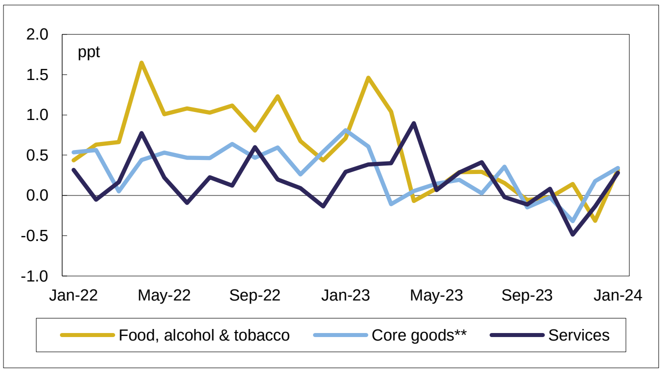
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



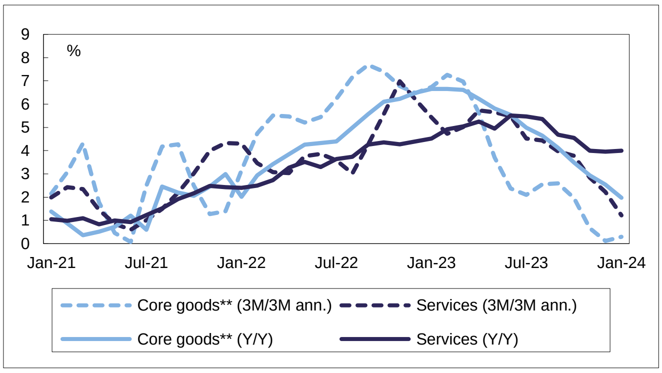
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

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: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum*



*Seasonally adjusted data for services through to December 2023, **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The week ahead in the euro area

The euro area’s data flow in the first half of the coming week, including producer price figures, final services PMIs (both due Monday) and the ECB’s consumer expectations survey (Tuesday), will provide some further insight into the outlook for inflation. Reflecting an ongoing drag from energy inflation as well as a further easing in underlying factory price pressures, the headline PPI rate is likely to have remained firmly in negative territory in December. But with consumer price inflation having jumped in December and the Commission’s measure of household price expectations having edged higher at the end of last year, the ECB’s survey gauge for inflation expectations one year ahead might also increase in December from the nineteen-month low (3.2%Y/Y) hit in November. More important for the ECB will be developments in inflation expectations for three years ahead, which in November eased to 2.2%YYY, the lowest since February 2022. Meanwhile, the final services price PMIs are likely to confirm a further pickup in input cost burdens, with the respective flash index rising to an eight-month high amid reports of persisting wage pressures.

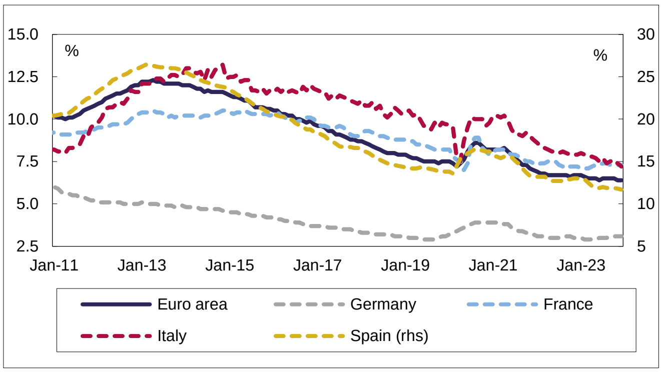
In terms of economic activity, euro area retail sales figures (Monday) will likely confirm that consumer spending on goods weakened further in December, in line with the unexpected contraction reported in Germany. Indeed, retail sales will again have provided a modest drag on euro area GDP growth in Q4. Meanwhile, among the national releases, the main focus will be Germany’s manufacturing performance heading into year-end, with December figures for goods trade (Monday), factory orders (Tuesday) and industrial production (Wednesday) due. Surveys and truck toll mileage figures suggest that production fell for a seventh successive month in December, leaving it a drag on GDP for the third quarter out of the past four in Q4. The January construction PMIs (Tuesday) will also illustrate that activity in Germany continues to contract sharply and underperform other member states.

UK

BoE removes tightening bias but wants more evidence before cutting rates

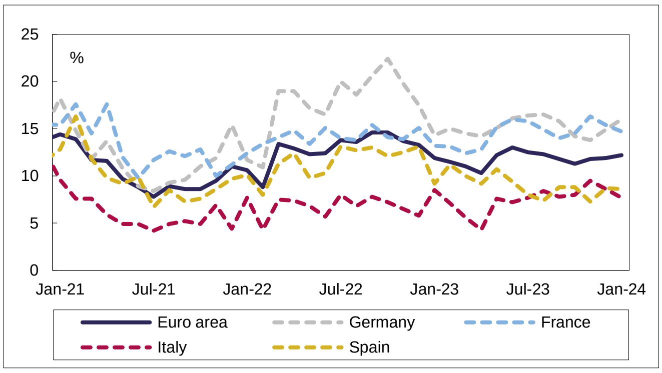
While it inevitably left Bank Rate unchanged at 5.25% today for a fourth successive policy meeting, the MPC’s message was somewhat more dovish though arguably not as dovish as the markets might have anticipated. For a start, one of the three external Committee members who voted for a hike at the prior meeting (Megan Greene) shifted to supporting the status quo. And one external member (the uber-dove Swati Dingra) voted for a cut. In addition, the Committee significantly adjusted its forward guidance, dropping its tightening bias. Instead, it stated that it will keep under review for how long Bank Rate should

Euro area: Unemployment rates



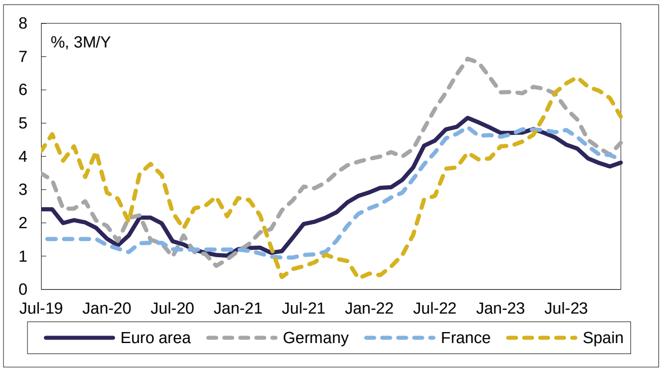
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Labour hoarding indices



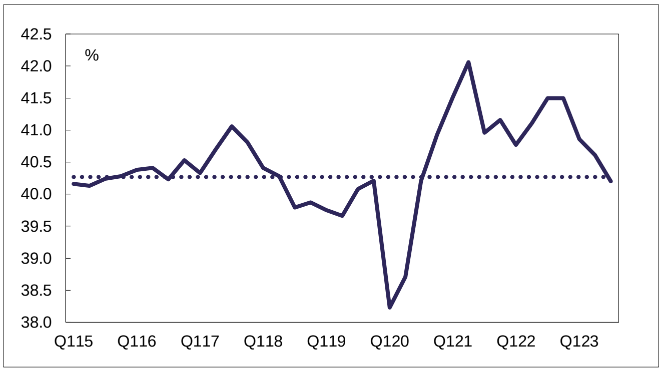
Source: EC and Daiwa Capital Markets Europe Ltd.

Euro area: Indeed wage tracker



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Profit share of NFCs*



**Dotted line represents long-run average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

be maintained at the current level. However, it repeated that monetary policy will need to be restrictive for an extended period. In his press conference, Governor Bailey insisted that rates wouldn't be kept at current levels longer than necessary. And he acknowledged that inflation had fallen faster than the BoE had expected. But he made clear that the MPC needs to see a lot more evidence that inflation will fall all the way to 2% and stay there before it decides to lower rates. Once again, the policy statement flagged the underlying tightness of labour market conditions, wage growth and services price inflation as the most important variables in its reaction function for determining when rates might be cut.

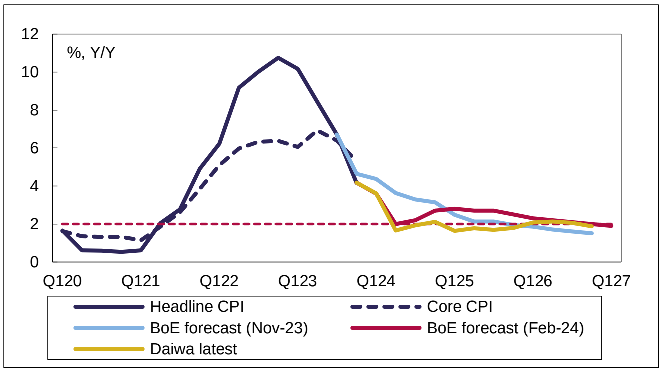
Bank forecasts only a gradual return to the 2% inflation target

In terms of those key variables, over recent months the labour market has been a touch tighter than the BoE had previously expected. While the drop in the vacancies-unemployment ratio suggested that it had become steadily looser over recent quarters, it was still judged to be relatively tight, and the Bank nudged down very slightly its unemployment forecast over the horizon. More importantly perhaps, services inflation and wage growth have moderated further than the MPC anticipated. And the BoE expects them to continue to ease gradually over coming quarters. Notably, however, several other key variables have shifted, with very significant implications for the BoE's projections. For example, the sharp recent fall in wholesale crude oil and gas prices will pull inflation lower over the coming few quarters. But the downwards shift in market interest rates compared to three months ago – by roughly 100bps over the next three years – means that overall financial conditions are significantly looser than the BoE previously thought, thus weighing more lightly on inflation than previously expected. Indeed, whereas three months ago the BoE thought that only about half of the effects of past rate hikes had been felt on the economy, the recent drop in mortgage and other interest rates means that it now thinks that about two thirds of the impact of its monetary tightening has been felt.

Rate cuts are coming, but timing and magnitude remains highly uncertain

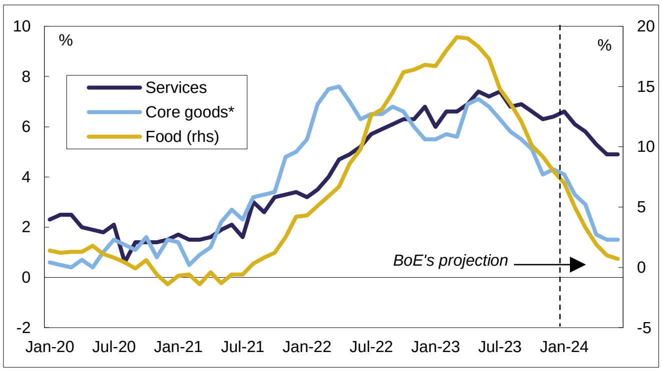
Taking account of all of these shifts, the BoE's inflation forecasts were significantly amended. After an initial uptick in January due to services base effects, the MPC thinks that inflation will fall back to about 2.0% in Q2 thanks in particular to lower household energy bills. But it then expects it to rebound to about 2¾%Y/Y in Q3 and Q4. And, assuming the market-based path whereby Bank Rate is cut by a cumulative 200bps between Q224 and the end of the forecast period, it expects inflation to fall back gradually in 2025, and return back to target only at the end of 2026, roughly a year later than previously anticipated. On unchanged rates, however, the inflation profile was significantly weaker, with inflation projected to be back at target in Q225, and as low as 1.4%Y/Y in two years' time. Moreover, it is projected to fall below 1%Y/Y by the end of the

UK: Consumer price inflation forecasts*



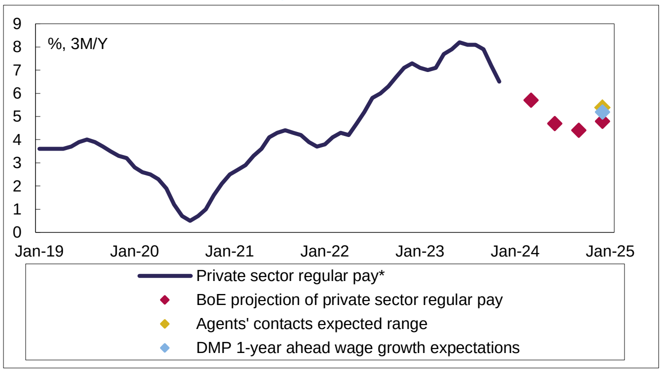
**BoE forecasts based on market implied Bank Rate. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: BoE forecast: CPI components



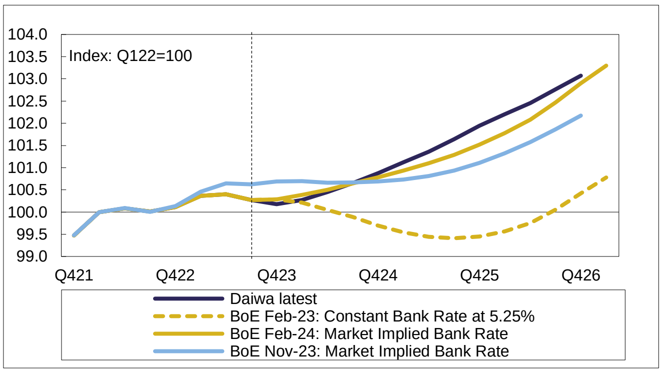
**Non-energy industrial goods. Source: BoE and Daiwa Capital Markets Europe Ltd.*

UK: Measures of pay growth



**Data between January 2020 and November 2022 are BoE staff estimates of underlying private sector regular pay growth. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: GDP forecasts



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

horizon. So, the updated projections strongly suggest that rates will be cut and it is only a question of timing and quantum of rate cuts to come. As our inflation projection is somewhat softer than that of the Bank, we maintain our view that the first rate cut can come in Q2, probably in May. However, there is a non-negligible risk that the first cut will not come until August, particularly if the government eases fiscal policy aggressively further in the March Budget.

BoE growth forecast boosted by expected rate cuts, lower energy prices and looser fiscal policy

In terms of the economic growth outlook, the Bank was less downbeat than three months ago. The impact of lower energy prices, easier fiscal policy and, most strikingly, the lower path for interest rates, have materially lifted the outlook for GDP growth. Admittedly, given back revisions and its revised expectation of zero growth in Q423, the level of GDP starts the forecast period around ½% lower than anticipated at the time of the November MPR. And while fiscal initiatives announced in the Autumn Statement were estimated to boost growth by 0.2% this year relative to the November projections, the outlook for GDP this year was only marginally improved. Indeed, the BoE merely anticipates an increase of 0.1%Q/Q (compared with 0.0%Q/Q) per quarter throughout 2024, to leave the full-year forecast for 2024 up just 0.1ppt from three months ago at 0.2%Y/Y, well below projected growth in both the euro area and US. But while the Bank revised down its expectation for household spending (-¼%Y/Y) and business investment (-2½%Y/Y) this year, they were more upbeat about the outlook for spending in 2025 and 2026 reflecting the waning drag from past interest rate hikes. Indeed, the Bank now anticipates GDP growth of 0.6%Y/Y and 1.1%Y/Y respectively, some 0.4ppt and 0.3ppt higher than in November. And overall, the level of GDP at the end of the forecast period had been revised up by almost ¾%, to be some 4½% above the pre-pandemic benchmark. The material impact of the rate cuts priced-in by the markets was illustrated in the Bank's growth projection based on the assumption of unchanged rates, whereby GDP would be forecast to contract in each quarter through to Q225 and only return to positive growth in Q126. Under this scenario, full year GDP would decline around ½%Y/Y this year and next and end the forecast horizon just 2% above the Q419 level.

The week ahead in the UK

The coming week's data calendar will be relatively light for top-tier releases, kicking off with the final January services PMIs on Monday. The flash release saw the headline activity index rise for a fourth consecutive month to an eight-month high of 53.8, suggesting an accelerated pace of expansion at the start of 2024. The new orders component also signalled ongoing growth ahead, while business expectations for the coming twelve months was the highest since April. The survey's price components were also more encouraging, albeit suggesting that price pressures remained well above the long-run average. Tuesday will bring updates on the construction and retail sectors, with the respective PMI and BRC surveys expected to flag ongoing challenges as a mix of high borrowing costs, weak consumer confidence and persisting economic uncertainties continue to hit demand. Finally, Thursday will bring further insights into recent developments in the housing market with the RICS residential survey, and labour market with the REC/KPMG report on jobs. In addition, and arguably most noteworthy, the ONS is scheduled to publish revised Labour Force Survey results (that have been suspended since the summer) from September 2022 to November 2023 reflecting a new methodology.

The next edition of the Euro wrap-up will be published on 05 February 2024

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	0.2	0.3	0.5	0.3	1.4
UK	-0.1	-0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.9
Inflation, %, Y/Y									
Euro area									
Headline HICP	5.0	2.7	2.4	2.0	1.6	2.1	5.4	2.0	1.8
Core HICP	5.1	3.7	2.9	1.9	1.6	2.0	4.9	2.1	1.6
UK									
Headline CPI	6.7	4.1	3.5	1.7	1.9	2.3	7.3	2.3	2.1
Core CPI	6.4	5.3	4.5	2.7	2.3	2.5	6.2	3.0	2.1
Monetary policy, %									
ECB									
Refi Rate	4.50	4.50	4.50	4.25	3.75	3.25	4.50	3.25	2.75
Deposit Rate	4.00	4.00	4.00	3.75	3.25	2.75	4.00	2.75	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	Final manufacturing PMI	Jan	**46.6**	*46.6*	44.4	-
	Preliminary HICP (core CPI) Y/Y%	Jan	**2.8 (3.3)**	*2.7 (3.3)*	2.9 (3.4)	-
	Unemployment rate %	Dec	**6.4**	6.4	6.4	-
Germany	Final manufacturing PMI	Jan	**45.5**	*45.4*	43.3	-
France	Final manufacturing PMI	Jan	**43.1**	*43.2*	42.1	-
Italy	Manufacturing PMI	Jan	**48.5**	47.0	45.3	-
	Preliminary HICP (CPI) Y/Y%	Jan	**0.9 (0.8)**	0.8 (0.9)	0.5 (0.6)	-
Spain	Manufacturing PMI	Jan	**49.2**	48.0	46.2	-
UK	Final manufacturing PMI	Jan	**47.0**	*47.3*	46.2	-
	BoE Bank Rate %	Feb	**5.25**	*5.25*	5.25	-
	BoE's DMP 1Y ahead inflation expectations %	Jan	**3.4**	3.8	4.0	-

Auctions

Country	Auction
France	sold €7.45bn of 3.5% 2033 bonds an average yield of 2.7%
	sold €1.81bn of 2.5% 2043 bonds at an average yield of 3.16%
	sold €2.30bn of 0.5% 2040 bonds at an average yield of 3.07%
	sold €1.43bn of 3.0% 2054 bonds at an average yield of 3.27%
Spain	sold €1.75bn of 1.45% 2029 bonds at an average yield of 2.69%
	sold €1.78bn of 0.1% 2031 bonds at an average yield of 2.868%
	sold €2.53bn of 3.25% 2034 bonds at an average yield of 3.17%
	sold €516mn of 2.05% 2039 index-linked bonds at an average yield of 1.518%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France		07.45	Industrial production M/M% (Y/Y%)	Dec	0.2 (-0.2)	0.5 (0.6)
Spain		08.00	Unemployment change '000s	Jan	-	-27.4
Auctions and events						
UK		12.15	BoE Chief Economist Pill scheduled to speak			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming few week's key data releases						
Country		GMT	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 05 February 2024			
Euro area		09.00	Final services (composite) PMI	Jan	*48.4 (47.9)*	48.8 (47.6)
		09.30	Sentix investor confidence	Feb	-	-15.8
		10.00	PPI Y/Y%	Dec	-	-8.8
Germany		07.00	Trade balance €bn	Dec	-	20.8
		08.55	Final services (composite) PMI	Jan	*47.6 (47.1)*	49.3 (47.4)
France		08.50	Final services (composite) PMI	Jan	*45.0 (44.2)*	45.7 (44.8)
Italy		08.45	Services (composite) PMI	Jan	-	49.8 (48.6)
Spain		08.15	Services (composite) PMI	Jan	-	51.5 (50.4)
UK		09.30	Final services (composite) PMI	Jan	*53.8 (52.5)*	53.4 (52.1)
			Tuesday 06 February 2024			
Euro area		08.30	Construction PMI	Jan	-	43.6
		09.00	ECB 1Y (3Y) inflation expectations Y/Y%	Dec	-	3.2 (2.2)
		10.00	Retail sales M/M% (Y/Y%)	Dec	-	-0.3 (-1.1)
Germany		07.00	Factory orders M/M% (Y/Y%)	Dec	-	0.3 (-4.4)
		08.30	Construction PMI	Jan	-	37.0
France		08.30	Construction PMI	Jan	-	42.6
Italy		08.30	Construction PMI	Jan	-	55.2
		09.00	Business (manufacturing) confidence Indicator	Jan	-	107.2 (95.4)
		09.00	Consumer confidence indicator	Jan	-	106.7
UK		00.01	BRC retail monitor, like-for-like sales Y/Y%	Jan	-	1.9
		09.30	Construction PMI	Jan	-	46.8
			Wednesday 07 February 2024			
Germany		07.00	Industrial production M/M% (Y/Y%)	Dec	-	-0.7 (-4.8)
France		07.45	Trade balance €bn	Dec	-	-5.9
Italy		09.00	Retail sales M/M% (Y/Y%)	Dec	-	0.4 (1.5)
Spain		08.00	Industrial production M/M% (Y/Y%)	Dec	-	1.0 (0.8)
			Thursday 08 February 2024			
UK		00.01	RICS house price balance %	Jan	-	-30
			Friday 09 February 2024			
Germany		07.00	Final HICP (CPI) Y/Y%	Jan	*3.1 (2.9)*	3.8 (3.7)
Italy		09.00	Industrial production M/M% (Y/Y%)	Dec	-	-1.5 (-3.1)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 05 February 2024
UK		07.00	ONS to publish updated Labour Force Survey results from September 2022 to November 2023
			Tuesday 06 February 2024
UK		10.00	Auction: £2.5bn of 1.5% 2053 green bonds
			Wednesday 07 February 2024
Germany		10.30	Auction: €3bn of 2.4% 2030 bonds
UK		08.40	BoE Deputy Governor Breeden scheduled to speak
		10.00	Auction: £4bn of 3.75% 2027 bonds
			Thursday 08 February 2024
Euro area		11.30	ECB's Wunsch scheduled to speak
		15.30	ECB's Chief Economist Lane scheduled to speak
UK		00.01	REC report on jobs
		15.00	BoE's Mann scheduled to speak
			Friday 09 February 2024
Euro area		14.15	ECB's Cipellone scheduled speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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