

Euro wrap-up

Overview

- Shorter dated Bunds made gains after US President Trumps threatened new tariffs against certain member states and euro area inflation fell back below the 2% target amid a broad-based easing in price pressures.
- Despite the UK also being threatened with higher US tariffs, Gilts were little changed.
- Tuesday will bring euro area construction activity data, a German investor survey and the latest UK labour market report.

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Daily bond market movements

Bond	Yield	Change
BKO 2 12/27	2.077	-0.031
OBL 2½ 04/31	2.434	-0.017
DBR 2.9 02/36	2.839	+0.006
UKT 3¾ 03/27	3.663	+0.003
UKT 4¾ 03/30	3.881	+0.011
UKT 4½ 03/35	4.414	+0.015

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

Euro area

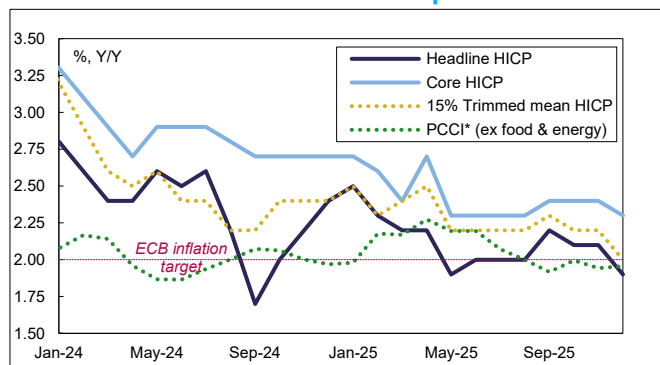
Euro area inflation back below 2.0% target amid a broad-based easing in pressures

Today's final euro area inflation data for December brought a small downwards revision from the flash estimate, with the headline HICP rate down to a seven-month low of 1.9%Y/Y – a drop of 0.1ppt from the flash and 0.2ppt from November – marking just the third sub-2.0% target reading in 4½ years. Admittedly, to two decimal places the revision was modest, of just 0.02ppt to 1.94%Y/Y. And it principally reflected adjustments in the non-core components, with the drag from energy (-1.9%Y/Y) a touch larger than in the flash release and the most in four months. Food inflation edged up to a three-month high (2.0%Y/Y) due to a jump in fresh vegetable prices. But this too was less than initially estimated, with further disinflation in certain items (e.g. coffee and chocolate) that spiked earlier in the year. More importantly, today's detail confirmed a downtrend in several core goods components suggestive of non-seasonal discounting, likely facilitated by the recent decline in producer imported goods prices (-2.9%Y/Y in November) which itself in part reflected the marked appreciation of the euro over the past year. Among the more notable sub-components, prices of clothing, household appliances and furniture were all cut from November while prices of cars were flat on the month. Overall, non-energy industrial goods inflation dropped to a 4½-year low of 0.4%Y/Y in December. And while there was the normal dose of volatility in certain travel-related components – this month saw rising airfares but slowing package holiday prices – services inflation moderated from November's seven-month high, by 0.1ppt to 3.4%Y/Y. As such, core inflation fell 0.1ppt to 2.3%Y/Y, matching the softest rate in over four years. Other measures of underlying inflation were similarly encouraging, with the PCCI (persistent and common components) and trimmed mean rates bang in line with the 2.0% target, the latter for the first time since April 2021.

Inflation to undershoot target this year, with US tariff threats a new downside risk

We expect inflation to take a further step down this month to 1.7%Y/Y, as favourable base effects and German fiscal initiatives to cut electricity prices push energy inflation to the most negative rate since September 2024. With seasonally adjusted momentum in food prices in December having slowed sharply to just 0.7%3M/3M annualised, food inflation should fade a little further too despite new pressures on certain components from winter weather. While services momentum remained somewhat sticky towards the end of 2025 (3½%3M/3M ann.), we expect a notable softening in the spring supported by smaller regular price resets than a year earlier and moderating wage pressures. And the impact of euro appreciation, subdued domestic demand, and competition from cheap Chinese imports should continue to keep a lid on core goods price pressures. Overall, like the ECB, we forecast headline inflation to slightly undershoot the 2.0% target this year and next before picking up in 2028. And while the euro area economy was relatively resilient to higher US tariffs last year, President Trump's latest threat of an additional 10% tariff from 1 February on imports from Germany, France, Finland and the Netherlands, as well as four non-euro area European countries, poses a new downside risk to activity and inflation.

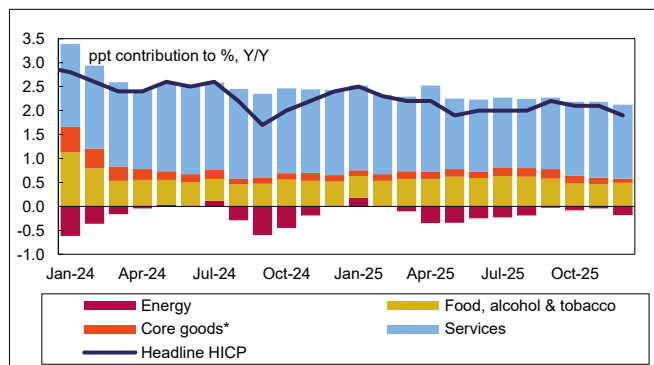
Euro area: Measure of consumer price inflation



*Persistent and Common Component of inflation.

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

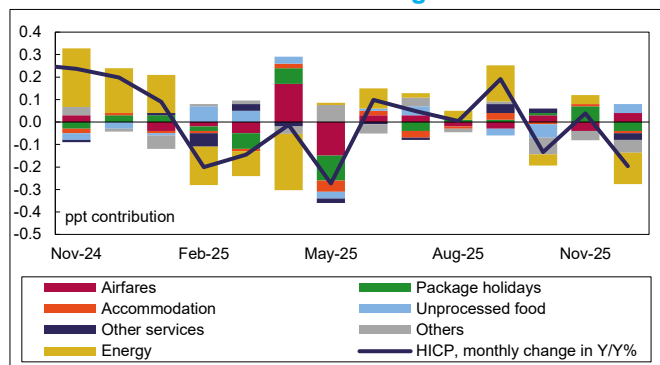
Euro area: Contributions to headline HICP inflation



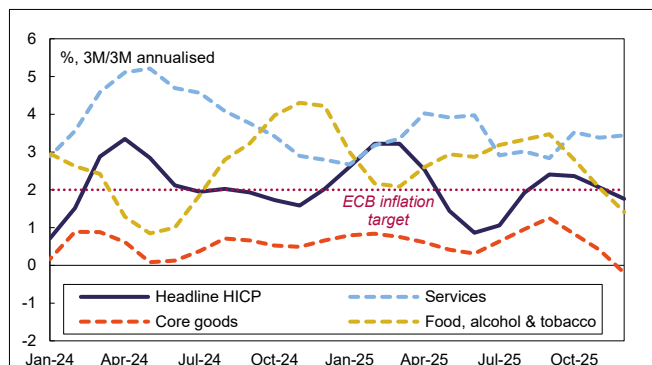
*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

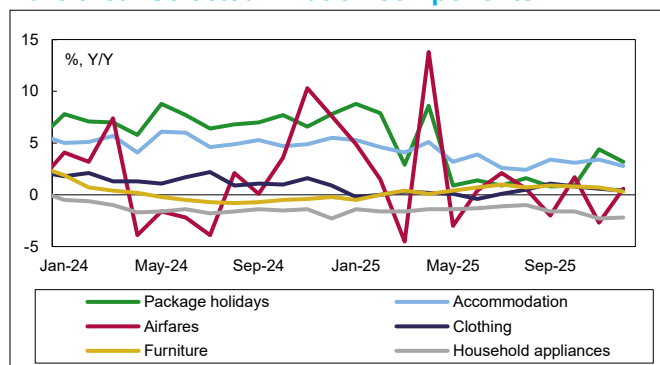
Euro area: Contribution to change in inflation



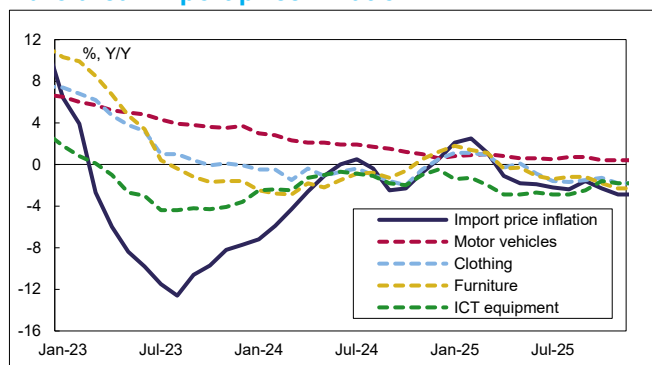
Euro area: Inflation momentum



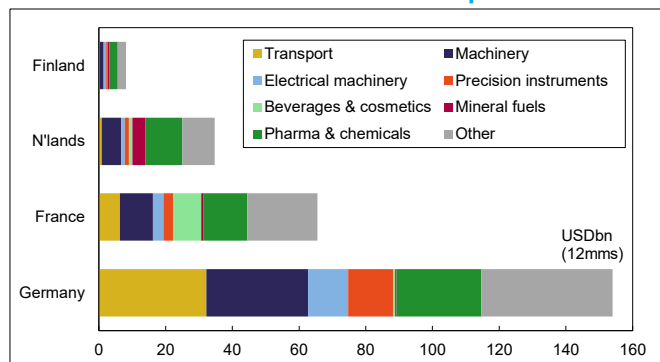
Euro area: Selected inflation components



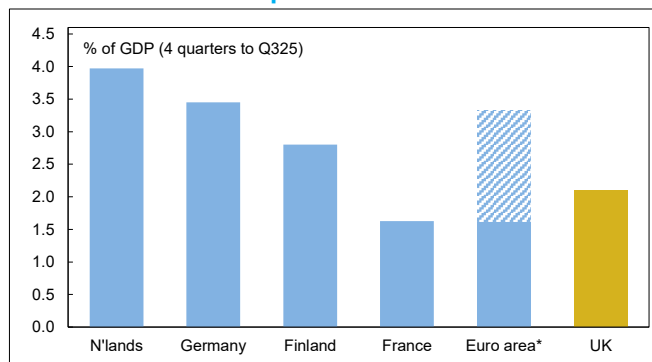
Euro area: Import price inflation



Euro area member states: Goods imports to the US



Euro area: Goods exports to the US



*Solid blue area represents the share of goods exports to the US accounted for by Germany, France, Netherlands & Finland. Shaded area represents other member states. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

There are a few notable data releases slated for the euro area on Tuesday. Among them will be January's ZEW sentiment indices, which we ordinarily expect to mirror the improvement in investor expectations displayed by last week's Sentix survey. To the extent that the sampling for the ZEW will have predominantly occurred last week – thereby limiting the extent of any downside raised by the US tariff threat announcement over the weekend – that assumption should continue to hold, albeit with any improvement likely to be more modest than otherwise. Meanwhile, German PPI data will likely confirm a further slight decline in industrial output prices in December to be down almost 2½%Y/Y consistent with a continued absence of underlying price pressures from the factory sector. With respect to the aggregate euro area data, we expect construction output to have contracted by around ½%M/M in November following a weaker performance in Germany (-0.8%M/M) and France (-1%M/M). Nevertheless, that decline should not completely reverse October's German-led rise, which will maintain hopes that the sector provided support to GDP growth in Q4.



The day ahead in the UK

The highlight of the coming day's European dataflow will be the latest UK labour market report. Indeed, while the MPC voted by a thin majority for further monetary policy easing in December, a number of MPC members highlighted their concerns about the still-elevated nature of forward-looking wage indicators. In that respect, we expect the official labour market data to provide some reassurance about the current pace of wage moderation. Admittedly, regular pay growth should ease only slightly, to around 4½%3M/Y, reflecting in part the recent firmness of public sector pay growth. But the BoE's preferred measure of private sector regular wages should decelerate a touch more, to 3.7%3M/Y, a new five-year low, to be on track to converge to, or slightly below, the BoE's year-end expectation of 3.5%3M/Y. Meanwhile, at 5.1%, the unemployment rate has already overshot the BoE's expectations. For the first month in three, it looks likely to have held steady in November. But given the continued weakness of hiring indicators and decline in the first estimate of payrolls in November, we expect employment growth to have remained weak at the end of last year.

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%	Dec	1.9 (2.3)	<u>2.0 (2.3)</u>	2.1 (2.4)	-
UK	 Rightmove house prices M/M% (Y/Y%)	Jan	2.8 (0.5)	-	-1.8 (-0.6)	-











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	 09.00	ECB current account balance €bn	Nov	-	25.7
	 10.00	Construction output M/M% (Y/Y%)	Nov	<u>-0.6 (-0.8)</u>	0.9 (0.5)
Germany	 07.00	PPI Y/Y%	Dec	-2.4	-2.3
	 10.00	ZEW current situation (expectations) balance	Jan	-76.0 (50.0)	-81.0 (45.8)
UK	 07.00	Average wages (excluding bonuses) 3M/Y%	Nov	4.6 (4.5)	4.7 (4.6)
	 07.00	Private sector regular wages 3M/Y%	Nov	3.7	3.9
	 07.00	Unemployment rate 3M%	Nov	5.1	5.1
	 07.00	Employment 3M/3M change 000s	Nov	31	-16
	 07.00	Payrolled employees M/M change 000s	Dec	-20	-38
	 07.00	Claimant count rate % (change 000s)	Dec	-	4.4 (20.1)

Auctions and events

Euro area	 10.00	Eurostat to publish update on Q325 GDP aggregates and employment
UK	 09.45	BoE Governor Bailey & Deputy Governor Ramsden to discuss the Financial Stability Report at Treasury Select Committee

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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