

Euro wrap-up

Overview

- Gilts ended the day little changed while UK inflation ticked higher in December but remained below the BoE's projection and underlying price pressures remained contained.
- Bunds made further modest losses on a quiet day for euro area economic news.
- Thursday will bring the Commission's flash consumer confidence indicator, the ECB account from the December policy-setting meeting and UK public finance figures.

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Daily bond market movements

| Bond | Yield | Change |
|---------------|-------|--------|
| BKO 2 12/27 | 2.085 | +0.019 |
| OBL 2½ 04/31 | 2.459 | +0.024 |
| DBR 2.9 02/36 | 2.878 | +0.021 |
| UKT 3¾ 03/27 | 3.666 | +0.007 |
| UKT 4¾ 03/30 | 3.904 | -0.002 |
| UKT 4½ 03/35 | 4.449 | -0.008 |

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

Source: Bloomberg

UK

Headline inflation ticks higher in December, but remains below BoE's projection

UK inflation predictably rose at the end of 2025 as government measures and typically volatile travel-related items provided upwards impulses. The headline CPI rate increased 0.2ppt to 3.4%Y/Y in December, up from the prior month's eight-month low (3.2%Y/Y). While December's outturn was a touch above the Bloomberg survey consensus, the range of forecasts was unusually wide due to uncertainty surrounding the precise date of data collection that month. More importantly, the headline CPI rate remained 0.1ppt below the BoE's projection in November's Monetary Policy Report. Like the Bank, we expect the uptick in December to prove temporary, with a notable step down likely over coming months. Taken together with the soft labour market and subdued economic growth momentum, there remains a reasonable case for Bank Rate to be cut next at the April MPC meeting, with one further cut likely over the summer too.

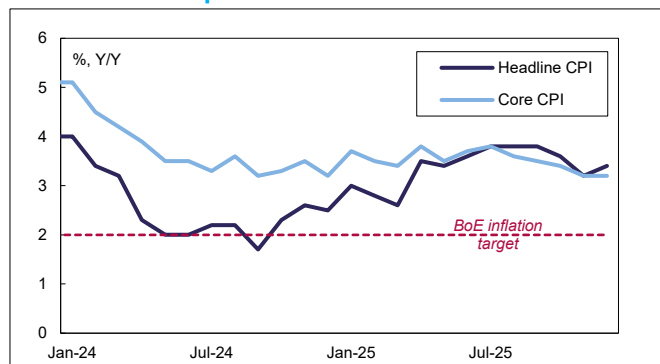
Increase related to unfavourable base effects, while underlying price pressures remain contained

One source of the rise in inflation in December was tobacco, which added 0.05ppt to the headline rate as excise duties were hiked one month later in 2025 than in 2024. Food inflation (4.4%Y/Y) also partially reversed the dip in November amid a further pickup in meat, bread and cereals. But this was still almost ½ppt below last year's high and a whopping 15ppts below the 2023 peak. And taken together with non-alcoholic beverages, the component ended the year 0.8ppt below the BoE's forecast. Despite a pickup in clothing inflation – perhaps related to a change in discounting period this year – other core goods price pressures were largely absent, pushing non-energy industrial goods inflation down 0.1ppt to a 14-month low of 1.0%Y/Y. Most notably, while services inflation ticked up by 0.1ppt to 4.5%Y/Y, this was a touch below the BoE's expectation and 0.3ppt below the 2025 average. Furthermore, the rise principally reflected a near-11ppt jump in inflation of airfares, at least in part due to the timing of return flights over the Christmas and New Year period captured by the sample. Indeed, indicators of underlying services were broadly stable in December, with the measure excluding indexed and volatile components, rents & overseas travel – which is watched by the BoE – holding steady at 4.0%Y/Y. Overall, core inflation moved sideways at 3.2%Y/Y, matching the lowest rate in more than four years.

Inflation set to fall back to target by the summer, amid broad-based easing in price pressures

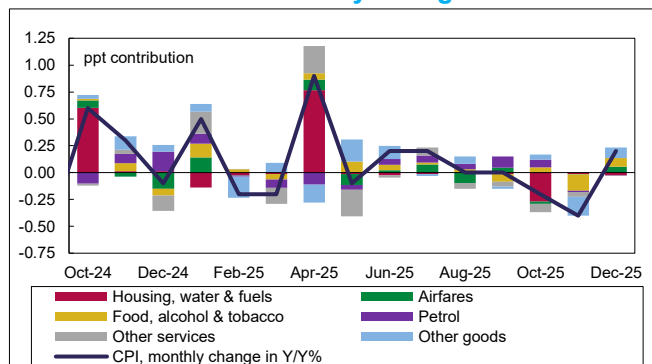
The near-term inflation outlook remains subject to significant uncertainty, not least due to heightened geopolitical tensions and President Trump's new threat of tariffs against the UK and seven other European countries. A spike in wholesale gas prices – up almost one third since the start of the year – poses an upside risk over the near term too, although the curve remains more than 10% below that assumed in the BoE's November Monetary Policy Report. Moreover, petrol prices are

UK: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

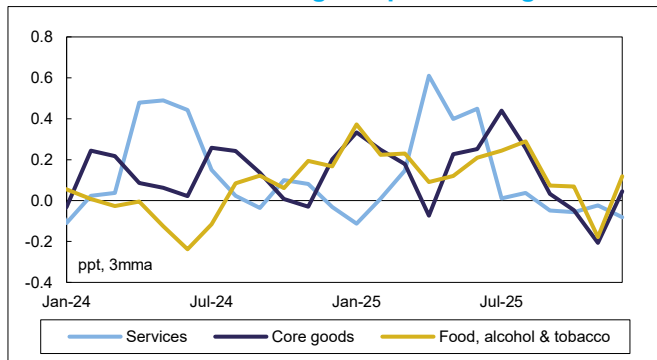
UK: Contribution to monthly change in inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

tracking more than 2% lower on the month in January. So, given a notable rise in petrol prices a year ago, energy inflation should fall close to 0%Y/Y this month and will take a further step down in April when the government reduces average household utility bills by £150. Food inflation will also resume a gradual downtrend through to the middle of the year, flattered by base effects from the spike in certain wholesale agricultural prices last year. And not least reflecting soft import prices and lacklustre domestic demand, core goods inflation will remain subdued. Of course, most focus remains on services inflation, for which the MPC's doves and hawks hold very different views about the risks of persistence. This component should fall sharply in April, as the impact of last year's fiscal tightening measures – including higher administered prices and vehicle excise duty – fall out of the calculation, the cost impact of higher employer NICs continues to fade and seasonal price resets should be lower than last year. As such, services inflation could drop by more than 1ppt to about 3¼%Y/Y by the summer. Overall, we expect headline inflation to fall below 2½%Y/Y from Q226 onwards and average about 2½%Y/Y over the year as a whole, before easing to about 2% in 2027. And while the moderation in underlying inflation will be more gradual, continued moderation in pay growth and persistent slack could well push the core CPI rate below 2% from the start of Q227.

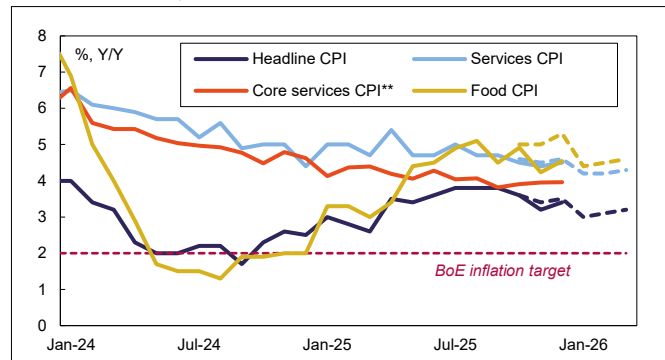
UK: Deviations from long-run price change*



*Monthly change in prices compared to the average for the month in the decade before the pandemic.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

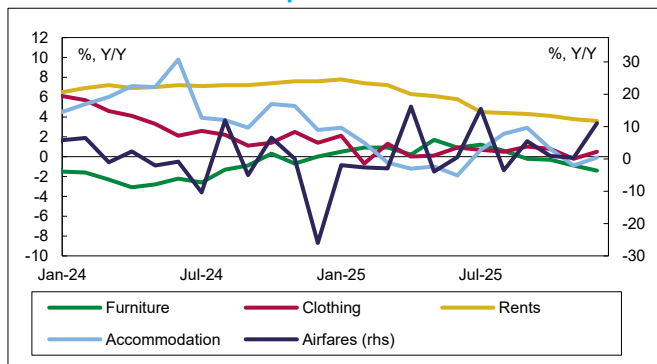
UK: Headline, service & food inflation



*Dashed lines represent BoE projections. **Services excluding indexed and volatile components, rents and foreign holidays' measure

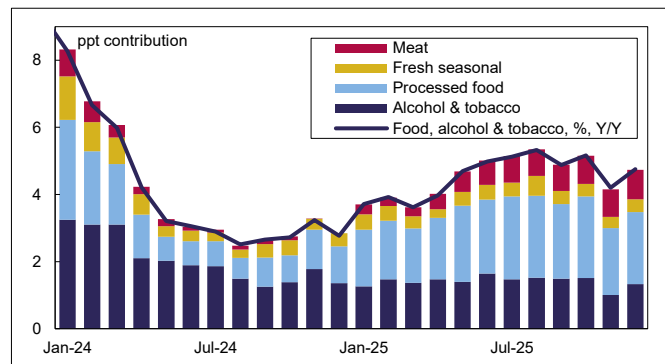
Source: BoE, Macrobond and Daiwa capital Markets Europe Ltd.

UK: Selected CPI components



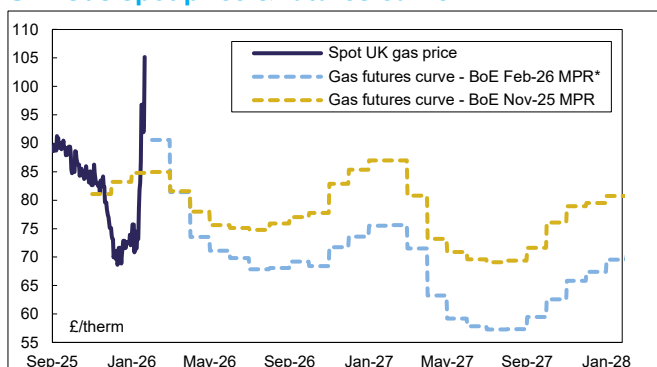
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to food inflation



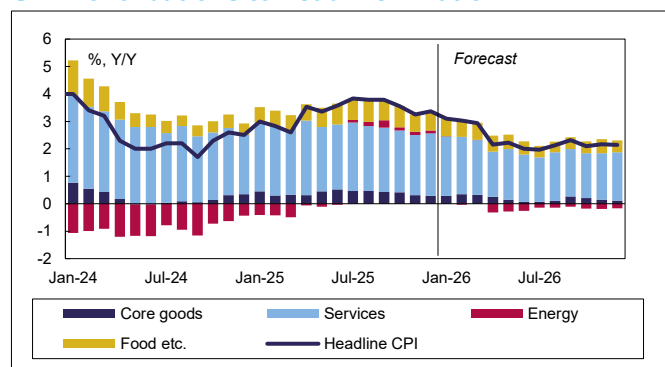
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Gas spot price & futures curve



*Daiwa estimate for the conditioning assumptions in BoE Feb-26 MPR.
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Contributions to headline inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

While yet more top-tier data are slated for release on Friday, the day ahead looks set to be relatively quiet for UK news. Of most interest will be December's government finance statistics, which will provide an update on the public sector borrowing overshoot at the end of the calendar year. That overshoot has been in part attributed to higher than forecast debt interest costs and local government borrowing, and recent data have shown that it continued to widen in the lead up to the Budget. Indeed, cumulative public sector net borrowing stood at £132.3bn in November, up £10bn on the equivalent period in FY24/25. Meanwhile, ahead of December's retail sales release on Friday, a survey from the CBI will provide a signal about activity in the retail sector this month.







The day ahead in the euro area

Ordinarily, the publication of the ECB's account of its most recent monetary policy meeting might mark the highlight on an otherwise thin Thursday for economic data. But the Governing Council was predictably unmoved by events at that meeting, when it inevitably left policy unchanged and raised its near-term inflation outlook for 2026 to reflect a slightly more bullish GDP growth outlook. And with the Governing Council still seemingly unconcerned about the prospect of a temporary undershoot of the 2% inflation target this year and next given somewhat diminished downside risks to activity, the likelihood of a change in policy in either direction this year already looked relatively small. As such, we expect tomorrow's account to offer little new information about the likely policy outlook. And to the extent that the macroeconomic outlook studied last month has been overtaken by recent geopolitical events, we think that its interpretation should require caution. On the data front, the Commission's flash consumer confidence reading will provide an early signal as to how far Greenland-related concerns have started to weigh on household sentiment. Government financial accounts data for Q325 are also due to be published.




European calendar

Today's results

Economic data

| Country | Release | Period | Actual | Market consensus/ <i>Daiwa forecast</i> | Previous | Revised |
|---------|--|--------|-----------|--|-----------|---------|
| France |  Retail sales Y/Y% | Dec | -1.0 | - | 0.7 | 0.6 |
| UK |  Headline (core) CPI Y/Y% | Dec | 3.4 (3.2) | 3.3 (3.2) | 3.2 (3.2) | - |
| |  PPI – output (input) prices Y/Y% | Dec | 3.4 (0.8) | 3.4 (1.0) | 3.4 (1.1) | - |
| |  CBI industrial trends survey – total orders (selling prices) net balance % | Jan | -30 (29) | -33 (16) | -32 (19) | - |
| |  CBI industrial trends survey – business optimism net balance % | Jan | -19 | - | -31 | - |
| |  House price index Y/Y% | Nov | 2.5 | - | 1.7 | 1.9 |




Auctions

| Country | Auction |
|---------|---|
| Germany |  sold €776mn of 2.6% 2041 bonds at an average yield of 3.23% |
| |  sold €786mn of 2.9% 2056 bonds at an average yield of 3.49% |
| UK |  sold £4.75bn of 4% 2029 bonds at an average yield of 3.821% |





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 |  15.00 | Preliminary Commission consumer confidence indicator | Jan | -13.0 | -13.1 |
| UK |  07.00 | Public sector net borrowing £bn | Dec | 13.0 | 11.7 |
| |  11.00 | CBI distributive trades survey – retailing reported sales net balance % | Jan | -35 | -44 |

Auctions and events

| | | |
|-----------|---|--|
| Euro area |  10.00 | Eurostat to publish Government financial accounts for Q325 |
| |  12.30 | ECB to publish monetary policy account of December 17-18 Governing Council meeting |
| France |  09.50 | Auction: to sell up to €13.5bn of 2.4% 2028, 2.75% 2029, 2.7% 2031 & 3% 2033 bonds |
| |  10.50 | Auction: to sell up to €1.75bn 0.1% 2029, 0.1% 2036, 0.55% 2039 & 0.1% 2053 inflation-linked bonds |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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