Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds were little changed on the day as euro area retail sales remained subdued and a construction sector survey remained consistent with contraction.
- Gilts made gains as the UK Chancellor resisted political pressures and announced a relatively modest fiscal easing that should have little impact on the BoE's forthcoming monetary policy decisions.
- Thursday will bring the ECB's latest monetary policy announcement and updated projections along with data for German factory orders.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/26	2.847	+0.005
OBL 2.1 04/29	2.358	+0.002
DBR 2.2 02/34	2.319	-0.002
UKT 0⅛ 01/26	4.229	-0.036
UKT 0½ 01/29	3.933	-0.036
UKT 4⅝ 01/34	3.989	-0.018

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

Euro area

Retail sales subdued but stable at the start of the year

Broadly in line with expectations, euro area retail sales were subdued but stable at the start of the year, rising minimally by just 0.1%M/M in volume terms in January following a revised drop of 0.6%M/M in December. That left sales down 1.0%Y/Y, 4.0% below the peak in June 2021 and 0.2% below the Q4 average. Among the large member states to publish data, sales fell 1.6%M/M and 1.1%M/M in January in Germany and France respectively following drops in both countries in December. However, sales grew in the Netherlands (1.2%M/M) and were also probably firmer in Italy and/or Spain where the figures are not currently available. By category of good, with price pressures having eased, sales of food and related items rebounded 1.0%M/M in January with sales of auto fuel also stronger (1.7%M/M). However, despite new year discounting, sales of core (non-food and non-fuel) items were soft, down for a second successive month albeit by just 0.2%M/M. And unlike sales of auto fuel, which were up 1.2%Y/Y, sales of food (-0.6%Y/Y) and core goods (-1.4%Y/Y) were still well down on a year earlier.

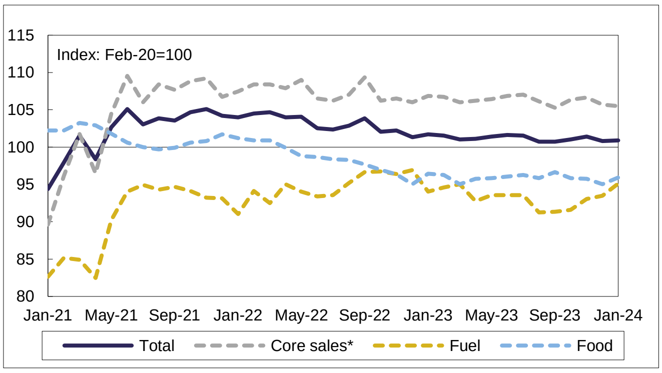
Retail sales should rise modestly again in Q1 & consumption should drive pickup in GDP in 2024

Given the positive revisions to the figures for the end of last year, euro area retail sales volumes are now estimated to have stabilised in Q4 with growth of 0.1%Q/Q following a drop of 0.4%Q/Q in Q3. That stabilisation tallies with the pick up in real disposable incomes and modest improvement in survey measures of consumer confidence and willingness to make major purchases. As spending on services also likely posted positive growth, the data reinforce our expectation that the expenditure breakdown of GDP, due on Friday, will report a second successive quarterly increase in household consumption in Q4, probably at 0.2%Q/Q. And despite the lacklustre start to 2024, retail sales should grow modestly in Q1 and coming quarters. And we maintain our expectation that a steady pickup in private consumption will drive the gradual recovery in overall GDP growth this quarter and as the year goes on.

Construction PMIs improve in February, but point to ongoing contraction in the sector

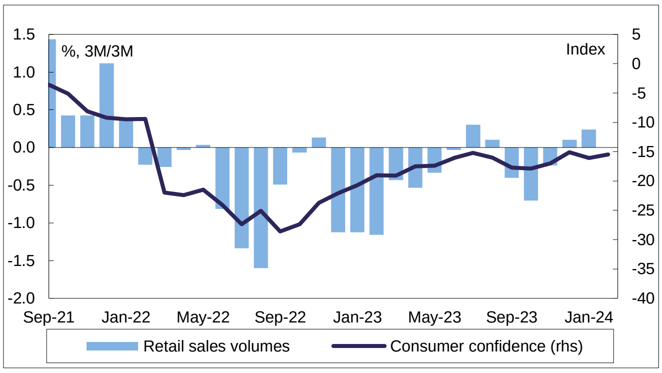
Today's euro area construction PMIs suggested that activity in the sector continued to contract sharply in the middle of Q1 as higher borrowing costs and falling real estate prices restrained demand. Having declined in January (by more than 2pts to 41.3) to its lowest level in more than a decade when excluding the first Covid-19 wave, the headline activity index edged up in February, by 1.6pts to 42.9, as the respective civil engineering index rose to a six-month high (+0.6pt to 48.7) and the commercial activity index reversed January's decline (+3.1pts to 43.9). But the survey signalled a persisting downtrend in house building, with the respective component down to a six-month low (-0.2pt to 36.2). While the German house building PMI edged up to a five-month high in February (30.6), it still implied the fastest pace of contraction among the larger member

Euro area: Retail sales



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales & consumer confidence



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

states. And the equivalent French PMI (34.1) slipped to its second-lowest level since the initial pandemic slump, while the respective Italian index fell sharply (-4.8pts to 47.0) to mark the first contractionary reading since August. Overall, having enjoyed strong growth over recent months, the Italian construction PMI was consistent with stagnation in the sector (50.3) in February. And today's survey also signalled that challenges remain more acute in Germany and France. And so, while yesterday's French construction output numbers saw activity edge higher in January, and Friday's release of equivalent German numbers might well also report a temporary boost amid unseasonably mild weather at the start of the year, we expect the construction sector to continue to subtract from euro area economic growth over coming quarters.

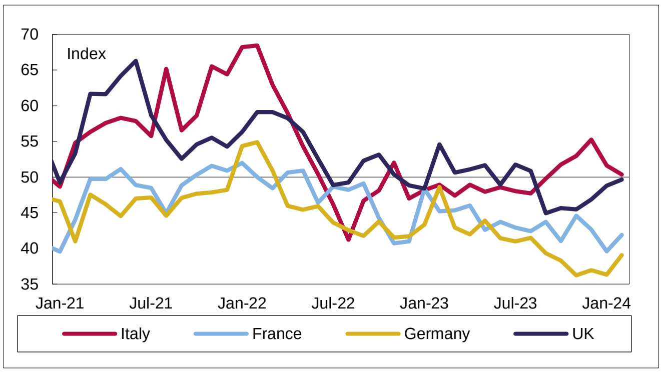
German goods trade surplus at record high in January amid a rebound in exports

Today's German goods trade report was more encouraging, suggesting a notable rebound in exports following a disappointing slump at the end of last year. Indeed, the value of exports jumped 6.3%M/M in January – the most since June 2020 and 2006 excluding the volatility at the start of the pandemic – led by a near-8%M/M increase in shipments to other euro area member states and a near-12%M/M increase in exports to elsewhere in the EU. So, on a three-month basis, export values were up 1.9%, the most in fourteen months. While there was also a pick up in the value of imports in January (3.6%M/M), this reversed only part of the decline in December, to leave them still down 2.9%3M/3M. As such, the goods trade surplus rose a much larger-than-expected €4.2bn in January to a new high of €27.5bn. Of course, it remains to be seen to what extent relative price changes played a role in the widening of the trade surplus. But, at face value, today's figures certainly provide cause for cautious optimism that net trade maintained a positive impulse on German GDP growth at the start of the year.

The day ahead in the euro area

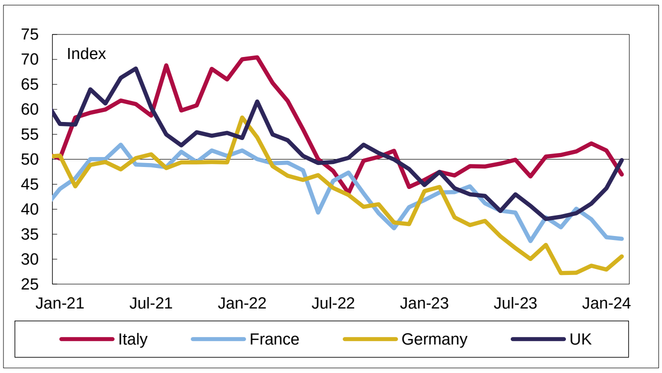
The main event in the euro area tomorrow will be the conclusion of the ECB's Governing Council meeting. Admittedly, the immediate policy decision will be a non-event, with the key policy parameters widely expectedly to be left unchanged. And the Governing Council will probably repeat much of what it stated following its previous monetary policy meeting in January. So, it should note that the declining trend in underlying inflation has continued, in part in response to the impact of past interest rate increases on demand, while reiterating that rates will continue to be set at sufficiently restrictive levels for as long as necessary. It will also restate that the Governing Council's policy decisions will remain data dependent. While the Governing Council's hawks will remain concerned that wages still pose an upside risk to the inflation outlook, and the pickup in recent momentum in services prices might also be disconcerting for many members, the Governing Council will be presented with updated economic forecasts, which should make clear that the return of inflation to target on a sustained basis is now within sight. As such, in her press conference, President Lagarde is likely to intimate that all subsequent policy

Europe: Headline construction PMIs



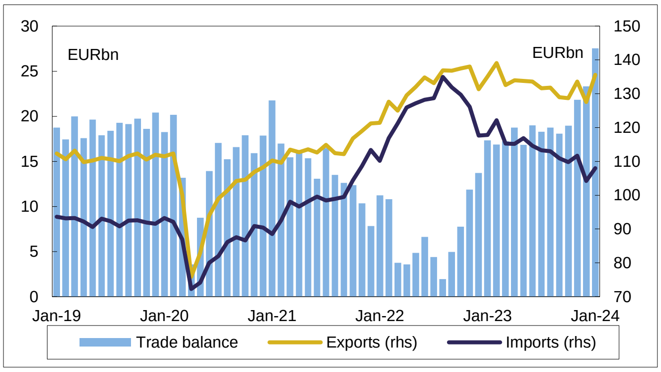
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Housing activity PMIs



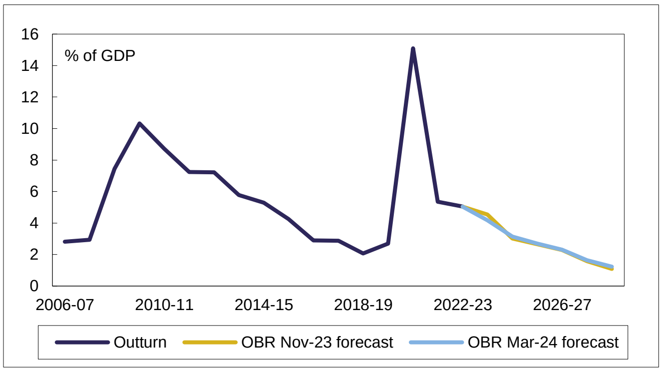
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: Goods trade balance, imports & exports*



**Seasonally adjusted values. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Public sector net borrowing



Source: OBR and Daiwa Capital Markets Europe Ltd.

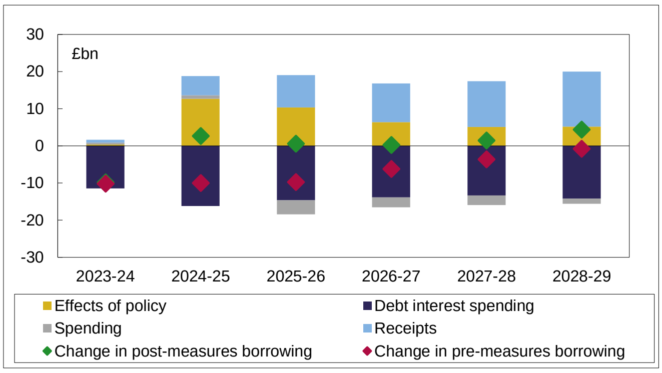
meetings could be live for a possible rate cut, even if that first easing of policy is much more likely to come in June than April.

In terms of the 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 current growth projection for this 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). More important for policy decisions will be the inflation forecasts. With headline HICP inflation currently on track to undershoot the ECB's previous forecast for Q1, and given the 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. There is also a decent case for the staff to forecast core inflation to average 2.0% or slightly less in 2026.

Finally, it is possible that 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 last week 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.

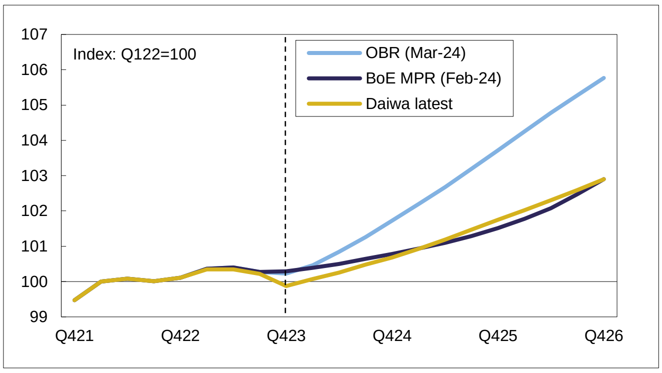
In terms of economic data, German factory orders will provide an update on conditions in the manufacturing sector at the start of the year. But having jumped in December (8.9%M/M) due to a high volume of bulk purchases, orders are expected to have fallen sharply at the start of the year. And so, when excluding major items, we expect the downtrend in core orders to have been maintained.

UK: Change in public sector net borrowing forecast*



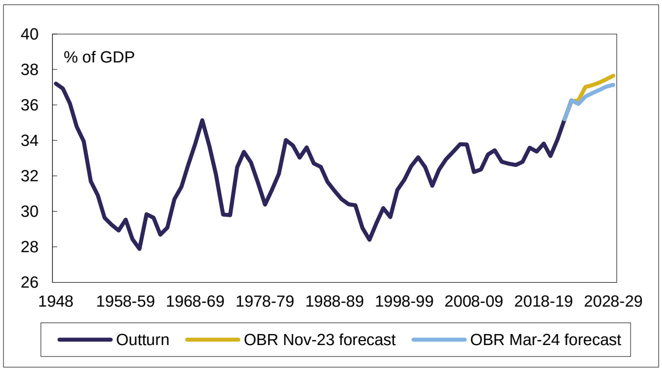
*Compared with Autumn Statement in November 2023. Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: GDP growth forecasts compared



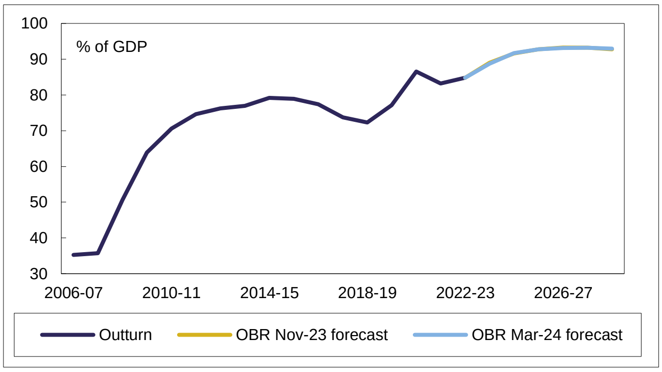
Source: Macrobond, BoE, OBR and Daiwa Capital Markets Europe Ltd.

UK: Tax revenues



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK

Modest fiscal easing will have little impact on BoE monetary policy decisions

In line with the media reports of recent days, the Chancellor today eschewed political pressures for a big pre-election Budget giveaway and instead announced a modest easing of fiscal policy based on relatively small-scale tax cuts. In particular, extending the cut of the same magnitude implemented at the start of this year, employee National Insurance Contributions (NICS) will be reduced by a further 2p from next month, which will be worth roughly £450 per year to 27mn people in work. And he cut self-employed NICS by the same amount, twice as much as at the start of the year, to give the same benefit to a further 2mn workers. The cost of those payroll tax cuts to the public finances was about £10bn. In addition, fuel and alcohol duties were frozen while additional incentives for investing in UK equities, including via a new British ISA, announced. But there were some small offsetting tax-raising measures, including with respect to North Sea oil and gas producers, e-cigarettes and non-domiciled taxpayers. And the Chancellor maintained his unrealistic plans for very modest growth (1% real annual increases) in current public expenditure over the coming five years, which will imply zero real-terms growth in public spending per capita and real-terms cuts to most public services. As a result, the net easing of fiscal policy announced today was modest at just £14bn (less than ½% of GDP) in FY24/5 declining to just £6bn by the end of the projection horizon in five years' time, an adjustment which is likely to have only a modestly positive impact on economic growth (less than ½ppt of GDP in the coming fiscal year) – principally via higher household consumption – and a negligible impact on inflation. As such, it is unlikely to impact significantly the BoE's judgements on monetary policy over coming months. And today's fiscal announcements had little significant impact on Gilts and sterling.

OBR makes little change to its GDP projection while nudging down its profile for GDP per capita

Indeed, despite today's fiscal easing, the OBR judged that the big picture with respect to the outlook for the UK economy is little changed from its judgement at the time of the autumn statement in November. Overlooking the negative carry-over from Q4's 0.3%Q/Q decline in GDP, the OBR nudged up its economic growth forecast for 2024 by just 0.1ppt to 0.8%Y/Y, which is admittedly significantly stronger than the BoE's (¼%Y/Y) and our own (0.2%Y/Y) pre-Budget projections. While growth is then forecast by the OBR to accelerate to (a perhaps unfeasibly strong) 1.9%Y/Y in 2025, it is then expected gradually to return to its estimate of medium-term potential growth around 1.6%Y/Y (which is similarly stronger than the BoE's estimate) by 2028. So, the OBR's updated forecast for the level of GDP in five years' time is broadly in line with its previous projection. We caution, however, that the OBR has a recent track record of over optimism regarding UK GDP growth. And as its updated growth projection benefits from an increased estimate of net immigration and population, the outlook for GDP per capita is anyway much less upbeat, with a second successive annual drop projected in 2024 to trough more than 1% below its pre-pandemic peak. And while it should grow from 2025 on, and real disposable income per person returns to its pre-pandemic peak in FY25/6, GDP per capita is projected at the end of its projection period in five years' time to be ¾% less than it forecast just four months ago.

Impact on PSNB modest but next government will need to tear up current fiscal plans

Meanwhile, in terms of the public finances, today's announcement represented the sixth successive modest fiscal easing since 2021. But public sector net borrowing (PSNB) was on track to undershoot the OBR's previous forecast by about £10bn this fiscal year, and a similar amount over the coming two fiscal years, principally due to lower debt interest costs. So, compared to the OBR's previous projection, after today's announcements, PSNB is now expected to be less than £3bn higher than anticipated in FY24/5, little different in the following two fiscal years, and less than £5bn (0.2% of GDP) higher in FY28/9. Moreover, contrasting the government's tax-cutting rhetoric, due not least to the freezing of personal tax thresholds, overall taxes as a share of GDP are still projected by the OBR to rise to the highest in at least 70 years, reaching 37.1% of GDP – some 4.0ppts above the pre-pandemic level – in FY28/9. At the same time, while public services are in a state of disrepair, public spending as a share of GDP is forecast unrealistically to drop 2ppts over the coming five years to 42.5% of GDP, some 3ppts above its pre-pandemic level. Those planned cuts to public expenditure account for more than two thirds of the 2.9ppt projected drop in public sector net borrowing (PSNB) to 1.2% of GDP over the coming five years. However, public sector net debt (excluding the Bank of England) is still projected to rise from 88.8% of GDP this fiscal year to a peak of 93.2% of GDP in four years' time before edging down slightly to 92.9% of GDP FY28/29. So, given the major uncertainties with respect to the outlook for growth and the public finances, there is evidently a significant risk that public debt will still be rising in five years' time. And there is also a very strong probability that the next government – almost certain to be led by the Labour party – will rip up these fiscal plans, boost public spending, and raise taxation further and/or redefine significantly its objectives for public net borrowing and debt.

UK construction PMI surprises on the upside as housing activity stabilises

Turning to today's data, the UK construction PMIs surprised to the upside, as recent signs of a pickup in house prices and mortgage approvals led to a stabilisation in building work. In particular, the headline construction activity PMI rose for the third consecutive month in February, by 0.9pt to 49.7, the highest since last August. This left it trending so far this quarter more than 3pts above the Q4 average. The improvement last month was led by housing activity, for which the respective output index jumped 5.6pts – the most since February 2022 – to 49.8. And while this was merely consistent with stagnation, the index was nevertheless some 10pts above the Q4 average. Meanwhile, the respective indices for commercial activity and civil engineering moved broadly sideways at 48.9 and 49.9. But while the new business component rose to a nine-month high (50.9) at a level implying modest growth in order books, and business optimism for the coming twelve months improved for the third time in four months to the highest level since January 2022, firms continued to cut headcount in February and at the fastest pace for more than three years.

The day ahead in the UK

Tomorrow will bring the results from the BoE's February Decision Maker Panel survey (DMP), with particular focus on firms' expectations for inflation and wages over the coming twelve months. While expectations for output prices for the year ahead rose slightly in January, up 0.3ppt to 4.5%Y/Y, perhaps reflecting higher shipping costs and supply-side disruption associated with the re-routing of cargo ships from the Red Sea, firms continued to expect CPI inflation to ease back, with the one-year forecast down 0.6ppt to 3.4%Y/Y, some 5ppts below the peak in September 2022. More importantly for monetary policy, inflation expectations three years ahead also edged lower, by 0.2ppt to 2.7%Y/Y, almost 2ppts below the peak. Meanwhile, the survey's gauge for expected pay over the coming year – which in January was still suggesting growth in excess of 5%Y/Y – will also be watched closely.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Construction PMI	Feb	**42.9**	-	41.3	-
		Retail sales M/M% (Y/Y%)	Jan	**0.1 (-1.0)**	0.1 (-1.3)	-1.1 (-0.8)	-0.6 (-0.5)
Germany		Trade balance €bn	Jan	**27.5**	21.0	22.2	23.3
		Construction PMI	Feb	**39.1**	-	36.3	-
France		Construction PMI	Feb	**41.9**	-	39.6	-
UK		Construction PMI	Feb	**49.7**	49.0	48.8	-

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/ *Daiwa forecast*	Previous
Euro area		13.15	ECB deposit rate %	Mar	*4.00*	4.00
Germany		07.00	Factory orders M/M% (Y/Y%)	Jan	-6.0 (-6.0)	8.9 (2.7)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jan	0.3 (-)	-0.3 (-0.2)
UK		09.30	BoE's DMP 3M (1Y) CPI expectations Y/Y%	Feb	- (3.0)	4.3 (3.4)

Auctions and events

Country		GMT	Event
Euro area		13.15	ECB monetary policy announcement
		13.45	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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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