Europe | Economic Research | 07 March 2024

Euro wrap-up

Overview

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- Bunds made gains as the ECB revised down significantly its inflation outlook and Lagarde signalled that the June meeting was live for a first rate cut.
- Gilts made losses as a BoE survey reported little improvement in firms' inflation expectations, while wage growth was also expected to remain above rates consistent with inflation returning to target.
- Tomorrow will bring German industrial production figures for January, as well as updated data for the euro area national accounts in Q4.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/26	2.816	-0.030
OBL 2.1 04/29	2.326	-0.032
DBR 2.2 02/34	2.293	-0.026
UKT 0⅛ 01/26	4.264	+0.035
UKT 0½ 01/29	3.948	+0.015
UKT 4⅝ 01/34	3.991	+0.002

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

Euro area

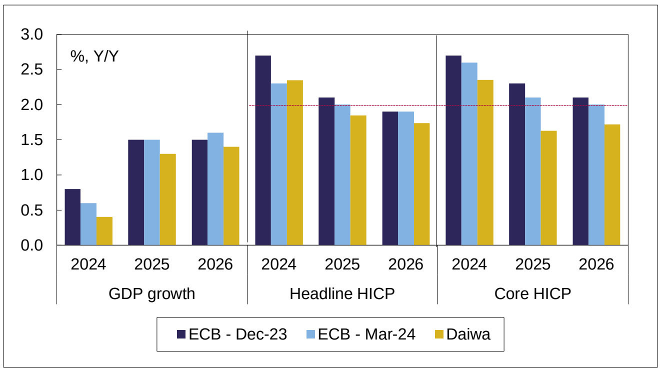
ECB revises down significantly its inflation outlook, Lagarde signals June live for a 1st rate cut

As expected, the Governing Council left the ECB's main interest rates unchanged when its monetary policy meeting concluded today. Its forward guidance was little changed too, with the policymakers insisting again that rates will be set at sufficiently restrictive levels for as long as necessary but also that future rate decisions will remain data dependent. Nevertheless, the ECB still moved closer to a rate cut, with President Lagarde noting in her press conference that, while there was no discussion of a possible rate cut this month, the Governing Council had a first debate on the pre-conditions for dialling back the restrictiveness of policy. And while the Governing Council's statement reiterated that domestic price pressures remain high, in part owing to strong wage growth, it also acknowledged that most measures of underlying inflation have continued to eased further. So, as we expected, the ECB's staff macroeconomic projections were significantly revised. Indeed, the outlooks for GDP and inflation were both nudged lower, with the latter forecast suggesting that the ECB is on track to meet its target. And so, the preconditions for a rate cut now appear close to being achieved. However, as intimated by the policy statement, the current rates of inflation and wage growth remain too high for the comfort of a majority of Governing Council members. And, with relatively few related pieces of data due to be released before the next policy meeting on 11 April, President Lagarde strongly intimated that the majority will only have sufficient evidence – particularly with respect to services inflation, labour costs and profit margins – to be ready to cut rates at the following monetary policy meeting on 6 June. So, that meeting remains our baseline expectation for a first rate cut.

Inflation outlook would justify rate cut already, but backwards-looking ECB wants more evidence

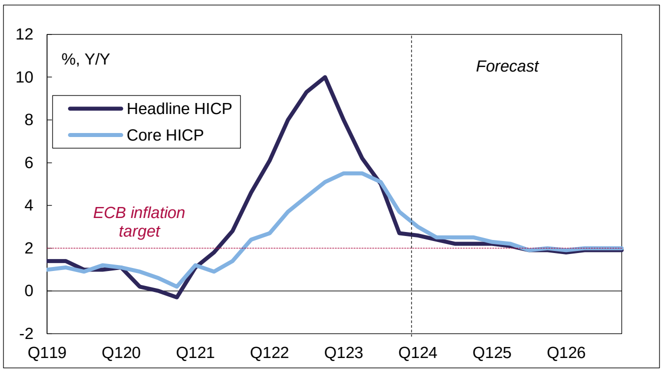
Among other things, the ECB's updated projections acknowledged the continued weakness of economic activity in Q1, with its growth forecast for the current quarter revised down to our own estimate of 0.1%Q/Q. But the ECB still thinks that momentum will gradually recover as the year goes on a little faster than we anticipate. So, it foresees growth reaching 0.4%Q/Q by Q423 and the same rate sustained each quarter thereafter. As such, it reduced its GDP growth forecast for 2024 by just 0.2ppt to 0.6%Y/Y, and left little changed its projections for 2025 and 2026 at around 1½%Y/Y. More notably, however, it revised down its inflation outlook from the current quarter through to Q126, bringing forward the date when the headline HICP rate falls below target to Q325. Indeed, its full-year forecasts for 2024 is now in line with our own, at 2.3%Y/Y (0.4ppt less than its previous projection), and is just 0.2ppt above our own at 2.0%Y/Y next year. And it also expects headline inflation to average a sub-target 1.9%Y/Y in 2026. While most of the improvement from its previous projection reflects lower energy prices, the ECB also revised down its outlook for core inflation across the horizon, to be in line with the 2.0% target in 2026. If policy was fully forward-looking, those projections would suggest that rates should now start to be cut to avoid policy becoming increasingly and damagingly restrictive. However, while growth and inflation have recently been undershooting its

Euro area: GDP & inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ECB inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

forecasts, the Governing Council is evidently still scarred by the experience of the past couple of years, and so is maintaining an excessively backward-looking reaction function when it comes to setting policy. The resulting (in our view unnecessary) delay to cutting rates is one reason why we are slightly more downbeat about GDP growth this year and think that core inflation will fall back to target and below in 2025.

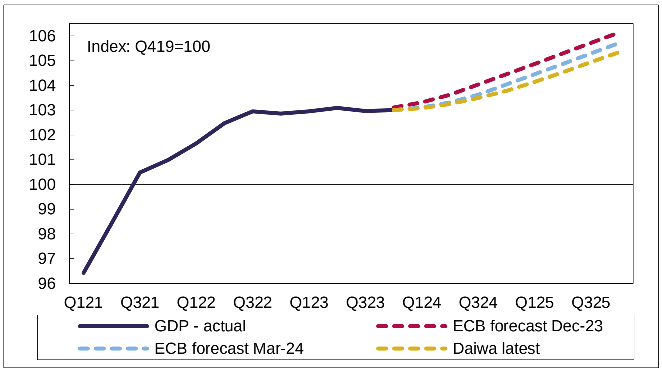
German factory orders slump in January following surge in December

Despite the rebound in exports at the start of the year, today's German factory orders data illustrated the persisting challenges facing the manufacturing sector in the euro area's largest member state. Indeed, total orders fell 11.3%M/M in January – the steepest monthly drop on the series excluding the initial slump at the start of the pandemic – to the lowest level since Q220 and Q213 before that. Admittedly, the magnitude of the decline in January largely reflected payback for the jump in one-off bulk orders at the end of last year, when total orders rose an upwardly revised 12%M/M. For example, electrical machinery orders slumped 33.2%M/M (vs +46.1%M/M in December) and orders for fabricated metals fell 14.5%M/M (vs +17.9%M/M in December), while orders for other transport equipment dropped 27.3%M/M (vs +125.0%M/M in December). So, when looking through monthly volatility, total orders were still up 2.4%3M/3M, the most in five months. But when excluding major items, a downtrend remained firmly in place. Core orders fell for the sixth month out of the past eight and by 2.1%M/M in January – the most since June – to the joint-lowest level since the global financial crisis excluding the first Covid-19 lockdown, reflecting notable declines in capital and consumer goods. So, on a three-month basis, core orders fell a further 1½% in January, the 22nd successive such drop, illustrating ongoing weakness in underlying demand for German manufactured goods.

Manufacturing turnover declines in January contrasting with improvement in truck toll mileage

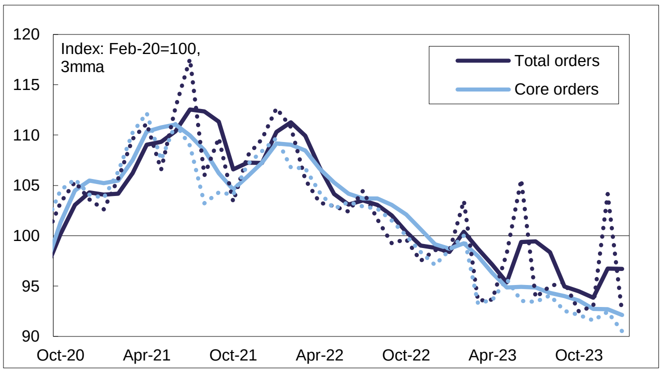
Today's release also reported a deterioration in manufacturing turnover at the start of the year, with the decline of 2.0%M/M the steepest since last March and the seventh monthly drop out of the past eight. So, while there was a notable upwards revision to turnover in December (up 1.4ppt to 1.3%M/M), this left the level at its lowest since April 2022 and down some 3½%Y/Y. Admittedly, the pace of decline on a three-month basis (0.7%3M/3M) was the softest since August. And contrasting with the monthly turnover data, truck toll mileage rebounded in January (2.4%M/M), while the manufacturing output PMI (45.7) rose to its highest in eight months, before falling back sharply in February (42.3). So, taken together with the expected boost to construction activity from the unseasonably mild weather at the start of the year, tomorrow's industrial production data are likely to report a modest (albeit likely temporary) increase in output for the first time since last April.

Euro area: GDP forecasts



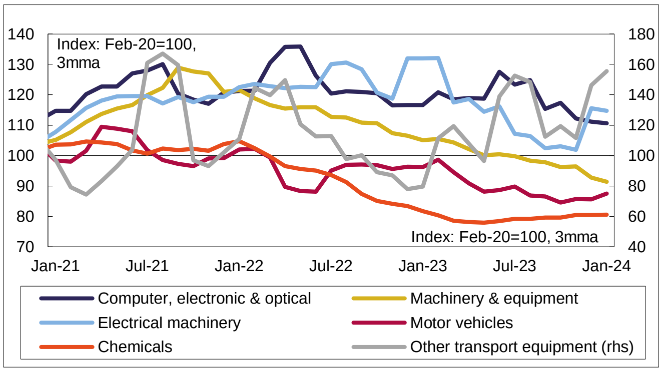
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders*



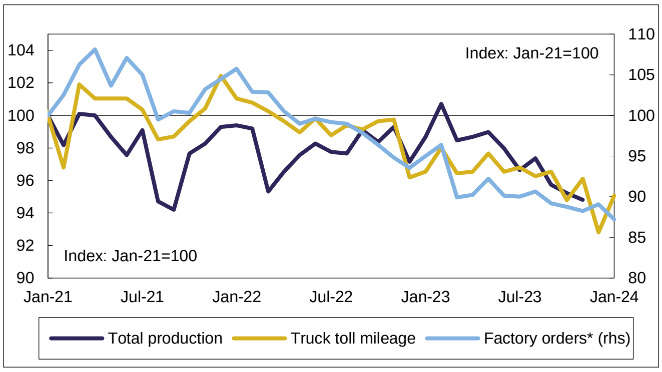
**Core orders exclude major items. Dotted lines represent unsmoothed data. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Germany: Orders in selected subsectors



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Orders, production & truck toll mileage



**Excluding major items. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

The day ahead in the euro area

Friday will bring the release of the aforementioned German industrial production figures for January. While today's manufacturing turnover figure points to a notable contraction at the start of the year, this is at odds with a pickup in truck toll mileage numbers in January. And the unseasonably mild weather that month should give a boost to construction work, which will help to offset any weakness in manufacturing. Meanwhile, updated national accounts data from the euro area are expected to confirm that, despite a marked downwards revision to Irish GDP in Q4 – figures last week 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. The ECB will also be watching the data for employee compensation given its possible implication for the inflation outlook.

UK

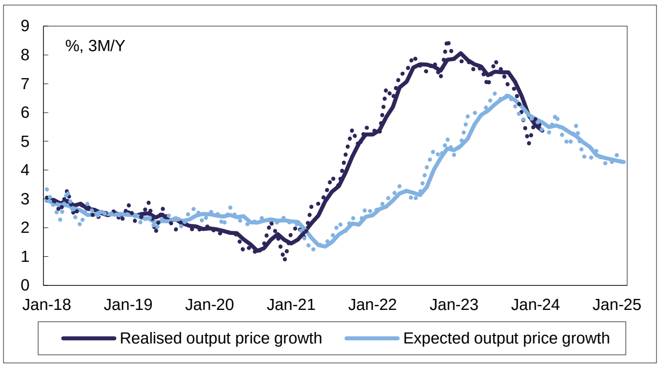
Firms' price and pay expectations still look too high to allow a rate cut just yet

The findings of the BoE's latest Decision Maker Panel (DMP) survey were, at face value, slightly disappointing, reinforcing the view that the majority of policymakers on the MPC will want to wait longer for more convincing evidence of a moderation in inflationary pressures before pulling the trigger on the first rate cut. In particular, firms' expectations for output price inflation in twelve months' time merely moved sideways in the three months to February at 4.3%Y/Y. This was nevertheless 2.3ppts below the peak in September 2022. Moreover, it largely reflected a jump in the single-month figure in January (4.5%Y/Y) perhaps related to the increase in shipping costs associated with the rerouting of cargo around the Red Sea, while the single-month rate in February fell to its lowest (4.1%Y/Y) since September 2021. The downtrend in firms' CPI expectations for the year ahead remained only gradual, down 0.1ppt to 3.3%Y/Y, while the forecast for three years' time moved sideways, still above target at 2.7%Y/Y. And policymakers will be discouraged to see that business expectations for wage growth for the year ahead – unchanged for a third conservative month at 5.2%3M/Y – remained above rates that would be consistent with achieving the 2% inflation target over the medium term. But the apparent stickiness in part reflected a spike in December, and expected pay growth in February fell 0.2ppt to 4.9%Y/Y, the lowest since May 2022, suggesting a more favourable outlook over the near term.

The day ahead in the UK

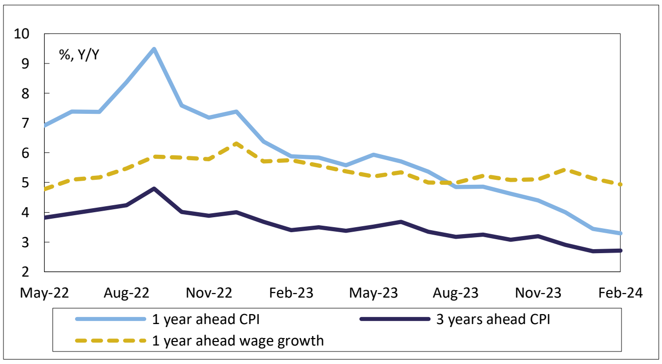
It should be a quiet end to the week with no UK top-tier data due.

UK: Firms' output price expectations*



**Dotted lines represent single-month figures. Source: BoE DMP survey, Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Firms' CPI & wage growth expectations



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

European calendar

Today's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
Euro area	ECB deposit rate %	Mar	**4.00**	*4.00*	4.00	-
Germany	Factory orders M/M% (Y/Y%)	Jan	**-11.3 (-6.0)**	-6.5 (-5.5)	8.9 (2.7)	12.0 (6.6)
UK	BoE's DMP 3M (1Y) CPI expectations Y/Y%	Feb	**4.3 (3.3)**	-	4.3 (3.4)	-

Auctions

Country	Auction
France	sold €4.68bn of 3.5% 2033 bonds at an average yield of 2.79%
	sold €2.85bn of 1.25% 2034 bonds at an average yield of 2.81%
	sold €4.62bn of 1.25% 2038 bonds at an average yield of 3.02%
	sold €842mn of 3.25% 2045 bonds at an average yield of 3.15%
Spain	sold €1.71bn of 3.5% 2029 bonds at an average yield of 2.857%
	sold €2.05bn of 0.5% 2031 bonds at an average yield of 2.965%
	sold €2.3bn of 3.25% 2034 bonds at an average yield of 3.162%
	sold €510mn of 2.05% 2039 index-linked bonds at an average yield of 1.381%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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	0.6 (-4.8)	-1.6 (-3.0)
	07.00	PPI Y/Y%	Jan	-6.6	-8.6
France	07.45	Trade balance €bn	Jan	-	-6.8
Italy	09.00	PPI Y/Y%	Jan	-	-20.5
Spain	08.00	Industrial production M/M% (Y/Y%)	Jan	0.3 (-)	-0.3 (-0.2)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.