Euro wrap-up

Overview

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- Bunds made gains at the shorter end of the curve as the German federal election result raised the likelihood that CDU/CSU leader Merz will lead a two-party coalition government with the SPD but might struggle to find the numbers in the new Bundestag to amend the constitutional debt brake.
- Gilts made modest gains across the curve on a quiet day for UK economic news.
- Tuesday will bring euro area negotiated wage data and the breakdown of German GDP in Q4, as well as a UK retail sector survey.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 03/27	2.076	-0.022
OBL 2.4 04/30	2.227	-0.010
DBR 2½ 02/35	2.468	+0.001
UKT 4⅛ 01/27	4.214	-0.007
UKT 4⅛ 07/29	4.239	-0.012
UKT 4¼ 07/34	4.558	-0.012

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

Euro area

German election result on track to deliver two-party grand coalition, as expected

The result of Sunday's federal election was broadly in line with the pre-vote polls, confirming that CDU leader Friedrich Merz will be Germany's next Chancellor and providing him the option of forming a two-party coalition government with the departing Chancellor Scholz's SPD. The centre-right CDU/CSU won 28.5% of the vote, almost 8ppts ahead of the far-right AfD in second and about 12ppts ahead of the centre-left SPD in third. So, the CDU/CSU and SPD would be able to govern together in another grand coalition with a slim Bundestag majority of 13. By adding the (fourth-placed) Greens to form a so-called 'Kenyan' coalition, Merz could secure an enhanced majority of almost 100 seats. But he appears not to be minded to complicate the process of policymaking in that way and would seemingly prefer to keep things simple with the SPD. The aim will be to conclude negotiations on that two-party coalition agreement within two months.

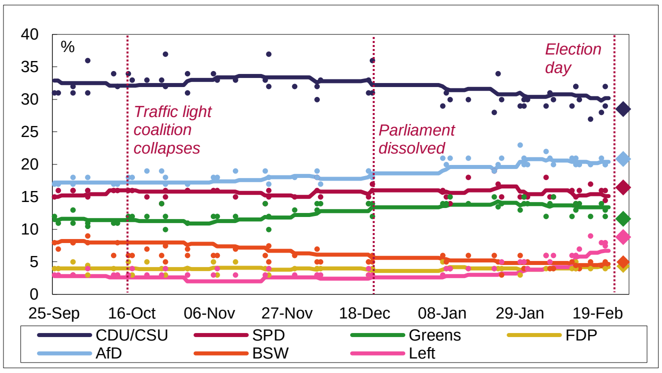
Debt brake uncertainty likely to persist given lack of two-thirds majority

In the absence of reform to, or emergency suspension of the constitutional debt brake, the new government's freedom of manoeuvre on fiscal policy – e.g. to meaningfully boost public investment on infrastructure and defence, and cut taxes – will be extremely limited. But since a constitutional amendment would require a two-thirds majority, assuming a deal is not reached in the current Bundestag before the new parliament sits, the support of the far-left Die Linke, which surprised expectations by winning more than 8% of the vote, as well as the Greens would be required. While Die Linke has expressed a willingness to support reform of the debt brake for increased spending on infrastructure, it does not support increased spending on defence. If there is no progress on lifting the debt brake, the new government might be forced to support the use of existing NGEU funds for common EU defence projects, and/or the issuance of a new round EU bonds, to fund such activities.

German ifo survey points to little improvement in business conditions in the middle of Q1

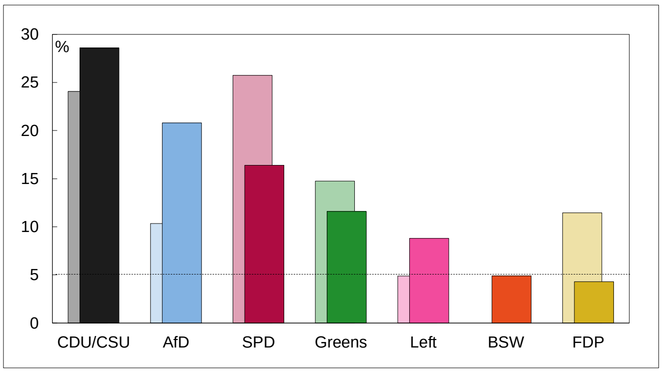
While the new government will bring hopes of new initiatives to spur economic growth after two years of contraction, surveys have provided mixed messages about conditions in Q1. Contrasting the further improvement in the composite output PMI to a nine-month high, today's ifo survey suggested that the business climate was little changed in February, with the index (85.2) some 11% below the long-run average. This in part reflected ongoing concern about the current business situation, with the respective index down 1pt to 85.0, in line with the Q4 average, with the deterioration broad-based across the sectors. Admittedly, manufacturers were less downbeat about the outlook for the coming six months, amid some stabilisation in order books. But expectations deteriorated slightly among services firms, and remained at the bottom of the range of the

Germany: Political polls & election outcome*



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

Germany: Federal Election vote shares*



*Shaded bars show 2021 Federal Election vote shares; horizontal line shows 5% threshold. Source: Die Bundeswahlleiterin & Daiwa Capital Markets Europe Ltd.

past year among retailers and constructors. So, while the composite expectations index rose 1.1pts to a three-month high (85.4), this remained below the 2024 average (86.9) and well below the long-run trend. So, while today the Bundesbank suggested that the German economy might grow slightly this quarter thanks to the services sector, it maintained its view that manufacturing will remain a drag, albeit to a lesser extent than in Q4. And overall, given significant uncertainties with respect to global trade, the risks to the German growth outlook remain skewed significantly to the downside.

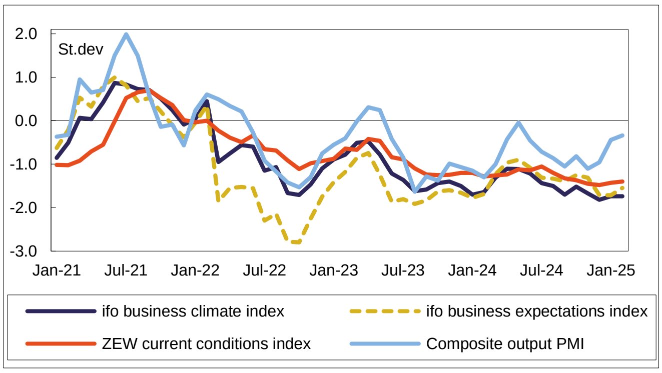
Final inflation unrevised at a 6-month high, but core steady for a fifth month in February

In terms of the inflation outlook, there were no surprises from the final January euro area HICP figures. Like the flash data, these showed headline inflation increasing 0.1ppt to a six-month high of 2.5%Y/Y, a touch above initial expectations. The rise was driven principally by higher energy prices in part related to the phasing out of government policy support. Electricity prices jumped near-4%M/M taking the annual rate up 2.6ppts to the highest in almost two years, accounting for 0.08ppt of the increase. A near-3%M/M rise in petrol prices pushed inflation of that component up to a five-month high. But prices of other goods were better behaved. For example, inflation of food, alcohol and tobacco eased to a five-month low (2.3%Y/Y). And non-energy industrial goods inflation moved sideways at just 0.5%Y/Y, with ongoing modest deflation in furniture and clothing offsetting a slight pickup in new cars. Meanwhile, services inflation was a touch softer in February, down 0.1ppt to 3.9%Y/Y. Admittedly, this merely maintained the oscillating trend in place since last summer. A drag from the typically-volatile airfares component was offset by slightly higher package holiday costs. But other services, including hospitality and insurance, maintained a downtrend. Overall, core inflation held steady for a fifth successive month at 2.7%Y/Y.

Core inflation momentum maintains a downtrend in January, supporting more rate cuts

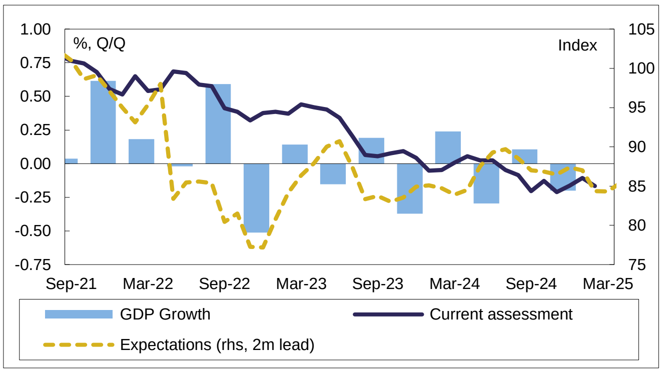
Other measures of underlying inflation published by the ECB today might support concerns of certain Governing Council hawks that the disinflationary trend might have paused. In particular, the 15% trimmed mean rate rose for a first month in nine in February (2.5%Y/Y), while the weighted median rate rose to an eleven-month high (2.8%Y/Y). But the persistent and common component of inflation (PCCI), which is judged by ECB staff to have good leading qualities, edged lower by 0.1ppt to 2.1%Y/Y, while the core PCCI rate remained below 2% for a third consecutive month. On a seasonally adjusted basis, services inflation momentum fell for the eighth successive month in January to a near 3½-year low of 2.5%3M/3M annualised. Furthermore, overall core momentum dropped to a 12-month low of 1.8%3M/3M annualised, arguably raising the possibility of an undershooting of the ECB's target if recent price-setting behaviour is maintained. We currently forecast core inflation to take a step down in February, and ease below the 2% target by the middle of the year. And while base effects will temporarily push core inflation higher towards year-end, we expect it to move back below target by spring 2026. Overall, we

Germany: Business sentiment indices



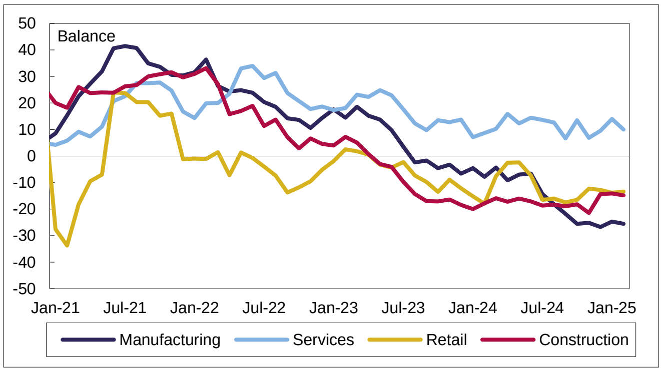
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth & ifo survey indices



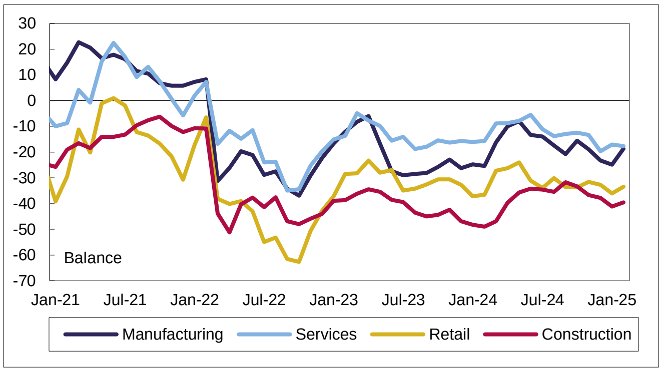
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ifo current conditions indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

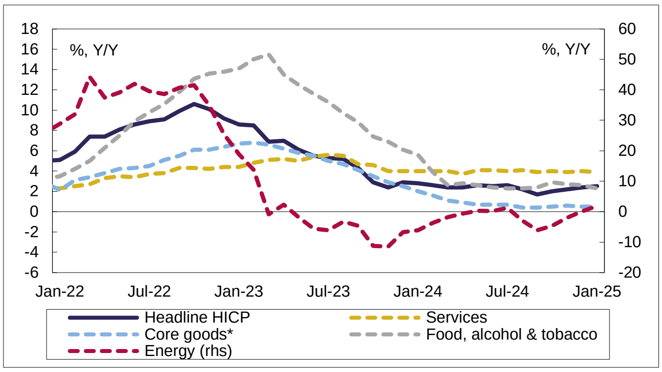
Germany: ifo expectations indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

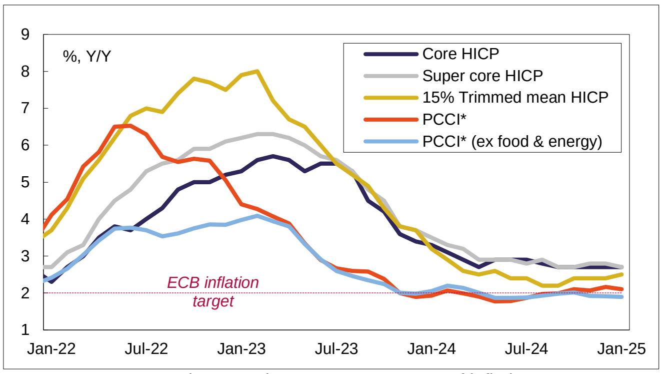
expect both headline and core inflation to average a touch below the 2% target in 2026. As such, we maintain our view that the ECB will cut rates again next week, with a further two cuts of 25bps to come later in the year too.

Euro area: HICP inflation & key components



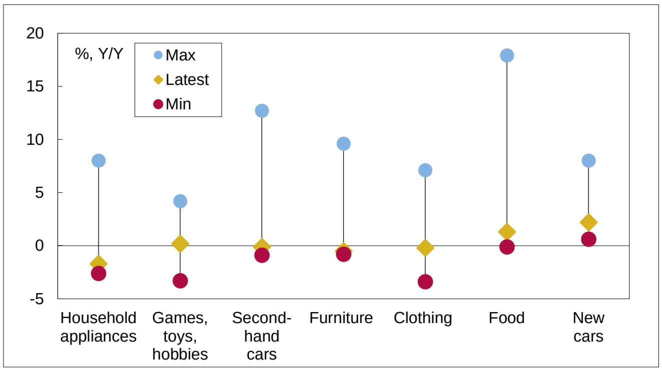
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying HICP inflation



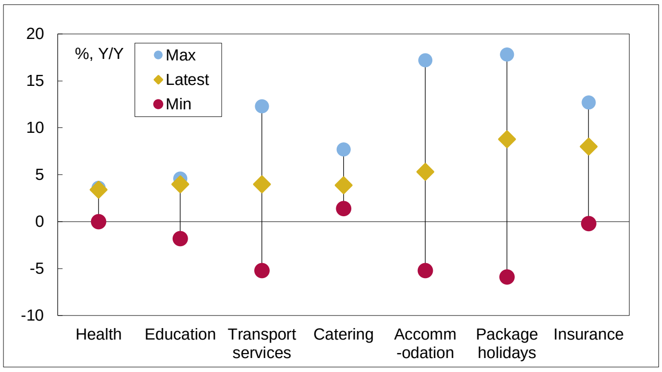
*Persistent and common component of inflation.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP inflation*



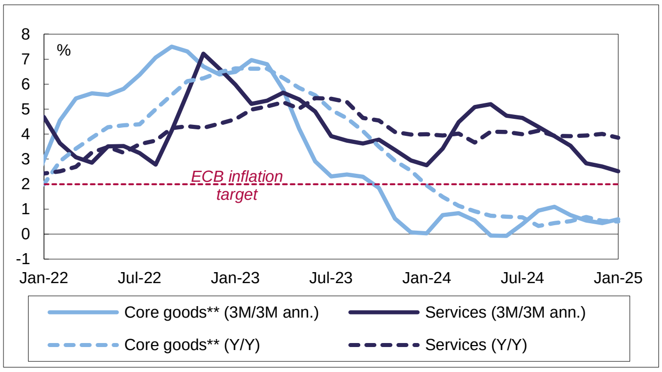
*Since 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services HICP inflation*



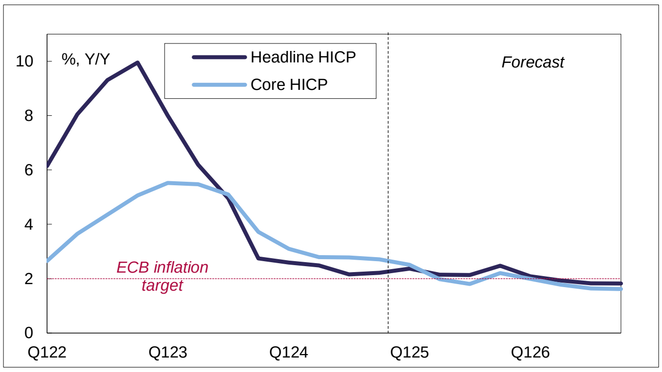
*Since 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum*



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

Euro area: HICP inflation forecast



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

With January's inflation detail pointing towards a gradual dissipation of underlying price pressures, policymakers will watch the Q4 negotiated wages figures for signs of a further easing of cost pressures in the labour market. Negotiated wage growth rose a stronger-than-expected 5.4%Y/Y in Q3 – the most for more than three decades – due principally to a spike in German wage settlements, as firms continued to compensate workers for higher inflation in recent years. While pay growth likely remained elevated in Q4, we expect to see a slight moderation as bargaining power should have been constrained by the slowdown in economic growth. Indeed, final estimates for German GDP in Q4 are expected to confirm that the economy contracted (-0.2%Q/Q) at the end of last year. The expenditure breakdown is expected to reveal a significant drop in exports, while final household consumption and government expenditure likely increased. Separately, ECB Executive Board Member Schnabel is due to deliver a keynote speech on safe asset abundance and the neutral interest rate at the BoE BEAR research conference in London.

The day ahead in the UK

After UK retail sales surprised to the upside in January, the CBI's distributive trades survey will provide insight into spending momentum in February. Given subdued consumer confidence, we expect retailers to signal that sales remained soft for the time of the year. In addition, the UK energy regulator Ofgem will announce the price cap on UK household energy bills between April and June, with expectations for a hike of 5% or more, to provide a further upwards impulse to inflation from the start of Q2.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final headline (core) HICP Y/Y%	Jan	**2.5 (2.7)**	*2.5 (2.7)*	2.4 (2.7)	-
Germany		ifo business climate indicator	Feb	**85.2**	85.8	85.1	85.2
		ifo current assessment (expectations) indicator	Feb	**85.0 (85.4)**	86.3 (85.0)	86.1 (84.2)	86.0 (84.3)
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		05.00	New car registrations Y/Y%	Jan	-	3.6
		10.00	Negotiated wages Y/Y%	Q4	-	5.4
Germany		07.00	GDP – final estimate Q/Q% (Y/Y%)	Q4	*-0.2 (-0.2)*	0.1 (-0.3)
UK		11.00	CBI distributive trades survey – reported sales volumes %	Feb	-20	-24
Auctions and events						
Euro area		13.00	External Board Member Schnabel to give speech at BoE 2025 BEAR conference, London			
Germany		10.00	President Nagel to hold press conference for the publication of the Bundesbank 2024 Annual Report			
		10.30	Auction: to sell up to €1.5bn of 1.8% 2053 green bonds			
Italy		10.00	Auction: to sell up to €2.75bn of 2.55% 2027 bonds			
		10.00	Auction: to sell up to €1.5bn of 1.8% 2036 inflation-linked bonds			
UK		10.00	Auction: to sell £1.6bn of 1.125% 2035 inflation-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.