Europe Economic Research 01 March 2024

Euro wrap-up

Overview

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- Bunds closed little changed on the day as the flash estimates of euro area headline and core inflation in February surprised slightly on the upside but maintained their downtrends.
- Gilts also ended the day little changed even as the Nationwide UK house price index rose on a year-on-year basis for the first time in 13 months.
- The ECB's monetary policy announcement on Thursday will leave rates unchanged, while new data due in the coming week include euro area retail sales and producer prices, and German IP and factory orders.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/26	2.882	-0.012
OBL 2.1 04/29	2.424	-0.004
DBR 2.2 02/34	2.411	+0.002
UKT 0⅛ 01/26	4.264	-0.002
UKT 0½ 01/29	4.025	-0.007
UKT 4⅝ 01/34	4.109	-0.010

*Change from close as at 5:00pm GMT.
Source: Bloomberg

Euro area

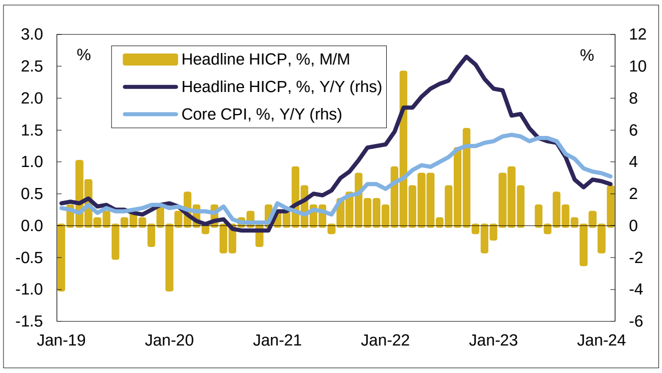
Disinflation trend remains intact as core HICP rate drops to two-year low

According to today's flash HICP estimate, euro area consumer price inflation dropped for a second successive month in February. The headline rate fell 0.2ppt to 2.6%Y/Y, 0.1ppt above median forecast on the Bloomberg survey and 0.2ppt above November's low, but a hefty 8.1ppts below the peak in October 2022. Encouragingly, the major core components both fell further to new multi-month lows, suggesting that underlying pressures continue to dissipate. In particular, services inflation, which remains the prime concern of the ECB's hawks, fell 0.1ppt to 3.9%Y/Y, the lowest since August 2022. And consistent with the global trend in the factory sector, inflation of non-energy industrialised goods dropped 0.4ppt to 1.6%Y/Y, the lowest since July 2021. As a result, overall core HICP inflation fell 0.2ppt to a two-year low of 3.1%Y/Y. Among the non-core items, food inflation continued to fall sharply, with its broader grouping including alcohol and tobacco down a steep 1.6ppts – the most in eleven months – to 4.0%Y/Y, the lowest in more than two years. So, it was only due to a 2.4ppts rise in the energy component to a six-month high of -3.7%Y/Y – related to the further withdrawal of government subsidies and higher petrol prices – that the drop in the headline inflation rate wasn't more marked.

Momentum in services inflation increases but headline rate undershoots ECB's projection

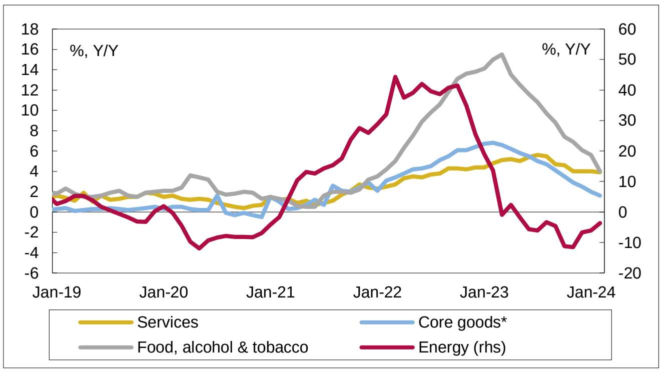
Despite the further decline in the annual core inflation rate, it exceeded the median forecast on the Bloomberg survey by 0.2ppt. And the improvement in underlying trends is highly unlikely to have been sufficient to persuade the Governing Council's hawks to cut rates at the ECB's monetary policy meeting on 6-7 March. Indeed, the drop in both major core components principally reflected significant base effects, while the monthly increases in prices of services and core goods in February were above their respective long-run averages for the month. On a seasonally-adjusted basis, core goods prices rose just 0.1%M/M to be up a modest 1.1%3M/3M annualised. But on the same basis, services prices rose 0.5%M/M, the most in ten months, to be up 3.1%3M/3M annualised. And core prices overall were up 2.4%3M/3M annualised, the most in four months and a rate that, if sustained, would be incompatible with a lasting return of inflation to target. To some extent, however, that likely reflects pressures in only a handful of isolated components, such as insurance. And, overall, disinflation remains on track. Indeed, given the likelihood of further easing in March, core inflation in Q1 is likely to match the ECB's forecast of 3.1%Y/Y, which would be the lowest quarterly rate in two years. And headline inflation is firmly on course to undershoot the ECB's forecast of 2.9%Y/Y in Q1, in our view by a non-negligible 0.3ppt. We also expect the headline and core HICP rates to fall further over the next two quarters, to firmly below 2½%Y/Y in Q2 and – even if first just temporarily – below the 2% target in Q3. And with a decent case for the ECB to revise down its inflation projection over the horizon, if negotiated wage growth moderates in Q1 and there are no unwelcome surprises, the Governing Council should be willing to cut rates for the first time in June.

Euro area: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key HICP inflation components



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

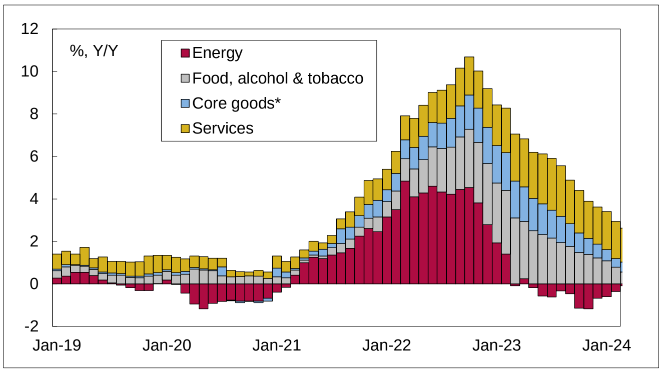
Series low unemployment rate suggests persisting tightness in the labour market

Despite the recent stagnation in economic output, the euro area's labour market remains resilient as firms appear willing still to hoard rather than lay off workers. The number unemployed fell for a third consecutive month in January and by a further 34k to a record-low 11.009mn, down some 232k from a year ago and 3.1mn below the pandemic peak. This pushed the jobless rate in January down 0.1ppt to a series-low 6.4% from the upwardly revised rate of 6.5% in the prior eleven months. The improvement was again led by Spain, where economic growth momentum remains more positive. Indeed, Spanish unemployment fell for the tenth month out of the past twelve (-22k), taking the jobless rate down 0.1ppt to 11.6%, the lowest for fifteen years. The unemployment rate in France also edged lower (-0.1ppt to 7.5%), reversing the modest uptick in December, while the respective rates in Germany and Italy were unchanged at 3.1% and 7.2%. While the number of job vacancies fell steadily last year, and the share of firms citing labour shortages as a restraining factor on output maintained a downtrend, both remain well above the long-run average. The latest Commission survey also suggested that firms – particularly in the services sector – on average still intend to add to headcount at the start of the year. And although German firms were the exception, signalling intentions to cut headcount particularly in the manufacturing sector, the share of firms aiming to hoard labour in the largest member state remained relatively high. The equivalent share of hoarders in the euro area as a whole also remained above the long-run average. As such, the labour market looks likely to remain broadly stable over coming months, reducing pressure on the ECB for an immediate rate cut.

The week ahead in the euro area: ECB to nudge down GDP outlook but still anticipate recovery

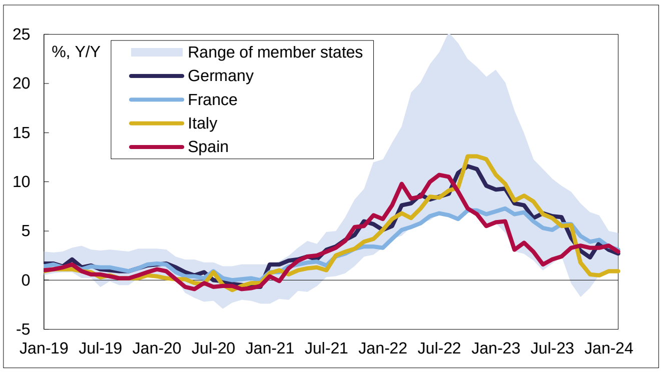
When it meets in the coming week, the ECB's Governing Council will be presented with new staff macroeconomic projections. Among other things, the staff will need to nudge down somewhat the outlook for euro area GDP. Economic growth in Q4 (0.0%Q/Q) slightly underperformed the Eurosystem's most recent projection (0.1%Q/Q). Survey indicators such as the flash PMIs and Commission ESIs point to slight improvement in Q1 in most member states with the notable exception of Germany. But the ECB's growth projection for the current quarter (0.2%Q/Q) looks too high to us, as does the pace anticipated in Q2 (0.3%Q/Q) and Q3 (0.4%Q/Q). Of course, while tight monetary policy is weighing significantly on activity and contributing to the continued major economic underperformance of the euro area relative to the US, the majority of Governing Council members will not be perturbed. They will continue to expect economic growth gradually to pick up over coming quarters. And the inflation projections will remain much more important in shaping the ECB's policy decision and forward guidance.

Euro area: Contributions to HICP inflation



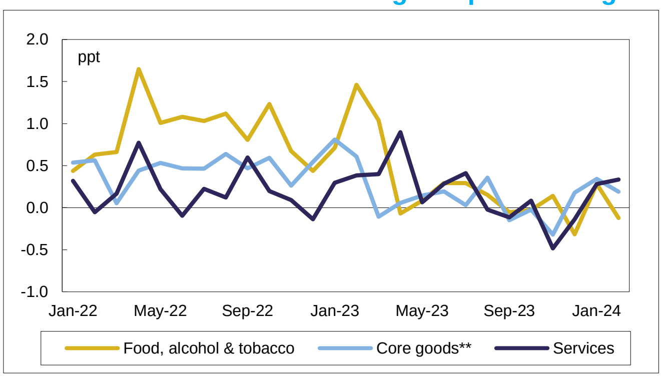
**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Euro area: Consumer price inflation



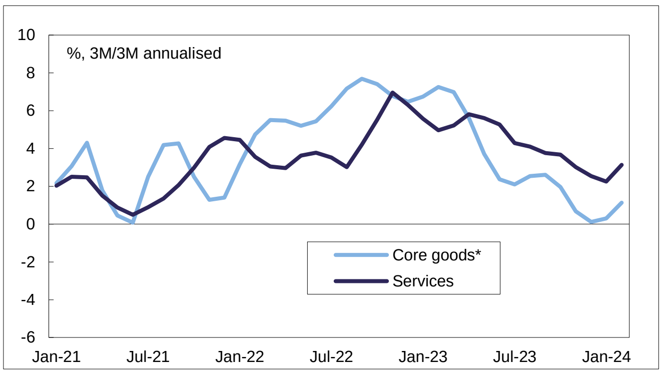
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

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



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

Inflation projection also set to be lowered slightly

Following today's flash February estimates, headline inflation appears to be slightly undershooting the Eurosystem's projection for the current quarter (2.9%Y/Y) while the core inflation forecast (3.1%Y/Y) remains on track. And thanks in particular to the further significant downwards shift in the wholesale natural gas price curve, the ECB should also revise down its inflation outlook for the coming few quarters. In its December projections, the Eurosystem expected the headline HICP rate to return to the 2.0%Y/Y target in Q325, and to slip slightly below target from Q126 on. It also expected core inflation to fall no lower than 2.1%Y/Y from Q425 on. In the updated projections, the ECB staff should raise the prospect that headline inflation will, temporarily at least, return to target later this year. And they should also project it to average 2.0%Y/Y or less in both 2025 and 2026. They should also forecast core inflation to average 2.0% or slightly less in 2026.

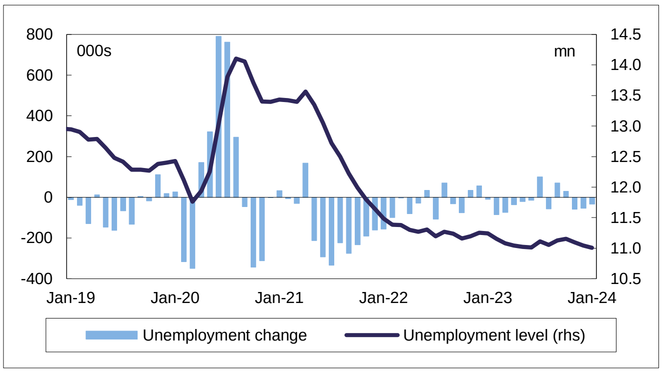
March too soon for a first rate cut, with June most likely

If the staff macroeconomic projections are revised as we expect, the case for a first rate cut for this cycle ought to be discussed, at least briefly, by the Governing Council this month. Indeed, with September's final rate hike of the tightening cycle having been presented merely as an insurance policy against upside risks, which have failed to materialise, the significant decline in the headline HICP rate and various underlying measures of inflation over recent months, and expectations of a return to target over the horizon, would suggest that the insurance hike can now be reversed. However, at 3.1%Y/Y, core inflation remains too high for comfort for the majority on the Governing Council while the pickup in recent momentum in services prices will also be disconcerting for many members. Despite evidence that firmer labour cost growth is being absorbed by lower profit margins, and firms are continuing to revise down their selling-price expectations, the Governing Council's hawks will also remain concerned that wages still pose an upside risk to the inflation outlook, not least as the euro area unemployment rate remains historically low while negotiated wage growth was more than double the long-run average in Q4 at 4.5%Y/Y. And so, we suspect that the majority on the Governing Council will want to see a further drop in headline and core inflation to below 2½%Y/Y, as well as a moderation in negotiated wage growth in the Q1 data to be released in May – which we think is likely – before agreeing in June for a first rate cut.

Statement to welcome disinflation progress and insist that policy will remain data dependent

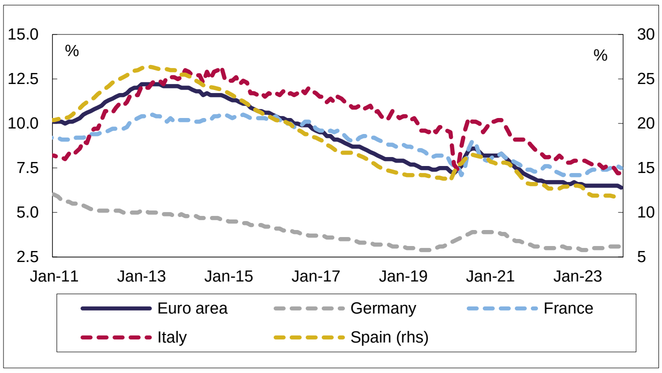
In its policy statement to be issued this month, therefore, the Governing Council will probably repeat much of what it stated following its previous monetary policy meeting in January. In particular, it will note that the declining trend in underlying inflation has continued, in part in response to the impact of past interest rate increases on demand. It will reiterate that rates will continue to be set at sufficiently restrictive levels for as long as necessary. And it will restate that the Governing Council's

Euro area: Unemployment rate & monthly change



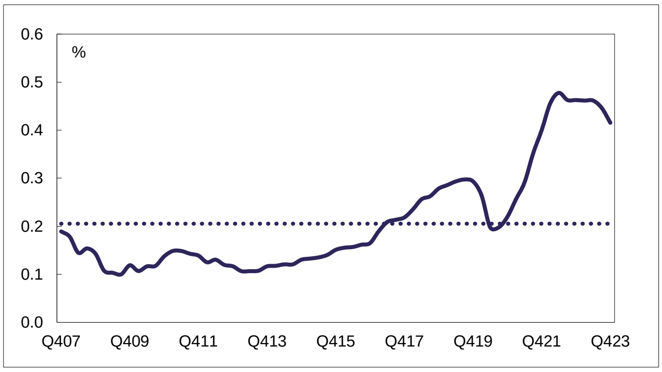
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates by member state



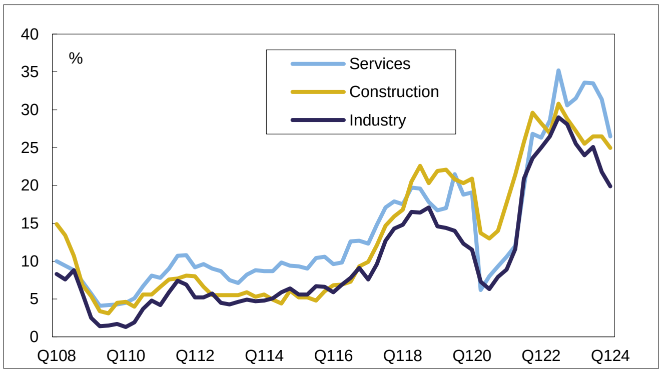
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Job vacancy-to-unemployment ratio*



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

Euro area: Firms reporting labour shortages



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

policy decisions will remain data dependent. However, its projections should make clear that the return of inflation to target on a sustained basis is now within sight. And, in her press conference, President Lagarde is likely to intimate that all subsequent policy meetings will be live for a possible rate cut, even if that first easing of policy is more likely to come in June than April.

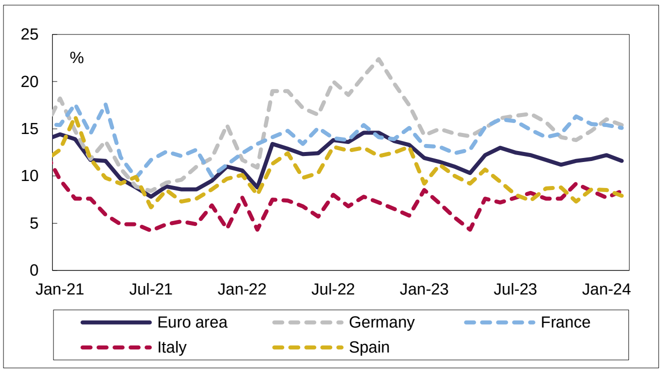
Framework announcement possible with implications for future money market functioning

Finally, it is possible that the Lagarde's press conference could bring information on the outcome of the ECB's review of its operational framework, which would have implications for future money market functioning as balance sheet reduction becomes more advanced. While Lagarde previously suggested that the review would be concluded by the end of the spring, a Reuters report published yesterday suggested that agreement had largely already been reached, although the detail might only be finalised later this month. The report stated that policymakers had agreed to adopt a BoE-style 'demand-driven floor' system. In particular, the ECB's deposit rate would continue to help to determine the lower bound of the interest rate corridor in money markets but the total level of bank reserves, and its distribution, would be determined via take-up at BoE-style lending operations. As excess liquidity is likely to persist for several years – perhaps until 2029 – the immediate consequences of any announcements should be minimal.

The data week ahead in the euro area

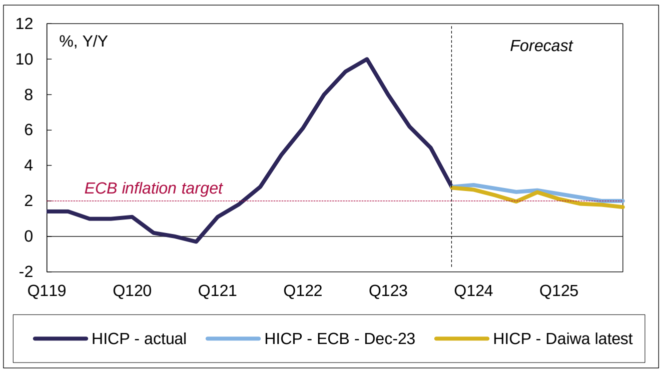
In terms of the coming week's economic data, producer price figures and final services PMIs (both due Tuesday) will provide some further insight into the outlook for inflation. While the annual pace of decline in euro area producer prices is likely to have moderated from -10.6%Y/Y in December due to a smaller drag from energy, it will still remain firmly in negative territory for the eighth consecutive month reflecting the ongoing easing in underlying factory price pressures. In contrast, however, the final services price PMIs are likely again to suggest a pickup in input costs in the sector, with the respective flash index rising to a nine-month high amid reports of persisting wage pressures. As such, the respective flash prices charged component also rose to its highest since last May to remain firmly above the long-run average. In terms of economic activity, euro area retail sales figures (Wednesday) will likely confirm that consumer spending on goods maintained subdued in January, with sales in Germany and France having edged lower that month. Meanwhile, updated national accounts data (Friday) are expected to confirm that, despite a marked downwards revision to Irish GDP in Q4 – figures today reported that the respective contraction was revised from -0.7%Q/Q to -3.4%Q/Q – euro area economic output in Q4 was unchanged from Q3, maintaining the sideways trend of the past five quarters. This release will bring the first official expenditure breakdown, which is likely to show that the drag from fixed investment was offset by a positive contribution from net trade, while household and government spending offered little support. Among the national releases, the main focus will be Germany's

Euro area: Labour hoarding indices



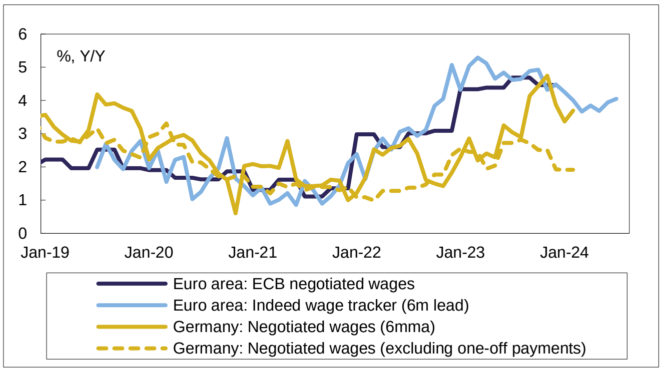
Source: EC and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



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

Euro area: Wage indices



Source: Macrobondand Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas contracts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

manufacturing performance at the start of the year, with January figures for goods trade (Wednesday), factory orders (Thursday) and industrial production (Friday) due. While surveys have been mixed, truck toll mileage figures suggest that production rose for the first month in nine in January, albeit by a modest 0.5%M/M. The February construction PMIs (Wednesday) will illustrate that building activity in Germany continues to contract sharply and underperform other member states.

UK

The week ahead in the UK: Budget to announce loosening of fiscal

The most notable event for UK financial markets in the coming week will be Wednesday's government Budget announcement, probably the last to come before the next general election. Given the ruling Conservative party's dire poll ratings and comments from ministers and tory MPs, the announcement of certain further tax cuts, following the reduction in National Insurance Contributions at the start of the year and extension of investment incentives, is fully expected. However, the full extent, nature and timing of any net easing of the fiscal stance to be announced is uncertain. And the precise details will have a bearing on the outlook for economic growth, inflation, BoE monetary policy and UK asset prices.

The OBR's updated forecasts for the public finances will determine the 'fiscal headroom' available to the Chancellor to ease policy while, at face value, remaining on track to meet the government's rather arbitrary objective for debt to fall as a share of GDP in five years' time. However, many of the OBR's assumptions – including for public expenditure and fuel duties – will be unrealistic. Indeed, the use of alternative, more plausible assumptions would suggest that tax cuts at the present juncture would be reckless and would need to be reversed following the general election. And it would certainly be unwise for the Chancellor to give away all of the headroom that the OBR suggests is available to him.

Nevertheless, at the time of the government's Autumn statement, the OBR's projections suggested that the Chancellor might have headroom for a further £13bn (or roughly ½% of GDP) easing of fiscal policy this time around, which might at a stretch (if accompanied by certain revenue hikes, e.g. higher duties on tobacco and vaping) be used to fund a 2p cut in income tax. Since then, public net borrowing has come in below the OBR's expectations. And – despite recent market moves – lower expectations for Bank Rate, lower Gilt Yields, and the likelihood of a sharp drop in inflation in April thanks not least to the cut in the regulated household energy price cap – should also increase the amount of headroom. At the same time, the 0.3%Q/Q drop in GDP in Q4, as well as the recent downwards revision to estimates of the unemployment rate and upwards revision to the level of labour inactivity, might lead the OBR to revise down its assessment of potential GDP growth (which is far higher than that of the BoE), acting to reduce the extent of fiscal headroom. And a recent media report even suggested that the Chancellor had been told that headroom had not increased at all since the autumn. So, the overall amount of fiscal easing currently priced into financial markets is highly uncertain.

The data week ahead in UK

The coming week's data calendar will be relatively light for top-tier releases, kicking off with the final February services PMIs, BRC retail sales monitor and new car registrations figures on Tuesday. The flash PMI release saw the headline services activity index move sideways at January's eight-month high of 54.3. The new orders component signalled an accelerated pace of growth ahead, while business expectations for the coming twelve months were the best for two years. The BRC retail monitor is likely to report a more modest improvement as households remain reluctant to buy durable goods. In this respect, new car registrations will have likely remain weak. The respective construction PMI survey (Wednesday) is, however, expected to flag ongoing challenges as a mix of high borrowing costs, weak consumer confidence and persisting economic uncertainties continue to hit demand. In terms of price pressures, the flash services PMIs suggested that input costs and selling-price pressures remained elevated and well above the long-run average as firms tried to pass on higher wage demands to consumers. The BoE's Decision Maker Panel survey results for February are also due Thursday.

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

Daiwa economic forecasts

	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4	2025 Q1	2023	2024	2025
GDP								**%, Y/Y**	
Euro area	0.0	0.1	0.2	0.2	0.3	0.3	0.5	0.4	1.3
UK	-0.3	0.2	0.2	0.2	0.2	0.2	0.1	0.2	1.0
Inflation, %, Y/Y									
Euro area									
Headline HICP	2.7	2.6	2.3	2.0	2.5	2.1	5.4	2.3	1.8
Core HICP	3.7	3.1	2.2	1.9	2.3	1.8	4.9	2.4	1.6
UK									
Headline CPI	4.1	3.5	1.7	1.9	2.3	2.2	7.3	2.3	2.1
Core CPI	5.3	4.5	2.7	2.3	2.5	2.4	6.2	3.0	2.1
Monetary policy, %									
ECB									
Refi Rate	4.50	4.50	4.25	3.75	3.25	2.75	4.50	3.25	2.75
Deposit Rate	4.00	4.00	3.75	3.25	2.75	2.25	4.00	2.75	2.25
BoE									
Bank Rate	5.25	5.25	5.00	4.50	4.00	3.50	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	Feb	**46.5**	*46.1*	46.6	-
	Preliminary headline HICP (core HICP) Y/Y%	Feb	**2.6 (3.1)**	*2.5 (2.8)*	2.8 (3.3)	-
	Unemployment rate %	Jan	**6.4**	6.4	6.4	6.5
Germany	Final manufacturing PMI	Feb	**42.5**	*42.3*	45.5	-
France	Final manufacturing PMI	Feb	**47.1**	*46.8*	43.1	-
Italy	Manufacturing PMI	Feb	**48.7**	49.5	48.5	-
	Unemployment rate %	Jan	**7.2**	7.2	7.2	-
	Preliminary HICP (CPI) Y/Y%	Feb	**0.9 (0.8)**	-	0.9 (0.8)	-
Spain	Manufacturing PMI	Feb	**51.5**	49.8	49.2	-
UK	Final manufacturing PMI	Feb	**47.5**	*47.1*	47.0	-
	Nationwide house price index M/M% (Y/Y%)	Feb	**0.7 (1.2)**	0.3 (0.7)	0.7 (-0.2)	-

Auctions

Country	Auction
- Nothing to report -	

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 04 March 2024						
Euro area		09.30	Sentix investor confidence index	Mar	-10.8	-12.9
Spain		08.00	Unemployment change 000s	Feb	-	60.4
Tuesday 05 March 2024						
Euro area		09.00	Final services (composite) PMI	Feb	_50.0 (48.9)_	48.4 (47.9)
		10.00	PPI Y/Y%	Jan	-8.0	-10.6
Germany		08.55	Final services (composite) PMI	Feb	_48.2 (46.1)_	47.7 (47.0)
France		07.45	Industrial production M/M% (Y/Y%)	Jan	0.0 (1.7)	1.1 (0.9)
		08.50	Final services (composite) PMI	Feb	_48.0 (47.7)_	45.4 (44.6)
Italy		08.45	Services (composite) PMI	Feb	52.3 (51.5)	51.2 (50.7)
		09.00	Final GDP Q/Q% (Y/Y%)	Q4	_0.2 (0.5)_	0.1 (0.1)
Spain		08.15	Services (composite) PMI	Feb	53.4 (52.0)	52.1 (51.5)
UK		00.01	BRC retail sales monitor, like-for-like sales Y/Y%	Feb	1.6	1.4
		09.00	New car registrations Y/Y%	Feb	-	8.2
		09.30	Final services (composite) PMI	Feb	_54.3 (53.3)_	54.3 (52.9)
Wednesday 06 March 2024						
Euro area		08.30	Construction PMI	Feb	-	41.3
		10.00	Retail sales M/M% (Y/Y%)	Jan	0.1 (-1.3)	-1.1 (-0.8)
Germany		07.00	Trade balance €bn	Jan	21.0	22.4
		08.30	Construction PMI	Feb	-	36.3
France		08.30	Construction PMI	Feb	-	39.6
UK		08.30	Construction PMI	Feb	49.0	48.8
Thursday 07 March 2024						
Euro area		13.15	ECB deposit rate %	Mar	_4.00_	4.00
Germany		07.00	Factory orders M/M% (Y/Y%)	Jan	-6.5 (-5.5)	8.9 (2.7)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jan	0.4 (-)	-0.3 (-0.2)
UK		09.30	BoE's DMP 3M (1Y) CPI expectations Y/Y%	Feb	-	4.3 (3.4)
Friday 08 March 2024						
Euro area		10.00	Final GDP Q/Q% (Y/Y%)	Q4	_0.0 (0.1)_	-0.1 (0.0)
		10.00	Final employment Q/Q% (Y/Y%)	Q4	_0.3 (1.3)_	0.2 (1.3)
Germany		07.00	Industrial production M/M% (Y/Y%)	Jan	0.4 (-4.9)	-1.6 (-3.0)
		07.00	PPI Y/Y%	Jan	-6.8	-8.6
France		07.45	Trade balance €bn	Jan	-	-6.8
Italy		09.00	PPI Y/Y%	Jan	-	-20.5

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country	GMT	Event / Auction
Monday 04 March 2024		
		- Nothing scheduled -
Tuesday 05 March 2024		
Germany	10.30	Auction: €4bn of 2.1% 2029 bonds
UK	10.00	Auction: £3.75bn of 3.75% 2027 bonds
Wednesday 06 March 2024		
UK	12.30	UK Chancellor Hunt to present Spring Budget
Thursday 07 March 2024		
Euro area	13.15	ECB monetary policy announcement
	13. 5	ECB President Lagarde holds post-meeting press conference
France	09.50	Auction: 3.5% 2033 bonds
	09.50	Auction: 1.25% 2034 bonds
	09.50	Auction: 1.25% 2038 bonds
	09.50	Auction: 3.25% 2045 bonds
Spain	09.30	Auction: 3.5% 2029 bonds
	09.30	Auction: 0.5% 2031 bonds
	09.30	Auction: 3.25% 2034 bonds
	09.30	Auction: 2.05% index-linked bonds
UK	09.30	BoE publishes Decision Maker Panel data – February
Friday 08 March 2024		
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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