Euro wrap-up

Overview

- Bunds made gains as euro area inflation moved firmly below the 2.0%Y/Y target in January to match the lowest rate since April 2021.
- Gilts made modest losses while the final UK PMIs signalled renewed growth and price momentum but also a weak job market.
- On Thursday, the ECB and BoE will keep interest rates unchanged, while the BoE will also publish updated macroeconomic projections. Data-wise, euro area retail sales and German factory orders for December are due.

Economic Research Team
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change
BKO 2.1 03/28	2.085	-0.028
OBL 2½ 04/31	2.426	-0.033
DBR 2.9 02/36	2.857	-0.032
UKT 3¾ 03/27	3.701	+0.012
UKT 4⅜ 03/30	3.963	+0.015
UKT 4½ 03/35	4.544	+0.029

*Change from close as at 4:45pm GMT.
Source: Bloomberg

Euro area

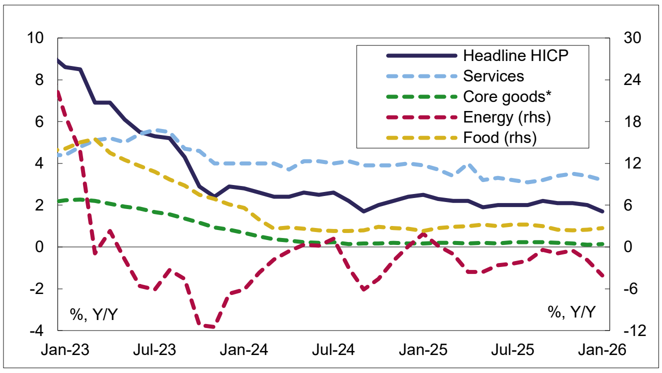
Inflation falls to match lowest rate since April 2021 with welcome moderation in services

Broadly in line with expectations, euro area inflation fell in January to a sub-target 1.7%Y/Y to match the lowest rate since April 2021. That marked a drop of 0.3ppt from December, whose estimate was revised up by 10bps to reflect the inclusion of Bulgaria in the data following its recent accession to the euro area. The detail was relatively encouraging. Services inflation moderated by 0.2ppt to a four-month low of 3.2%Y/Y. So, with the non-energy industrial goods component only 0.1ppt firmer than in December and still highly subdued at just 0.4%Y/Y, the ECB should be pleased to see the core inflation (excluding food, energy, alcohol and tobacco) edge down 0.1ppt to 2.2%Y/Y, the lowest rate since October 2021. Beyond the core items, inflation of food, alcohol and tobacco rose 0.2ppt to a four-month high of 2.7%Y/Y due to pressures in unprocessed items. But that impact on headline inflation was more than offset by a drop in energy inflation of more than 2ppts to -4.1%Y/Y, the weakest in fifteen months, due to sharp increases in prices of electricity and auto fuels a year earlier. Among the member states, inflation in Germany (2.1%Y/Y) and Italy (1.0%Y/Y) exceeded expectations. But it fell more than anticipated in France (0.4%Y/Y), Spain (2.5%Y/Y), the Netherlands (2.2%Y/Y) and several other member states.

Core rate likely to ease further to keep headline inflation below target in 2026 and 2027

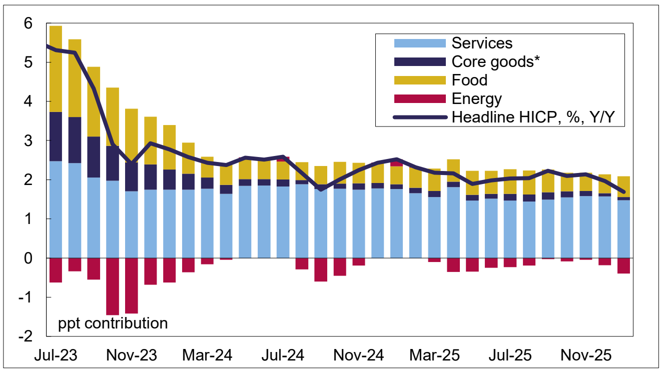
If the moderation in services inflation in January was related to volatile holiday-related components, the improvement might not prove durable. Indeed, we note that today's final euro area services PMIs reported the strongest cost pressures in the sector in 11 months, as well as a pickup in output prices, which might in part reflect strong hikes in minimum wages. Nevertheless, we suspect that the slowing in services inflation in January more likely reflected softer new year price re-sets than in 2025, and perhaps also fiscal measures. So, today's data should foreshadow a further easing in the services component over coming quarters. Reassuringly too, the PMIs' report of firmer cost pressures in the manufacturing sector was not matched by evidence of significant pass-through to prices. Indeed, industrial producer prices were still down on the month in December and by 2.1%Y/Y, the steepest annual drop in 14 months. Euro area industrial import prices fell in November (the most recent month for the data) by 2.5%Y/Y, the most in 20 months. And we expect past euro appreciation and cheap supply to continue to weigh on core goods consumer prices in coming months. Admittedly, although gas prices have recently fallen back from the swoon at the start of the year, base effects in energy will become less favourable from February on. And food prices might yet add a new inflationary impulse. But today's data suggest that core and headline inflation are on track to undershoot slightly the ECB's projections for the current quarter. We expect both rates to track below the 2% target for most of 2026 and 2027. And while the risks to the inflation outlook remain two-sided, there is a non-negligible probability of a persistent target undershoot if the euro exchange rate maintains its uptrend.

Euro area: HICP inflation & key components



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

Euro area: Contributions to headline HICP inflation

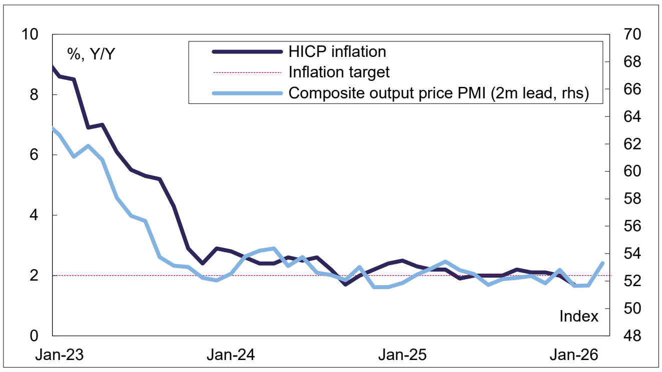


*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area PMIs consistent with expansion in early 2026 despite drop in January

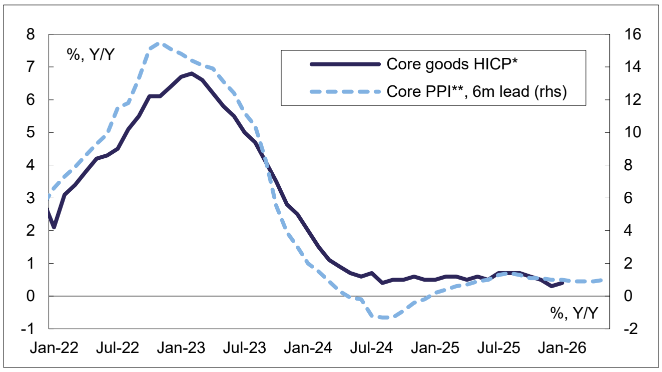
While manufacturing surveys have pointed to a gradual recovery at the start of 2026, today's final euro area services PMIs suggested a slight moderation in growth momentum in the sector. Indeed, the headline services activity index was revised down from the flash reading to 51.6, a four-month low and some 1.4pts below the Q4 average. Moreover, the new business component (50.7) was the softest since August and a full 2pts below the Q4 level. This pushed the euro area composite output index down to a four-month low (51.3), a level that before the pandemic would have been consistent with GDP growth slowing to 0.1%Q/Q. Part of the deterioration reflected a questionable weakening in the French services PMI (48.4), which contrasted the stable conditions presented by the larger INSEE survey. But today's survey also implied a softening in Spanish services activity at the start of the year, with the respective index down 3.6pts to 53.5, a five-month low. And that pushed Spain's composite PMI (52.9) to the lowest level since June. This was, however, still the highest level of the member states and some 1½pts above the pre-pandemic average. Moreover, it contrasted the Spanish ESI, which has a sample more than four times the size of the equivalent PMI and rose to the highest level since September 2024. Meanwhile, like the Commission survey, today's PMIs suggested renewed momentum in Italian economic growth momentum (up 1.1pt to 51.4) supported by a pickup in services activity. And while the final German services PMI was downwardly revised from the flash by a chunky 0.9pt, the composite PMI (52.1) was still up 0.8pt from December and just 0.4pt below the Q4 average when GDP expanded 0.3%Q/Q. Overall, we place more weight on the ESIs than the PMIs and so continue to forecast steady euro area GDP growth of 0.3%Q/Q in Q1.

Euro area: Headline inflation & composite price PMI



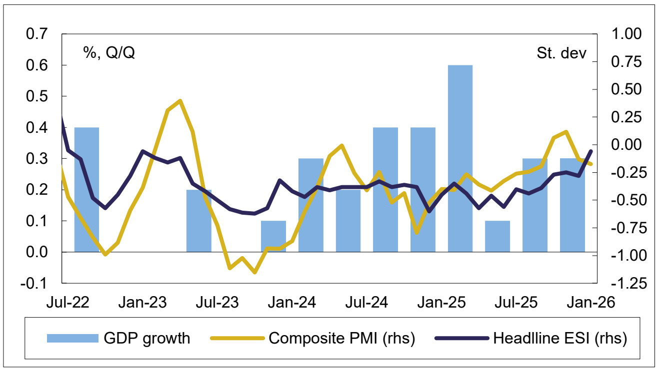
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core goods HICP & PPI inflation



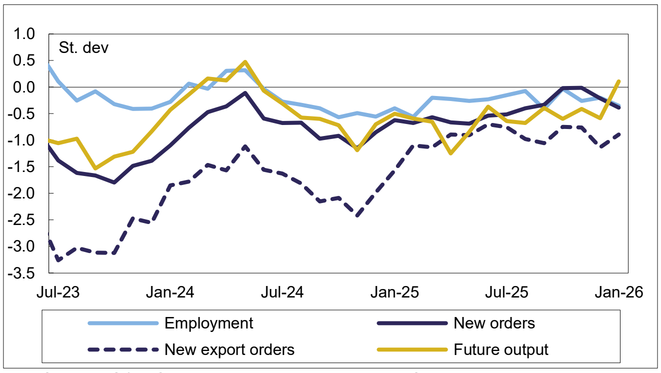
**Non-energy industrial goods. **Excludes energy.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & survey indices



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

Euro area: Composite PMIs



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

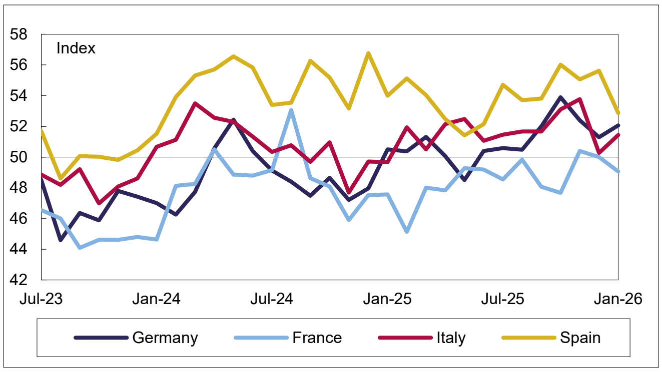
The day ahead in the euro area

Unsurprisingly, the focus in Europe on Thursday will be squarely on monetary policy. For the euro area, the ECB's announcement will be of most interest. The ongoing signs of reluctance from Governing Council members to depart from their 'good place' just yet means that we, like the consensus, expect the ECB to leave its key policy rates unchanged. The Governing Council will also leave key elements of its statement largely unchanged, inevitably maintaining that decisions will follow a 'data-dependent and meeting-by-meeting approach' without pre-committing to a particular rate path. Indeed, in the absence of new forecasts, we think that the Governing Council should draw reassurance from the continued resilience of economic activity indicators, including the stronger-than-expected GDP growth at the end of last year. And while today's inflation data were relatively soft, they did not (yet) materially contradict the Governing Council's broader inflation outlook.

The account of December's Governing Council meeting had already inferred that slightly more policymakers saw the inflation risks skewed to the downside, and we see cause for those concerns to have increased last month. In addition to the signs of tighter credit conditions last quarter, it seems likely that renewed dollar weakness – which recently helped the euro briefly peek above a 4½-year high of \$1.20 before coming back to \$1.18 – will have resurrected concerns about the disinflationary implications of exchange rate moves. Euro appreciation has been less stark in trade-weighted terms but was noted by some influential Governing Council members, such as Banque de France head Villeroy and new Austrian Governor Kocher. So, we might expect President Lagarde to adopt a less hawkish tone in her press conference. But as uncertainty remains high and upside risks to the outlook are also non-negligible, Lagarde will also look to retain maximal optionality, remaining broadly non-committal with respect to future decisions.

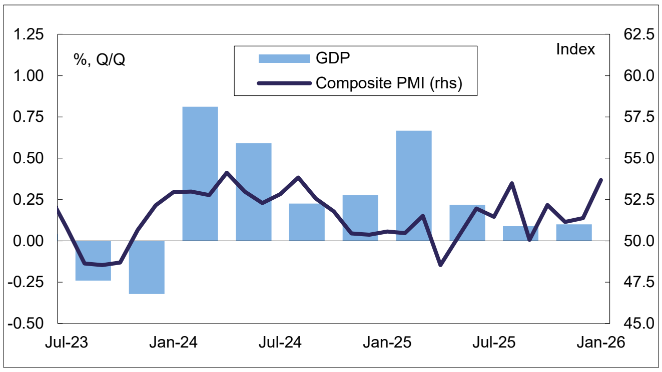
ECB aside, it will be a busy day for euro area economic data too. The highlights will be December's euro area retail sales and German manufacturing new orders. Despite the confirmation of a return to growth in Germany last quarter, euro retail sales are likely to have finished Q4 on a weak note. The available data from the member states suggests that volumes fell a little less than ½%M/M mostly owing to weakness in France (-1.4%M/M) and Spain (-0.9%M/M). Still, sales over the quarter are expected to have risen for a ninth consecutive quarter and at a similarly paced ¼%3M/3M. German factory orders are also likely to have picked up in Q4. But considering the boost from one-off large defence-related items, which led the 5.6%M/M increase in November, payback in December looks inevitable. Euro area construction PMIs will give an indication as to whether the German-led uptrend in the sector continued into the new year, while French industrial output data for December are also due.

Euro area member states: Composite PMIs



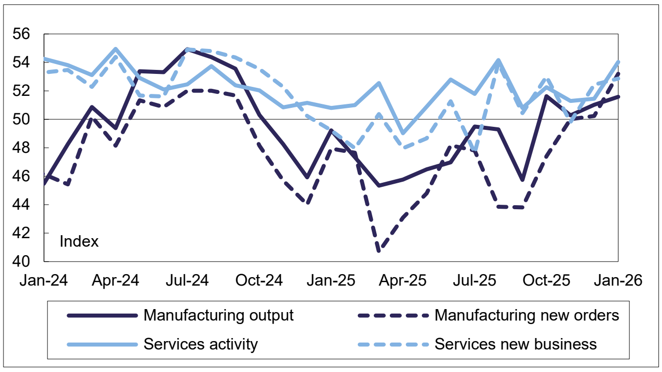
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite output PMI



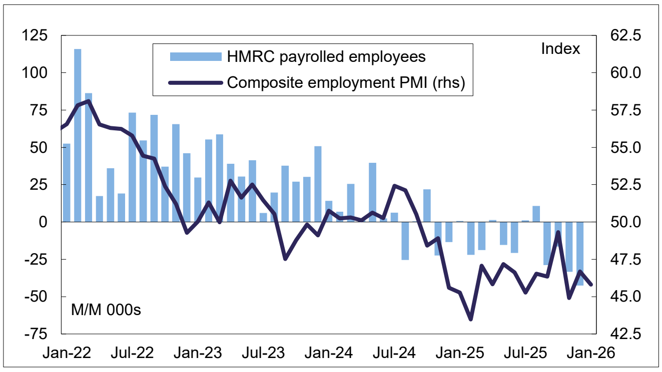
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing & services PMIs



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

UK: Payrolled employees & employment PMI



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

UK

UK services PMIs point to renewed growth and price momentum but also a weak job market

Today's final UK services activity PMI in January also brought a modest downwards revision from the flash release. But contrasting the euro area, the UK survey still signalled accelerated growth momentum in the sector at the start of the year, with the activity index rising 2.6pts from December to 54.0, a five-month high close to the long-run average. Respondents speculated that the further improvement in demand partly reflected waning Budget-related uncertainty, but there was also a recovery in new export sales. As such, firms in the sector were more upbeat about the coming 12 months than any time since October 2024. Taken together with greater optimism in manufacturing, the composite PMI rose 2.3pts in January to 53.7. This suggested the strongest economic growth since August 2024 and at a pace firmer than the long-run average. This might reflect the seasonal pattern of recent years when firm expansion at the start of the year was followed by a loss of momentum in the second half of the year. Nevertheless, we forecast GDP growth to accelerate to 0.3%Q/Q this quarter from 0.1%Q/Q in Q4, with a similar pace to be maintained over coming quarters too. Less positively, despite signs of economic recovery, today's survey flagged continued job-shedding at the start of the year. This was most acute in the services sector, as firms reportedly looked to increase automation and offset higher payroll costs. And while the composite input price PMI edged lower in January (down 0.7pt to 63.1) suggesting a welcome moderation in costs, firms seemingly attempted to protect profit margins through higher prices charged, for which the composite index rose to a five-month high.

The day ahead in the UK

The BoE's monetary policy announcement and updated macroeconomic projections will be the main point of order for UK markets on Thursday. After narrowly voting (5-4) to ease restrictiveness by a further 25bps in December, we see the MPC holding Bank Rate steady at 3.75%. Indeed, while softness in inflation, labour market and activity data, as well as clarity on fiscal policy, helped to frame a cut at that meeting, the MPC cautioned that 'judgements around further policy easing will become a closer call' as rates converged towards its range of estimates for neutral. The absence of continued weakness in activity data last month suggests that the policy statement will strike a similarly cautious tone, which we would interpret as an attempt to call time on the present quarterly cadence of rate cuts. Some MPC members have also re-emphasised concerns about the stubbornness of forward-looking pay indicators – for which the DMP survey, also due Thursday, will provide an update – which underscores our expectation for a larger 7-2 split in favour of a hold. On the other hand, the BoE's updated macroeconomic projections should bring about a material downwards revision to the near-term inflation outlook, which should allow the MPC to reaffirm that rates are likely to 'continue on a gradual downward path'. The most pronounced change to the inflation outlook is expected from Q2, principally to reflect the disinflationary impact of policy measures announced in November's Budget. Changes to the Bank's conditioning assumptions – such as the decline in commodity futures prices and the recent rise in Cable – are also likely to support a softer inflation outlook. As a result, the BoE should see inflation converging closer to target earlier than before, even if only sustainably at target in 12 months' time.

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary headline (core) HICP Y/Y%	Jan	**1.7 (2.2)**	*1.7 (2.3)*	1.9 (2.3)	2.0 -
	PPI Y/Y%	Dec	**-2.1**	-2.1	-1.7	-
	Final composite (services) PMI	Jan	**51.3 (51.6)**	*51.5 (51.9)*	51.5 (52.4)	-
Germany	Final composite (services) PMI	Jan	**52.1 (52.4)**	*52.5 (53.3)*	51.3 (52.7)	-
France	Final composite (services) PMI	Jan	**49.1 (48.4)**	*48.6 (47.9)*	50.0 (50.1)	-
Italy	Preliminary HICP (CPI) Y/Y%	Jan	**1.0 (1.0)**	0.8 (0.9)	1.2 (1.2)	-
	Composite (services) PMI	Jan	**51.4 (52.9)**	50.1 (51.3)	50.3 (51.5)	-
Spain	Composite (services) PMI	Jan	**52.9 (53.5)**	55.4 (56.8)	55.6 (57.1)	-
UK	Final composite (services) PMI	Jan	**53.7 (54.0)**	*53.9 (54.3)*	51.4 (51.4)	-

Auctions

Country	Auction
Germany	sold €3.197bn of 2.5% 2032 bonds at an average yield of 2.60%

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	Jan	-	47.4
		10.00	Retail sales M/M% (Y/Y%)	Dec	*-0.4 (1.5)*	0.2 (2.3)
		13.15	ECB Deposit (Refinancing) Rate %	Feb	*2.00 (2.15)*	2.00 (2.15)
Germany		07.00	Factory orders M/M% (Y/Y%)	Dec	-2.2 (1.2)	5.6 (10.5)
		08.30	Construction PMI	Jan	-	50.3
France		07.45	Industrial production M/M% (Y/Y%)	Dec	0.2 (2.3)	-0.1 (2.1)
		08.30	Construction PMI	Jan	-	43.4
Italy		08.30	Construction PMI	Jan	-	47.9
UK		09.00	New car registrations Y/Y%	Jan	-	3.9
		09.30	Construction PMI	Jan	42.0	40.1
		12.00	BoE Bank Rate %	Feb	*3.75*	3.75
		14.00	DMP 3M output price (1Y CPI) expectations Y/Y%	Jan	3.5 (3.2)	3.6 (3.2)

Auctions and events

Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde to hold post-Governing Council meeting press conference
France		09.50	Auction: to sell up to €13.5bn of 3.2% 2035, 3.5% 2035, 3.6% 2042 & 3% 2049 bonds
Spain		09.30	Auction: to sell 2.35% 2029, 3% 2033 & 3.2% 2035 bonds and 0.7% 2033 inflation-linked bonds
UK		12.00	BoE monetary policy announcement, summary and minutes, and Monetary Policy Report to be published
		12.30	BoE Governor Bailey to conduct post-MPC press conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research reports at:
https://www.uk.daiwacm.com/ficc-research/research-reports

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited ("DCME"). DCME is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange. DCME and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or derivatives or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of DCME and its affiliates may have positions and effect transactions in such the Securities or derivatives or options thereof and may serve as Directors of such issuers. DCME may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended only for investors who are professional clients as defined in MiFID II and should not be distributed to retail clients as defined in MiFID II. Should you enter into investment business with DCME's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

DCME has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory. Regulatory disclosures of investment banking relationships are available at https://daiwa3.bluematrix.com/sellside/Disclosures.action.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

IMPORTANT
This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Capital Markets Europe Limited retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.