Euro wrap-up

Overview

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- Longer-dated Bunds followed USTs lower, but shorter-dated Bunds were little changed as euro area inflation aligned with initial expectations and core inflation momentum continued to moderate.
- Despite an underwhelming UK retail and construction survey, Gilts followed USTs lower with 30Y yields the highest since 1998 after today's auction attracted the lowest demand for more than a year.
- Wednesday will bring the Commission's December sentiment survey results, as well as November figures for German factory orders and retail sales.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.188	-0.002
OBL 2½ 10/29	2.276	+0.016
DBR 2.6 08/34	2.481	+0.036
UKT 4⅛ 01/27	4.460	+0.035
UKT 4⅛ 07/29	4.445	+0.048
UKT 4¼ 07/34	4.683	+0.074

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

Euro area

Rise in inflation in December due principally to energy prices & capped by French & Italian data

While yesterday's German figures surprised significantly on the upside, today's flash December estimate of euro area HICP inflation aligned with initial expectations, rising 0.2ppt to a five-month high of 2.4%Y/Y. That reflected softer-than-expected figures from France (up 0.1ppt to 1.8%Y/Y) and Italy (down 0.1ppt to 1.4%Y/Y). Moreover, the German preliminary HICP estimate was revised down from the initial estimate (by 0.1ppt to 2.8%Y/Y) presumably to correct an error. Admittedly, to two decimal places, euro area headline inflation came in at 2.44%Y/Y, leaving the non-negligible risk of an upwards revision to 2.5%Y/Y when the final data are published on 17 January. However, the limited detail suggest that the Governing Council should not fret about the pickup in inflation, which was driven principally by energy prices and associated base effects, while underlying price pressures appeared to remain relatively well behaved. Indeed, the energy component accounted fully for the rise in the headline rate, rising more than 2ppts to a five-month high of 0.1%Y/Y. That reflected the increase in energy prices of 0.6%M/M last month, in part due to higher prices of petrol, in contrast to the decline of 1.6%M/M a year earlier.

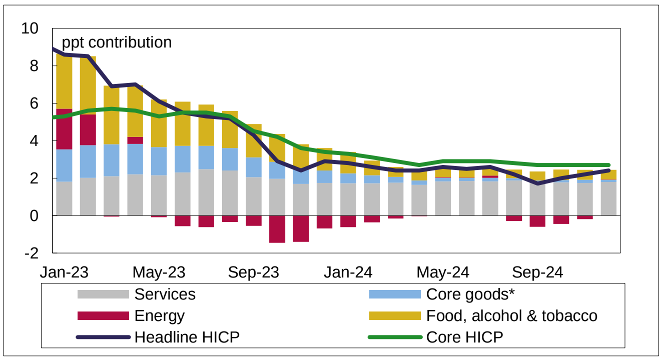
Core momentum continues to moderate despite uptick in services inflation in December

Among the other components, the hawks on the Governing Council will probably express concern about the rise of 0.1ppt in services inflation back to 4.0%Y/Y, the average rate for that component in 2024. However, the 0.8%M/M increase in services prices was in line with the average for the month in the years between the euro crisis and pandemic, and a touch below the long-run average. So, on a seasonally adjusted basis, services inflation momentum fell for the fifth successive month to an 11-month low of 2.7%3M/3M annualised. Moreover, with non-energy industrial goods prices down slightly on the month, core goods inflation edged down to 0.5%Y/Y, with momentum in the category at a five-month low of just 0.4%3M/3M annualised. So, core inflation remained at 2.7%Y/Y for the fourth successive month. And core momentum dropped below 2.0%3M/3M annualised for the first time in eleven months, suggesting consistency with the ECB's target if recent price changes are sustained. Finally, inflation of food, alcohol and tobacco was steady (also at 2.7%Y/Y) as prices in that category fell (albeit very slightly) for the first time in more than three years.

Higher consumer inflation expectations & record low unemployment no obstacle to disinflation

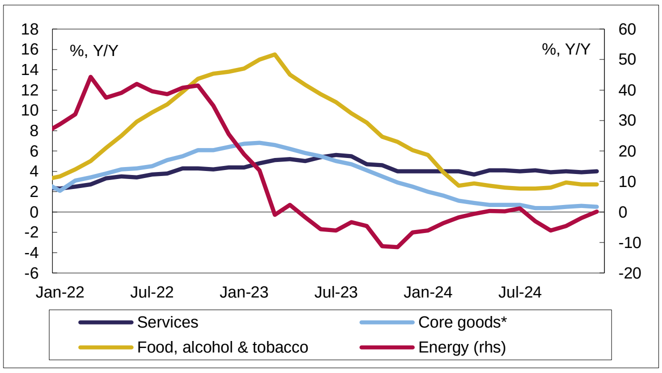
Together with the rise in headline inflation and the services component in December, certain other data released today will also have resonated with the ECB's hawks. According to the ECB's consumer survey, household expectations of inflation three years ahead picked up significantly in November, with the median rate rising 0.3ppt to 2.4%Y/Y. However, that is no higher than the average in the first six months of last year, and below the range from Russia's invasion of Ukraine through to

Euro area: HICP inflation & contributions



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

Euro area: Key HICP inflation components



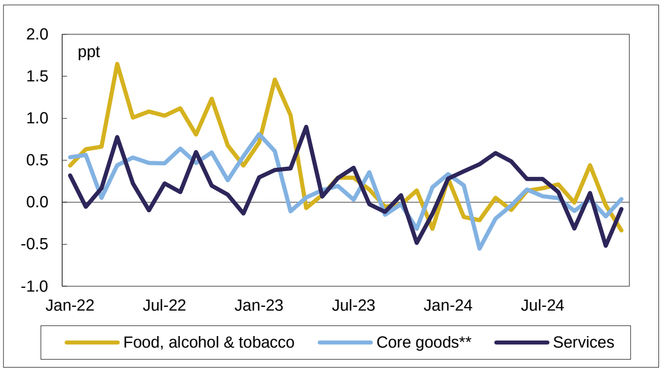
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

end-2023. Moreover, the increase in inflation expectations was principally due to Belgium (up 0.4ppt to 2.9%Y/Y), while there were minimal increases in Germany (2.1%Y/Y) and Italy (3.0%Y/Y). In contrast, inflation expectations were steady in France (2.0%Y/Y), and fell in Spain (2.2%Y/Y). The hawks will also be mindful of the continued resilience of the labour market, with the euro area unemployment rate unchanged at the series low of 6.3% in November. Among the member states, the rate picked up in France to a three-year high (7.7%). But it edged lower in Italy (5.7%) and was steady in Germany (3.4%) and Spain (11.2%). Survey indicators such as the employment PMIs point to the increased desire of firms to cut headcount. Moreover, the ECB survey today reported a notable pickup in consumer expectations of the unemployment rate 12 months ahead (to a 12-month high of 7.9%). And most notably, the ECB's wage trackers published last month pointed to a significant moderation of negotiated pay growth over the coming year, with the headline index having been anticipated to peak at around 5.4% at the end of 2024 before gradually easing to an average of 3.2% during 2025. With strong recent pay growth already being absorbed significantly by margins, and services price base effects to become more favourable, we therefore maintain our expectation that euro area HICP inflation will be back at the 2.0% target or below by Q2 and – in the absence of new shocks – remain thereabouts in H225 and beyond too.

Construction PMI remains firmly in contractionary territory despite pickup in Italy

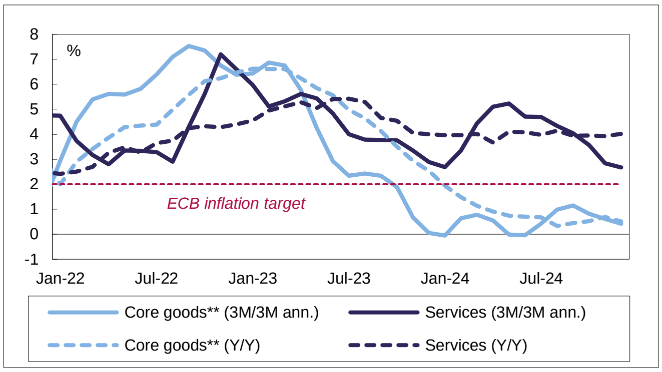
With inflation set to moderate from January onwards, we expect the ECB to continue to cut rates by 25bps at each of its two policy meetings this quarter. That pace of monetary easing, however, is unlikely to be sufficiently aggressive to provide much support for the rate-sensitive sectors, which remain in a funk. Indeed, like the equivalent manufacturing survey, today's construction PMIs suggested that momentum in the sector remained weak heading into year-end, underscoring that the ECB's policy stance remains restrictive. Indeed, despite edging slightly higher on the month, the headline euro area construction activity index remained firmly in contractionary territory (42.9), just as it has done since April 2022. The improvement last month reflected an uptick in Italy – to an eleven-month high of 51.2 – where sentiment was seemingly buoyed by the strongest growth in output in nine months in October (1.6%M/M). In contrast, the survey signalled a further sharp decline in construction activity in Germany (37.8) and France (42.6), with the former index the weakest since April. House-building again posted the sharpest decline of all subsectors, and the steepest since September. And while there was a softer pace of decline in commercial activity and civil engineering, both indices remained below 50 for the thirty-third consecutive month. New orders similarly remained close to the bottom of the recent range and consistent with an ongoing decline in activity.

Euro area: Deviation from LR average price change*



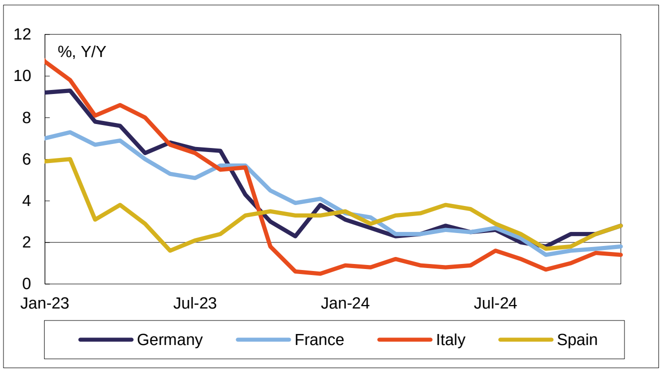
*Monthly change in prices compared with average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum*



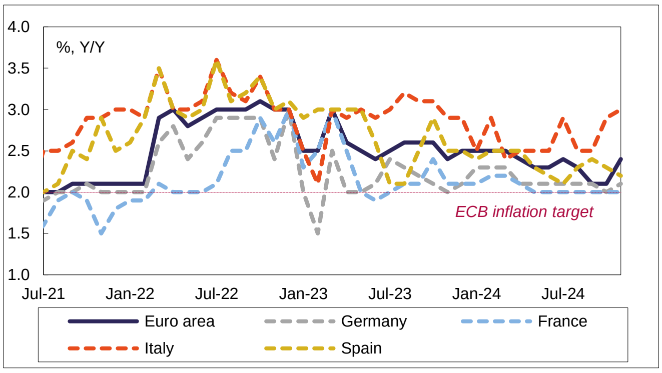
*Seasonally adjusted data. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: 3Y consumer inflation expectations*



*Median expectation. Source: Macrobond & Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Ahead of Germany's industrial output figures for November on Thursday, tomorrow's factory orders and turnover data will provide a guide to the health of the manufacturing sector in the euro area's largest member state after production fell in October to the lowest level since 2010. Having been flattered by ongoing support from major items in October, factory orders are expected to decline slightly in November. However, we see the potential for an upside surprise if the heightened risks of new US tariffs on imports from Germany led firms to bring forward shipments that might otherwise have been planned for 2025. Nevertheless, we would also expect the impact of any such frontloading on production and turnover in November to be muted. Certainly, with the extension of unfavourable weather conditions and elevated power costs likely to have served as a headwind to electricity generation and energy-intensive production, industrial output would appear set to disappoint in November. Higher energy costs are also likely to be reflected in tomorrow's euro area PPI data for November, having been the primary driver in the month-on-month price increases across the member states. Nevertheless, euro area producer prices will still be down almost 1½%Y/Y, consistent with continued soft consumer goods price inflation.

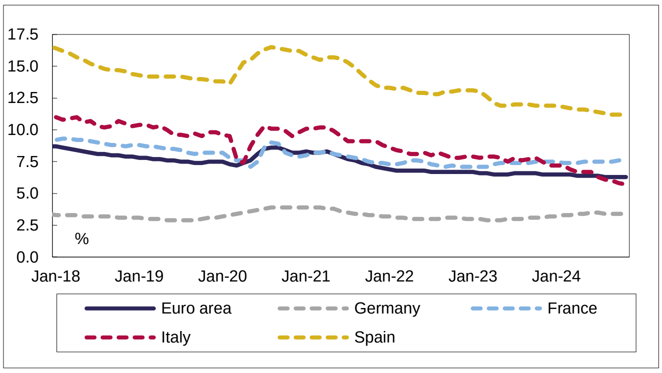
Elsewhere, and after the flash release indicated that consumer confidence in the euro area slipped back to an 8-month low in December, tomorrow's final Commission economic sentiment indicators are expected to tally with the PMIs to remain consistent with economic stagnation. December's French INSEE consumer confidence survey results are also likely to be particularly downbeat reflecting the impact of the collapse of the Barnier government. Indeed, having briefly recovered to a more than 2½-year high in September (95), French consumer confidence subsequently slumped to a 5-month low in November (90) as political uncertainties increased. Wednesday will also bring French trade and German retail sales data for November.

UK

Retail sales growth softens in Q4 despite Black Friday boost in December

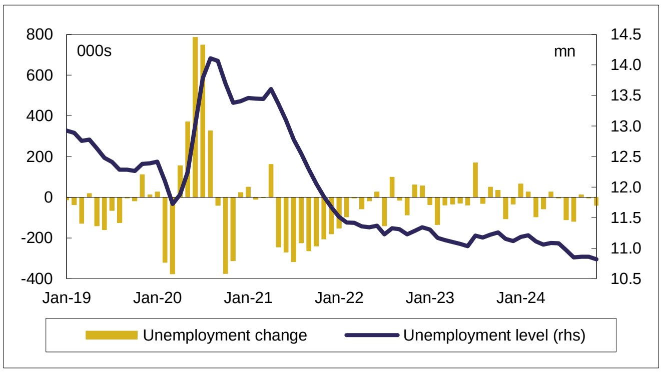
Tallying with the loss of momentum signalled in the December services and manufacturing PMIs, today's surveys on retail sales and construction activity similarly underwhelmed. Admittedly, the BRC retail monitor reported a rebound in growth in December, with the value of sales up 3.2%Y/Y, the strongest annual increase since March. But this merely reversed the decline in November (-3.3%Y/Y), which principally reflected the inclusion of Black Friday discounting in December's sampling period this year compared with November last year. Non-food sales rose 4.4%Y/Y in December, with online sales surging 11.1%Y/Y, as computing, mobile phones and beauty products reportedly fared particularly well. But, when smoothing out monthly volatility, overall growth in sales values slowed to just 0.4%Y/Y in Q4 from 1.2%Y/Y in Q3 and an increase of

Euro area: Unemployment rates



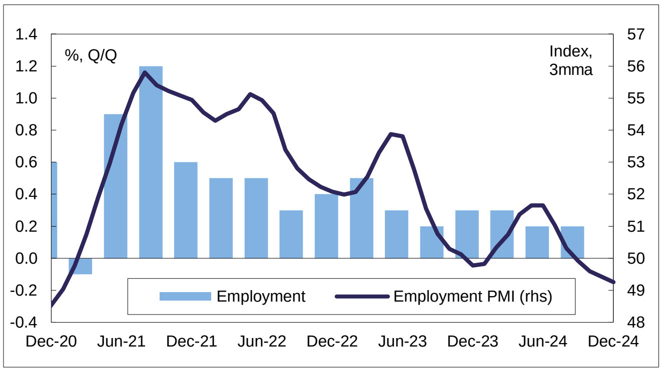
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment level



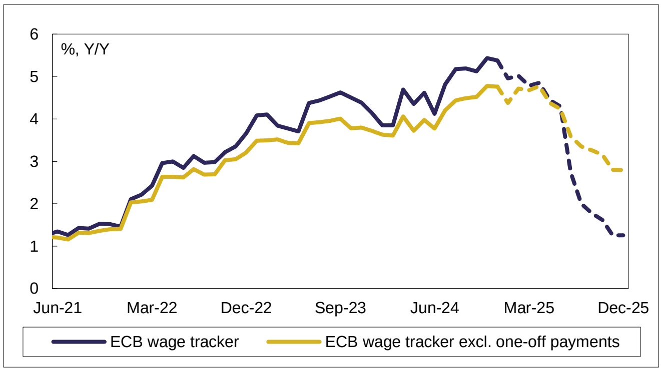
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Employment growth & composite PMI



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

Euro area: ECB wage trackers



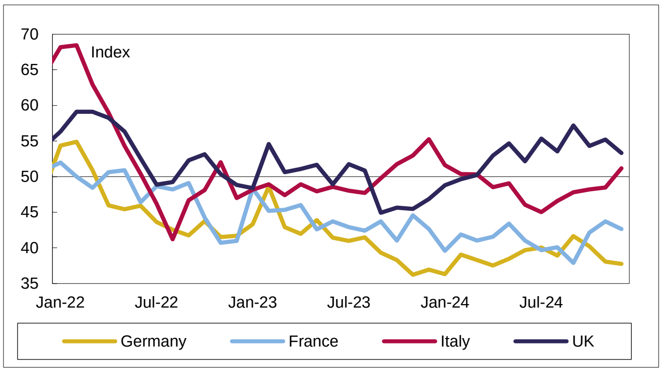
Source: ECB and Daiwa Capital Markets Europe Ltd.

2.4%Y/Y in Q423. And, despite the boost to certain big-ticket items in December, overall non-food sales fell 1.1%Y/Y in Q4. While this was offset by a rise in food sales (2.1%3M/Y), a Kantar survey published today suggests that a pickup in supermarket prices – by the most since March – inflated food sales values in the run up to Christmas. Overall, today's release tallies with the downbeat message from the CBI, which showed more than 40% of respondent retailers reporting a decline in sales volumes in Q4. And with disposable incomes hit by the near-10% hike in household energy tariffs at the start of October, we expect overall household consumption to have moderated substantially last quarter following growth of 0.5%Q/Q in Q3, providing little to no support to GDP growth in Q4.

Construction PMI drops to a six-month low amid high borrowing costs and subdued confidence

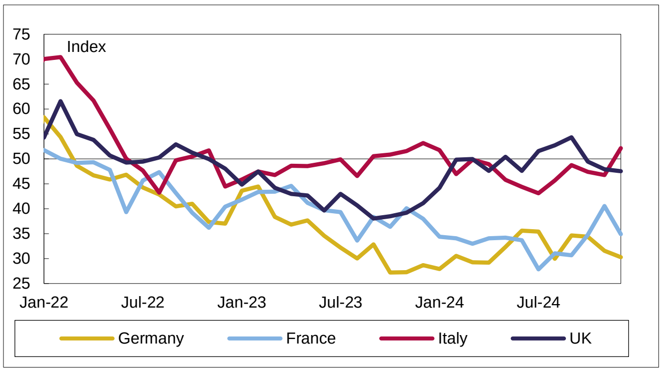
Today's construction PMI survey also signalled a loss of momentum, suggesting that the sector similarly provided modest support to the economy over the fourth quarter. Indeed, the headline activity index fell a steeper-than-expected 1.9pts to 53.3 in December, a six-month low and a touch below the long-run average. This left the Q4 average down to 54.3, some 1.1pts below the Q3 average. While the moderation in December was broad-based, house-building remained the key drag on activity, with the respective PMI declining for a third consecutive month to 47.6, the joint lowest since last January and more than 6½pts below September's high. Despite the recent recovery in the housing market, demand appeared to remain

Europe: Construction activity PMIs



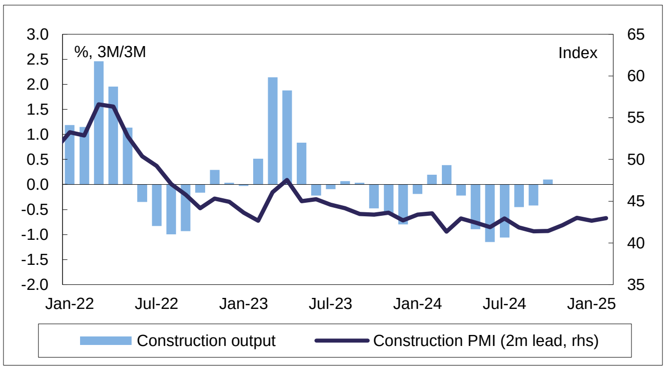
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Housing activity PMIs



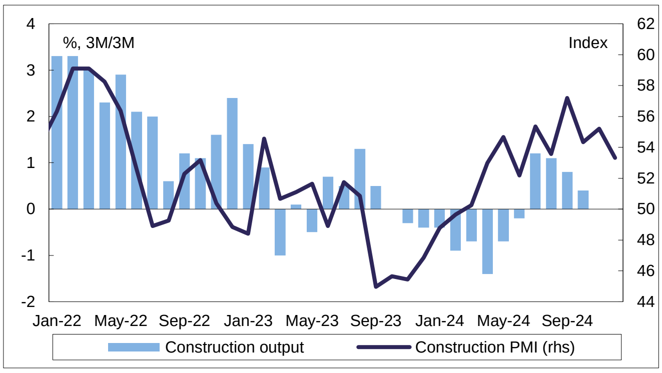
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Construction activity & PMI



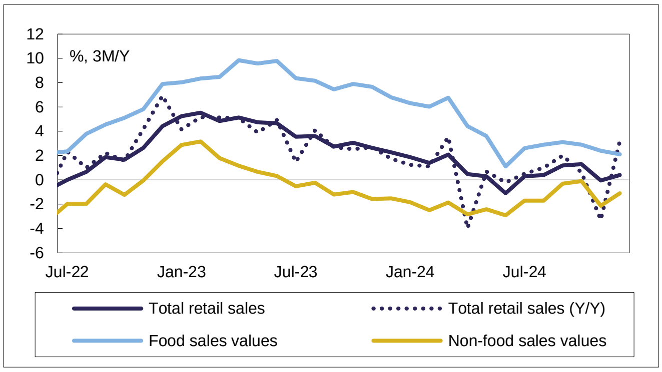
Source: Macrobond, S&P Global, and Daiwa Capital Markets Europe Ltd.

UK: Construction activity & PMI



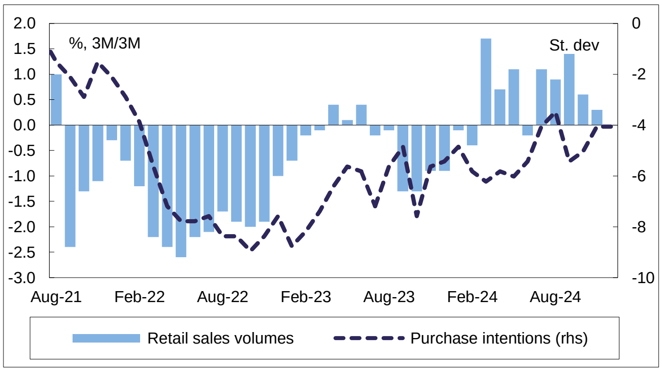
Source: Macrobond, S&P and Daiwa Capital Markets Europe Ltd.

UK: BRC retail sales monitor



Source: Macrobond,and Daiwa Capital Markets Europe Ltd.

UK: Retail sales & purchase intentions



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

restrained by still high borrowing costs and subdued consumer confidence – indeed, the new orders index moderated for the third consecutive month to a six-month low of 52.9. So, while business optimism about the year ahead improved from November, less than 50% of construction firms expect output to rise over the coming twelve months.

The day ahead in the UK

It should be a quiet day ahead for UK economic news, with no top-tier data releases scheduled for Wednesday.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary headline (core) HICP Y/Y%	Dec	**2.4 (2.7)**	*2.5 (2.8)*	2.2 (2.7)	-
	Unemployment rate %	Nov	**6.3**	6.3	6.3	-
	ECB consumer expectations survey – 1Y CPI (3Y CPI) Y/Y%	Nov	**2.6 (2.4)**	-	2.5 (2.1)	-
	Construction PMI	Dec	**42.9**	-	42.7	-
Germany	Construction PMI	Dec	**37.8**	-	38.0	-
France	Preliminary HICP (CPI) Y/Y%	Dec	**1.8 (1.3)**	1.9 (1.5)	1.7 (1.3)	-
	Construction PMI	Dec	**42.6**	-	43.7	-
Italy	Preliminary HICP (CPI) Y/Y%	Dec	**1.4 (1.3)**	1.6 (1.5)	1.5 (1.4)	-
	Construction PMI	Dec	**51.2**	-	48.5	-
UK	BRC retail sales monitor – like-for-like sales Y/Y%	Dec	**3.1**	-	-3.4	-
	Construction PMI	Dec	**53.3**	54.4	55.2	-

Auctions

Country	Auction
Germany	sold €3.472bn of 2% 2026 bonds at an average yield of 2.18%
UK	sold £2.25bn of 4.375% 2054 bonds at an average yield of 5.198%

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	Commission economic sentiment indicator	Dec	95.6	95.8
	10.00	Final Commission consumer confidence indicator	Dec	*-14.5*	-13.7
	10.00	Commission industrial (services) confidence indicator	Dec	-11.6 (5.7)	-11.1 (5.3)
	10.00	PPI Y/Y%	Nov	-1.4	-3.2
Germany	07.00	Factory orders M/M% (Y/Y%)	Nov	0.0 (3.0)	-1.5 (5.7)
	07.00	Retail sales M/M% (Y/Y%)	Nov	0.5 (2.5)	-0.3 (5.1)
France	07.45	INSEE consumer confidence indicator	Dec	90	90
	07.45	Trade balance €bn	Nov	-	-7.7

Auctions and events

Country	GMT	Event
Germany	10.30	Auction: to sell €5bn of 2.5% 2035 bonds
UK	10.00	Auction: to sell £4.25bn of 4.375% 2030 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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