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Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds were little changed on the day despite a more upbeat German investor survey.
- Gilts made losses as UK pay growth picked up towards year-end while the labour market appeared to remain broadly resilient despite soft economic growth.
- Wednesday will bring new data on UK inflation in January and euro area labour costs in Q4.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 03/27	2.123	-0.008
OBL 2.4 04/30	2.264	-
DBR 2½ 02/35	2.492	+0.004
UKT 4⅛ 01/27	4.230	+0.036
UKT 4⅛ 07/29	4.246	+0.031
UKT 4¼ 07/34	4.555	+0.030

*Change from close as at 4:45pm GMT.
Source: Bloomberg

Euro area

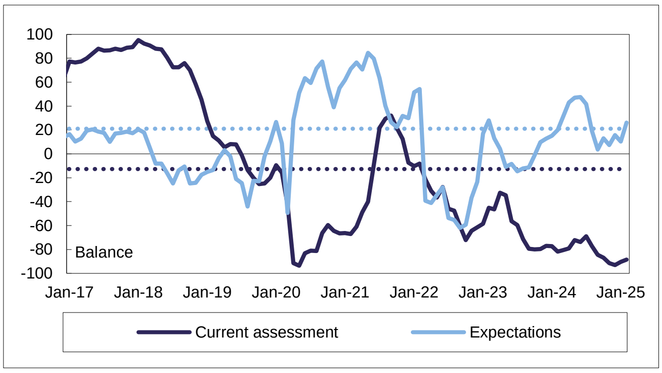
ZEW investor survey reports notable improvement in assessment of the German economic outlook

Tallying with the strong performance of German equities since the start of the year, and with expectations that Sunday's federal election will deliver a more constructive government better able to tackle the causes of recent economic underperformance, today's ZEW survey results for February signalled increased investor optimism with respect to the six-month outlook. While the majority of survey respondents considered current conditions still to be poor, the ZEW expectations index rose by the most in more than two years to a seven-month high of 26, above the long-run average. And with luck, that improved investor mood will translate itself into a pickup in business survey indicators such as the ifo indices as well as firmer demand in the real economy. In part, the improved investor assessment of the outlook reflects increased expectations of ongoing ECB rate cuts, perhaps into accommodative territory. But ZEW survey recipients are also taking a more positive view of the profit outlook in a range of services, including banks and insurers, as well as construction and utilities. Notwithstanding recent market enthusiasm for defence firms' stocks as European governments recognise the need for greater expenditure on military equipment, perceptions of the outlook for manufacturers remain largely downbeat, not least for producers of steel and autos, given the threat of new US tariffs.

Another grand coalition of CDU/CSU & SPD eventually likely to emerge after Sunday's election

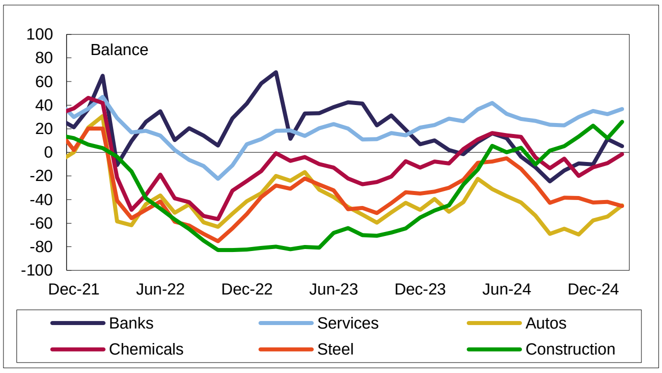
Of course, given the recent poor performance and dire assessment of current conditions in the German economy, it would be particularly concerning if investors did not expect things to improve over the coming couple of quarters. But after years of policy drift under the unwieldy traffic-light coalition government of Chancellor Olaf Scholz, investors are no doubt also looking for more assertive policy-making once the dust settles on the federal election due this Sunday. While last July's French election delivered a divided National Assembly where no single group of parties was able to form a workable government, Sunday's German election should – admittedly after negotiations between various parties – eventually lead to the formation of a relatively stable coalition capable of agreeing and implementing policy over the coming four years. Certainly, the centre-right CDU/CSU alliance of Friedrich Merz has maintained a comfortable lead in the polls since mid-2022 (currently with a share of around 30%). And like his predecessor as CDU leader Angela Merkel, Merz will eventually most likely become Chancellor as part of a grand coalition with Scholz's centre-left SPD. Merz has made clear that he will be open for coalition talks with the SPD and Greens, though he would seem to have few options otherwise. Reassuringly, the CDU/CSU has joined other parties in signalling that it would not consider the far-right AfD, currently polling in second thanks to its domination of the states of former East Germany, for participation in any coalition talks. Amongst the smaller parties, the far-left BSW and Der Linke (The Left) are also both incompatible with the CDU/CSU, with at least one of these populist left-wing groups anyway likely to fall short of winning the necessary share of votes for representation in the Bundestag. Meanwhile,

Germany: ZEW investor sentiment indices*



*Dotted lines denote long-run average.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW survey – profit situation by sector



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

the centrist FDP – which would be considered more compatible with the CDU/CSU but whose intransigence in the current coalition was often an obstacle to policymaking and whose expulsion from Scholz's government ultimately triggered its collapse – also risks falling short of re-entering the Bundestag.

Fingers crossed for a post-election relaxation of the damaging debt brake

While negotiations on a coalition agreement between the CDU/CSU and SPD after the election are unlikely to be concluded swiftly, there ought eventually be progress on several policy areas with scope to tackle sources of recent economic and geopolitical weakness and thus provide a source of hope for investors. While the CDU/CSU pledged to keep the damaging *schuldenbremse* (constitutional debt brake) intact, and a complete overhaul of the rule would likely be politically undeliverable, we expect Merz to seek greater flexibility within the mechanism to be able to support greater investment in public infrastructure and defence. And despite Scholz's reticence this week to commit to providing troops to defend a peace settlement, the new coalition would be expected to maintain support for Ukraine. Nevertheless, there will undeniably be bones of contention between the CDU/CSU and SPD on fiscal policy details, including Merz's pledges to cap corporation tax at 25%, reduce income tax thresholds, or reform to the *Bürgergeld* (social welfare). CDU/CSU commitments to put nuclear energy back on the table, as well as stricter immigration policies, could also present stumbling blocks.

The day ahead in the euro area

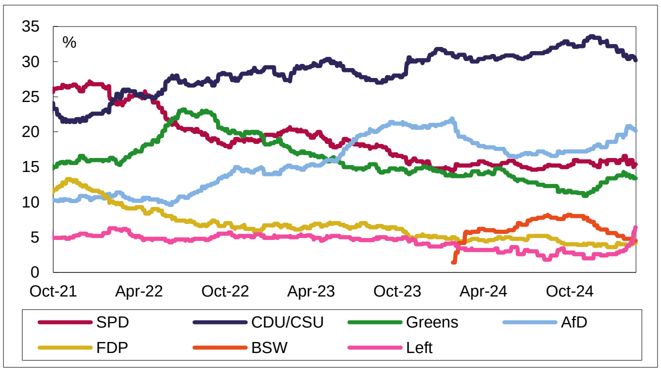
With an otherwise quiet day ahead for euro area economic data, the first estimates for euro area labour costs and job vacancies in Q4 should be tomorrow's focus. Certainly, as policymakers continue to expect wage growth to soften over the coming year to support underlying disinflation, further signs of normalisation in labour market conditions should help to reinforce their confidence. We expect job vacancies to continue their downtrend in Q4, consistent with both the deceleration in employment growth towards the end of last year and business survey indicators of willingness to hire. And despite unemployment having remained close to its historical lows (6.3%) over this period, gradual loosening in the labour market should also be expected to translate into further moderation in labour cost growth.

UK

Pay growth accelerates broadly in line with expectations

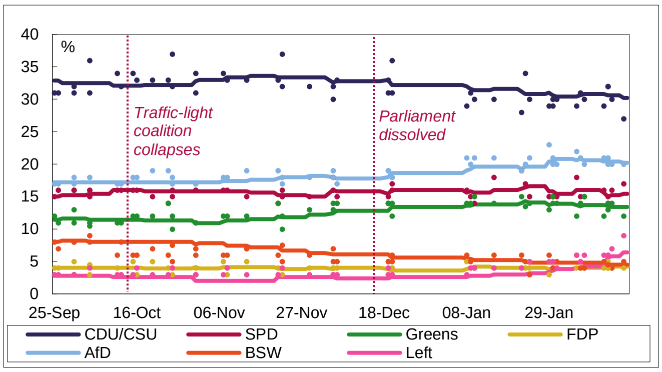
Since the start of its easing cycle last summer, the BoE's MPC has taken a gradual approach to rate cuts, reducing Bank Rate by just 25bps each quarter. Today's labour market data will have reinforced the majority view on the MPC that the pace

Germany: Polling since 2021 Federal Election



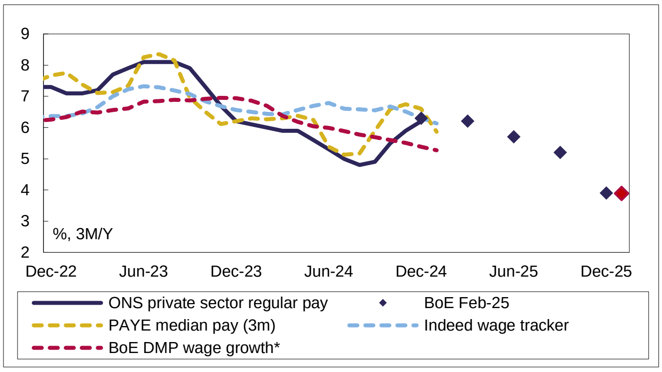
**Average of polls from FGW, YouGov, Kantar, Allensbach, Infratest. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Germany: Political polls



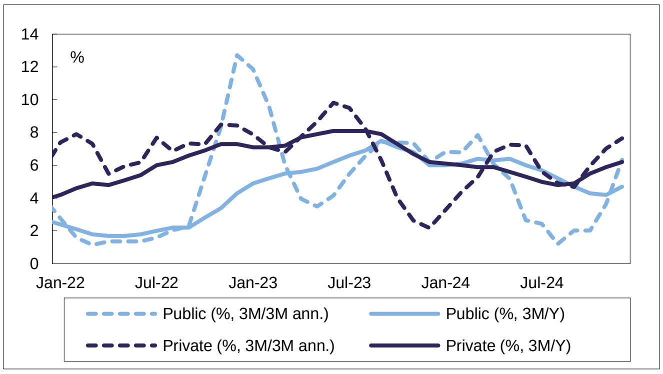
**Average polls from FGW, YouGov, Kantar, Allensbach, Infratest. Dots show individual polls. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Private sector pay indicators



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

UK: Pay growth momentum by sector



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

of easing should remain no faster than one cut per quarter. Broadly in line with its expectations, wage growth accelerated further towards year-end, with total pay growth (including bonuses) at a 13-month high of 6.0%3M/Y in December, up 1.6ppts from three months earlier and slightly above the consensus forecast. Total pay growth picked up in the private (6.3%3M/Y) and public (4.8%3M/Y) sectors alike. Excluding bonuses, the BoE's preferred measure of private sector regular pay grew 6.2%3M/Y in December, just 0.1ppt below its latest projection, up 1.3ppts from the three months to September and the strongest rate in a year. Pay growth was stronger in services, including hospitality, distribution and finance, as well as construction. In real terms, total and regular wages rose 2.5%3M/Y in December, the strongest in almost 3½ years. And when excluding the pandemic years, the full-year figure for regular pay growth in 2024 was the best in two decades, which should point to a positive outlook for private consumption. Admittedly, this follows a protracted period of weak income growth, with real average weekly pay just £12 (2.3%) above the level in early 2008 ahead of the global financial crisis.

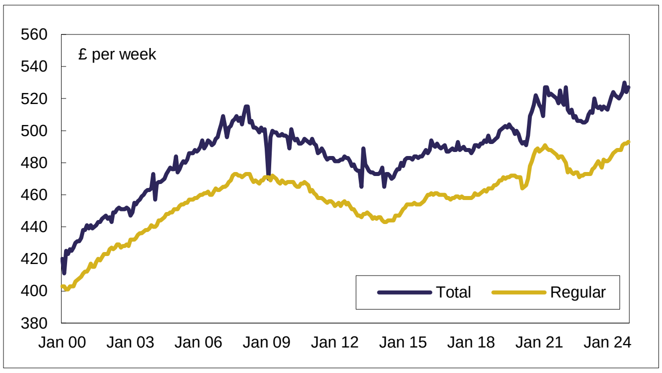
Wage growth expected to moderate as firms plan for increase in employers' NICs

The BoE will be mindful that momentum in private regular pay accelerated towards year-end at 7.7%3M/3M annualised, the strongest since August 2023. However, HMRC's figure for median pay suggested a moderation in the new year, with growth on this measure slowing in January to a five-month low of 5.9%3M/Y. And survey indicators suggest widespread expectations that pay will moderate over the coming year. For example, the BoE's own DMP survey reported that firms in January expected year-ahead wage growth to slow to 3.9%3M/Y, down 1.4ppts from their estimate of realised pay growth in the past 12 months. Despite the large-scale increase in the National Living Wage from April, 38% of firms on the DMP survey expect to pay lower wages than they otherwise would have done this year due to the forthcoming increase in employer National Insurance Contributions (NICs). However, larger shares of respondent firms expect to respond to the NICs hike by lowering profit margins (62%), raising prices (56%) or reducing employment (53%). And a CIPD survey reported that a quarter of firms plan to make redundancies – the highest share in a decade outside of the pandemic. Moreover, the employment PMIs suggest that private firms at the end of last year planned to cut headcount by the most since the global financial crisis.

Despite downbeat surveys, jobs & vacancies remain broadly steady heading into 2025

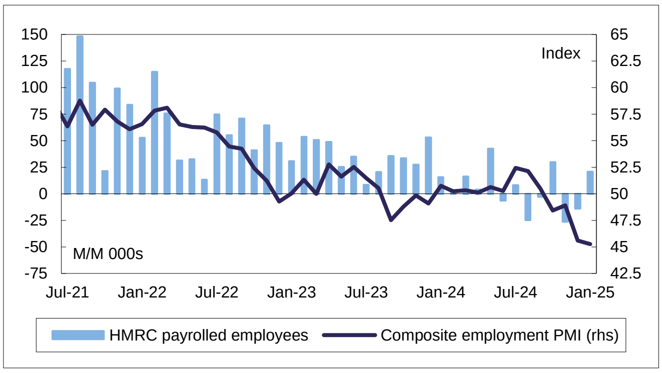
At this stage, job cuts appear to have been relatively modest and the labour market still appears relatively resilient. While they have recently picked up, redundancies and notifications of possible redundancies to come remain within the range of the past three years and also within the range of the five years ahead of the pandemic. And while the true picture is distorted by data limitations, employment appears recently to have been broadly flat. Indeed, the LFS measure of employment rose a larger-than-expected 107k in the three months to December. And with much of the initially reported drop in payrolled

UK: Real average weekly earnings



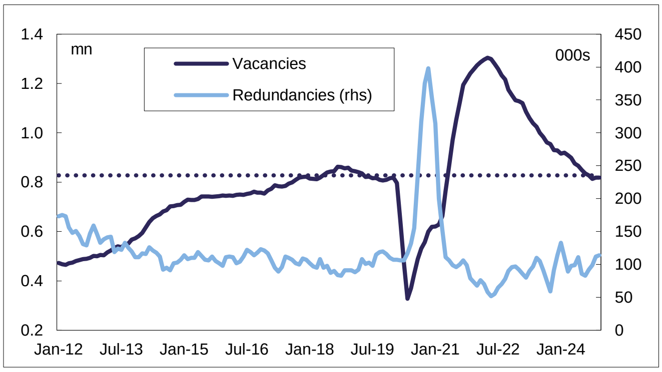
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Payrolls & composite employment PMI



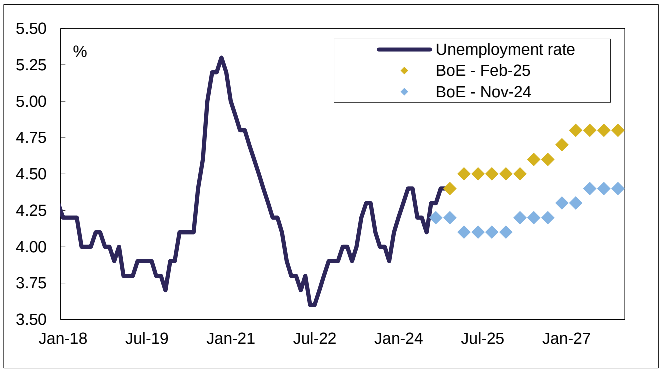
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Vacancies & redundancies



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Unemployment



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

employees in December revised away, the trend in this alternative indicator was sideways heading into January. In line with the BoE's projection, the LFS unemployment rate in the three months to December was also unchanged at 4.4%, albeit 0.5ppt above the level a year earlier and 0.8ppt above the trough in mid-2022. And with the number of vacancies also broadly flat, the ratio of the number of unemployed people per vacancy remained close to levels ahead of the pandemic in the second half of 2019. So, the BoE is likely to consider the labour market still to be broadly in balance. We note, however, that the number of vacancies in sectors with a large share of low-income workers – including retail and hospitality – was down significantly in the past quarter, with payrolls in those subsectors also down from a year earlier. And like the BoE, in part due to pressures on labour costs, we expect labour market slack to gradually build over coming quarters allowing pay growth to moderate to below 5%3M/Y by year-end and further in 2026.

The day ahead in the UK

Just as today's labour market data are likely to have reinforced the BoE's case for a gradual pace of policy easing, January's CPI report tomorrow will also likely justify a cautious response. Despite a softer December print – with both headline (2.5%Y/Y) and services (4.4%Y/Y) inflation surprising to the downside – we, like the BoE, expect a rebound in January. In particular, we expect the headline rate to jump 0.3ppt to 2.8%Y/Y. Core inflation should rise 0.4ppt to 3.6%Y/Y, with services inflation once again accelerating to above 5.0%Y/Y, at least in part driven by the recent softness of certain components – including airfares and accommodation – as well as firmer increases in regulated price components at the start of the year. Furthermore, while food prices also seem likely to increase their contribution to the headline rate, energy should have provided more of a headwind as base effects likely offset higher petrol prices in January. And while higher fuel costs may apply upwards pressure to input costs, these are not expected to have materially affected producer output prices at the factory gate.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	ZEW current situation (expectations) balance	Feb	**-88.5 (26.0)**	*-89.5 (15.0)*	-90.4 (10.3)	-
France	Final HICP (CPI) Y/Y%	Jan	**1.8 (1.7)**	*1.8 (1.4)*	1.8 (1.3)	-
UK	Average wages (excluding bonuses) 3M/Y%	Dec	**6.0 (5.9)**	*5.9 (5.9)*	5.6 (5.6)	5.5 (-)
	Unemployment rate 3M%	Dec	**4.4**	*4.5*	4.4	-
	Employment 3M/3M change 000s	Dec	**107**	48	36	-
	Payrolled employees M/M change 000s	Jan	**21**	-30	-47	-14
	Claimant count rate % (change 000s)	Jan	**4.6 (22.0)**	-	4.6 (0.7)	4.5 (-15.1)
	Preliminary output per hour Y/Y%*	Q4	**-0.8**	-	-1.8	-2.3

Auctions

Country	Auction
Germany	sold €3.54bn of 2.2% 2027 bonds at an average yield of 2.14%
UK	sold €1.75bn of 4% 2063 bonds at an average yield of 5.076%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	09.00	Current account balance €bn	Dec	-	27.0
	10.00	Preliminary labour costs Y/Y%	Q4	-	4.6
	10.00	Preliminary job vacancy rate %	Q4	-	2.5
UK	07.00	CPI (core CPI) Y/Y%	Jan	*2.8 (3.6)*	2.5 (3.2)
	07.00	PPI – output (input) prices Y/Y%	Jan	0.1 (-0.6)	0.1 (-1.5)
	09.30	House price index Y/Y%	Dec	-	3.3

Auctions and events

Country	GMT	Event
Germany	10.30	Auction: to sell up to €4.5bn of 2.5% 2035 bonds
UK	10.00	Auction: to sell £4.25bn of 4.375% 2028 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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