Euro wrap-up

Overview

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- Despite a downbeat French business survey, Bunds followed USTs lower as German consumer confidence edged higher.
- Gilts outperformed, making gains at the shorter end of the curve, as the BoE left monetary policy unchanged but three MPC members voted for a rate cut and a fourth suggested that they might support more activist policy in future.
- Friday will bring updates on euro area consumer confidence, Italian economic sentiment, UK retail sales and German producer prices.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.045	+0.026
OBL 2½ 10/29	2.113	+0.048
DBR 2.6 08/34	2.304	+0.061
UKT 4⅛ 01/27	4.415	-0.035
UKT 4⅛ 07/29	4.363	-0.026
UKT 4¼ 07/34	4.580	+0.024

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

Euro area

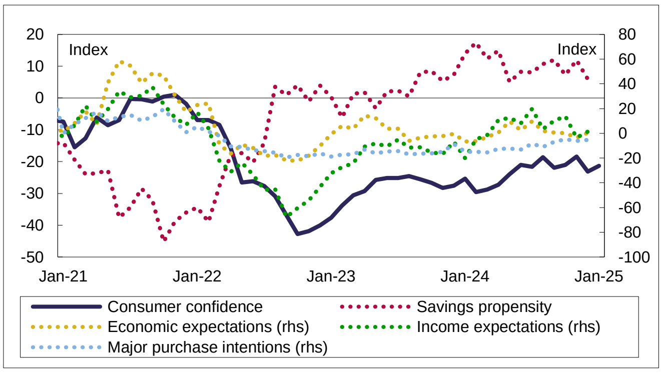
German households a touch less downbeat heading into the New Year

According to the GfK survey, German consumer confidence is expected to tick slightly higher in January. The headline index, presented as a forecast for the coming month, rose 1.8pts in January from December's eight-month low. At -21.3, however, it remained below the average of the second half of 2024 and almost two standard deviations below the long-run average to suggest that households are still exceptionally downbeat by historical standards. According to GfK, household concerns of job insecurity have unsurprisingly risen as large manufacturers announced their intention to cut headcount and close production facilities. Consumers also remain dissatisfied at still-high levels of energy and food prices after the inflationary shock of the past few years. Indeed, the detail of the GfK survey for December suggested that consumers anticipate less progress with disinflation than over the past ten months. However, with interest rates being reduced, their propensity to save fell back close to the bottom of the range of the past 15 months having earlier this year risen to a historical high. Most encouragingly, and perhaps reflecting hopes of more constructive economic policy-making to come sometime after February's federal election, consumers were less downbeat this month about the outlook for the German economy and their own incomes. As a result, their readiness to make major purchases edged up to be consistent with modestly positive, albeit still sub-par, growth in consumer spending.

INSEE survey adds to evidence that French GDP might have contracted in Q4

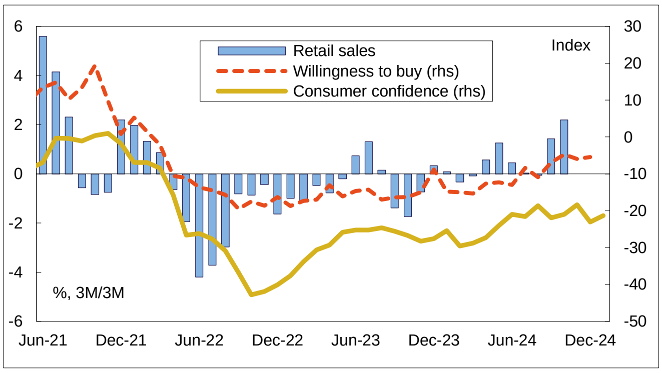
The flash PMIs, released on Monday, suggested that French economic output shrank for a fourth successive month in December. While the headline composite PMI rose for the first month in four, it remained firmly in contractionary territory at just 46.7, the second-lowest level since January, with the services and manufacturing sectors reportedly both in reverse. While sometimes – such as earlier in the summer – its message differs significantly from the PMIs, today's more comprehensive INSEE business climate survey similarly suggested that momentum in the French economy remains negative. Indeed, the headline INSEE index fell for a third successive month and by almost 2ppts to a five-month low of 94.3, almost 6% below the long-run average and the second-lowest level in almost four years. But while the flash PMIs suggested that a marked drop in manufacturing output was the principal source of weakness at the end of the year, the INSEE survey suggested that the deterioration in services and retail was most acute. Indeed, with new factory orders reportedly having picked up, the INSEE industrial climate index was steady in December, 3% below its long-run average. In contrast, the services and retail indices both fell 2ppts to 4% below their respective long-run norms as firms revised down their assessments of the demand outlook. The survey also reported that construction firms have become more downbeat. And with the INSEE survey thus reporting broad-based weakness, its employment climate index also fell this month to 4% below

Germany: Consumer confidence & components



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

Germany: Retail sales & consumer confidence



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

the long-run average to suggest that businesses are increasingly looking to cut headcount. Earlier this week, the Bank of France maintained its forecast of zero GDP growth in Q424. And it downgraded its projection for 2025 by 0.3ppt to 0.9%Y/Y. The INSEE indices and PMIs suggest that the risks to those forecasts for both the current quarter and next year are skewed significantly to downside, suggesting that the current French political and fiscal dysfunction is increasingly being matched by intensifying economic challenges.

The day ahead in the euro area

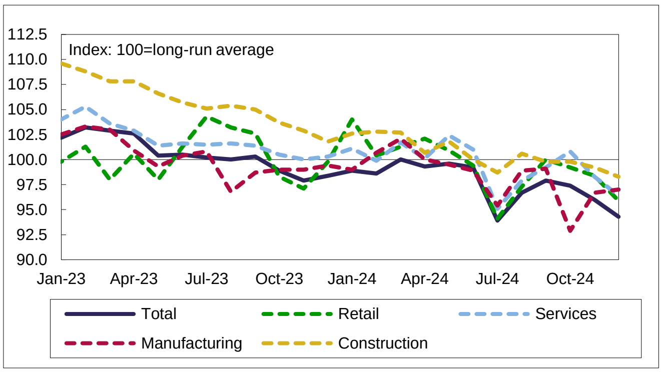
Bearing in mind ECB Chief Economist Lane's remarks earlier this week – which noted the downside risks to euro area GDP growth and inflation posed by weak household sentiment – tomorrow's flash Commission consumer confidence index should be the highlight of tomorrow's euro area dataflow. Having slipped back to a five-month low in November on rising political uncertainty, today's improvement in German consumer confidence will have raised hopes for a similar rebound to the Commission's euro area indicator. Settled nerves may also lend some support at the margin to the ISTAT Italian consumer confidence indicator, which has anyway recently been running above its long-run average. Meanwhile, producer prices in Germany, France and Italy are expected to rise again in November, for the second consecutive month, primarily owing to a further rise in energy costs due in part to the impact of weather on electricity generated by renewables.

UK

MPC still on track for one rate cut per quarter in 2025 while some members back faster easing

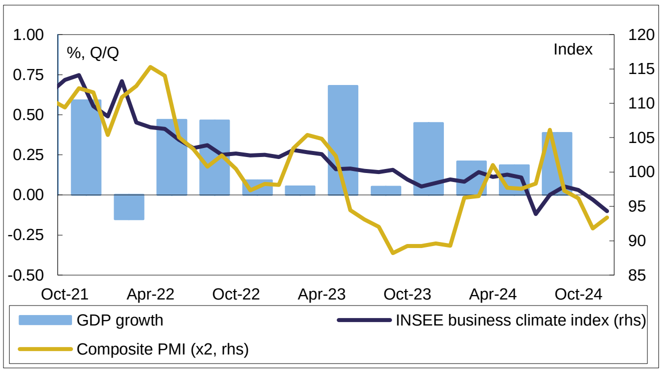
As had been widely expected, the BoE's MPC today left Bank Rate on hold at 4.75%, still just 50bps below its summer peak. However, the vote on the Committee was tighter than most observers had anticipated, with three members (Deputy Governor Ramsden and external members Dhingra and Taylor) in favour of a cut of 25bps to 4.50%. The meeting minutes also suggested that one unnamed member of the six to vote for unchanged policy today might be minded to join the three dissenters in voting for an 'activist' (by implication accelerated) pace of easing in future. The remaining five members still appear to back a 'gradual approach to the withdrawal of policy restrictiveness', which we interpret as implying one 25bps rate cut per quarter of 2025. So, we still expect Bank Rate to be cut by 25bps to 4.50% at the next MPC meeting in February. Contrasting the current more hawkish market pricing, our baseline forecast also continues to envisage a total of four such cuts next year and further easing in 2026 too. And if economic output continues to flat-line or worse, then we would not rule out seeing more than four cuts in 2025.

France: Business climate by sector



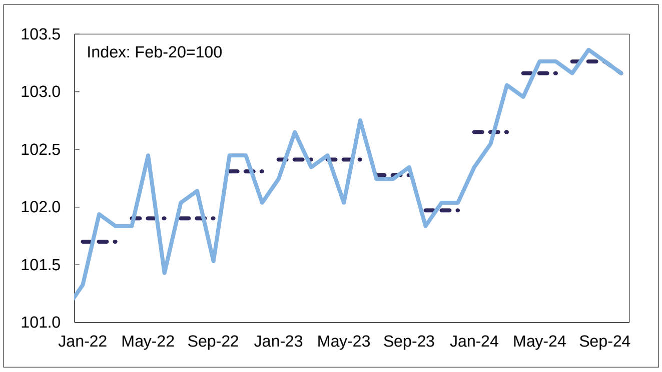
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: GDP & business sentiment indices



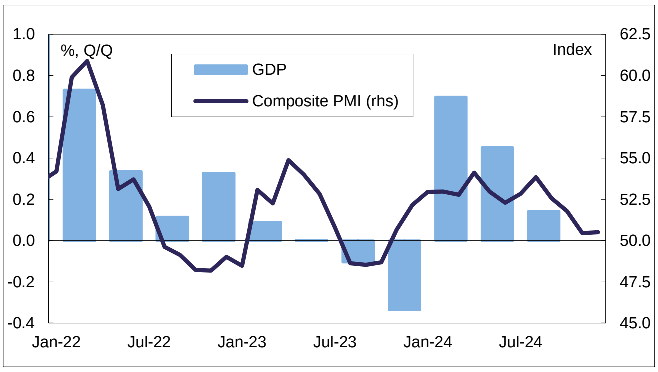
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP level*



**Dashed lines denote quarterly average.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite PMI



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

Majority of MPC members fear supply-side restraints might sustain inflation persistence

As far as a majority of MPC members is concerned, the case for a pause in rates this month and a 'gradual approach' to easing over the coming year was strengthened by this week's data reporting a pickup in wage growth and inflation, as well as an uptick in inflation expectations. Admittedly, they also had to acknowledge that most near-term indicators of economic activity have declined and that the labour market has softened recently. And the Bank staff now expects zero GDP growth in Q4 compared to its baseline projections of 0.3%Q/Q published just last month, representing a second successive quarterly forecast miss. But the majority on the MPC is not yet ready to conclude whether the persistent absence of economic growth relates more to constrained supply or weak demand. If it is supply-driven, the majority fears that inflation might persist above target over the horizon. But if – as the three MPC members who voted for a rate cut warn – it is demand-driven, continued stagnation would likely lead to the emergence of a non-negligible amount of economic slack and significant risks that inflation will undershoot the target on a sustained basis over the medium term.

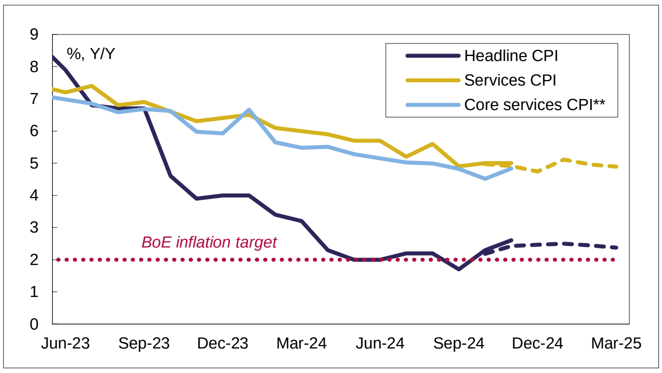
Failure to follow ECB in shift to neutral risks ongoing UK stagnation

We think that concerns about the pickup in inflation and wage growth in this week's data have been overdone. With increases in prices of both core goods and services over the past few months back in line with their long-run averages, the price-setting behaviour appears to be broadly back to normal. And we think the recent pickup in wage growth in part reflects random volatility and need not represent a significant threat to the eventual return of inflation to target over the medium term. So, we remain more concerned that the weakness of economic activity since the spring in no small part relates to excessively tight monetary policy. And noting the continued significant similarities between recent UK and euro area macroeconomic data, we think the MPC should follow the ECB's lead in jettisoning its commitment to maintaining 'restrictive' policy 'for sufficiently long'. If not, UK economic output might continue to flat-line at best, not only lagging the US in 2025 but perhaps falling behind the euro area too.

The day ahead in the UK

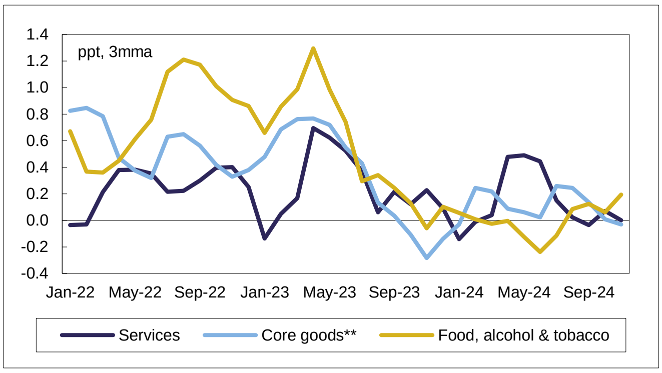
At the end of a busy week for UK data, November's retail sales figures are expected to be downbeat. Indeed, whilst also consistent with preliminary survey indicators which have flagged disappointing spending activity in the lead up to Christmas, November's weakness should be affirmed by the rollover of the Black Friday discounting period into December's sampling period this year. But, as a result, some payback should be in order in December's sales data, as will likely be alluded to in tomorrow's CBI distributive trades survey release. November's public finance statistics are also due tomorrow.

UK: Headline & services inflation*



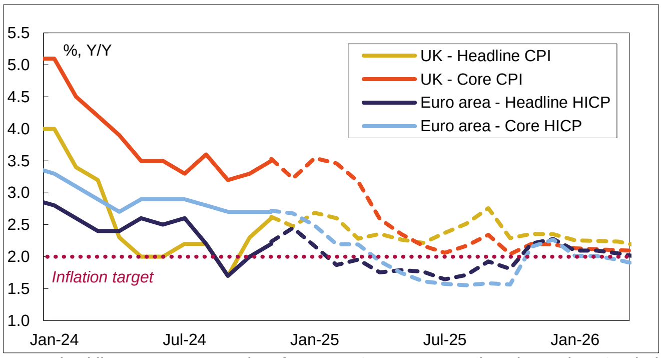
*Dashed lines represent BoE projections from November MPR. **Core services CPI excluding indexed & volatile components, rents & package holidays. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Deviations from long-run price average change*



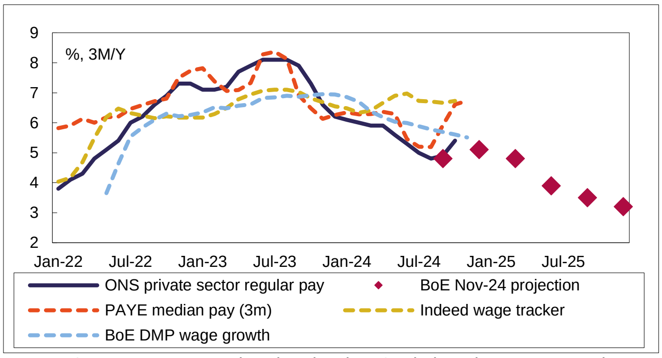
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Macrobond & Daiwa Capital Markets Europe Ltd.

Euro area & UK: Inflation projections*



*Dashed lines represent Daiwa forecast. Source: Macrobond & Daiwa Capital Markets Europe Ltd.

UK: Selected pay indicators & BoE projection



Source: BoE, 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		Current account balance €bn	Oct	**25.8**	-	37.0	38.8
		New car registrations Y/Y%	Nov	**-3.4**	-	-0.3	-
Germany		GfK consumer confidence indicator	Jan	**-21.3**	-22.5	-23.3	-23.1
France		INSEE business (manufacturing) confidence indicator	Dec	**94 (97)**	96 (98)	96 (97)	-
UK		BoE Bank Rate %	Dec	**4.75**	*4.75*	4.75	-

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		15.00	Preliminary Commission consumer confidence indicator	Dec	-14.0	-13.7
Germany		07.00	PPI Y/Y%	Nov	-0.3	-1.1
France		07.45	PPI Y/Y%	Nov	-	-5.7
		-	Retail sales Y/Y%	Nov	-	-0.2
Italy		09.00	ISTAT consumer confidence indicator	Dec	97.0	96.6
		09.00	ISTAT business (manufacturing) confidence indicator	Dec	- (86.0)	93.1 (86.5)
		11.00	PPI Y/Y%	Nov	-	-3.8
UK		07.00	Retail sales – including auto fuel M/M% (Y/Y%)	Nov	0.5 (1.0)	-0.7 (2.4)
		07.00	Retail sales – excluding auto fuel M/M% (Y/Y%)	Nov	0.5 (0.9)	-0.9 (2.0)
		07.00	Public sector net borrowing £bn	Nov	13.6	17.4
		11.00	CBI distributive trades survey – reported sales volumes %	Dec	-10	-18

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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