Euro wrap-up

Overview

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- Bunds made big losses as yesterday evening's German proposals for extra military and infrastructure spending significantly beat expectations.
- Gilts followed Bunds lower, while BoE policymakers repeated the case for a careful and gradual approach to future rate cuts given heightened economic uncertainties.
- While EU leaders are set to meet tomorrow to discuss plans to fund increased military spending, the ECB should cut its deposit rate by 25bps to 2.50% but Lagarde will likely be non-committal about the policy outlook.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 03/27	2.238	+0.209
OBL 2.4 04/30	2.480	+0.298
DBR 2½ 02/35	2.789	+0.297
UKT 4⅛ 01/27	4.264	+0.091
UKT 4⅛ 07/29	4.342	+0.130
UKT 4¼ 07/34	4.685	+0.148

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

Euro area

A watershed moment for fiscal policy

The opening weeks of Trump's second term represent a watershed moment for European fiscal policy. The need for accelerated military rearmament and – in the words of German Chancellor-elect Merz – 'independence' from a US administration acting in line with Russian interests will mean higher public spending and higher government borrowing for the foreseeable future, and eventually probably more common EU borrowing too. That was evident in yesterday afternoon's proposals from Commission President von der Leyen and the evening announcement by the leaders of the parties likely to form the next German government. Indeed, with the German proposals in particular significantly more aggressive than had been anticipated, bond markets responded in predictable fashion, with 10Y Bund yields closing today roughly 30bps wider to mark the biggest one day sell-off since 1990.

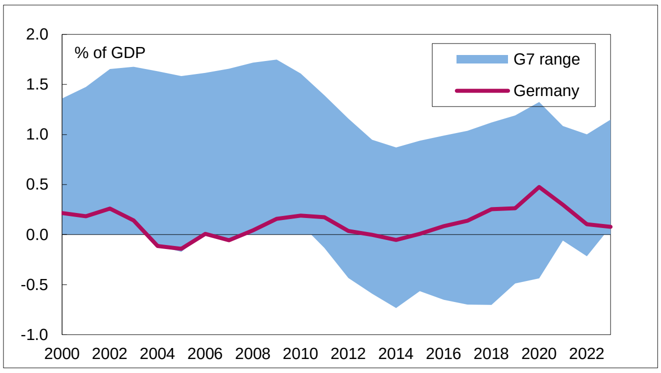
German reforms could add more than 20% of GDP to government debt over 10 years

While they were bigger than expected, yesterday evening's proposals by the negotiators of the CDU/CSU and SPD to overhaul German fiscal policy were long-overdue and appropriate in light of the long-standing underperformance of the German economy, in particular the low level of investment in infrastructure and military capacity. In particular, the suggested reforms aim to allow all spending in the German defence budget in excess of 1% of GDP to be exempted from the national debt brake; the establishment of a special infrastructure fund of up to €500bn over ten years also exempted from the debt brake; and a further exemption from the debt brake of 0.35% of GDP for the federal states. The sum total of all that could add in excess of €1trn (more than 22% of current GDP) to German public debt over the coming decade. To operationalize the military initiatives, the party leaders also proposed the acceleration of planning and permissioning of new defence projects to allow rapid deployment of the extra funds. And they also proposed the establishment of an expert commission on long-term reforms to the debt rules to encourage more investment in future. With the Green party also likely to be supportive, we expect the necessary legislation to be passed by the Bundestag and the Bundesrat before the new Parliament sits.

EU REARM proposals up for discussion on Thursday

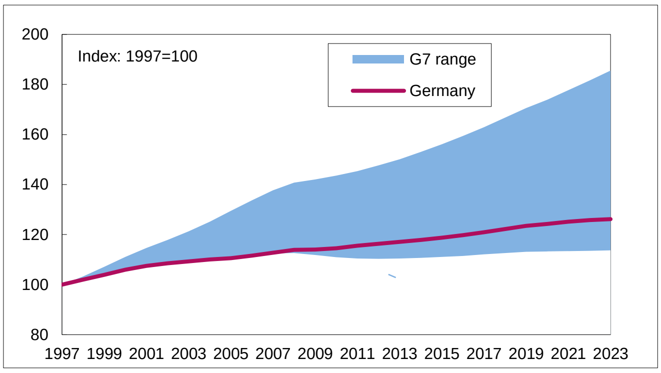
At the EU level, meanwhile, leaders will tomorrow discuss the REARM Europe proposals of Commission President von der Leyen. Among the various components, the Commission will allow Member States to increase significantly their defence expenditures without triggering the Excessive Deficit Procedure. As such, governments could feasibly increase their annual military spending by 1.5% of GDP on average over four years, to increase borrowing by about €650bn over four years. The

Germany & G7: General government net investment



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany & G7: Net capital stock



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Commission is also proposing a new joint EU instrument to provide €150bn of loans to member states to support pan-European defence capabilities, including via joint procurement as well as the provision of extra military support for Ukraine. As the new lending instrument would require qualified majority rather than unanimity for approval, we assume that it will eventually be operationalized. Moreover, there also appears scope for the EU budget to channel cohesion policy funds to provide for increased spending on defence, with EIB loans also likely to play a role to support the mobilization of private capital. So, extra expenditure on euro area military activities and German infrastructure looks set to provide a direct boost to GDP via multiple channels over coming years, and probably with positive multipliers for broader economic activity.

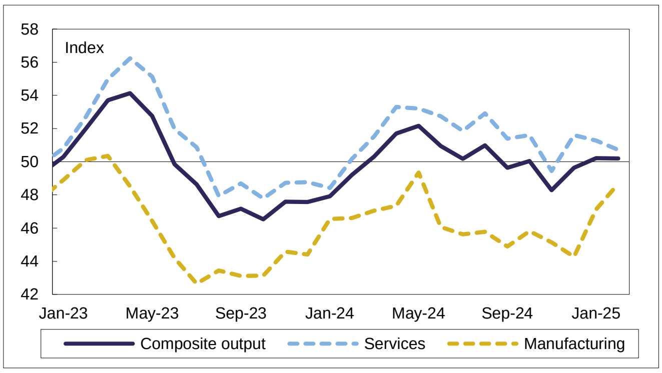
Prospect of fiscal easing to underscore ECB caution regarding monetary policy from Q2 on

Of course, in addition to the EU summit, tomorrow will also bring the ECB's latest monetary policy announcement. That policy decision will be conditioned on updated macroeconomic projections, which will not take account of the new policy proposals to increase public spending on military activities or boost German infrastructure spending. Not least as the new fiscal measures will not be approved for a while, the evolving fiscal outlook will not prevent the Governing Council from cutting the deposit rate again by 25bps to 2.50% tomorrow. But as looser budgetary policy will be expected eventually to boost economic activity and inflation over the projection horizon, we expect Lagarde to be highly non-committal with respect to the monetary policy outlook further ahead. We certainly do not expect a further rate cut at the following monetary policy meeting in April, with a further cut in June highly dependent on the ECB's updated projections that month, which will also likely have to assess the implications of new US tariffs on imports from the EU.

Final euro area PMIs point to ongoing absence of growth momentum

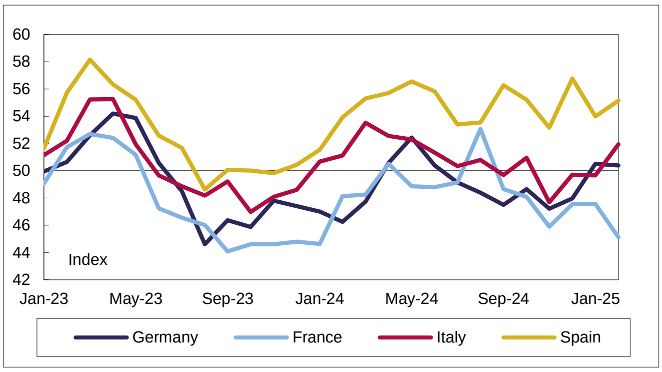
While of secondary importance, and despite some revisions across the member states, today's final euro area composite output PMI was unrevised in February (50.2) from the flash estimate, and steady compared with January, suggesting no meaningful recovery so far in Q1. As expected, the revisions included a bump to what had been a questionable French services activity index (up 0.8pt to 45.3) and to the respective composite index (up 0.6pt to 45.1). But this still represented a notable deterioration from January, contradicting the improvement shown by the (often more reliable) national INSEE survey. Consistent with the decline in the INSEE manufacturing survey in January, today's French industrial production data weakened. Indeed, compounding December's fall (-0.5%M/M), output fell a further 0.6%M/M in January to its lowest level since October 2022. Despite a partial reversal to the sharp decline in car manufacturing in December, lower output of machinery (-1.9%M/M) and zero growth in chemicals and pharmaceuticals contributed to manufacturing output falling to its lowest level since April 2022. The improvement in the final French PMIs from the flash estimates was offset by an equivalent negative revision to the German composite index (down 0.6pt to 50.4). And despite rising to a nine-month high, the new

Euro area: Headline PMIs



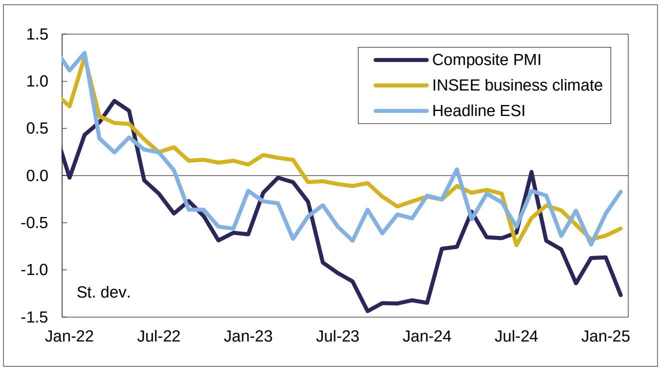
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Composite output PMIs by member state



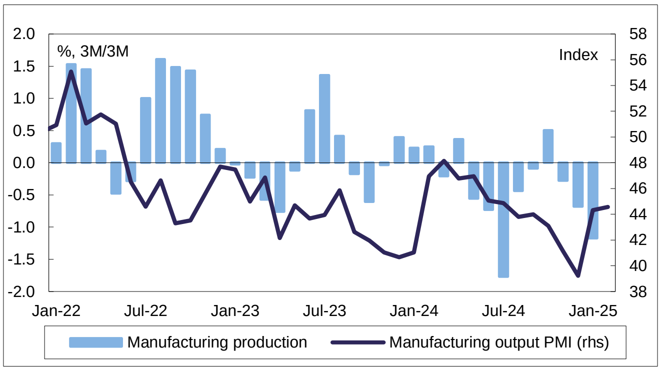
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

France: Standardised business survey indicators



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

France: IP & manufacturing output PMI



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

orders (49.2) and new export orders (48.9) indices were still consistent with ongoing contraction. Today's survey again underscored that the euro area's two largest member states continue to lag behind their Southern European peers. Certainly, the Italian composite index in February (up 2.2pts to 51.9) flagged a first expansion in activity for four months and a nine-month high, primarily attributed to a notable pickup in services activity. And the Spanish PMIs remained consistent with ongoing outperformance in Q1 (up 1.1pts to 55.1) at a similar pace of GDP growth to Q4 (0.8%Q/Q).

The day ahead in the euro area

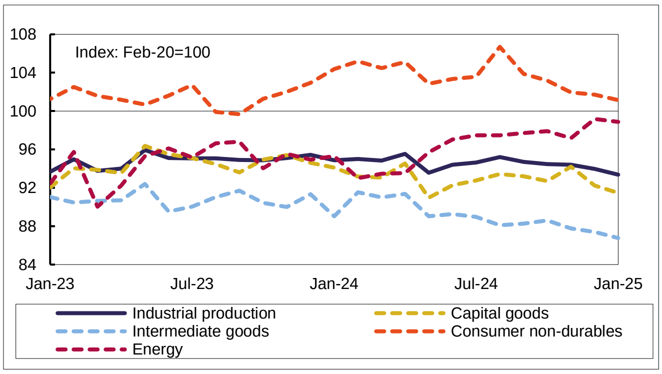
While EU leaders debate ways to boost military spending, the ECB's Governing Council still looks highly likely to cut the deposit rate by further 25bps, for a fifth successive meeting, to a two-year low of 2.50%. That will reflect the persisting absence of economic growth, the recent moderation in core inflation and fading pressures from labour costs. In terms of forward guidance, the post-meeting statement will likely maintain an emphasis on keeping a data-dependent, meeting-by-meeting approach to setting policy. The ECB's updated macroeconomic projections are likely to still point towards inflation settling around the 2% target from the first half of next year despite an upwards revision to the neat-term outlook, with a downwards revision to its profile for GDP in 2025 to weight on the inflation profile (see Friday's Euro wrap-up for details). On balance, this would have been consistent with further rate cuts over coming quarters, albeit our expectation was for a slower pace of reduction. But, not least given the likely non-negligible inflationary impulse from additional fiscal spending, the ECB's forecasts will be out of date before they are published. We would expect President Lagarde in her post-meeting press conference to refer to the expected impact of a near-term fiscal boost. But uncertainties with respect to the impact of Trump's policy actions will also add downside risks to the near-term growth outlook. So, with the policy stance now closer to neutral (and likely at neutral for some on the Governing Council) Lagarde will try her best to be non-committal with respect to the near-term monetary policy outlook.

While of secondary importance, tomorrow will bring euro area retail sales figures for January, which are likely to suggest that spending on goods remained subdued at the start of the year (0.2%M/M). Meanwhile, ahead of Friday's updated euro area Q4 national accounts figures, tomorrow will bring final estimates from Ireland, which are often revised significantly but also have a significant impact on the region's aggregate figures – indeed, the preliminary estimate reported a sharp decline in Irish GDP of 1.3%Q/Q in Q4. The February construction PMIs are also due.

The day ahead in the UK

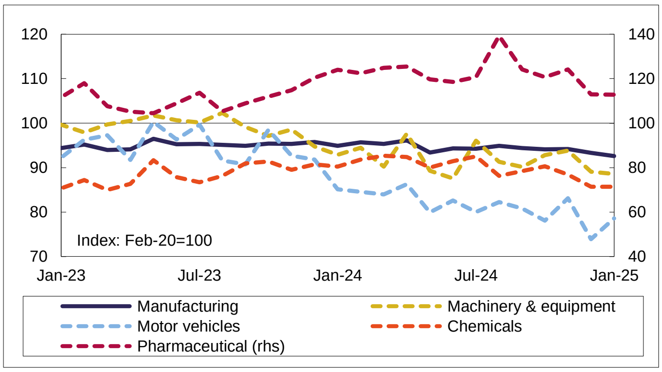
After today's final services PMIs brought a downwards revision to the survey's services input cost index but saw the prices charged component little changed at a still-above average 58.0, tomorrow's BoE Decision Maker Panel survey will provide insight into businesses' inflation and wage expectations after an upside surprise to January's inflation data and with several new cost pressures in the pipeline. To date, the DMP has flagged firms' intentions to absorb the increased costs from April's rise in employer NICS and the national living wage through a combination of lower wages, headcount and profit margins, as well as higher prices. The construction PMI survey for February is also due.

France: IP by main industrial groupings



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: Manufacturing output by subsectors



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final composite (services) PMI	Feb	**50.2 (50.6)**	*50.2 (50.7)*	50.2 (51.3)	-
	PPI Y/Y%	Jan	**1.8**	1.3	0.0	0.1
Germany	Final composite (services) PMI	Feb	**50.4 (51.1)**	*51.0 (52.2)*	50.5 (52.5)	-
France	Industrial production M/M% (Y/Y%)	Jan	**-0.6 (-1.6)**	0.4 (-0.2)	-0.4 (-1.7)	-0.5 (-1.5)
	Final composite (services) PMI	Feb	**45.1 (45.3)**	*44.5 (44.5)*	47.6 (48.2)	-
Italy	Composite (services) PMI	Feb	**51.9 (53.0)**	50.0 (51.0)	49.7 (50.4)	-
	GDP – final estimates Q/Q% (Y/Y%)	Q4	**0.1 (0.6)**	*0.0 (0.5)*	0.0 (0.4)	-
	Retail sales M/M% (Y/Y%)	Jan	**-0.4 (0.9)**	-	0.6 (0.6)	-
Spain	Composite (services) PMI	Feb	**55.1 (56.2)**	54.8 (55.5)	54.0 (54.9)	-
UK	Final composite (services) PMI	Feb	**50.5 (51.0)**	*50.5 (51.1)*	50.6 (50.8)	-
	New car registrations Y/Y%	Feb	**-1.0**	-	-2.5	-

Auctions

Country	Auction
UK	sold £4.25bn of 4.375% 2030 bonds at an average yield of 4.311%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tuesday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Unemployment rate %	Jan	**6.2**	6.3	6.3	6.2
Spain	Unemployment (net employment) change 000s	Feb	**-6.0 (58.7)**	-	38.7 (35.8)	-12.7 (6.7)
UK	BRC shop price index Y/Y%	Feb	**-0.7**	-0.6	-0.7	-

Auctions

Country	Auction
Germany	sold €3.505bn of 2.4% 2030 bonds at an average yield of 2.15%
UK	sold £2.25bn of 4.375% 2054 bonds at an average yield of 5.104%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	08.30	Construction PMI	Feb	-	45.4
	10.00	Retail sales M/M% (Y/Y%)	Jan	0.1 (1.9)	-0.2 (1.9)
	13.15	ECB Deposit Rate (Refi Rate) %	Mar	*2.50 (2.65)*	2.75 (2.90)
Germany	08.30	Construction PMI	Feb	-	42.5
France	08.30	Construction PMI	Feb	-	44.5
Italy	08.30	Construction PMI	Feb	-	50.9
UK	09.30	DMP 3M output price (1Y CPI) expectations %	Feb	4.0 (3.1)	3.9 (3.0)
	09.30	Construction PMI	Feb	49.5	48.1
Auctions and events					
Euro area	13.15	ECB monetary policy announcement			
	13.45	ECB President Lagarde to hold post-Governing Council meeting press conference			
	14.45	ECB to publish updated macroeconomic projections			
France	09.50	Auction: to sell up to €13bn 3.2% 2035, 4.75% 2035, 1.75% 2039 and 2.5% 2043 bonds			
Spain	09.30	Auction: to sell 3.1% 2031, 3.15% 2035 bonds, and 0.7% 2033 inflation-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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