

Euro wrap-up

Overview

- Euro area government bond yields made notable losses after German inflation data surprised significantly on the upside.
- Gilts also made losses as the UK manufacturing PMI suggested that the sector strengthened at the end of 2016.
- Wednesday will bring the flash estimate of euro area inflation in December along with the final euro area services PMIs, French consumer confidence indices and UK construction PMIs for the same month.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.775	+0.022
OBL 0 10/21	-0.516	+0.036
DBR 0 08/26	0.266	+0.081
UKT 1¼ 07/18	0.135	+0.119
UKT 3¼ 09/21	0.563	+0.102
UKT 1½ 07/26	1.330	+0.094

*Change from close as at 4.30pm GMT.
Source: Bloomberg

Euro area

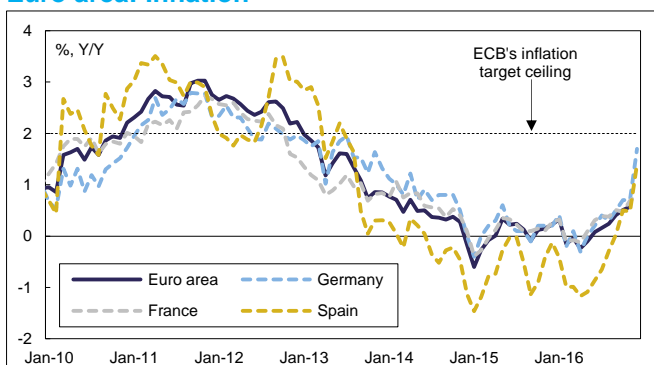
German inflation jumps most since introduction of the euro

After a relatively quiet festive period for economic data with no show-stopping new releases, today brought a notable upwards surprise from the flash estimate of German inflation in December. In particular, German CPI on the EU-harmonised measure jumped a much bigger-than-expected 1.0ppt – the largest one-month increase since the introduction of the single currency – to 1.7%Y/Y, the highest rate since mid-2013. The breakdown on the national methodology revealed that the increase in German inflation was driven principally by higher prices of food and energy, the latter contributing positively to headline CPI for the first time since the end of 2013. However, inflation of services also jumped, up 0.4ppt to a five-month high of 1.5%Y/Y. In contrast, the equivalent flash estimate of French inflation surprised slightly on the downside, rising just 0.1ppt on the EU methodology to 0.8%Y/Y, still nevertheless the highest since the first half of 2014. Like in Germany, the increase was driven by higher prices of food and energy, but services inflation slipped back while the pace of decline of manufactured goods accelerated, suggesting that French core inflation weakened at the end of the year. However, data released at the end of last week revealed an upside surprise in the Spanish figures, with the headline rate on the EU methodology rising 0.9ppt to 1.4%Y/Y, also a near-3½-year high. Therefore, overall, we expect the flash euro area figure due tomorrow similarly to beat earlier expectations by some margin – we now forecast euro area headline CPI to rise by up to 0.7ppt to 1.3%Y/Y with the core measure rising 0.2ppt to 1.0%Y/Y.

German labour market continues to tighten

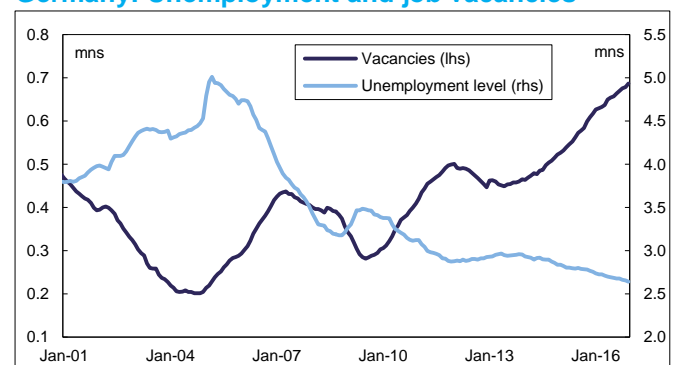
With the jump in euro area inflation at the end of 2016 seemingly driven principally by higher fuel and food prices, core inflation likely remained relatively subdued not least due to the significant amount of labour market slack that continues to bear down on wages in most member states. In Germany, however, the labour market is becoming increasingly tight, with the level of unemployment falling to a new post-reunification low in December. Indeed, the decline of 17k in unemployment was the largest since January 2016 taking the drop over the year to 115k, albeit leaving the jobless rate on the national measure unchanged at the series low of 6.0%. While the rate of employment growth moderated over the course of the year to just 0.7%Y/Y in November, down 0.5ppt from a year earlier, that still took the increase in the number of people in work to more than 300k compared to the same month in 2015, with the slowdown in jobs growth likely at least in part reflecting the impact of skill shortages. Indeed, the level of vacancies rose further in December to a new series high. And with surveys suggesting an acceleration in German economic growth in the final quarter of 2016 and the likelihood of a solid start to 2017, employers will need to respond to the tight labour market by increasing the average hours worked by existing employees, particularly part-time workers, and also by raising wages. Indeed, on 1 January, Germany's statutory minimum wage was increased by 4%, from €8.50 to €8.84 per hour. And we expect to see German wage growth rise steadily over coming quarters from

Euro area: Inflation*



*Flash estimates for December for Germany, France and Spain.
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Unemployment and job vacancies



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.



2.0%Y/Y at the whole-economy level and little more than 2½%Y/Y in the productive sector at the start of the fourth quarter. The associated increase in overall labour costs should contribute to a further modest increase in underlying inflation in Germany as the year progresses. Given persistent labour market slack elsewhere, however, we do not expect to see a similar pick up in wage pressures in any other member state.

The day ahead in the euro area and US

Wednesday brings the aforementioned flash estimate of euro area inflation in December, which we now expect to rise by up to 0.7ppt to 1.3%Y/Y, which would be the highest since August 2013. However, since the rise in the headline rate will have been driven principally by higher energy and food prices, the flash estimate of core CPI is likely to post a smaller rise of 0.2ppt, to 1.0%Y/Y, having remained unchanged for the preceding four months. Also due on Wednesday are the final services and composite PMIs. The flash euro area services PMI fell 0.7pt on the month to 53.1 due not least to a drop of more than 1pt in the German index. Nevertheless, after the euro area manufacturing PMI was yesterday confirmed at its flash estimate of 54.9 with increases in the respective indices from each of the five largest member states, the final euro area composite PMI looks set to be confirmed close to the flash estimate of 53.9, which matched November's 2016 high. Finally, the French INSEE consumer confidence survey for December is also scheduled for release on Wednesday.

In the US, the focus on Wednesday will be the release of the minutes of the Fed's December policy meeting, when the FOMC raised the target range for the fed funds rate. December vehicle sales figures are also due for release.

UK

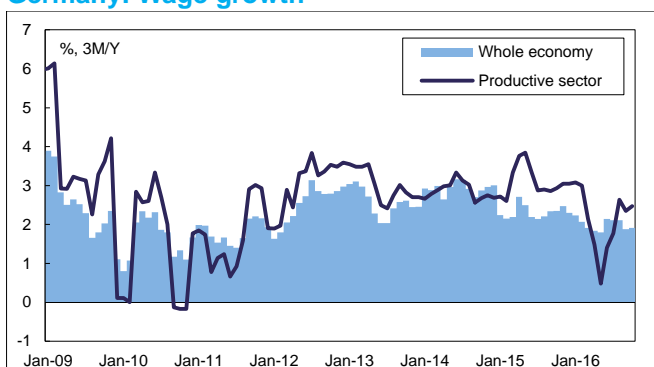
Manufacturers ended 2016 in buoyant mood

While the consensus among most economists, including ourselves, is that UK GDP growth will ease in 2017 as Brexit uncertainty increases with the anticipated triggering of Article 50 in March and as higher inflation puts downward pressure on real earnings growth, today's upward surprise to the manufacturing PMI suggested that growth in this sector held up well in the second half of 2016. The headline index rose by 2.5pts in December to a two-and-a-half year high of 56.1, while the major survey components – the output and new orders indices – posted even larger increases to 58.8 and 58.5, with the latter reflecting strength in both domestic and foreign demand. Overall, the average manufacturing PMI for Q4 is consistent with manufacturing output growth of around 0.6%Q/Q in Q4, which would represent a turnaround from Q3, which saw output falling by 0.8%Q/Q. But the PMI survey was not an accurate guide to manufacturing output growth in the third quarter. And having got off to a poor start in Q4 with output falling 0.9%M/M in October, it remains to be seen whether the manufacturing sector will provide support to GDP growth in Q4.

The day ahead in the UK

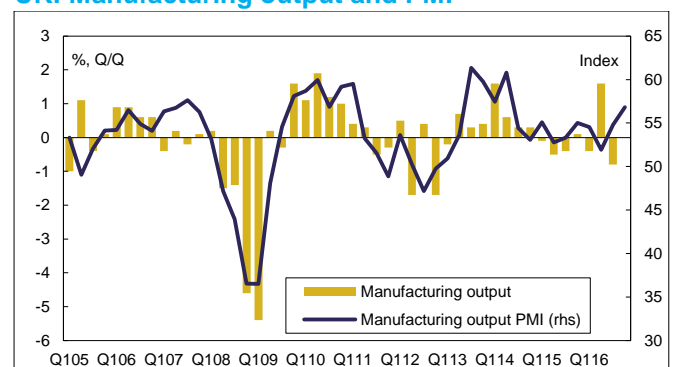
Wednesday brings the December construction PMI, which is expected to have been little changed from November's 52.8. Meanwhile, the BoE's lending figures for November, also out tomorrow, are likely to show that mortgage approvals were broadly unchanged, having increased rapidly in the previous two months, while consumer credit growth also seems likely to have continued growing firmly.

Germany: Wage growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output and PMI







Source: Thomson Reuters, Markit 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
Germany	 Unemployment change '000s (rate %)	Dec	-17 (6.0)	-5 (6.0)	-5 (6.0)	-6 (-)
	 Preliminary EU-harmonised CPI Y/Y%	Dec	1.7	1.1	0.7	-
France	 Preliminary EU-harmonised CPI Y/Y%	Dec	0.8	0.9	0.7	-
UK	 Manufacturing PMI	Dec	56.1	53.6	53.4	53.6

Auction

- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
EMU	09:00	Final services PMI (final composite PMI)	Dec	53.1 (53.9)	53.8 (53.9)
	10:00	Flash CPI estimate Y/Y%	Dec	<u>1.3</u>	0.6
	10:00	Flash core CPI estimate Y/Y%	Dec	<u>1.0</u>	0.8
Germany	08:55	Final services PMI (final composite PMI)	Dec	53.8 (54.8)	55.1 (55.0)
France	07:45	Consumer confidence survey	Dec	99	98
	08:50	Final services PMI (final composite PMI)	Dec	52.6 (52.8)	51.6 (51.4)
Italy	08:45	Services PMI (composite PMI)	Dec	52.6 (53.0)	53.3 (53.4)
	10:00	Preliminary EU-harmonised CPI Y/Y%	Dec	0.3	0.1
Spain	08:15	Services PMI (composite PMI)	Dec	54.7 (55.0)	55.1 (55.2)
	08:00	Unemployment M/M '000s	Dec	-50.0	24.8
UK	00:01	BRC shop price index Y/Y%	Dec	-	-1.7
	09:30	Construction PMI	Dec	52.6	52.8
	09:30	Mortgage approvals '000s	Nov	68.9	67.5
	09:30	Net consumer credit (net lending secured on dwellings) £bn	Nov	1.6 (3.3)	1.6 (3.3)

Auctions and events






Country	GMT	Auction / Event
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- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Final manufacturing PMI	Dec	54.9	54.9	53.7	-
Germany	 Final manufacturing PMI	Dec	55.6	55.5	54.3	-
France	 Final manufacturing PMI	Dec	53.5	53.5	51.7	-
Italy	 Manufacturing PMI	Dec	53.2	52.3	52.2	-
Spain	 Manufacturing PMI	Dec	55.3	54.6	54.5	-

Auctions

Country	Auction
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- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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