Euro wrap-up

Overview

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- Shorter-dated Bunds made gains as ECB Chief Economist Lane flagged downside risks to the growth outlook, while euro area inflation was revised down from the flash estimate and the ECB wage tracker anticipated a notable moderation in 2025.
- Ahead of tomorrow's BoE announcement, Gilts made losses as the UK's headline inflation rose to an eight-month high in November.
- The BoE is expected to hold Bank Rate steady at 4.75%, while a German consumer and French business sentiment survey are due.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.019	-0.024
OBL 2½ 10/29	2.065	+0.003
DBR 2.6 08/34	2.243	+0.015
UKT 4⅛ 01/27	4.451	+0.006
UKT 4⅛ 07/29	4.390	+0.023
UKT 4¼ 07/34	4.556	+0.034

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

Euro area

Final euro area inflation revised a touch lower from the flash but still highest since August

Today's final euro area inflation figures for November brought a modest downwards revision from the flash estimate, by 0.1ppt to 2.2%Y/Y. This still represented a rise of 0.2ppt from October and the highest rate since August. But like in the flash release, the detail confirmed that the energy component was the main cause of the rise in inflation in November. With prices of auto fuel and household utilities up this month in contrast to the marked declines a year ago, energy inflation jumped a chunky 2.6ppts to a four-month high (-2.0%Y/Y), albeit a touch less than initially estimated. In contrast, inflation of food, alcohol and tobacco moderated 0.2ppt to 2.7%Y/Y. And while inflation of non-energy industrial goods rose 0.2ppt to a four-month high (0.7%Y/Y), reflecting upwards impulses from clothing and motor vehicles, services inflation reversed the slight rise in October to fall back to 3.9%Y/Y, with a decline in inflation of package holidays, accommodation and catering services, more than offsetting a pickup in airfares and a still-elevated insurance component. So, euro area core inflation was unchanged at 2.7%Y/Y for a third successive month.

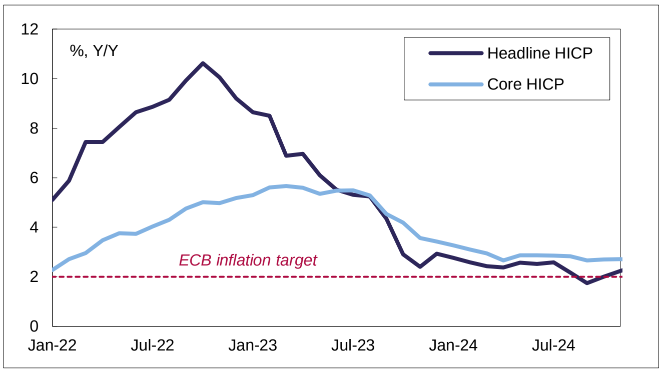
Services price-setting behaviour now consistent with a return of inflation to target

Other measures of underlying inflation published by the ECB today, including the 15% trimmed mean (2.4%Y/Y) and supercore HICP (2.8%Y/Y), similarly moved sideways last month. The principal common component estimate (PCCI) – which ECB staff think often provides the best guide to underlying pressures – was also unchanged at just 2.0%Y/Y in November, while the core PCCI fell to a four-month low of 1.85%Y/Y. And a closer look at the core HICP components suggests that underlying disinflation continues, with price-setting behaviour very much consistent with a return of headline inflation to target in the course of next year. On a seasonally-adjusted basis, prices of non-energy industrial goods rose 0.1%M/M to be up just 0.7%3M/3M annualised and suggest that core goods price pressures remain minimal. Moreover, services prices fell in November on the month (admittedly just 0.1%M/M) for the first time in more than 3½ years, to leave services inflation momentum on a three-month annualised basis down 0.9ppt to a ten-month low of just 2.6%. While extreme weather events have pushed the recent trend in fresh food prices significantly higher (7.4%3M/3M annualised), the seasonally-adjusted trends in both core (1.9%3M/3M annualised) and headline inflation (1.5%3M/3M annualised) are now consistent with a return back to target by the spring.

Inflation set to resume disinflation trend in New Year, supported by moderating wage growth

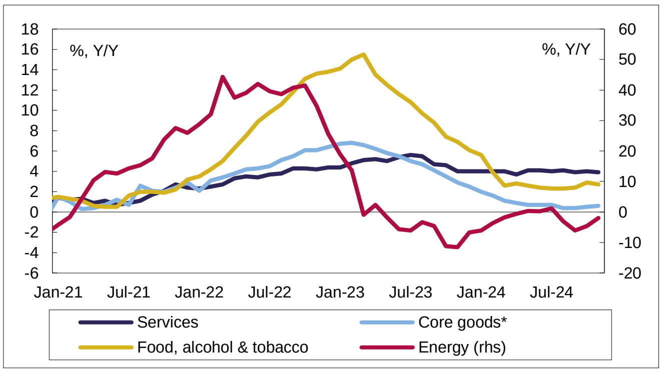
Indeed, while we expect a further modest rise in headline inflation in December, perhaps to as high as 2½%Y/Y, a disinflationary trend should resume in the New Year, supported not least by the recent slowdown in economic momentum.

Euro area: Headline & core HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key HICP components



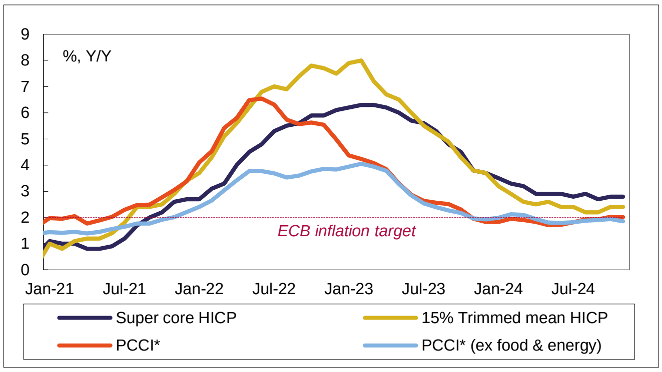
**Non-energy industrial goods.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Importantly for ECB policymakers, services inflation is set to take a step down in the spring and should maintain a gradual downwards trajectory through to the autumn supported by moderating pay growth. Today's ECB wage tracker suggested that, after peaking in Q424, wage growth should fall sharply in the second half of 2025, not least reflecting base effects stemming from one-off payments that were paid this year to compensate for the spike in inflation. Indeed, the headline wage tracker is currently anticipated to peak at around 5.4%Y/Y before easing to 1.4%Y/Y in Q425 and average a little more than 3%Y/Y in 2025 as a whole. Overall, we forecast services inflation to ease almost 2ppts to just above 2% by mid-2025. And so, with an ongoing absence of non-energy industrial goods price pressures, core inflation looks set to fall below the 2% target in the second half of 2025 and average below 2% in 2026 too. So, with risks to the near-term growth outlook skewed to the downside, the ECB seems highly likely to cut the deposit rate to neutral territory in the first half of next year, with a terminal rate of around 2.0% probably reached by Q325 at the latest.

Construction output rebounded in October, raising hopes for a second quarterly rise in seven

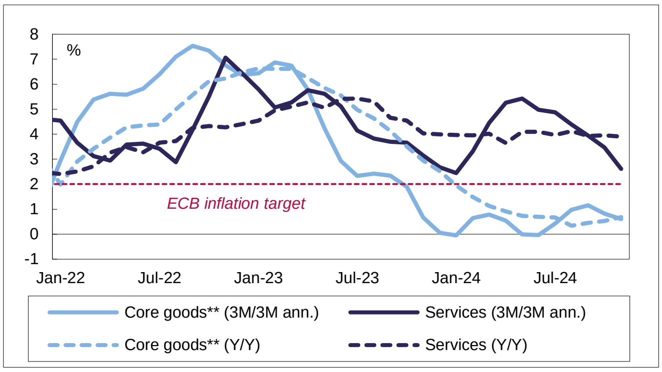
While the euro area's construction sector has struggled more adversely amid the ECB's restrictive policy environment, today's data pointed to an acceleration at the start of Q4, raising hopes that the sector has finally started to bottom out. In particular, construction output rose 1.0%M/M in October – its largest monthly increase in 20 months – to mark the first

Euro area: Measures of underlying inflation



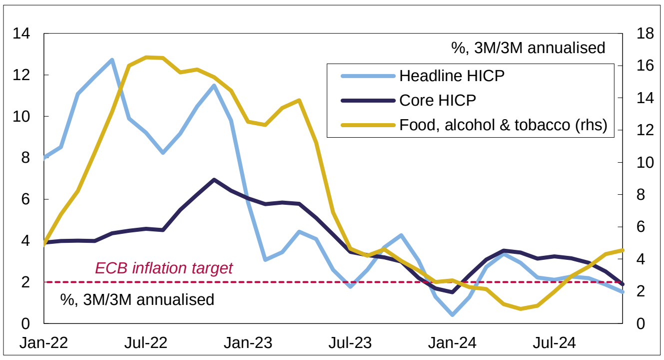
*Principal common component of inflation.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum*



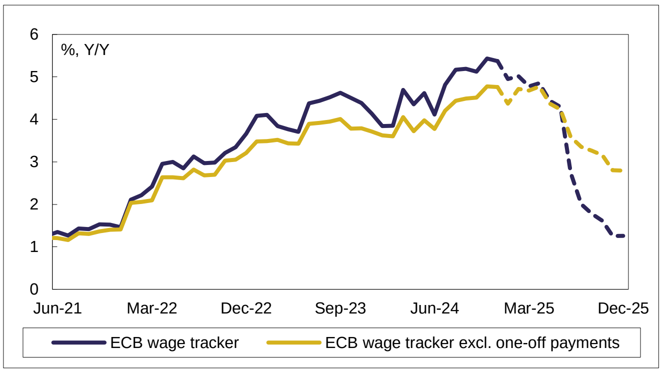
*Seasonally adjusted data. **Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation momentum*



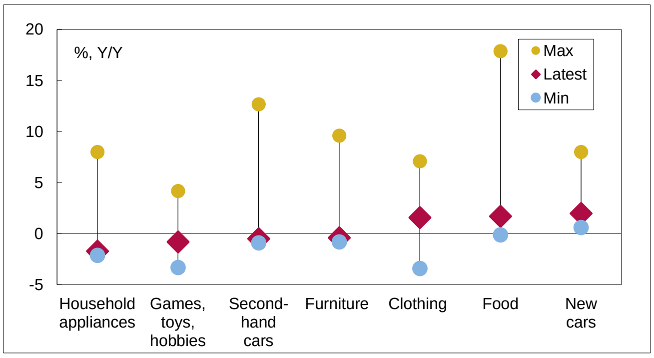
*Seasonally adjusted data.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ECB wage tracker



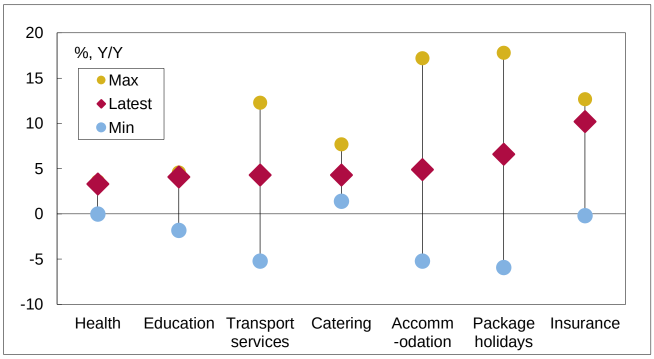
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

positive increase on a three-month basis (albeit of just 0.1%3M/3M) since March and raising hopes of just a second quarterly rise in Q4 in seven. October's upturn was also relatively broad based, with civil engineering up by 1.6%M/M for a second consecutive month, while building work (0.7%M/M) and specialised construction (0.5%M/M) each recovered some of their respective losses in September. It is worth noting, however, that this month's growth was flattered somewhat by downward revisions in September. And while overall output is some 2.6% above the pre-pandemic level, it is still some 2½% below its recent peak in February 2023, with building work remaining around 5% below the February 2020 benchmark. The absence of distinguishable progress in Germany (0.0%M/M) and France (0.1%M/M) – some 10% and 4.2% below their pre-pandemic levels – also remains a challenge to sustained recovery in construction. And with building permits yet to show a notable increase, and the PMIs continuing to flag ongoing contraction, we might expect to see some payback over coming months.

The day ahead in the euro area

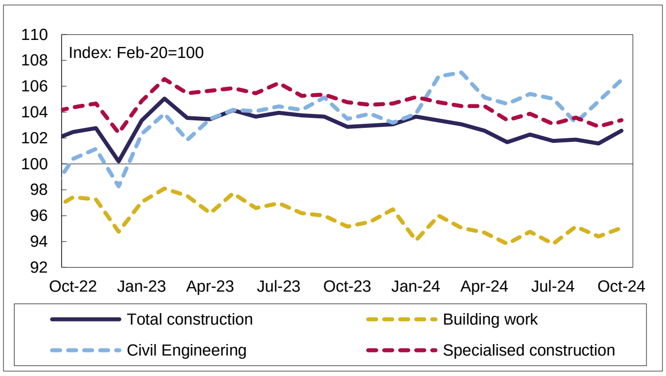
Sentiment surveys will dominate the euro area dataflow on Thursday. Following the collapse of French Prime Minister Barnier's minority government, December's INSEE business surveys might well be of most interest. Indeed, the INSEE survey frequently provides a more reliable indicator for French business sentiment than the comparatively volatile PMIs, for which the flash December survey flagged deepening woes for manufacturers, albeit against a relative improvement for services. Meanwhile, the German GfK consumer confidence is expected to improve only slightly from the seven-month low (-23.3) recorded in the previous survey, amid ongoing political and economic uncertainties. Meanwhile, the day ahead will also bring euro area new car registrations for November.

UK

UK inflation rose to an 8-month high, all but ruling out a rate cut tomorrow

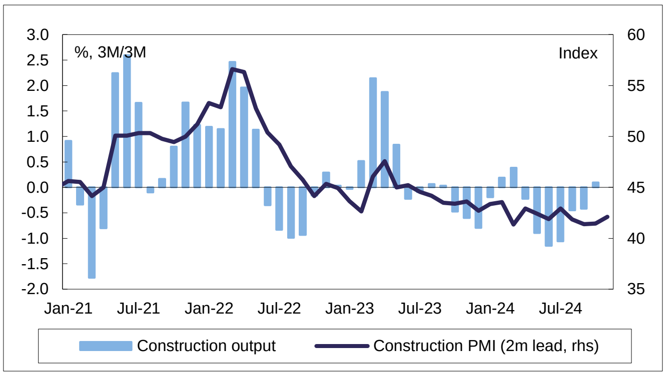
After the upside surprise to yesterday's pay growth, today's CPI report reaffirmed our expectation that the BoE will keep policy unchanged this week. Indeed, headline inflation rose for a second successive month in November, by 0.3ppt to 2.6%Y/Y, an eight-month high, bang in line with market expectations but 0.2ppt above the BoE's projection in last month's Monetary Policy Report. The pickup in part reflected a smaller drag from energy inflation (up 1.3ppts to -8.8%Y/Y) amid a rise in petrol prices compared with a notable decline in November last year. A hike in the tobacco duty announced in October's Budget also saw inflation of that component jump 3.8ppts to 12.8%Y/Y, similarly accounting for almost 0.1ppt of the increase in headline inflation. Non-energy industrial goods inflation also rose a larger-than-expected 0.6ppt to an eight-month high of 1.1%Y/Y, reflecting a slower pace of deflation in second-hand cars and computer games, while clothing inflation jumped to a four-month high. But the increase largely reflected base effects from a more marked decline in prices in

Euro area: Construction output



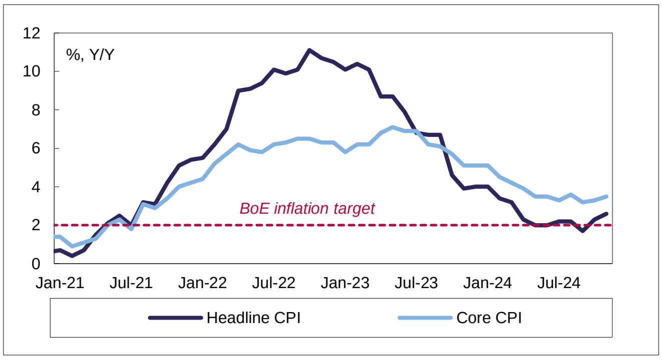
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output & PMI



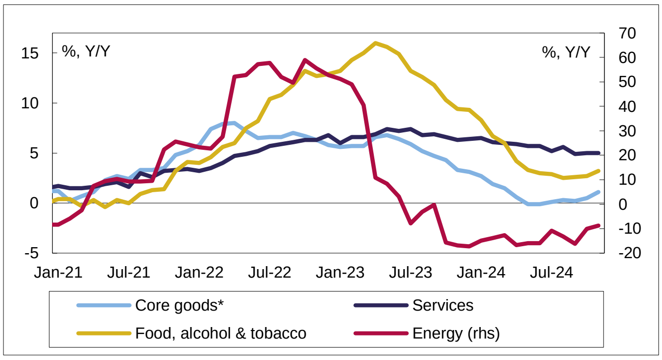
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key inflation components



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

November 2023. Indeed, the monthly increase in prices of core goods was below the norm for the month for a third month out of the past four, suggesting that price pressures remain well contained. The monthly price increase in services was also below the norm ahead of the financial crisis for just the second month out of the past ten, suggesting better-behaved pricing in that sector too. This notwithstanding, services inflation remained steady at a still-elevated 5.0%Y/Y in November, slightly below the Bloomberg survey consensus, but a touch above the BoE's projection. And overall, core CPI inflation rose 0.2ppt to a three-month 3.5%Y/Y.

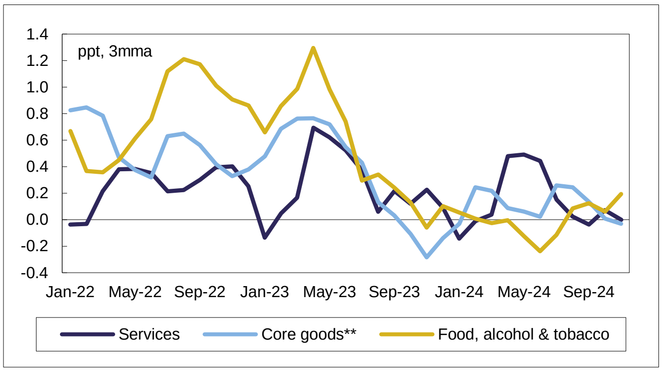
Underlying services inflation also ticked higher in November

Admittedly, the sideways move in services inflation benefitted from a notable drop in airfares in November (-19.3%M/M), which fell the most in any November since the series began in 2001. Having risen to a four-month high in October, inflation in accommodation also moderated slightly, while the catering component fell to the lowest in almost 3½ years. So, when excluding additional volatile items – such as package holidays, rents and education – underlying services inflation ticked up 0.2ppt to a three-month high of 4.3%%Y/Y. And the BoE's closely watched series – excluding indexed and volatile components, rents and foreign holidays – fully reversed the 0.3ppt drop in October to 4.8%Y/Y, which might reinforce policymakers concerns about risks of underlying inflation persistence in the sector. But this still represented the second-softest reading since February 2022. And looking at the detail, this in part reflected a rebound in inflation in cultural services – particularly admission fees to live music events and theatres – which is often volatile depending on the acts that are performing. When excluding the highest and lowest 5%, NIESR's trimmed mean CPI measure remained extremely weak, rising just 0.2ppt to 1.5%Y/Y.

Inflation likely to take a step down in Q2 on base effects and return to target in H226

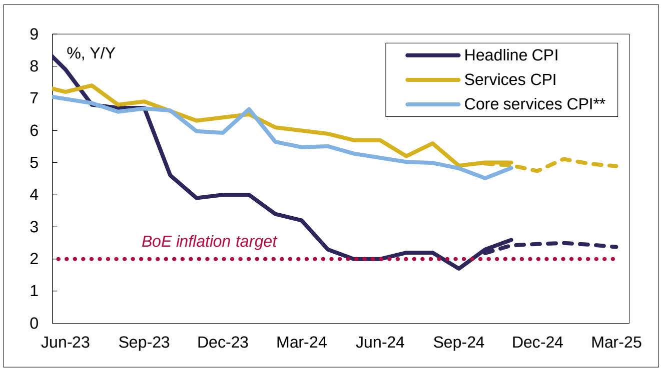
Notwithstanding some month-to-month volatility, inflation is expected to move broadly sideways through to February. Services inflation is also likely to move broadly sideways through to spring, before taking a step down in April due to base effects. Despite the recent pickup in private regular wage growth, a continuing downtrend in job vacancies should reduce pay pressures in due course, which should also support further gradual services disinflation thereafter. And with non-energy industrial goods inflation set to remain relatively subdued as pipeline pressures remain largely absent core inflation will also ease sharply in Q225. Overall, we expect inflation to return to the 2% target in H226. So, while the MPC will leave policy unchanged tomorrow, we continue to forecast the BoE to ease policy gradually further over the coming year, with one 25bps rate cut each quarter to coincide with updated macroeconomic projections in February, May, August and November.

UK: Deviations from long-run price change*



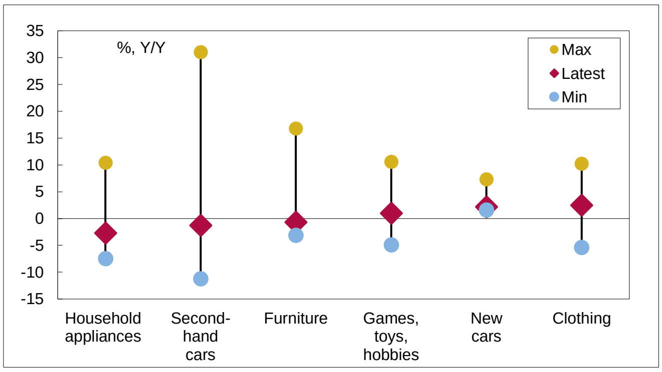
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & services inflation*



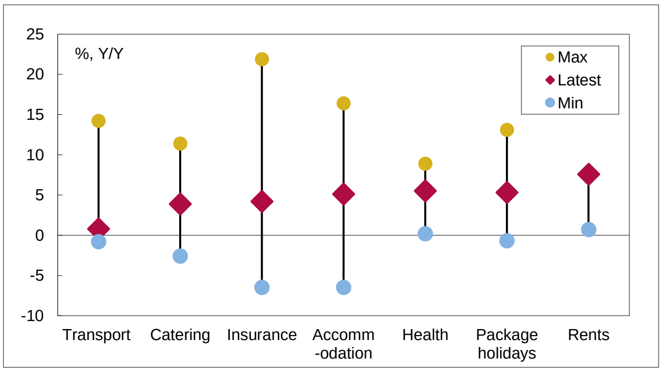
*Dashed lines represent BoE projections from November MPR. **Core services CPI excluding indexed & volatile components, rents & package holidays. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected goods CPI components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services CPI components

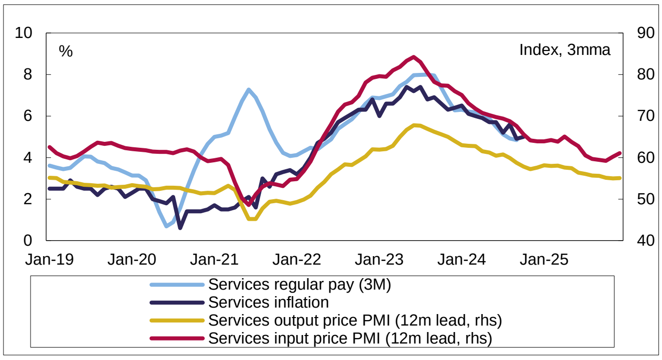


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

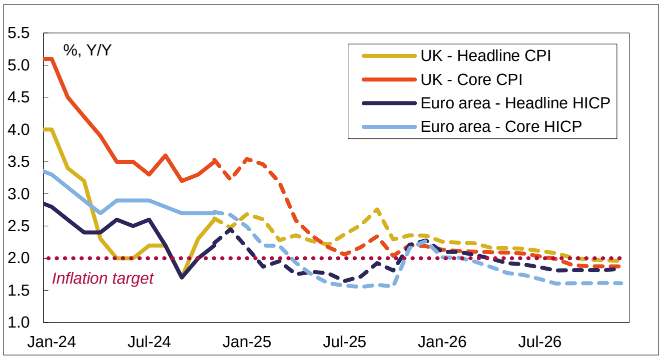
Attention in the UK tomorrow will be on the aforementioned BoE monetary policy announcement, where we expect the MPC to leave policy unchanged, in line with market expectations. Indeed, despite the disappointing result for October's GDP, today's pickup in inflation and yesterday's stronger pay print might prove sufficient to keep dovish-leaning policymakers (chiefly new external member Taylor and Deputy Governor Ramsden) with the status quo. So, we expect a comfortable majority of 8-1 on the MPC to favour holding Bank Rate at 4.75%, with just external member Dhingra the sole supporter for a cut. While the BoE might well revise down its expectation for GDP growth in Q4, we expect the overall assessment to be little changed from that in November, with the Bank's forward guidance likely maintaining that a gradual approach to removing policy restraint remains appropriate

UK: Services CPI, pay & price PMIs



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

Euro area & UK: Inflation projections*



**Dashed lines represent Daiwa forecast.*
Source: Macrobond 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 headline (core) HICP Y/Y%	Nov	**2.2 (2.7)**	*2.3 (2.7)*	2.0 (2.7)	-
	Construction output M/M% (Y/Y%)	Oct	**1.0 (0.2)**	-	-0.1 (-1.6)	-0.3 (-2.0)
UK	CPI (core CPI) Y/Y%	Nov	**2.6 (3.5)**	*2.6 (3.6)*	2.3 (3.3)	-
	PPI – output (input) prices Y/Y%	Nov	**-0.6 (-1.9)**	-0.6 (-1.6)	-0.8 (-2.3)	-0.9 (-2.4)
	CBI industrial trends survey – total orders (selling prices) balance %	Dec	**-40 (23)**	-22 (13)	-19 (11)	-
	House price index Y/Y%	Oct	**3.4**	-	2.9	2.8

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	05.00	New car registrations Y/Y%	Nov	-	-0.3
	09.00	Current account balance €bn	Oct	-	37.0
Germany	07.00	GfK consumer confidence indicator	Jan	-22.5	-23.3
France	07.45	INSEE business (manufacturing) confidence indicator	Dec	96 (98)	96 (97)
UK	12.00	BoE Bank Rate %	Dec	*4.75*	4.75

Auctions and events

Country	GMT	Event
UK	12.00	BoE monetary policy announcement and minutes to be published

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

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