

# Euro wrap-up

## Overview

- While December's ifo business survey reported less upbeat expectations for German economic conditions in the first half of 2026, Bunds followed USTs lower after euro area inflation in November was revised down.
- Gilts made gains across the curve after November's CPI inflation data surprised to the downside, cementing the likelihood of a BoE rate cut.
- On Thursday, the BoE will cut rates but the ECB will continue to hold while its updated projections will likely suggest that inflation will be back on target in 2028.

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### Daily bond market movements

Bond	Yield	Change
BKO 2 12/27	2.134	+0.004
OBL 2.2 10/30	2.464	+0.014
DBR 2.6 08/35	2.860	+0.018
UKT 3¾ 03/27	3.692	-0.061
UKT 4¾ 03/30	3.903	-0.054
UKT 4½ 03/35	4.466	-0.051

\*Change from close as at 4:15pm GMT.

Source: Bloomberg

## Euro area

### ifo survey flags downgrade of German business expectations heading into 2026

If yesterday's ZEW survey is anything to go by, investors remain upbeat about the German economic outlook for 2026. Indeed, the survey's index of expectations for the coming six months rose in December to a five-month high back near the top of the range of the past three years and well above the long-run average. However, survey signals from the real economy have disappointed towards year-end. After yesterday's flash German composite activity PMI for December registered a second successive monthly decline to a four-month low (51.9), today's ifo survey also missed expectations, with the headline business climate index dropping almost 1pt to a seven-month low (87.6) well below the long-run average. The ifo index of current conditions was broadly stable at a low level (85.6). But disappointingly, the gauge of expectations for the coming six months (89.7) weakened to its lowest level since May, when firms were still somewhat shellshocked by Trump's Liberation Day fiasco.

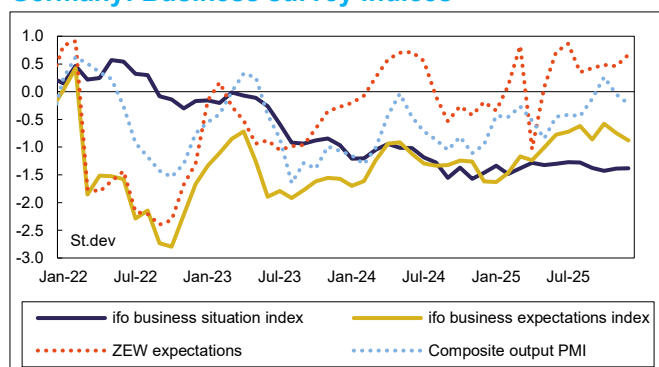
### Manufacturers frustrated by weak new orders, but constructors less downbeat about the outlook

According to the ifo institute, firms in the factory sector judged that current conditions had improved slightly in December for a second successive month. But reporting lower new orders, they revised down their expectations for the coming six months to the worst since May, perhaps suggesting somewhat greater scepticism among manufacturers that the fruits of the government's extra spending will materialise over the near term. Moreover, with the notable exception of hospitality, conditions in services were judged to be slightly less favourable in December. And as the outlook was judged to have deteriorated back close to the bottom of the range of the past year, firms in the tertiary sector were on average net pessimists for the first time in three months. The retail outlook was judged no better than last month's seven-month low, with shops demeaning lacklustre Christmas sales. But while construction activity appeared to have softened towards year-end, firms in that sector became a touch less downbeat about the outlook, suggesting some glimmer of hope that extra public investment might provide a modicum of support in the New Year.

### Inflation revised lower in November, increases in energy & services to prove temporary

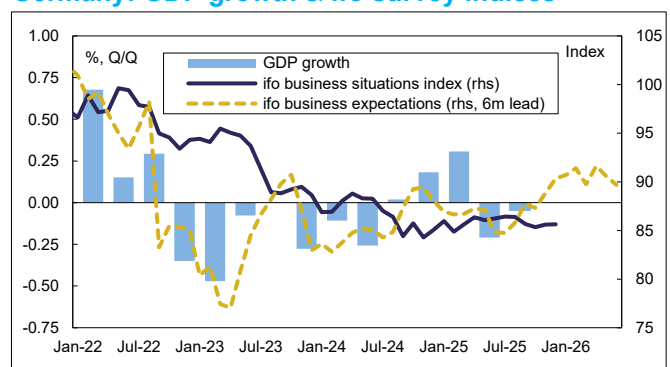
While there were no major surprises in today's final November euro area inflation report, it nevertheless brought a modest downwards revision to the headline HICP rate, by 0.1ppt to 2.1%Y/Y, to be unchanged from October. The downwards tweak partly reflected a further moderation in inflation of food, alcohol and tobacco to a ten-month low of 2.4%Y/Y, as the annual rates for fresh and processed foods were a touch softer than initially estimated. Core goods inflation was also nudged slightly lower (0.5%Y/Y) with an ongoing absence of price pressures in a range of goods including clothing, furniture and household

### Germany: Business survey indices



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

### Germany: GDP growth & ifo survey indices



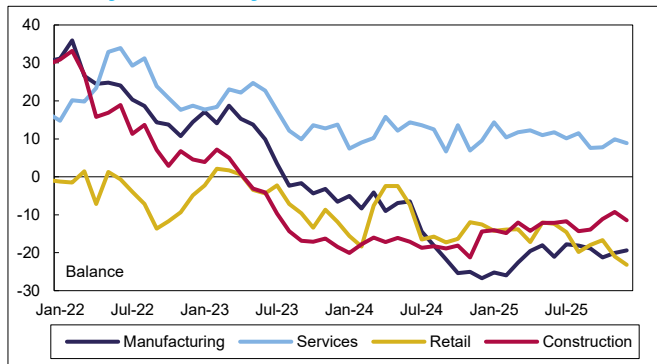
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

appliances. To two decimal places, the revision to the headline HICP rate was admittedly negligible at 0.02ppt to 2.14%Y/Y. But there should be nothing in the detailed data to concern the Governing Council. For example, the rise in energy inflation (up 0.4ppt to -0.5%Y/Y) seems likely to reverse given recent developments in wholesale markets and German subsidies in the New Year. Meanwhile, the uptick in services inflation (up 0.1ppt to 3.5%Y/Y) was largely due to package holidays, for which inflation jumped 3½ppts in November to a seven-month high, adding 0.1ppt to headline inflation. A jump in rail fares – principally in Germany – to a series high is also unlikely to be repeated. And despite these localised pressures, on a seasonally adjusted basis, services inflation momentum eased notably in November to 2.8%3M/3M annualised, a ten-month low. And while the core HICP rate measure moved sideways at 2.4%Y/Y – a touch above the ECB’s September projection – the persistent and common component of inflation (PCCI), which provides an alternative guide to underlying pressures, remained bang in line with the 2% target.

## ECB projections to suggest no urgency to change rates or guidance

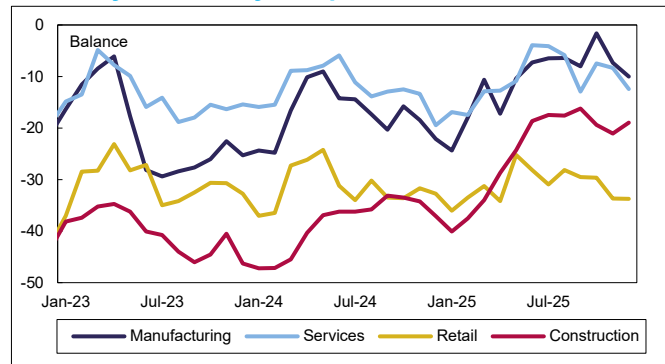
The Governing Council seems bound to keep policy unchanged tomorrow for a fourth consecutive meeting, leaving the deposit rate at 2.00%. It will also maintain its forward guidance that future decisions will be data dependent and taken on a meeting-by-meeting basis. But President Lagarde already acknowledged after October’s meeting that the downside risks to the outlook had become less pronounced. While ongoing shifts in global goods trade and a stronger euro might weigh further

### Germany: ifo survey – current conditions



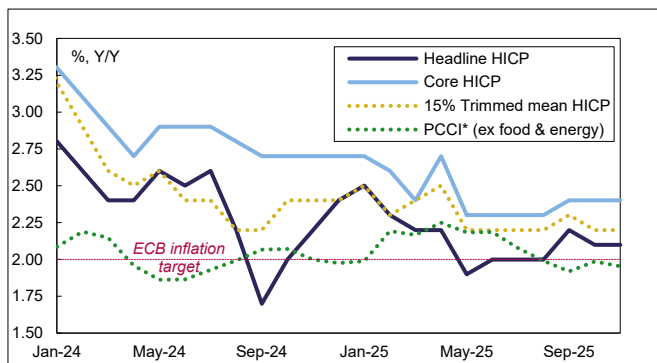
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### Germany: ifo survey – expectations



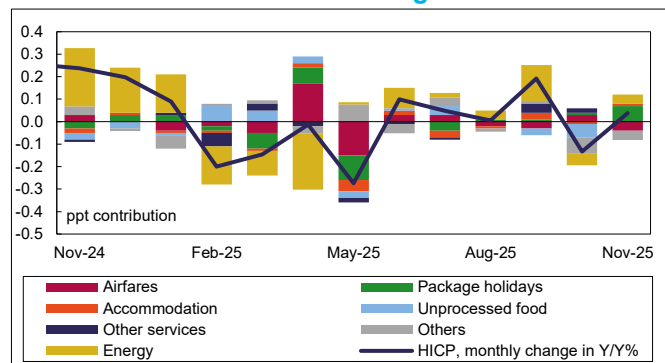
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### Euro area: Measures of inflation



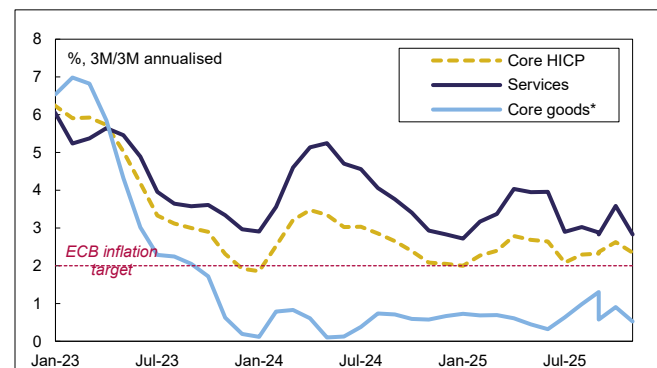
\*Persistent and Common Components of inflation. Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

### Euro area: Contribution to change in HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

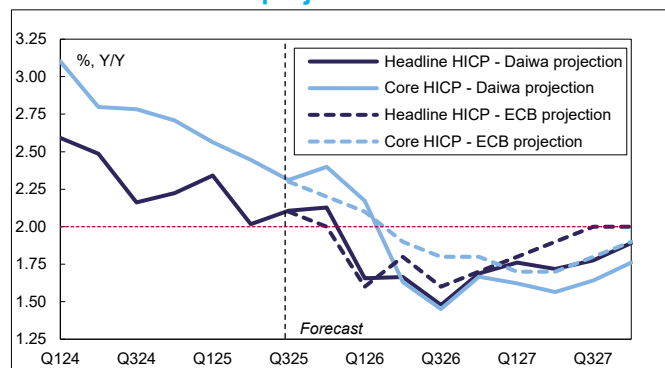
### Euro area: Core inflation momentum



\*Non-energy industrial goods.

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

### Euro area: Inflation projections



Source: ECB's September projections, Macrobond and Daiwa Capital Markets Europe Ltd.

on activity and prices, and today's ifo indices provided a reminder that a fiscal-led recovery in Germany can't be taken for granted, the ECB's updated projections will likely revise up slightly the outlook for GDP to reflect the resilience of euro area economic activity over the past couple of quarters. More importantly, revisions to the inflation projections are unlikely to provoke a significant shift in the ECB's messaging. Policymakers will continue to expect inflation to take a step down from January and trend below the 2% inflation target throughout 2026. Lower oil and gas price assumptions – the latter down more than 10% from its last forecast period – risk accentuating the undershoot. And the postponement of the EU's ETS2 levy from 2027 to 2028 will maintain a sub-2% projection for the year after next. But with an acceleration in economic growth to around 1½%Y/Y likely to be projected from 2027, a return of inflation to the 2.0%Y/Y target will be projected in the first forecast for 2028.

## UK

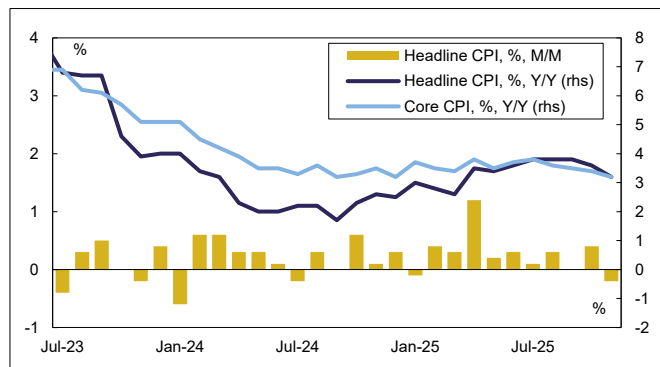
### Inflation surprises to the downside in November, teeing up Thursday's rate cut

If a rate cut from the BoE on Thursday was not already assured by the latest evidence of [rising labour slack](#) and acute sluggishness of [economic activity](#), today's inflation report should have all-but locked in expectations for easier policy. At face value, inflation in November was decisively softer than expected. With prices down 0.2%M/M, headline CPI inflation fell 0.4ppt to just 3.2%Y/Y, its weakest pace in eight months. That marked undershoots of the BoE's projection, by a non-negligible 0.2ppt, and the consensus (and our own) forecast by 0.3ppt. Predictably, that moderation partly owed to favourable base effects in tobacco (down 2½ppts to 4.2%Y/Y) relating to the increase in duty applied in the 2024 budget. But food inflation also fell back 0.8ppt to 4.0%Y/Y, a seven-month low. The softness was broad-based, and perhaps encouragingly did not yet reflect a lesser contribution from recent drivers (such as chocolate, coffee and beef) to imply that food disinflation has further to run. And the easing of that component may help to allay some concerns about potential second-round effects on inflation stemming from elevated food prices.

### Core inflation falls to YTD low, but potentially flattered by Black Friday discounting

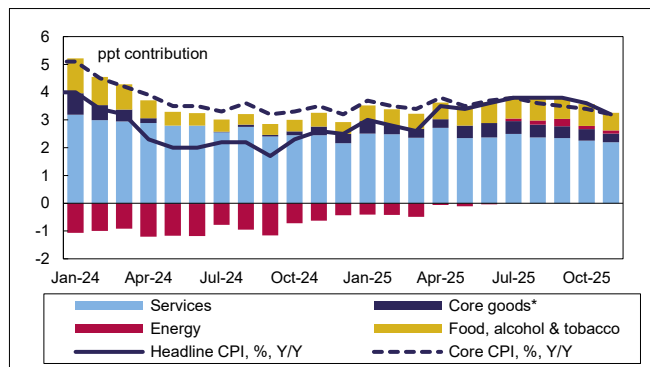
Since energy prices were also remarkably stable, non-core components were responsible for roughly half (0.15ppt) of the reduction in the headline CPI rate in November. But the softness was more widespread, including throughout the core components. Indeed, with the exception of communications, each major subcategory in the CPI moved either sideways or subtracted from inflation in November. Clothing inflation eased 1ppt to -0.7%Y/Y, a nine-month low and the softest since October 2021 besides. Furnishings also subtracted, down 1ppt to -0.3%Y/Y amid steeper discounting of household appliances. And bicycle prices also fell, and at the sharpest rate since January 2024 and August 2016 before that

#### UK: Headline & core CPI inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

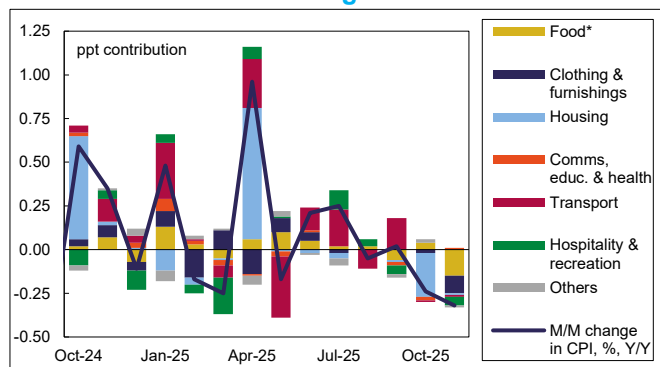
#### UK: Contributions to CPI inflation



\*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

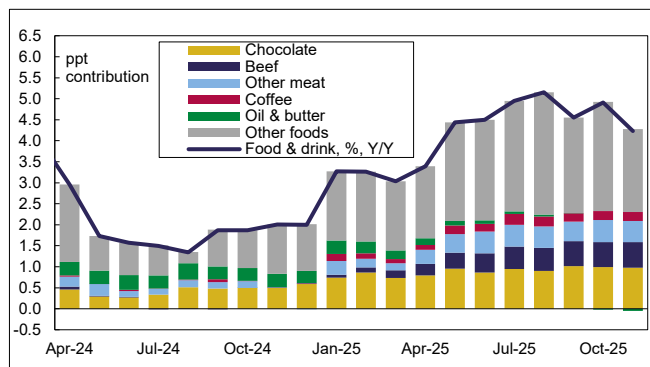
#### UK: Contributions to change in CPI inflation



\*Food, alcohol & tobacco.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

#### UK: Contributions to food inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

(-4.3%M/M). In each of those instances, we caution that more aggressive Black Friday discounting – a consistent response to the weakness of current household consumption – likely had an exaggerated effect. Nonetheless, those declines helped to knock 0.4ppt off core goods inflation (1.1%Y/Y) last month. And thanks in part to another month of moderation in hotels (down 2.1ppt to -2%Y/Y), services inflation also softened a touch to 4.4%Y/Y, a year-to-date low. As a result, the core CPI rate surprisingly eased 0.2ppt to 3.2%Y/Y, which while elevated, marks its calmest since December last year.

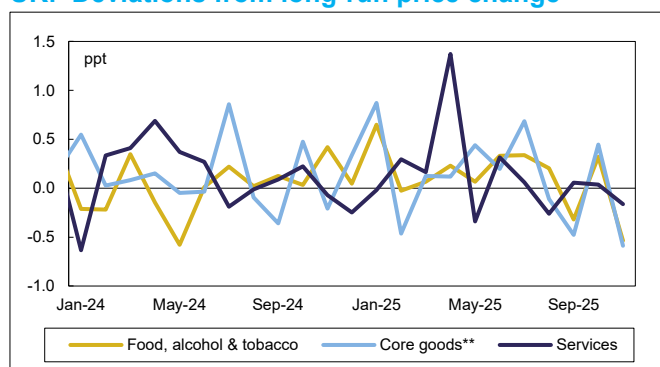
### While risks have not abated, the MPC's split could become less pronounced

While the BoE will lower Bank Rate by another 25bps on Thursday, to a near-three year low of 3.75%, the evidence of today's data in isolation probably won't be enough to sway some of the MPC's hawks. At the very least, some will prefer to see another month's inflation data to confirm the extent to which November's softer picture was influenced by temporary Black Friday distortions. Despite its latest moderation, services inflation remains elevated, and according to one underlying BoE-deployed measure (excluding indexed, volatile components, rents and package holidays) edged back up to 4%Y/Y in November, a three-month high. And food inflation too, like some measures of household inflation expectations, remains elevated. But to the extent that the BoE's 'weak demand scenario' set out by the latest Monetary Policy Report looks to have become significantly more likely than its 'inflation persistence' counterpart, we would not discount the likelihood that at least one of the MPC's hawks also softens their stance to support a cut this time too (perhaps Chief Economist Pill, or external member Mann). And we think that there is a very strong chance that at least one MPC member (most likely external members Dhingra or Taylor) will vote for an outsized 50bps cut.

### Kinder inflation outlook, heightened downside risks justify loosening policy

At the very least, Governor Bailey looks set to recognise the increased risk of an eventual inflation target undershoot. So, he will adjust his vote to back a cut and deliver a majority of at least 5-4 in favour of looser policy. Indeed, while the potential for a post-Black Friday rebound in core goods inflation adds upside risks to December's inflation reading, its trajectory thereafter will be downwards. We forecast headline CPI to fall a little below 3%Y/Y in Q1, with a negligible change to Ofgem's energy price cap in January leading to another step down in the energy component. The new year should also see the inflationary impulses from last year's budget fade out, starting with the small upside from last year's application of VAT to private school fees in January, before more explicitly declining in Q2. That process will also be accelerated by the disinflationary contents of last month's budget measures, including provisions to fund a fare freeze for regulated train tickets and household energy subsidies, which BoE Deputy Governor Lombardelli told the Treasury Select Committee could knock as much as ½ppt off headline inflation. As a result, CPI inflation should converge to target sooner than the BoE initially expected, by mid-2026. And with decelerating wage growth reinforcing our confidence about the sustainability of the underlying disinflation process, we expect the BoE to cut (at least) twice more by next summer.

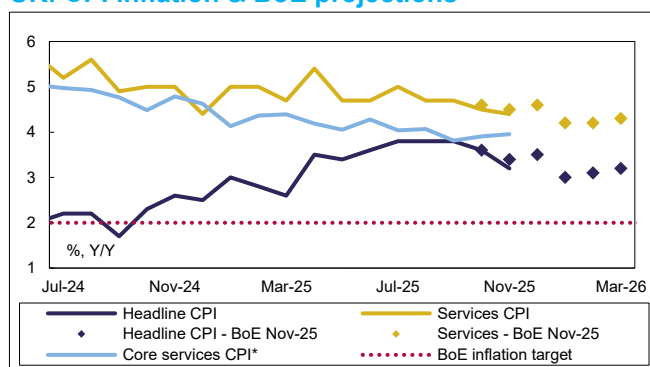
UK: Deviations from long-run price change\*



\*Monthly change in prices compared to average for the month in the decade before the pandemic. \*\*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation & BoE projections











\*Excluding indexed, volatile components, rents & package holidays.  
 Source: Macrobond, BoE and Daiwa Capital Markets Europe Ltd.

# European calendar

## Today's results

### Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Final headline (core) HICP Y/Y%	Nov	<b>2.1 (2.4)</b>	<u>2.2 (2.4)</u>	2.1 (2.4)	-
	 Final labour costs Y/Y%	Q3	<b>3.3</b>	<u>3.5</u>	3.6	3.9
Germany	 ifo business climate indicator	Dec	<b>87.6</b>	88.2	88.1	88.0
	 ifo current assessment (expectations) indicator	Dec	<b>85.6 (89.7)</b>	85.8 (90.5)	85.6 (90.6)	- (90.5)
UK	 Headline (core) CPI Y/Y%	Nov	<b>3.2 (3.2)</b>	<u>3.5 (3.4)</u>	3.6 (3.4)	-
	 PPI – output (input) prices Y/Y%	Nov	<b>3.4 (1.1)</b>	3.2 (0.6)	3.6 (0.5)	- (0.8)
	 House price index Y/Y%	Oct	<b>1.7</b>	-	2.6	2.0
	 CBI industrial trends survey – total orders (selling prices) balance %	Dec	<b>-32 (19)</b>	-35 (9)	-37 (7)	-





### 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/ <i>Daiwa forecast</i>	Previous
Euro area	 10.00	Construction output M/M% (Y/Y%)	Oct	-	-0.5 (-0.3)
	 13.15	ECB Deposit (Refinancing) Rate %	Dec	<u>2.00 (2.15)</u>	2.00 (2.15)
France	 07.45	INSEE business (manufacturing) confidence indicator	Dec	-	98 (98)
UK	 12.00	BoE Bank Rate %	Dec	<u>3.75</u>	4.00

### Auctions and events

Euro area	 13.15	ECB monetary policy announcement
	 13.45	ECB President Lagarde to hold post-Governing Council meeting press conference, Frankfurt
	 14.45	ECB to publish updated macroeconomic projections
UK	 12.00	BoE monetary policy announcement and minutes to be published
	 12.00	BoE to publish quarterly Agents' summary of business conditions (Q425)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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