Euro wrap-up

Overview

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- Bunds followed Gilts higher as data suggested that German GDP contracted in Q4 to leave output down for a second successive year in 2024.
- Gilts made significant gains as UK headline, core and services inflation undershot expectations in December to increase the likelihood that the MPC will cut Bank Rate at its next meeting in February.
- Thursday will bring the ECB account from December's Governing Council meeting, as well as November figures for euro area goods trade and UK GDP.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.251	-0.059
OBL 2½ 10/29	2.360	-0.092
DBR 2½ 02/35	2.558	-0.091
UKT 4⅛ 01/27	4.451	-0.136
UKT 4⅛ 07/29	4.461	-0.144
UKT 4¼ 07/34	4.728	-0.159

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

Euro area

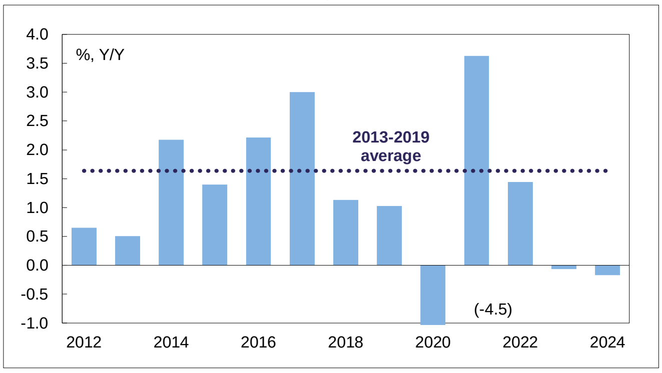
German GDP contracted in Q4 to leave output down for a second successive year in 2024

The ongoing economic woes of the euro area's largest member state were again illustrated in today's German full-year GDP figures for 2024, which confirmed that the economy contracted modestly for a second successive year for the first time in more than two decades. In particular, economic output fell on a calendar-adjusted basis by 0.2%Y/Y in 2024 following a decline of 0.1%Y/Y (-0.3%Y/Y in unadjusted terms) in 2023, well off the average annual growth between the euro crisis and pandemic of 1.6%. And today's estimates suggest that GDP contracted in Q4 (-0.1%Q/Q), maintaining the oscillation between positive and negative growth in place since Q322 and the broadly sideways trend evident since the pandemic. Admittedly, today's updated retail sales figures in November reported an upwards revision from last week's release, with a drop of just 0.1%M/M compared with 0.6%M/M in the preliminary release. And this left sales trending so far in Q4 more than 1% higher than in Q3. But while this suggests that household consumption increased for a second successive quarter, investment and net trade likely remained a drag in Q4.

Manufacturing and construction remain significant drag on economy in 2024

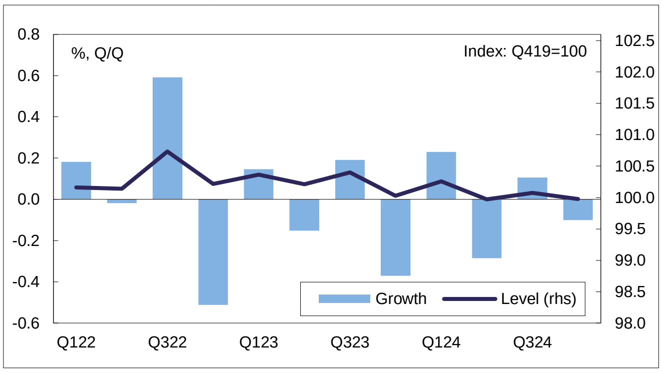
Weakness in the German economy remains centred on the industrial sector, as it continues to adjust to higher energy prices, increased competition and weaker demand from China, and restrictive monetary policy. Indeed, manufacturing output was down 3.0%Y/Y over 2024 as a whole, reflecting sizeable declines in the machinery and autos subsectors, and subdued production in energy-intensive industries following the marked retrenchment in 2023. In addition, construction activity (-3.8%) contracted for the fourth consecutive year amid an ongoing slump in house-building. And while services (0.8%Y/Y) offered some offset, trade, transport, accommodation and food services largely stagnated as households preferred to save than spend (household consumption fell 0.3%Y/Y in unadjusted terms). Growth in the sector was led by information and communication as well as public sector services – indeed, government spending in 2024 (2.6%Y/Y) rose the most in three years. As a result, the general government budget deficit of 2.6% of GDP was 0.4ppt larger than expected, with the deficit in 2023 also revised higher (by 0.6ppt to 2.6% of GDP). Of course, this remains within the EU 3% deficit limit, and we continue to consider German fiscal policy to have been excessively tight. Indeed, given the lacklustre economic backdrop and downside risks to the outlook, the next German government which will emerge from February's federal election ought to prioritise amendments to the Constitutional debt brake to facilitate an easier fiscal stance. But as such amendments will require a two-thirds parliamentary majority to pass, their adoption might well prove frustratingly elusive.

Germany: Full-year GDP growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth & level



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area IP on track for decline in Q4 despite a second successive modest rise in November

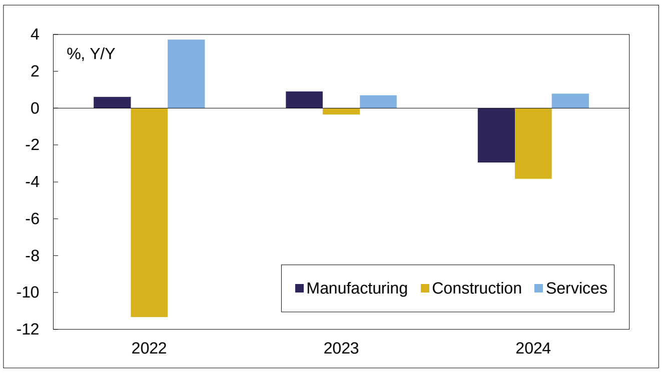
Given its larger size and more acute structural challenges, German manufacturing output has underperformed that of the rest of the euro area for several years. Indeed, while German IP growth (1.3%M/M) exceeded the euro area total in November (0.2%M/M), its level was still a hefty 13% below the pre-Covid-19 benchmark and almost 18% below the peak in late-2017. In contrast, IP in the remainder of the euro area was almost 3.0% above the pre-Covid-19 benchmark. Part of the post-pandemic resilience reflects significant growth in Ireland, where output has been boosted by multinational firms based there for tax purposes. But a sharp drop in Ireland in November (-5.9%M/M) had a non-negligible impact on the euro area figure that month, offsetting strong growth in the Netherlands and Belgium. Within the manufacturing detail for the euro area as a whole, production of capital goods rose for a second successive month – supported by cars and other transport equipment – to leave it trending some 0.4% higher from Q3. But despite modest increases in November, intermediate and consumer goods were trending below the Q3 average. And overall, with production in Germany, France, Austria, Belgium and Ireland in October and November trending below the Q3 level, euro area manufacturing production looks on track for a modest contraction in Q4 (about 0.4%Q/Q). Certainly, surveys pointed a notable deterioration in manufacturing conditions in December, with falling new orders suggesting little improvement in momentum heading into the New Year.

The day ahead in the euro area

In line with last week's flash estimates, today's French and Spanish inflation print confirmed that the upwards pressure in December was mostly driven by energy components. According to the French final estimates on the national CPI measure, energy prices rose some 1.2%Y/Y last month, rebounding from -0.7%Y/Y% in November owing to higher fuel and electricity prices. Despite a slight uptick in services prices (0.5%M/M), they continued to slow on an annual basis (by 0.2ppt to 2.2%Y/Y), while falling prices in non-energy industrial goods led the core rate to a 40-month low of 1.3%Y/Y. Similarly, while more expensive tourist packages resulted in a slightly stronger reading for Spanish services inflation, close to two-thirds of December's CPI increase was likewise attributable to the pickup in energy components. Tomorrow will bring the final estimates of German and Italian inflation in December, for which the respective HICP rates rose 0.4ppt and fell 0.1ppt to 2.8%Y/Y and 1.4%Y/Y. So, with the flash euro area headline inflation estimate on the high side to two decimal places (2.44%Y/Y), an upwards revision to tomorrow's data could invoke an upwards revision to the aggregate figure on Friday.

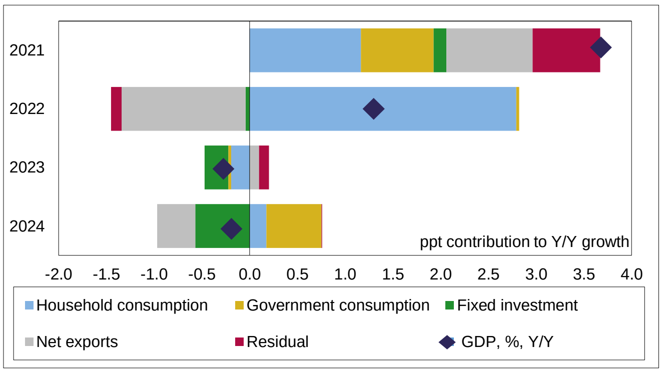
Nonetheless, policymakers will be unphased by any potential upside revision. Indeed, the Governing Council is widely expected to continue to ease policy by a cumulative 50bps this quarter, having last month dropped its earlier guidance to keep monetary policy 'restrictive for as long as necessary'. Consequently, tomorrow's account of that monetary policy

Germany: Industry, construction & services growth



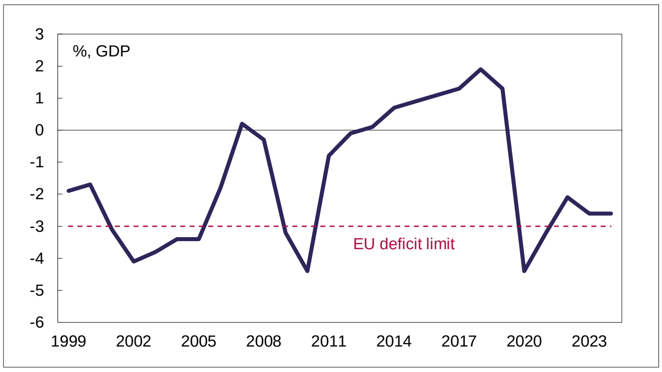
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & expenditure contributions



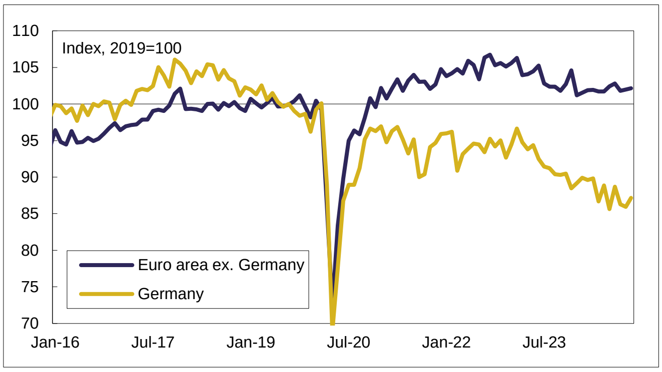
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: General government budget



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

meeting will be closely examined for further insight into the debate on the changed forward guidance and, in particular, the extent to which Governing Council members assessed slowing economic activity to pose such a downside risk to the inflation outlook so as to require the policy rate to move beyond neutral into accommodative territory. Meanwhile, euro area goods trade data for November are due. Reflecting the moderate rebound in German exports that month, the euro area trade surplus is also expected to widen.

UK

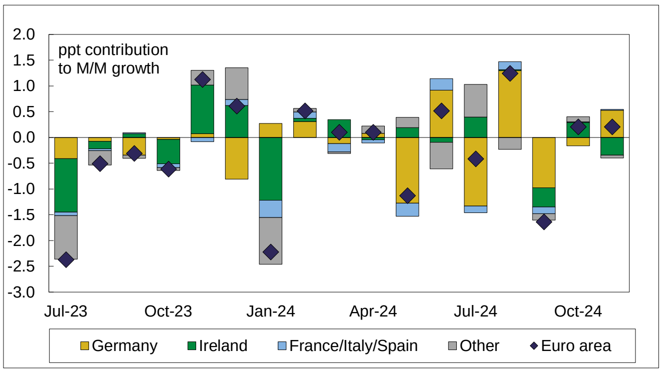
Services-led drop in inflation leaves BoE on track for February rate cut

Contrary to the market consensus of no change, but in line with the BoE's projection for the month, CPI inflation fell 0.1ppt in December to 2.5%Y/Y. More importantly, the key services inflation component significantly undershot both the market consensus and the BoE's projection, declining a chunky 0.6ppt to 4.4%Y/Y, the lowest since March 2022, to increase the likelihood that the MPC will cut Bank Rate after its next policy meeting on 6 February. Admittedly, one of the reasons for the decline in services inflation was airfares, which are typically volatile and fell an extreme 26%Y/Y in part due to a change in the sampling period that month. Indeed, airfares reduced headline inflation by a little more than 0.1ppt. But prices of many other services – which account for a much larger share of the basket – were also soft. For example, inflation in hospitality fell 0.6ppt to 3.4%Y/Y, the lowest since July 2021. And the insurance component fell 0.9ppt to 3.3%Y/Y, the lowest since end-2021 and down from almost 20%Y/Y a year earlier. Notably, having ticked up in November, a BoE measure of underlying services inflation – which excludes indexed and volatile components, rents and items related to foreign holidays – fell back 0.2ppt to 4.6%Y/Y, just 4bps above October's near-three-year low. And with the underlying softness in December extending the trend of recent months, the average change in services prices over the second half of the year undershot the long-run norm, suggesting that price-setting behaviour in the sector is increasingly consistent with an eventual return of inflation to target or below.

Core rate down more than expected to match September's 3-year low

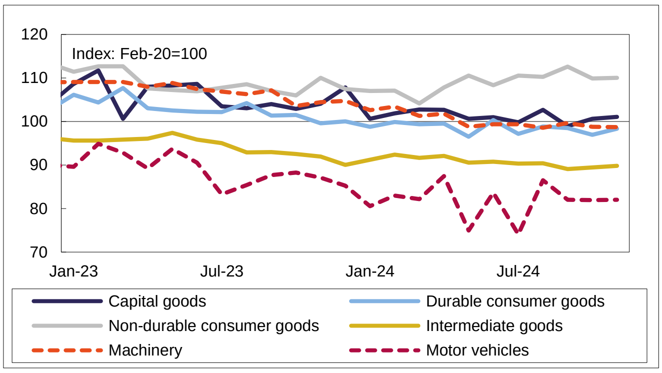
Beyond services, inflation of non-energy industrial goods ticked up 0.1ppt principally due to the first positive annual rate of used-car inflation (1.0%Y/Y) in 17 months. But core goods inflation remained subdued at just 1.2%Y/Y. And that was enough to push overall core CPI inflation down 0.3ppt to 3.2%Y/Y, 0.2ppt below the consensus on the Bloomberg survey and matching September's three-year low. Meanwhile, inflation of food, alcohol and tobacco slowed 0.4ppt to 2.8%Y/Y, in part reflecting a base effect related to an increase in duty a year earlier. But due to higher petrol prices, energy inflation rose

Euro area: Industrial production



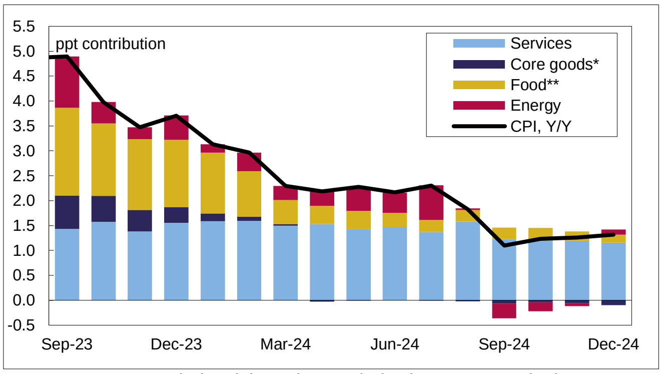
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing production



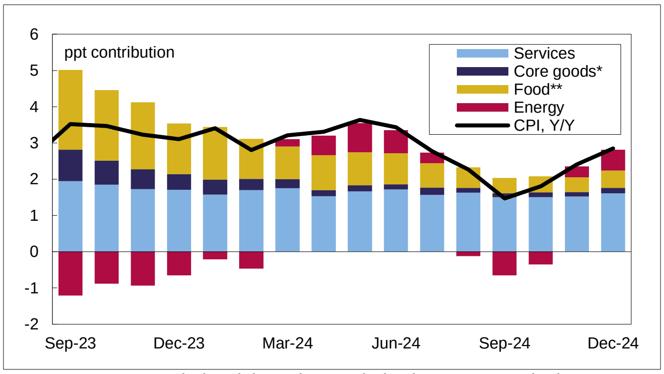
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: CPI inflation



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

Spain: CPI inflation



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

2.75ppt to -6.0%Y/Y, the smallest decline since September 2023. That added 0.2ppt to the headline CPI rate, insufficient to offset the impact of lower core and tobacco inflation.

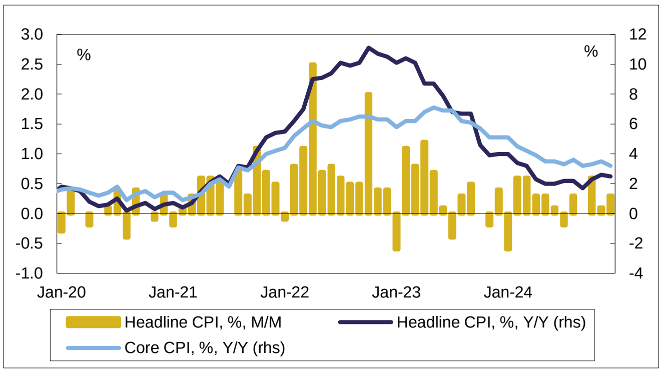
Budget measures, energy price cap & softer sterling to add to inflation in 2025

While price-setting behaviour for services and core goods recently appears to have broadly normalised to be consistent with an eventual return of inflation to target over the policy horizon, certain new inflationary impulses will keep the headline CPI rate firmly above 2.0%Y/Y throughout 2025 and ensure that the MPC continues to take a cautious approach to monetary easing. In particular, the BoE estimates that Budget measures, such as the increase in VAT on private school fees from January and the increase in employer National Insurance Contributions from April, will add more than 0.1ppt to inflation this quarter and a peak of around 0.4ppt by year-end. Meanwhile, Ofgem’s regulated energy price cap was raised by 1.2% this month, and will likely be hiked by more than 2½% in April due to the upwards shift in European wholesale energy prices over the past couple of months. Moreover, the recent weakening of sterling will, at the margin, increase prices of imported goods. However, we note that the significant depreciation against the US dollar since the US election (around 6%) contrasts a more modest depreciation of sterling in trade-weighted terms (only about 2½%) over the same period. Not least given the disinflationary impulse from China, prices of imported materials and fuel were still down 2.7%Y/Y in December, helping to keep input producer price inflation for manufacturing in negative territory at -1.5%Y/Y. And services producer price inflation was also softer in Q4 with prices down on the quarter for the first time since Q320 to leave the respective annual rate at just 2.9%Y/Y, the lowest in more than three years.

Inflation to rise in January & remain above target in 2025 before falling to 2.0% or below in 2026

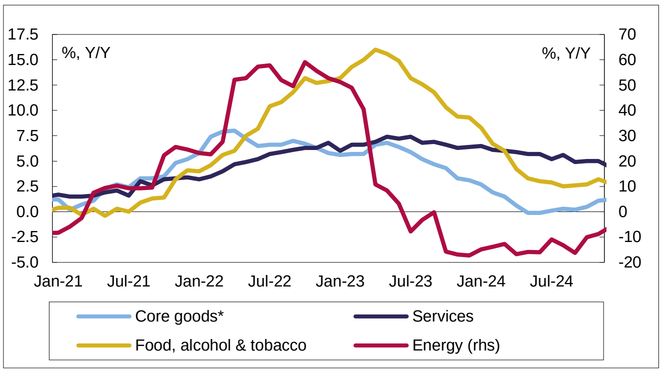
Looking ahead, principally due to Budget measures, we currently expect headline CPI inflation to edge up 0.2ppt in January to 2.7%Y/Y. And while it will then decline over the remainder of Q1, inflation will likely oscillate around 2½%Y/Y over the course of 2025 due to some of the aforementioned temporary factors. Core inflation will also likely rise in January to around 3½%Y/Y before easing back only gradually over the remainder of the year. Thereafter, however, with growth momentum having evaporated and the labour market softening amid restrictive monetary policy, in the absence of new shocks, headline and core inflation should moderate to the BoE’s target or below in the course of 2026. With the sideways trend in GDP throughout H224 notably softer than the BoE had projected, the economic outlook merits steady easing of BoE policy, more substantive than is currently priced in the swap market, to reduce risks of a persistent undershooting of the inflation target by the end of the horizon. Indeed, we still expect one rate cut of 25bps a quarter, from the February MPC meeting through to the middle of 2026. That would leave Bank Rate at 3.75% at end-2025, and take the terminal rate for this easing cycle to 3.25% from Q226 on.

UK: Consumer price inflation



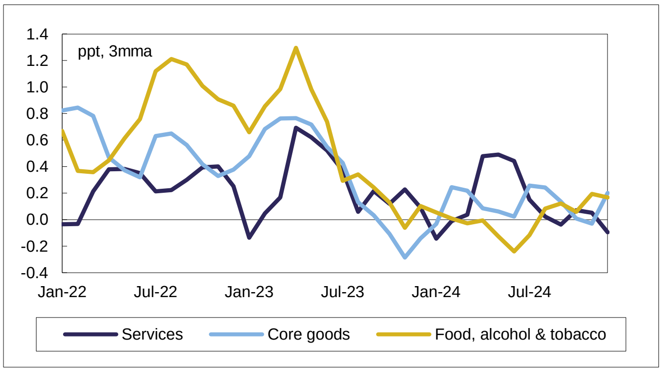
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key CPI inflation components



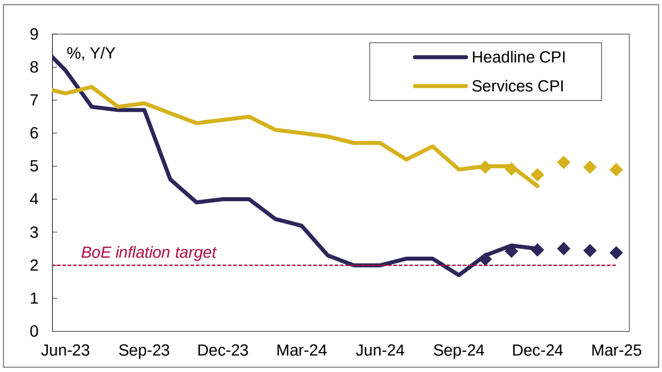
**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Deviations from long-run average price change*



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

UK: CPI inflation & BoE projection

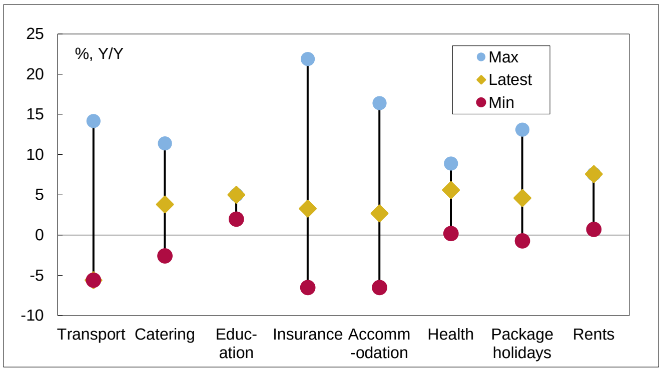


Source: BoE (November 2024), Macrobond & Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

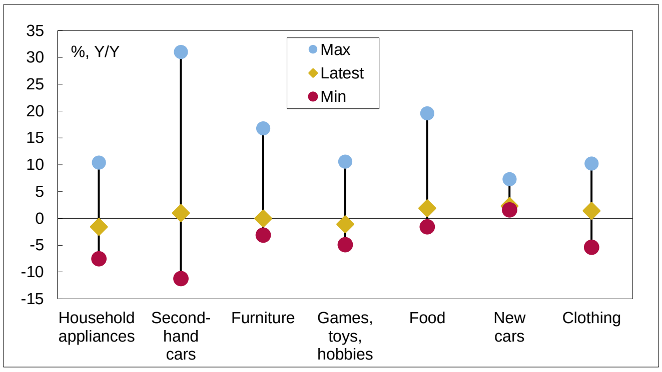
Following two consecutive negative (-0.1%M/M) prints in September and October, November's monthly GDP estimates (due tomorrow) will assume significance for policymakers. At face value, output should pick up, particularly in industry which fell back 0.6%M/M in October to be some 1.1% below its level in August. But with November's PMIs having flagged particular weakness in manufacturing and services in the wake of the October budget, and storms having potentially disrupted activity later in the month, GDP growth is expected to be weak (perhaps 0.1%M/M) and stagnant on a 3M/3M basis. The downside risks posed to the inflation outlook from the sudden loss in growth momentum is appropriately a growing concern among some MPC members – three of whom voted to cut rates by 25bps at December's meeting when the BoE revised down its outlook for Q424 growth to 0.0%Q/Q from 0.3%Q/Q previously. Meanwhile, the BoE's credit conditions survey for Q4 will tomorrow provide more insights into banks' response to gradual policy loosening. Finally, the RICS survey of surveyors has so far shown a steady recovery in housing market activity; tomorrow's release will provide December's update.

UK: Selected services CPI inflation components



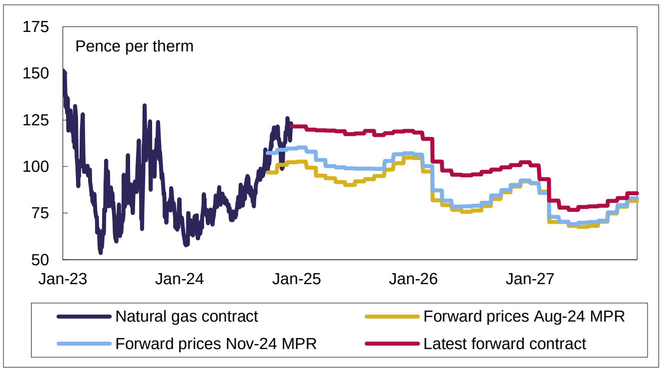
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected goods CPI inflation components



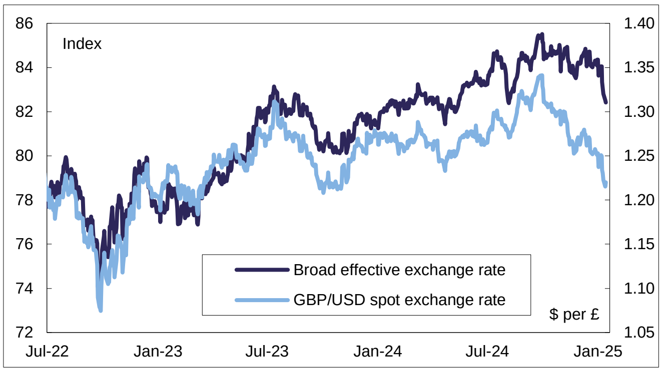
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Natural gas prices



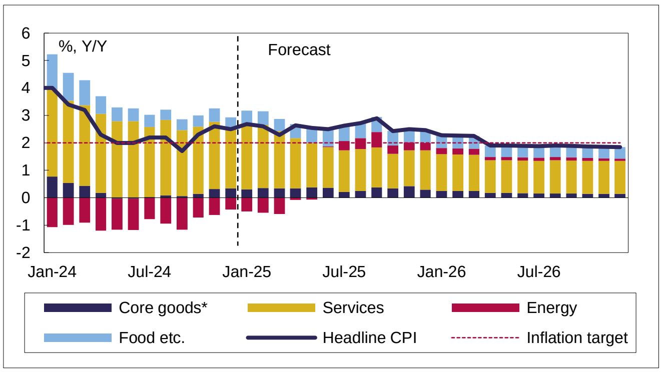
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Sterling exchange rates



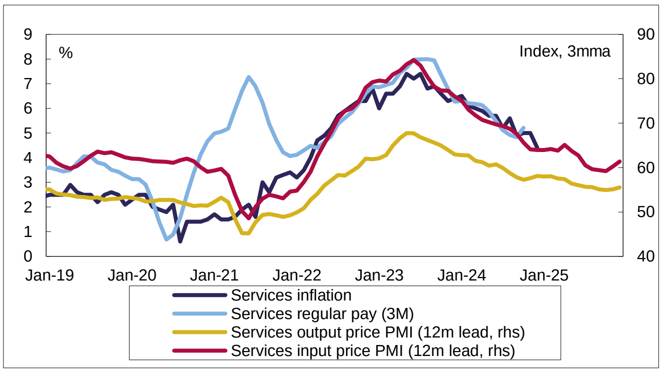
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation projection



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services pay & wage indices



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	Industrial production M/M% (Y/Y%)	Nov	**0.2 (-1.9)**	0.2 (-1.9)	0.0 (-1.2)	0.2 (-1.1)
Germany	GDP* Y/Y%	2024	**-0.2**	-0.2	-0.3	-
	Government fiscal balance % of GDP	2024	**-2.6**	-2.3	-2.0	-2.6
France	Final HICP (CPI) Y/Y%	Dec	**1.8 (1.3)**	*1.8 (1.3)*	1.7 (1.3)	-
Spain	Final HICP (CPI) Y/Y%	Dec	**2.8 (2.8)**	*2.8 (2.8)*	2.4 (2.4)	-
UK	CPI (core CPI) Y/Y%	Dec	**2.5 (3.2)**	*2.5 (3.2)*	2.6 (3.5)	-
	PPI – output (input) prices Y/Y%	Dec	**0.1 (-1.5)**	0.0 (-1.3)	-0.6 (-1.9)	-0.5 (-2.1)
	House price index Y/Y%	Nov	**3.3**	-	3.4	3.0

Auctions

Country	Auction
Germany	sold €754mn of 1.8% 2053 bonds at an average yield of 2.84%
	sold €1.19bn of 2.5% 2054 bonds at an average yield of 2.84%
UK	sold £4bn of 4.25% 2034 bonds at an average yield of 4.808%

**Non-seasonally adjusted data. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

Tuesday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Industrial production M/M% (Y/Y%)	Nov	**0.3 (-1.5)**	0.1 (-2.3)	0.0 (-3.6)	0.1 (-3.5)

Auctions

Country	Auction
Germany	sold €3.79bn of 2.4% 2030 bonds at an average yield of 2.42%
UK	sold £1bn of 1.25% 2054 inflation-linked bonds at an average yield of 2.126%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
			- Nothing to report -			

Auctions

Country	Auction
Italy	sold €2.75bn of 2.7% 2027 bonds at an average yield of 2.85%
	sold €3bn of 3.15% 2031 bonds at an average yield of 3.49%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	Trade balance €bn	Nov	11.5	6.1
Germany	07.00	Final HICP (CPI) Y/Y%	Dec	*2.8 (2.6)*	2.4 (2.2)
Italy	09.00	Final HICP (CPI) Y/Y%	Dec	*1.4 (1.3)*	1.5 (1.4)
UK	00.01	RICS house price balance %	Dec	28	25
	07.00	Monthly GDP M/M% (3M/3M%)	Nov	0.2 (0.0)	-0.1 (0.1)
	07.00	Services output M/M% (3M/3M%)	Nov	0.1 (0.1)	0.0 (0.1)
	07.00	Industrial output M/M% (Y/Y%)	Nov	0.1 (-0.9)	-0.6 (-0.7)
	07.00	Construction output M/M% (Y/Y%)	Nov	0.4 (0.1)	-0.4 (-0.7)
	07.00	Trade (goods trade) balance £bn	Nov	-3.6 (-18.0)	-3.7 (-19.0)

Auctions and events

Country	GMT	Event
Euro area	12.30	ECB to publish monetary policy account of 11-12 December Governing Council meeting
Spain	09.30	Auction: to sell 2.7% 2030, 0.85% 2037 and 1% 2050 bonds
UK	09.30	BoE to publish Credit Conditions Survey for Q4 2024

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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