Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds made modest losses as German industrial production and export figures surprised to the upside, while euro area retail sales remained on track for modest growth in Q4.
- Gilts were little changed while a BoE Deputy Governor reaffirmed that she expects rates to be cut and a survey reported that firms have revised up their inflation expectations but expect wage and job growth to slow.
- A relatively quiet end to the week for European releases will bring November figures for French industrial production and consumer spending.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.223	+0.027
OBL 2½ 10/29	2.327	+0.031
DBR 2½ 02/35	2.563	+0.019
UKT 4⅛ 01/27	4.499	-
UKT 4⅛ 07/29	4.511	-0.003
UKT 4¼ 07/34	4.808	+0.015

*Change from close as at 5.00pm GMT.
Source: Bloomberg

Euro area

Retail sales move broadly sideways in November but remain on track for modest growth in Q4

Euro area retail sales growth in Q3 of 1.0%Q/Q was the strongest since Q421, providing a significant contribution to the welcome rebound of 0.7%Q/Q in private consumption that quarter. Since then, perhaps unsurprisingly, retail sales have lost momentum. After dropping 0.3%M/M in October, retail sales moved broadly sideways in November, edging up a smaller-than-expected 0.1%M/M. Sales were flattered by stronger sales of auto fuel (0.8%M/M) that month. So, with food sales growth minimal (also 0.1%M/M), core sales (i.e. excluding food and fuel) fell in November by a chunky 0.6%M/M. Given the strong carry-over from September, however, both total retail sales and core sales were up 0.4% on average in the first two months of Q4 from Q3. Admittedly, consumer confidence deteriorated to an eight-month low in December against the backdrop of increased political uncertainty. However, buoyed by continued strong gains in real disposable income, retail sales remain on track for a fifth successive quarter of positive growth in Q4, albeit at a much softer pace than in Q3. And in the absence of new shocks, we expect continued modest growth in sales in the current quarter too.

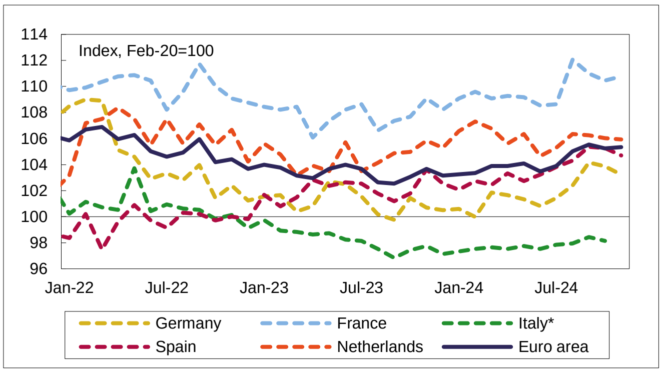
German industrial output unlikely to boost GDP in Q4 despite upwards surprise in November

Contrasting yesterday's downbeat factory orders data, today's German industrial production figures provided a positive surprise. Tallying with rising turnover, total output rose 1.5%M/M in November, more than reversing the drop in October, which was revised from -1.0%MM to -0.4%M/M. Admittedly, this still left output down 2.8%Y/Y, almost 12% below the pre-pandemic benchmark in February 2020 and 15% below the peak in 2018. And given the negative carryover from a steep drop in September, production was still trending in the first two months of Q4 0.2% below the Q3 average. Within the detail, a rebound in energy (5.6%M/M) failed to fully reverse the slump at the start of the quarter when the Dunkelflaute (dark doldrums) of windless cloudy weather hit power generation by renewables – indeed, energy production was still trending some 3.0% below the Q3 average. While the initially estimated drop in manufacturing output of 1½%M/M in October was largely revised away and production rose 1.2%M/M in November – thanks not least to a rebound in the aerospace subsector (11.4%M/M) – this too left average output in Q4 so far a touch below the Q3 level. And while construction activity rose in November (2.1%M/M) by the most in nine months, it was trending only ½% above the Q3 average.

Surveys point to production slump in December, but industry gas usage jumped

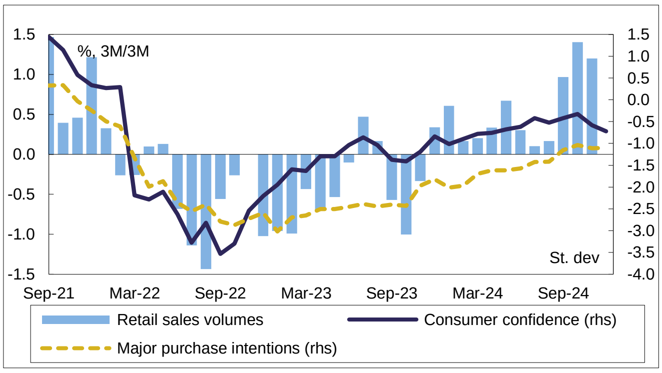
The near-term outlook for German industry remains subdued, weighed by heightened political uncertainty at home and in key export markets, increased competition from China, and the lingering effects of the energy-price shock. Despite a large-scale ship order at the start of the fourth quarter, factory orders continue to move broadly sideways at an extremely low level

Euro area member state: Retail sales



*Latest figure for October 2024.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales & consumer confidence



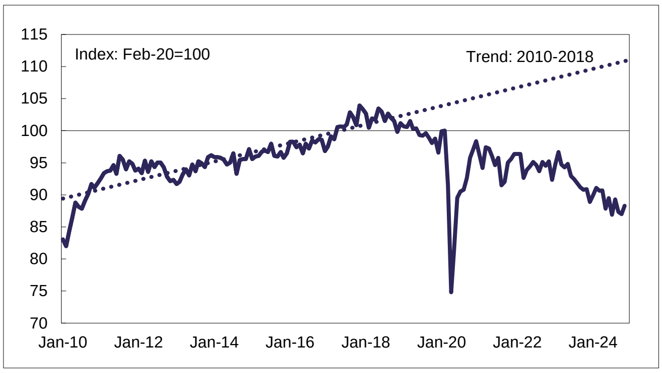
Source: Macrobond, EC and Daiwa Capital Markets Europe Ltd.

consistent with a lack of underlying demand. And although today's figures showed car production in the first two months of Q4 trending almost 2% above the Q3 average, surveys point to a significant deterioration in conditions in the subsector heading into year-end as order backlogs continued to fall. Germany's auto association (VDA) suggested that output fell 10%Y/Y in December to the lowest level in that month since the series began in 2005, albeit still leaving the quarterly average up 1.6%Y/Y in Q424. Meanwhile, consistent with declining orders, production of general machinery in November remained close to the bottom of the range of the past 14 years (excluding the initial slump in the first pandemic wave). Admittedly, this was offset by a further modest improvement in electrical machinery to a five-month high in November, which left that category trending almost 4% above the Q3 average. And a further notable rise in industrial gas usage in December (18%Y/Y) might provide further support to energy-intensive production after rising in November (2.1%M/M) for the first month in five. Overall, however, we expect some payback in December for the strength in total production in November. And while the contraction will be significantly smaller than in Q2 and Q3, manufacturing likely remained a modest drag on GDP in Q4 for the sixth quarter out of the past seven.

Net trade likely to be drag on German GDP, despite jump in goods exports in November

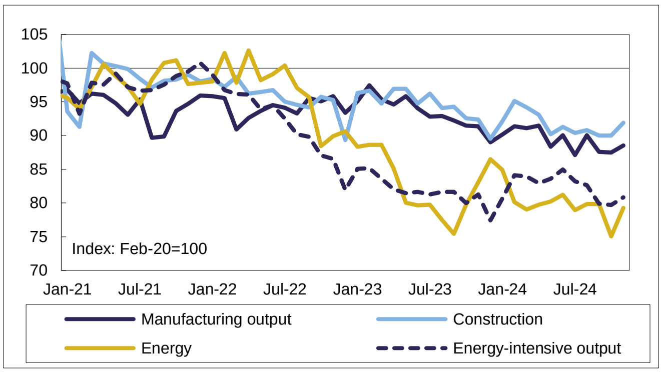
At face value, today's German goods trade report for November was also more encouraging. The seasonally adjusted trade surplus increased €6.3bn to a three-month high of €19.7bn reflecting a pickup in the value of goods exports (2.1%M/M) and

Germany: Industrial production



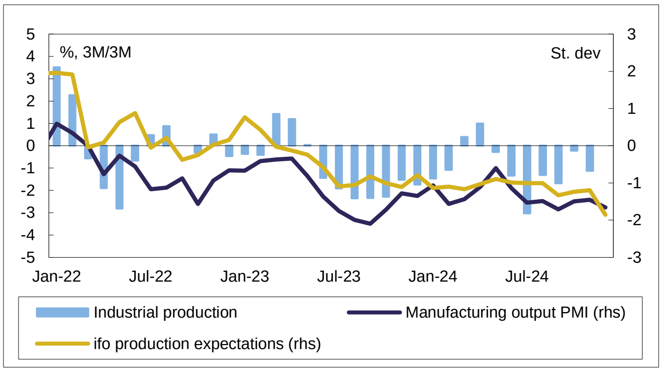
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production



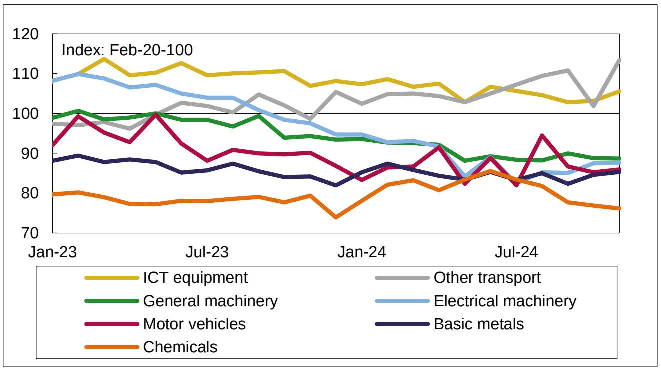
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production & expectations



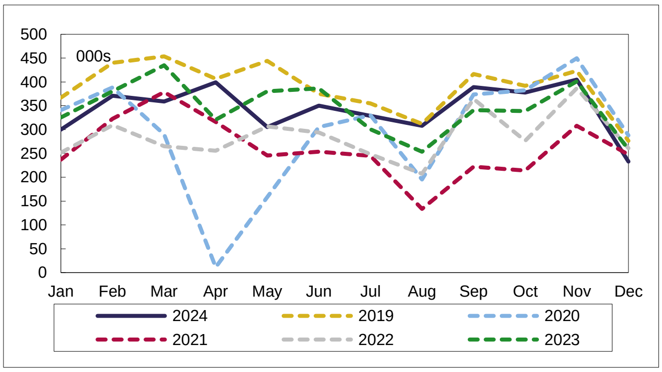
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing production



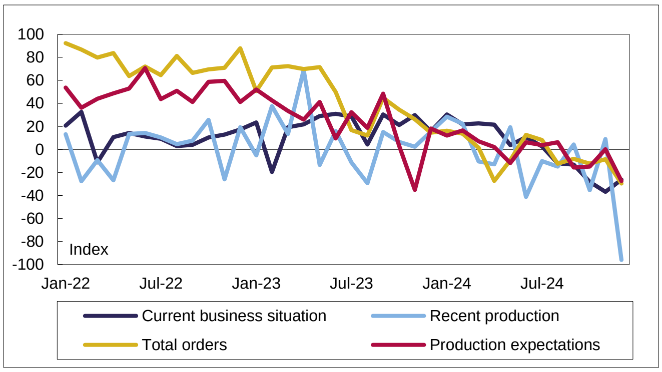
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Car production



Source: Bloomberg, VDA and Daiwa Capital Markets Europe Ltd.

Germany: Car manufacturer sentiment



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

a further decline in imports (-3.3%M/M). But the increase in exports only partially reversed the cumulative near-4½% decline in the previous two months, to leave the level still close to the bottom of the range of the past three years. Indeed, export values in the first two months of Q4 were trending some 2.6% below the Q3 average, with the ongoing downtrend in shipments to China offsetting a sideways trend to the US and modest increase to the UK. Admittedly, the decline in import values so far in Q4 (1.4% vs Q3 average). But with overseas goods orders weak, we expect export volumes to remain extremely subdued in December. And overall, net trade looks unlikely to have provided any support to GDP growth in Q4.

The day ahead in the euro area

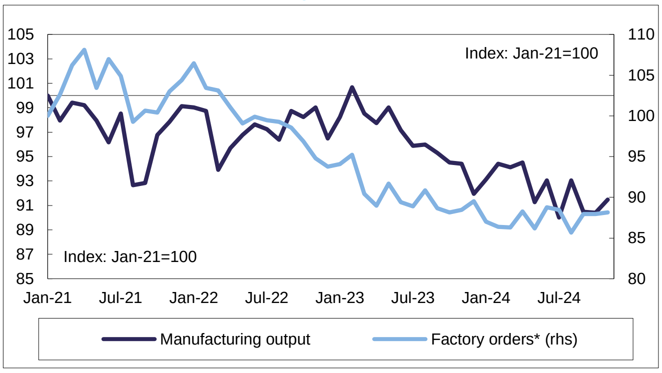
With only a handful of data releases scheduled across the member states on Friday, it should be a relatively quiet end to the week for euro area economic news. With November's aggregate euro area industrial output release due next week, tomorrow's IP releases from France and Spain will be most informative, although a rebound akin to today's stronger German data should not be expected. Likewise, and consistent with the recent deterioration in INSEE's consumer confidence indicator – which yesterday extended its decline into December, and to a 12-month low (89), on deepening political uncertainty – French consumer spending in November is also expected to be subdued. Italian retail sales figures for November are also due.

UK

BoE likely to offset tightening of financial conditions as long as sterling index remains resilient

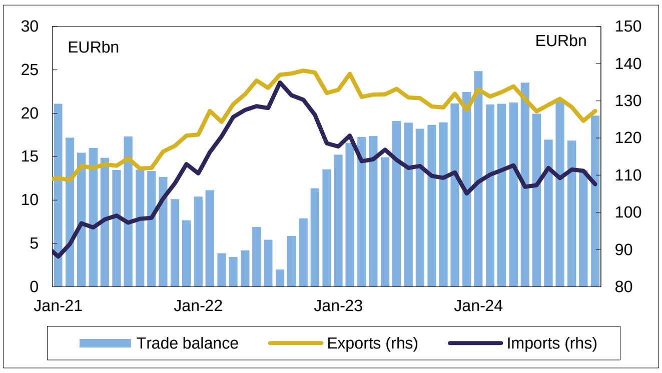
While Gilts were steadier today, the recent global bond-market sell-off undoubtedly poses new challenges for UK policymakers, contributing to recent underperformance of Gilts relative to USTs even if sterling's weakness has moved broadly in tandem with that of other European currencies. While government debt interest costs for the first eight months of the current fiscal year have undershot the OBR's October forecast, if sustained the significant increase in yields of recent weeks will necessarily mean higher debt interest costs than planned over the horizon. Indeed, the IFS estimates that a sustained increase in relevant yields of 50bps – broadly in line with the rise in 10Y yields over the past month – would add about 0.25% of GDP to debt interest spending in four years' time, enough to erode the lion's share of the government's headroom for meeting its fiscal objectives. So, market developments increase the likelihood that the government will have to make offsetting fiscal adjustments in due course. Rather than significantly higher borrowing or further tax hikes, however, we expect the coming public sector spending review to be tougher than it otherwise would have been, with offsetting cuts to the spending plans of certain lower-priority government departments to negate the effect of any increase in debt interest costs.

Germany: Manufacturing output & orders



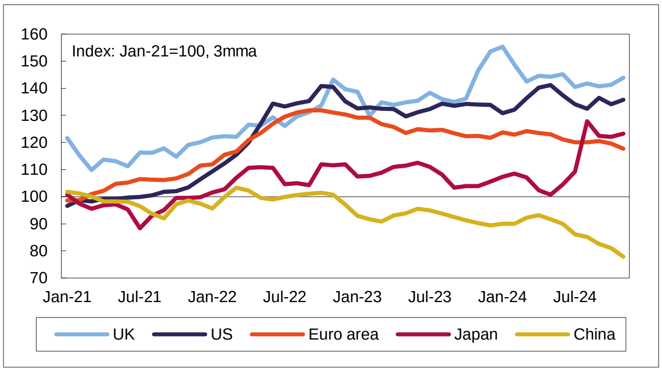
**Excluding major orders.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Goods trade balance, exports & imports*



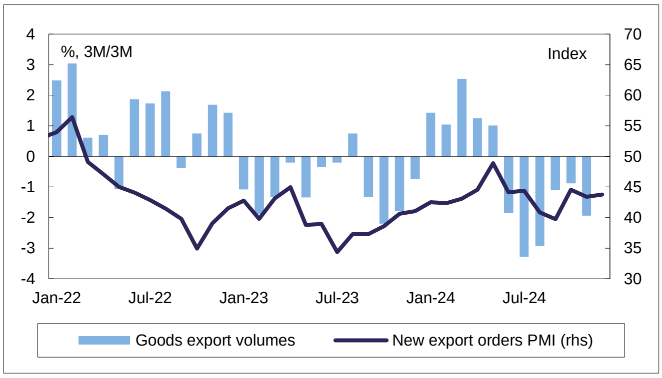
**Seasonally adjusted values.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Export values by destination



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Goods export volumes & orders



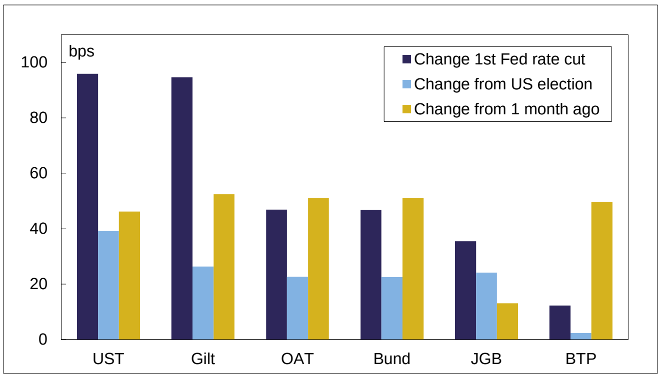
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

In terms of monetary policy, meanwhile, the BoE will interpret the big rise in Gilt yields as a significant tightening of financial conditions that it should seek to offset with further cuts to Bank Rate, as long as the depreciation in sterling's trade-weighted exchange rate – which remains up on a year earlier – does not extend too far as to inject a new inflationary impulse.

Firms look to offset higher labour costs with pay & hiring restraint, lower margins & higher prices

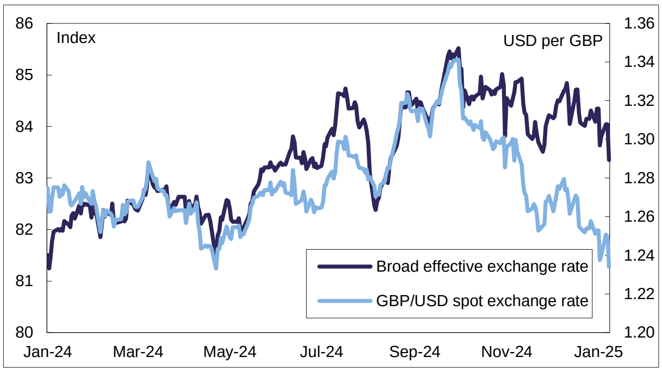
Despite recent market events, therefore, we still expect the MPC to cut Bank Rate by 25bps when its next monetary policy announcement is made on 6 February. And in only her second published speech on monetary policy, BoE Deputy Governor Breeden today stated that she expects further gradual easing over coming quarters, not least due to cooling inflation and signs of weaker growth. But much will still depend on the incoming economic data, with the forthcoming policy decision to be influenced in part by the December CPI report (15 January), November GDP figures (16 January) and labour market data (21 January). Some of today's data will also have been noted by the BoE, not least its own DMP survey results for December. Amid concerns about the impact of the forthcoming increase in employer National Insurance Contributions and National Living Wage on the labour market, MPC members might note that firms' year-ahead wage growth expectations ticked up marginally in December to 3.9%Y/Y. However, that was still the second-lowest estimate since April 2022, and left the three-month average at a new 2½-year low of 4.0%3M/Y. In addition, tallying with reports of increased redundancies in today's REC report on jobs, firms' expected employment growth slowed to just 0.4%3M/Y, the softest on the survey since the

UK: Change in 10Y government bond yields



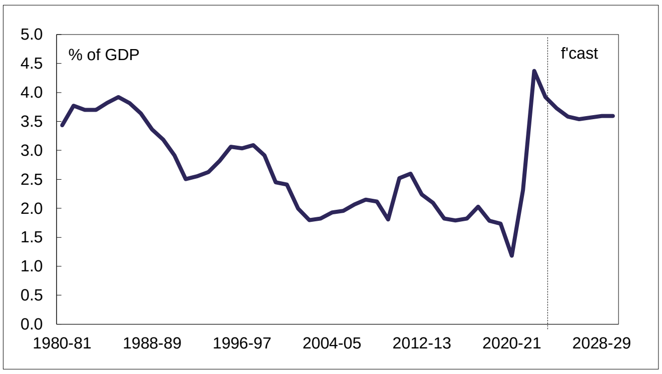
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Sterling exchange rate



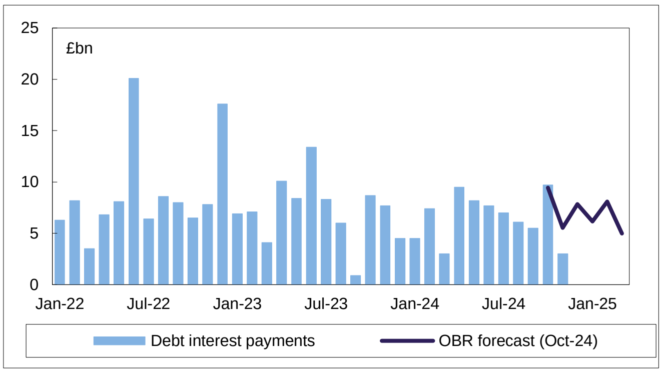
Source: Macrobond, BoE and Daiwa Capital Markets Europe Ltd.

UK: Central government debt interest payments



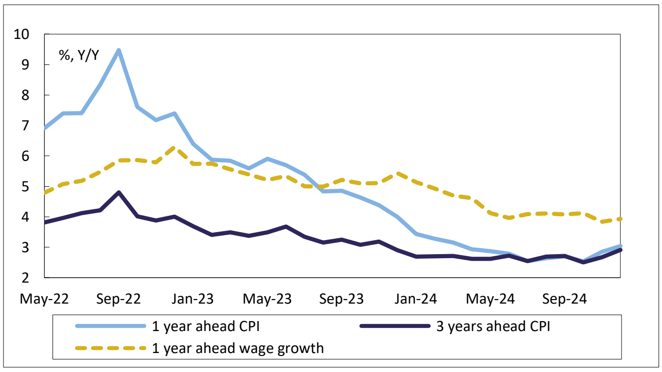
Source: OBR (October 2024) and Daiwa Capital Markets Europe Ltd.

UK: Central government debt interest payments



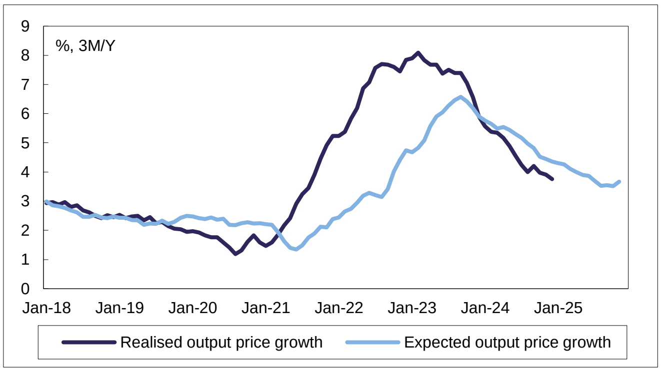
Source: ONS, OBR and Daiwa Capital Markets Europe Ltd.

UK: Firms' CPI & wage growth expectations



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

UK: Firms' output price expectations



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

pandemic in late 2020, with business managers expecting to respond to increased labour costs via a mix of reduced hiring, compressed pay growth and lower margins. More than half of firms expect to raise prices, however, with the DMP survey measure of year-ahead inflation expectations rising in December to 3.0%Y/Y, up 0.5ppt from October and a nine-month high. 3-years ahead inflation expectations picked up too, to 2.9%Y/Y, the highest in a year, which is likely to concern the more hawkish members of the MPC.

The day ahead in the UK

With no top-tier data releases scheduled for Friday, it should be a relatively quiet end to the week for UK economic news.

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Retail sales M/M% (Y/Y%)	Nov	**0.1 (1.2)**	0.3 (1.7)	-0.5 (1.9)	-0.3 (2.1)
Germany	Industrial production M/M% (Y/Y%)	Nov	**1.5 (-2.8)**	0.5 (-4.5)	-1.0 (-4.5)	-0.4 (-4.2)
	Trade balance €bn	Nov	**19.7**	14.5	13.4	-
UK	DMP 3M output price (1Y CPI) expectations %	Dec	**3.8 (3.0)**	3.7 (2.8)	3.7 (2.8)	-
	BRC shop price index Y/Y%	Dec	**-1.0**	-0.4	-0.6	-

Auctions

Country	Auction
France	sold €7.06bn of 3% 2034 bonds at an average yield of 3.4%
	sold €1.84bn of 1.25% 2036 bonds at an average yield of 3.49%
	sold €1.95bn of 2.5% 2043 bonds at an average yield of 3.77%
	sold €2.15bn of 3.25% 2055 bonds at an average yield of 3.93%
Spain	sold €2.6bn of 2.4% 2028 bonds at an average yield of 2.586%
	sold €2.6bn of 3.1% 2031 bonds at an average yield of 2.897%
	sold €1.03bn of 2.9% 2046 bonds at an average yield of 3.71%
	sold €515mn of 2.05% 2039 inflation-linked bonds at an average yield of 1.536%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France	07.45	Industrial production M/M% (Y/Y%)	Nov	-0.1 (-1.3)	-0.1 (-0.6)
	07.45	Consumer spending M/M% (Y/Y%)	Nov	0.2 (-0.2)	-0.4 (0.4)
Italy	09.00	Retail sales M/M% (Y/Y%)	Nov	-	-0.5 (2.6)
Spain	08.00	Industrial production M/M% (Y/Y%)	Nov	- (1.5)	0.5 (1.9)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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