Euro wrap-up

Overview

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- Bunds made losses as the flash estimates of German inflation in December surprised on the upside.
- Gilts also made losses even as the final December PMIs provided further evidence that the UK economy flat-lined towards year-end.
- Tuesday will bring the flash estimates of euro area inflation in December as well as updates on euro area unemployment, UK retail sales and the construction sector PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.190	+0.038
OBL 2½ 10/29	2.263	+0.039
DBR 2.6 08/34	2.448	+0.027
UKT 4⅛ 01/27	4.424	+0.011
UKT 4⅛ 07/29	4.396	+0.015
UKT 4¼ 07/34	4.609	+0.017

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

Euro area

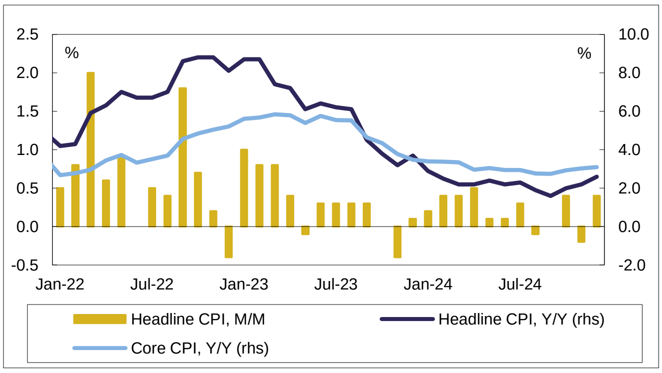
German inflation in December surprises to the upside leaping to 11-month high

According to today's flash estimates, German inflation in December surprised significantly to the upside to tally with early indications from certain other member states and suggest that tomorrow's equivalent euro area will similarly exceed consensus expectations. In particular, the EU-harmonised HICP rate leapt 0.5ppt to an 11-month high of 2.9%Y/Y, 0.3ppt above the Bloomberg median forecast. On the national CPI measure, the rise of 0.4ppt to 2.6%Y/Y, also the highest since January 2024, was 0.2ppt above expectations. Inflation in December had always been expected to rise if only as the near-2%M/M drop in energy price a year earlier was not repeated. Indeed, on the CPI measure for which the detail is available, energy prices were broadly flat on the month in December to push the respective annual rate to a five-month high (-1.7%Y/Y). However, the remainder of the detail suggest that the rise in inflation last month was broad-based. Having fallen further than expected in November, the food component reversed some of that step down (up 0.2ppt to 2.0%Y/Y). More importantly, services inflation edged up slightly to 4.1%Y/Y, the highest since September 2023. And while it remained relatively subdued, our estimate of core goods inflation rose for a third successive month to a six-month high of 1.5%Y/Y. So, German core CPI inflation edged up for a third successive month to a nine-month high of 3.1%Y/Y. We should probably expect to see a similar slight increase in German core inflation on the EU-harmonised measure when it is published. However, we caution that the December data incorporate classification changes which might limit comparability with the November figures. Moreover, we note that most of the detailed regional CPI data, which is normally available ahead of the German flash estimates, was not published today, also limiting scope for analysis of the drivers of inflation last month.

Euro area inflation set to rise to 2.5%Y/Y or more with core rate probably a touch higher too

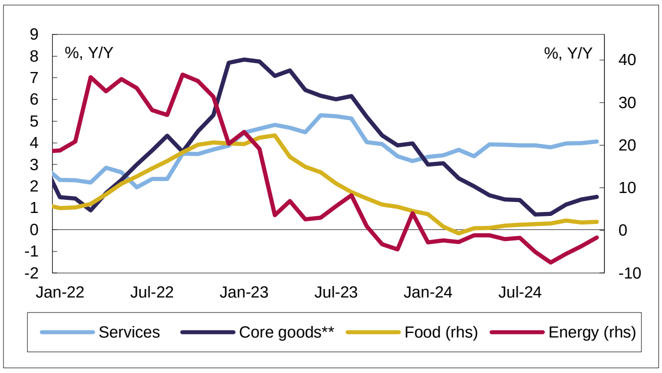
Ahead of the release of the German data, most other member states to publish flash estimates had already flagged risks of an upside surprise to euro area inflation in December. Most notably, Spanish HICP inflation jumped 0.4ppt – twice as much as expected – to a five-month high of 2.8%Y/Y. While INE reported that energy price base effects were the key driver, the Spanish national core CPI rate – which excludes prices of energy and fresh but not processed food – also rose to suggest broader-based pressure, quite possibly associated with vigorous economic growth in the country. The EU-harmonised inflation rate also rose 0.4ppt in Portugal (3.1%Y/Y) while the national rate in Cyprus rose more than 1ppt (2.6%Y/Y). Only in Belgium (down 0.4ppt to 4.4%Y/Y) was HICP inflation softer last month. Given our expectation of increases in France and Italy, therefore, we now expect euro area headline inflation to rise 0.3ppt to 2.5%Y/Y, with the core rate edging up from 2.7%Y/Y in each of the prior three months. Such data would likely reinforce the determination of the hawks on the ECB Governing Council not to countenance the possibility of a shift in monetary policy to an accommodative stance over coming months, with neutral likely to remain the chosen destination. However, we would still expect inflation to be back to target by

Germany: Headline & core CPI*



*National measure. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: CPI inflation – selected components*



*National measure. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

mid-year. And in the absence of a pickup in economic growth over coming quarters, there would remain non-negligible risks that inflation would undershoot the target in 2026 and beyond.

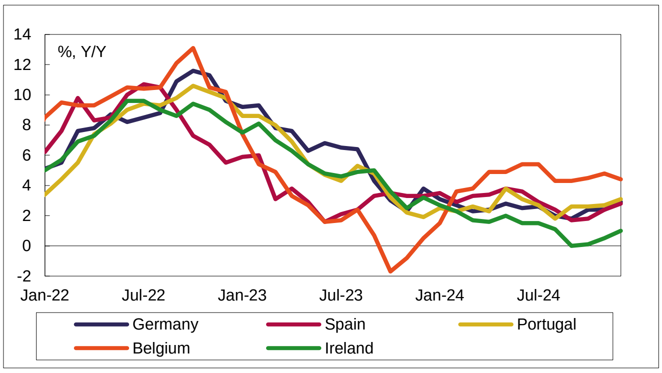
Final PMIs suggest ongoing goods disinflation but services inflation persistence

Disconcertingly perhaps, today's final euro area PMIs for December also pointed to a pickup in price pressures across the euro area. According to the survey, input costs rose the most since July and at a rate above the pre-pandemic average, with the respective PMI up almost 1½pts on the month to 57.0. Output prices also reportedly rose at the fastest pace since August, and above the long-run average, albeit with the relevant composite index up a smaller 0.6pt to 52.5. However, the sectoral indicators flagged significant differences in price pressures consistent with ongoing mild disinflation for goods but inflation persistence in services. While wholesale gas prices have in recent days risen to 14-month highs, input costs in the factory sector were considered broadly flat across the region, while the lack of demand meant that manufacturers cut output prices for a fourth successive month. In contrast, costs in services were up the most in five months while prices charged in that sector rose the most since June.

Spanish strength provides the only bright spot in an otherwise gloomy survey

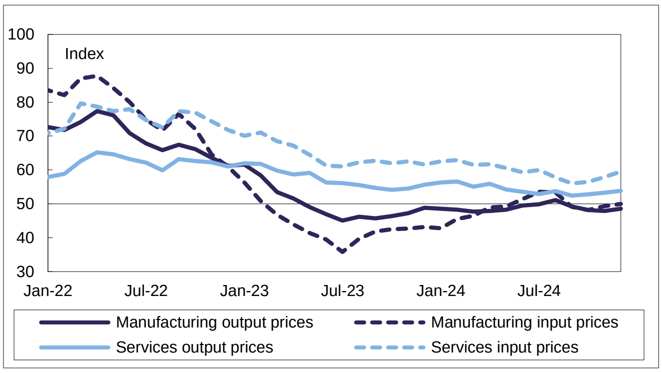
With respect to economic activity, the final PMIs sustained concerns about the lack of momentum at year-end. Thanks to a slightly improved services index, the headline euro area composite output PMI was nudged higher to 49.6, up 1.3pts from November but still consistent with stagnation. Over Q4 as a whole, the composite output PMI averaged just 49.3, the softest since Q124 and a level that ahead of the pandemic would have implied a marginal drop in GDP of 0.1%Q/Q, as modest growth in services (50.9) was more than offset by a further drop in manufacturing (45.1). With new orders down the most in four quarters and employment reportedly cut the most since 2020, the detail pointed to ongoing weakness in early 2025 too. As for the euro area as a whole, the German headline indices similarly suggested the weakest quarter in three with a quarterly composite PMI in contraction territory (47.9) as the industrial sector continued to retrench. As in the prior three months, the French services and composite output PMIs were revised up by roughly 1pt apiece from their flash December estimates to maintain doubts about the robustness of the survey. But they also left the Q4 average at just 47.2, credibly consistent with a drop in French GDP last quarter after the Olympics-assisted acceleration in growth to 0.4%Q/Q in Q3. So, with the Italian composite PMI down to a four-quarter low of 49.5, Spain offered the only bright spot in an otherwise gloomy survey. Indeed, having dipped in November due not least to the impact of the terrible floods in Valencia, and propelled by a strong rebound in services, the Spanish headline composite PMI rose to the highest since March 2023 (56.8). That took the Q4 average at 55.0, up 0.6pt on the quarter and the second-highest in seven quarters, pointing to another quarter of strong Spanish expansion after growth of 0.8%Q/Q in both Q2 and Q3.

Euro area: HICP inflation in selected member states



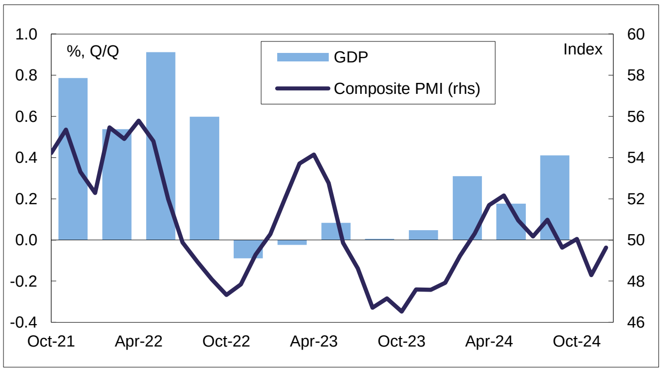
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Price PMIs



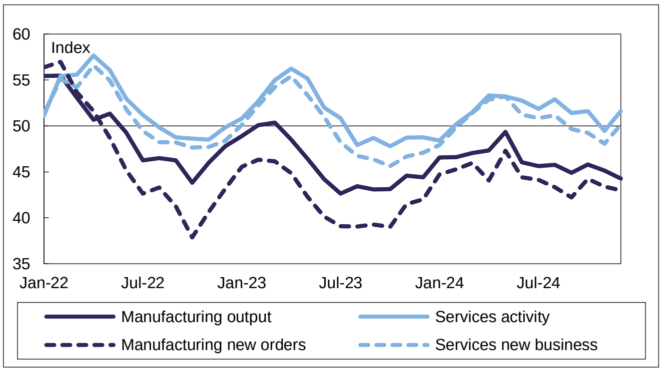
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & composite output PMI



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

Euro area: Services & manufacturing PMIs



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

The day ahead in the euro area

After the upside surprises in the flash figures from Germany today and other member states last week, tomorrow's aforementioned euro area estimates will take centre-stage. We now expect the headline HICP rate to rise by 0.3ppt to 2.5%Y/Y, along with a marginal rise in core (0.1ppt to 2.8%Y/Y). While such data will play into the hands of the hawks as they fret about inflation persistence, they should not prevent a further rate cut at the next Governing Council meeting on 30 January. Indeed, while concerns about the loss of growth momentum mount, tomorrow's ECB consumer survey should provide further evidence that consumers' inflation expectations remain well anchored, lending additional confidence to policymakers as they push rates closer to a neutral footing.

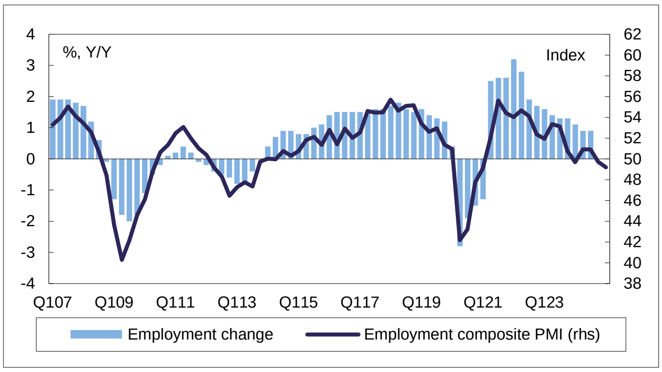
Meanwhile, in terms of the labour market, despite well-publicised announcements of industrial firms' intentions to cut headcount, Friday's German unemployment data for December came in lower than expectations. And with Spanish unemployment also falling steadily, November's euro area unemployment rate, due tomorrow, is expected to move sideways, holding steady at its historical low of 6.3%. Nevertheless, with interest rates still in restrictive territory, tomorrow's euro area construction PMI will have remained sub-50 at the end of the year, marking a 31st consecutive month in such contractionary territory.

UK

Final PMIs revised a touch lower to underscore loss of economic momentum heading into year-end

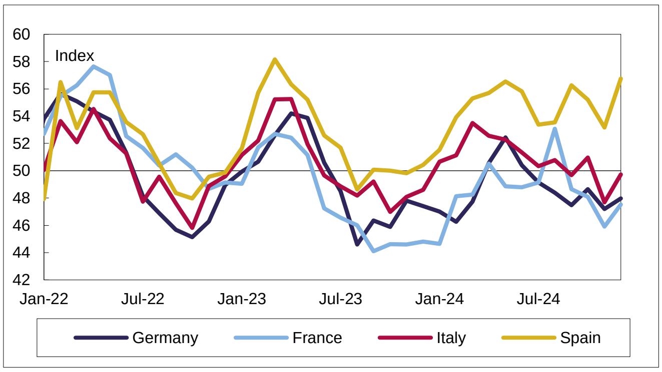
After a solid start to 2024, the UK economy repeatedly underwhelmed in the second half of last year. Updated national accounts figures published in the run up to Christmas revised away the modest growth initially estimated in Q3 (see below). And today's final December PMIs underscored the lack of growth momentum towards year-end. Certainly, a modest downwards revision to the composite output index left it down 0.1pt at 50.4 in December, the softest reading for 14 months. And this left the Q4 average at 50.9, more than 2pts below the Q3 average and the lowest quarterly reading since Q423 (50.5) when economic output contracted 0.3%Q/Q. The services activity index was revised down 0.3pt to 51.1, up just 0.3pt from November's 13-month low and well below the long-run average. And the manufacturing output PMI was unrevised at 45.9, down more than 2pts on the month and the lowest since February, to be consistent with substantive contraction.

Euro area: Employment growth & PMI



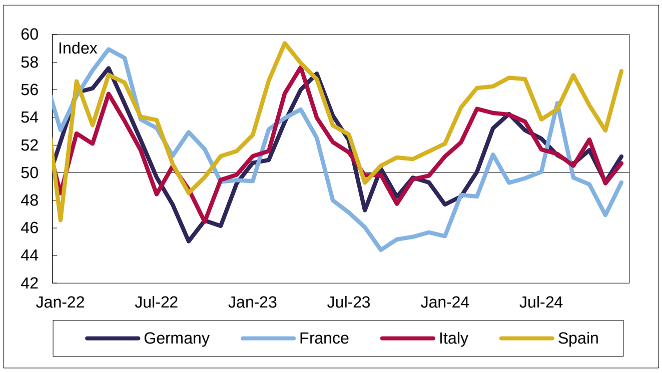
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite output PMIs



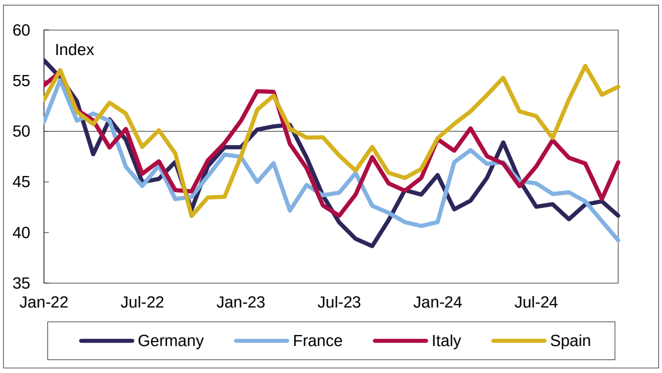
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Services output PMIs



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

Euro area: Manufacturing output PMIs



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

Firms signal largest cut in headcount in four years as demand weakens & costs rise

The PMIs also point to a further loss of growth momentum in the New Year, with incoming business in the services sector seemingly stalling in December, while new factory orders declined at the steepest pace in 14 months. As such, business expectations for output growth over the coming year were unchanged from November's near-two-year low. Taken together with the Budget announcement of increased employer National Insurance Contributions (NICs), the composite employment index (45.6) signalled the sharpest cuts to headcount since January 2021 and the global financial crisis aside from the initial pandemic slump. And while the final PMIs signalled a more pronounced rise in input costs in December (up to an eight-month high of 61.8), today's survey brought a downwards revision to the output price index (55.4) from the flash, perhaps recognising diminishing pricing power in the face of lacklustre demand. Indeed, while a survey by the British Chambers of Commerce (BCC) published today suggested that about 55% of respondent firms planned to increase prices over the coming three months, up from around 40% three months ago, only half expected sales to increase over the coming 12 months.

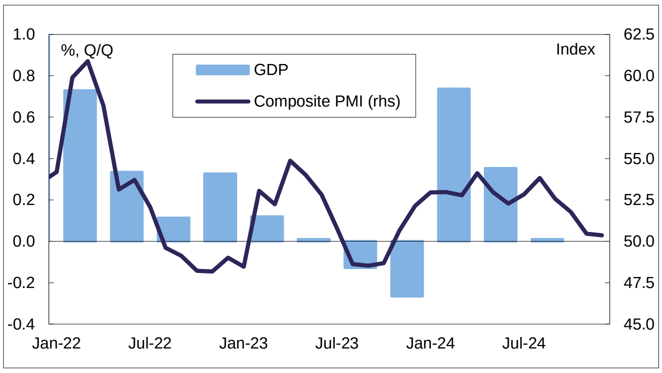
Downward revision left GDP moving sideways in Q3

The weakness around the turn of the year follows the lacklustre economic performance over the summer. Indeed, GDP is now judged to have moved merely sideways in Q3, compared with the modest growth of 0.1%Q/Q previously estimated. This left the level of economic output up just 0.9%Y/Y and 2.9% above the pre-pandemic benchmark in Q419, lagging well behind the respective recoveries in the euro area (4.5%) and US (11.5%). In per capita terms, GDP fell 0.2%Q/Q in Q3 to be down 0.2%Y/Y and 0.8% below the Q419 level, with a weaker performance only in Germany among the major economies. Moreover, GDP growth in Q3 was 0.2ppt softer than assumed by BoE staff in the November Monetary Policy Report.

Pickup in household and business spending growth in Q3 likely to be short-lived

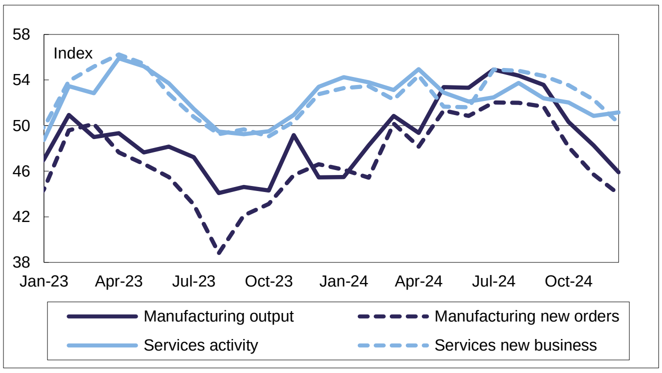
The revision to GDP in Q3 in part reflected softer government spending than previously assumed (down 0.4ppt to 0.1%Q/Q). Meanwhile, a larger drag from private inventories (-1.2ppts) was partly offset by a more positive contribution from net trade (0.9ppt), with a third successive decline in exports more than offsetting the non-monetary gold-related slump in imports. More positively, the increase in household consumption (0.5%Q/Q) was stronger than initially estimated and added 0.3ppt to overall GDP growth, supported by a drop in the savings ratio (by 0.4ppt to a still-high 9.7%) and a fourth quarterly rise in real disposable income, albeit more modest than in recent quarters. Growth in business fixed investment was also revised higher (1.9%Q/Q) to the strongest in six quarters and some 5.4% above the pre-pandemic level. However, given heightened uncertainties surrounding the outlook for both domestic and global demand, firms might be expected to scale back their

UK: GDP growth & composite PMI



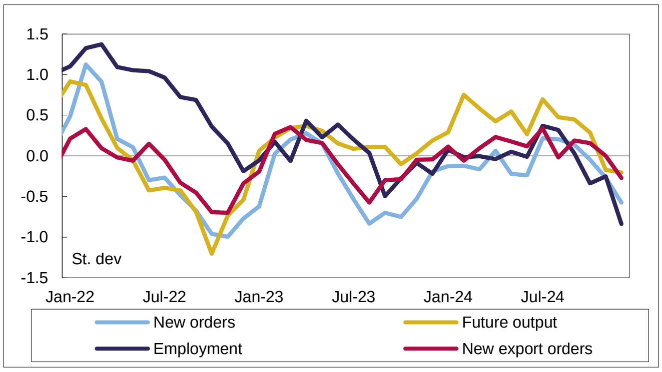
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services & manufacturing PMIs



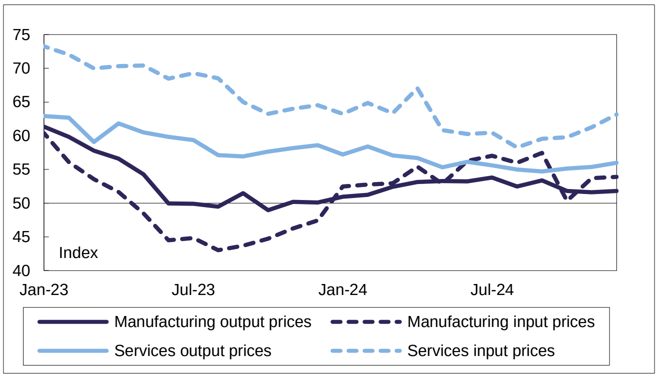
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Selected composite PMIs



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

UK: Price PMIs



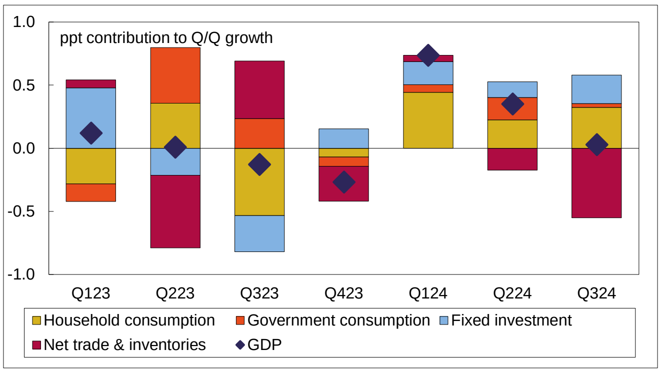
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

capex plans over the near term. Indeed, the BCC survey suggested that almost a quarter of companies had cut their planned capex for the next 12 months. Surveys also point to a renewed loss of momentum in consumer spending over recent months, and – as suggested by today's final PMIs – that GDP probably continued to flatline in Q4. So, the BoE will have to revise down its GDP projection in February, when it is also likely next to cut Bank Rate.

The day ahead in the UK

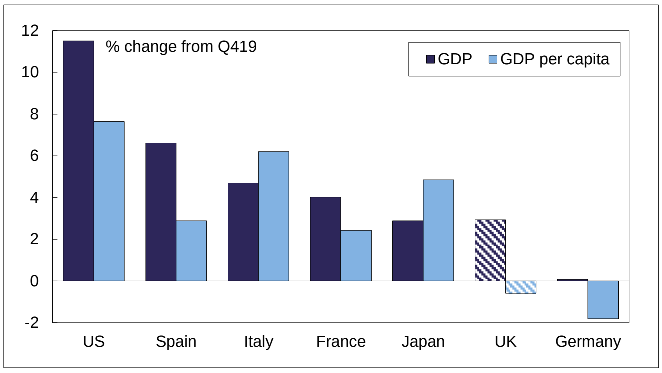
After November's BRC retail monitor flagged a sharp downturn in consumer spending – in part credited to the later timing of this years' Black Friday discounts, which fell out of November's sample period – December's like-for-like sales indicator will be expected to exhibit a rebound in shoppers' activity. And with similar calendar changes also having dampened November's official retail sales figures, any pickup should also be reflected positively in December's retail sales data, which are due next week. But with consumer confidence still subdued, and any festive rebound in consumer spending seemingly absent across other leading surveys, including from the CBI, the risks to tomorrow's survey remain skewed to the downside. Indeed, an underwhelming result would increase the likelihood for a contraction in retail sales in Q4 as a whole. Meanwhile, tomorrow's construction PMI should continue to defy the slowdown across the broader manufacturing sector, particularly supported by civil engineering.

UK: Contributions to GDP growth



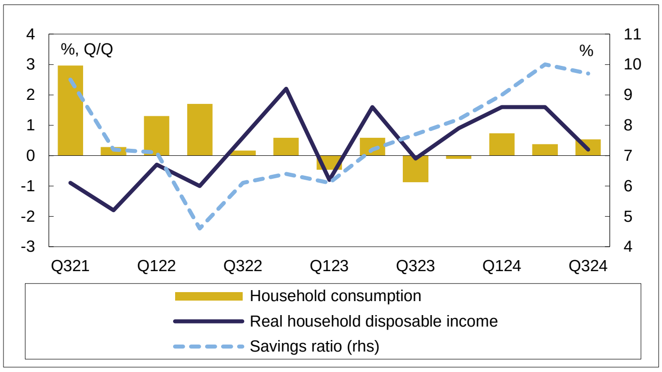
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP comparisons since pandemic



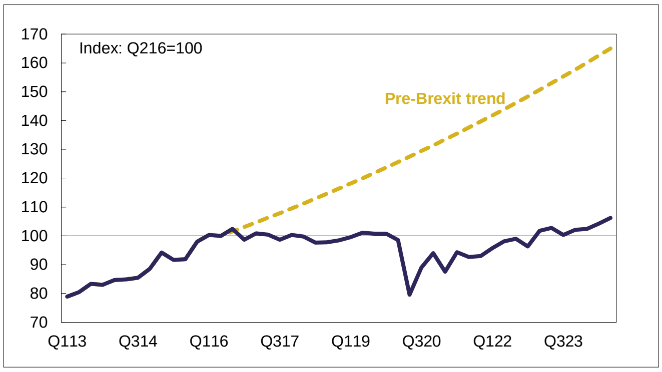
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Household consumption, savings & income



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Business investment



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 composite (services) PMI	Dec	**49.6 (51.6)**	*49.5 (51.4)*	48.3 (49.5)	-
		Sentix investor confidence index	Jan	**-17.7**	-17.9	-17.5	-
Germany		Preliminary HICP (CPI) Y/Y%	Dec	**2.9 (2.6)**	2.6 (2.4)	2.4 (2.2)	-
		Final composite (services) PMI	Dec	**48.0 (51.2)**	*47.8 (51.0)*	47.2 (49.3)	-
France		Final composite (services) PMI	Dec	**47.5 (49.3)**	*46.7 (48.2)*	45.9 (46.9)	-
Italy		Composite (services) PMI	Dec	**49.7 (50.7)**	50.1 (50.0)	47.7 (49.2)	-
Spain		Composite (services) PMI	Dec	**56.8 (57.3)**	54.3 (54.1)	53.2 (53.1)	-
UK		Final composite (services) PMI	Dec	**50.4 (51.1)**	*50.5 (51.4)*	50.5 (50.8)	-
		New car registrations Y/Y%	Dec	**-0.2**	-	-1.9	-

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		08.30	Construction PMI	Dec	-	42.7
		09.00	ECB consumer expectations survey – 1Y CPI (3Y CPI) Y/Y%	Nov	-	2.5 (2.1)
		10.00	Preliminary headline (core) HICP Y/Y%	Dec	*2.5 (2.8)*	2.2 (2.7)
		10.00	Unemployment rate %	Nov	6.3	6.3
Germany		08.30	Construction PMI	Dec	-	38.0
France		07.45	Preliminary HICP (CPI) Y/Y%	Dec	1.9 (1.5)	1.7 (1.3)
		08.30	Construction PMI	Dec	-	43.7
Italy		08.30	Construction PMI	Dec	-	48.5
		10.00	Preliminary HICP (CPI) Y/Y%	Dec	1.6 (1.5)	1.5 (1.4)
UK		00.01	BRC retail sales monitor – like-for-like sales Y/Y%	Dec	-0.2	-3.4
		09.30	Construction PMI	Dec	-	55.2

Auctions and events			
Germany		10.30	Auction: to sell €4.5bn of 2% 2026 bonds
UK		10.00	Auction: to sell £2.25bn of 4.375% 2054 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs