# Euro wrap-up

## Overview

- Bunds were little changed as euro area inflation rose to its highest in more than three years while the PMIs signalled firmer euro area economic growth momentum at the end of 2016.
- Gilts were little changed as UK data showed continued strong lending growth to individuals and a firming of activity in the construction sector.
- Thursday will bring the UK services and composite PMIs for December.

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**Daily bond market movements**

| Bond | Yield | Change* |
|---|---|---|
| BKO 0 12/18 | -0.778 | -0.002 |
| OBL 0 10/21 | -0.516 | -0.002 |
| DBR 0 08/26 | 0.276 | +0.013 |
| UKT 1¼ 07/18 | 0.151 | +0.015 |
| UKT 3¾ 09/21 | 0.561 | -0.004 |
| UKT 1½ 07/26 | 1.337 | +0.007 |

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

# Euro area

### Inflation jumps to a 3½-year high

After yesterday's strong German inflation data (headline CPI up 1ppt to 1.7%Y/Y), today's flash estimate of euro area CPI in December was always bound to show a significant rise. In the event, the 0.5ppt increase in the headline rate to 1.1%Y/Y, the highest since August 2013, was a touch less than might have been expected, but nevertheless still represented the biggest single-month jump since 2010. The increase was driven principally by higher prices of energy (up 2.5%Y/Y to make a positive contribution to overall inflation for the first time in more than two years) and food (1.2%Y/Y). But, although inflation of non-energy goods was unchanged from November (0.3%Y/Y), services inflation rose to a fourteen-month high (1.2%Y/Y) taking the flash estimate of core CPI up 0.1ppt to 0.9%Y/Y having remained stable over the preceding four months.

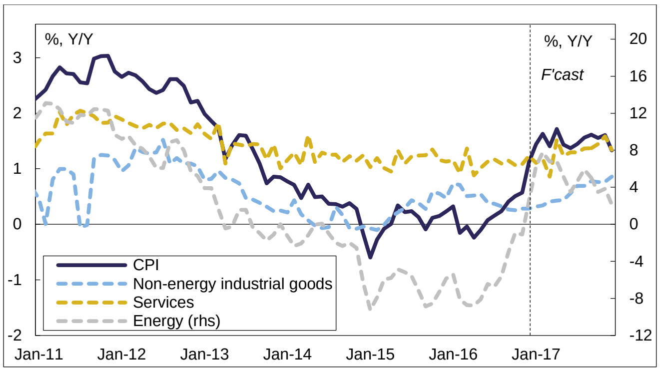
### Inflation to take a further step up in Q117

The uptick in core inflation in December certainly does not yet represent the *sustained* upwards trend that the ECB is seeking to achieve. And given the limited detail published so far, it is also too soon to tell whether it will merely represent a temporary seasonal blip. Indeed, while there appear good reasons to expect underlying price pressures to emerge from Germany's tight labour market and buoyant property market, for now that country looks to be the exception within the euro area, with rising inflation in other member states set to remain reliant on the upwards shift in energy prices. Nevertheless, with the oil price close to $55pb and the euro currently hovering close to $1.04, we expect euro area headline CPI to take a further step up to average about 1½%Y/Y in the current quarter and to continue to oscillate around 1½%Y/Y over the remainder of the year. We expect euro area core CPI, however, to remain more subdued with an average rate close to 1%Y/Y in 2017. Given the country's more advanced cyclical position, we forecast German headline CPI in the coming year to be consistent with the ECB's target of below but close to 2%Y/Y, with core inflation averaging close to 1½%Y/Y too.

### Composite PMI at 5½-year high signals firm end to 2016

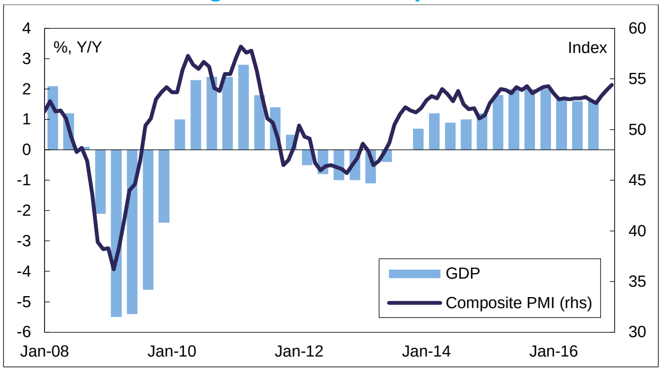
All recent economic surveys have signalled an encouraging pickup in growth momentum in the euro area at the end of 2016 and today's final services and composite PMIs for December were no exception. Most notably, an upwards revision of 0.5pt from the flash estimate took the euro area composite PMI to 54.4, the highest since May 2011. That left the Q4 average at 53.9, a significant step up from Q3 and the highest in one year, suggesting euro area GDP growth of 0.4%Q/Q in the final quarter of 2016. At the country level, the PMIs pointed to a widespread improvement. Certainly, Germany looks bound to have seen a marked acceleration at the end of the year and an upwards revision to the country's composite PMI in December took the Q4 average to a ten-quarter high. Similarly, the equivalent French index was upwardly revised to leave the Q4 average at a six-quarter high consistent with a stronger pace of expansion. More surprisingly given the heightened political uncertainty

**Euro area: CPI inflation**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

**Euro area: GDP growth and composite PMI**




*Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

associated with Renzi's failed referendum and resignation, the Italian composite PMI was also consistent with firmer growth, rising in Q4 to its highest since the first quarter of 2016. And Spain's headline index rose to a six-month high in December to leave the Q4 average well above that in Q3 suggesting that the country will continue to provide the euro area's most vigorous pace of expansion. Moreover, the increased momentum appears to have been relatively widespread at the sectoral level – after the euro area manufacturing PMI was confirmed at the start of the week at a more than five-year high, today brought a sizeable upwards revision to the headline services index to leave the Q4 average at the highest in one year. With firms also signalling a pickup in new orders towards the end of the year, prospects look good for continued domestic demand-led growth at the start of 2017.

### The day ahead in the euro area and US

Thursday is set to be relatively quiet for economic data from the euro area with November producer price figures perhaps most notable. In the markets, France and Spain will sell a range of bonds. In the US, ahead of Friday's payrolls data, tomorrow will bring the ADP and Challenger employment reports as well as the latest weekly claims numbers and the December ISM non-manufacturing survey.

## UK

### Lending to individual remains firm

The lack of any disruption in the flow of credit in the wake of the EU referendum, helped by the actions the BoE took to make banks' funding costs cheaper, supported economic momentum in the UK in the second half of 2016. And the BoE figures released today confirmed that most lending indicators remained strong in November. The stock of mortgage lending continued to grow at a pace above 3%Y/Y, with both gross new lending and refinancing remaining close to the previous month's readings. And having risen at a rapid pace in the prior two months, the number of approved mortgages for house purchase increased only slightly in November, to 67.5k, the highest level since March. Meanwhile, given that consumer spending indicators were particularly strong in recent months, there was no surprise that consumer credit growth accelerated further, hitting 10.8%Y/Y, a pace not seen since 2005. Overall, lending flows look set to continue supporting consumer spending, but with real earnings growth set to fall, consumers may well decide to be more cautious about how much debt they take on.

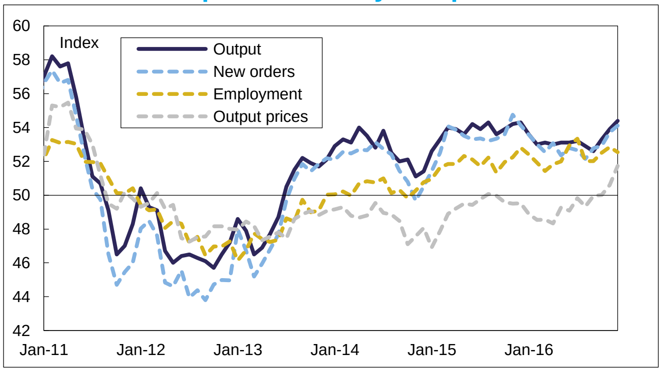
### Construction PMI signalled a year-end improvement

Yesterday's manufacturing PMI signaled a sharp improvement in manufacturing activity at the end of the year and today's construction PMI suggested that the mood in the construction sector was also upbeat. The headline construction PMI rose by 1.4pts in December to 54.2, a level last seen in March. The improvement in conditions in the sector appears to be widespread, with solid gains in the respective PMIs for housing and commercial activity, and a particularly large gain in the civil engineering activity index. And the new orders index, a forward-looking component, suggested that momentum at the start of the 2017 should pick up further.

### Price pressures hit the High Street

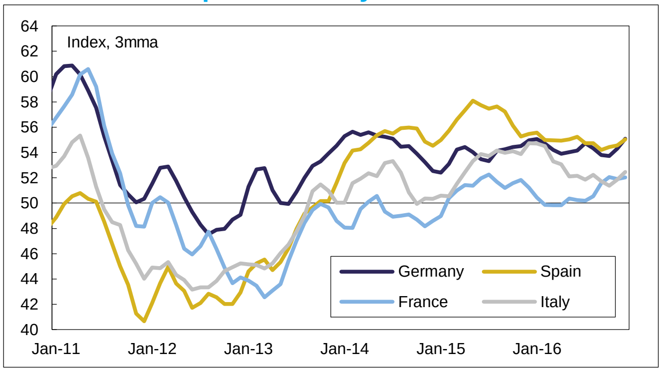
The BRC Shop Price index for December added to the stock of evidence that inflationary pressures are on the rise in the UK. Of course, as far as the UK High Street is concerned, these pressures are emerging against a backdrop of significant downwards pressure on prices associated not least from intense competition. So, while the BRC survey showed that High Street inflation hit a sixteen-month high, the headline figure remained firmly in negative territory at -1.4%Y/Y, albeit with both food and non-food items reporting a smaller fall in prices than in the previous month. Of course, the sudden shift in price pressures is being principally driven by the weaker currency. While sterling recovered a little lost ground towards the end of last year, with energy prices up and the trade-weighted exchange rate remaining more than 12% lower than the level seen

**Euro area: Composite PMIs by component**




*Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

**Euro area: Composite PMI by member state**



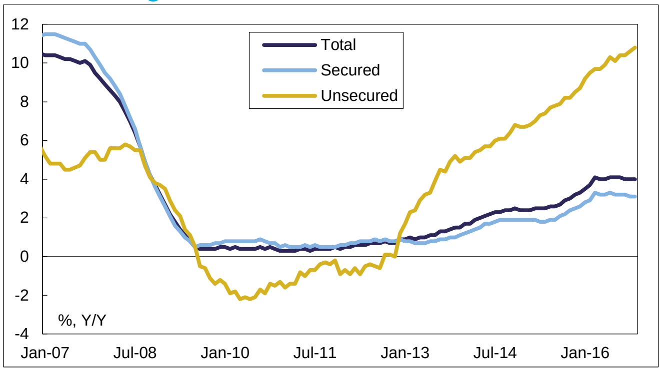

*Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

before the referendum, we expect headline CPI inflation to rise rapidly over the course of this year to about 3%Y/Y by year-end.

## The day ahead in the UK

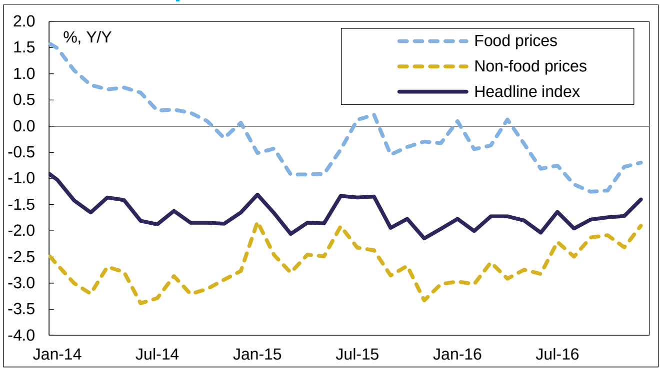
The flow of December PMIs continues tomorrow with the services survey. Following the upward surprises to the headline manufacturing and construction indices, the services PMI is also expected to rise, from 55.2 in November. This might well take the composite PMI to its highest level in 2016, above 56, which would suggest firm economic growth at the end of the year.

### UK: Lending to individuals




*Source: BoE and Daiwa Capital Markets Europe Ltd.*

### UK: BRC Shop Price Index




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd*

# European calendar

**Today's results**

**Economic data**

| Country | Release | Period | Actual | Market consensus/ *Daiwa forecast* | Previous | Revised |
|---|---|---|---|---|---|---|
| EMU | Final services PMI (final composite PMI) | Dec | **53.7 (54.4)** | 53.1 (53.9) | 53.8 (53.9) | - |
| | Flash CPI estimate Y/Y% | Dec | **1.1** | *1.0* | 0.6 | - |
| | Flash core CPI estimate Y/Y% | Dec | **0.9** | *0.8* | 0.8 | - |
| Germany | Final services PMI (final composite PMI) | Dec | **54.3 (55.2)** | 53.8 (54.8) | 55.1 (55.0) | - |
| France | Consumer confidence survey | Dec | **99** | 99 | 98 | **99** |
| | Final services PMI (final composite PMI) | Dec | **52.9 (53.1)** | 52.6 (52.8) | 51.6 (51.4) | - |
| Italy | Services PMI (composite PMI) | Dec | **52.3 (52.9)** | 52.6 (53.0) | 53.3 (53.4) | - |
| Spain | Services PMI (composite PMI) | Dec | **55.0 (55.5)** | 54.7 (55.0) | 55.1 (55.2) | - |
| | Unemployment M/M '000s | Dec | **-86.8** | -50.0 | 24. 8 | - |
| UK | BRC Shop Price index Y/Y% | Dec | **-1.4** | - | -1.7 | - |
| | Construction PMI | Dec | **54.2** | 52.5 | 52.8 | - |
| | Mortgage approvals `000s | Nov | **67.5** | 68.5 | 67.5 | **67.4** |
| | Net consumer credit (net lending secured on dwellings) £bn | Nov | **1.9 (3.2)** | 1.6 (3.3) | 1.6 (3.3) | **1.7 (3.2)** |

| Country | Auction |
|---|---|
| | - Nothing to report - |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Tomorrow's data releases

**Economic data**

| Country | | GMT | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|---|
| UK | | 09:00 | New car registrations Y/Y% | Dec | - | 2.9 |
| | | 09:30 | Services PMI (composite PMI) | Dec | 54.7 (55.0) | 55.2 (55.2) |

**Auctions and events**

| Country | | GMT | Auction / Event |
|---|---|---|---|
| Spain | | 09:30 | Auction: To sell 0.75% 2021 bonds (30-Jul-2021) |
| | | 09:30 | Auction: To sell 1% 2030 index-linked bonds (30-Nov-2030) |
| | | 09:30 | Auction: To sell 1.3% 2026 bonds (31-Oct-2026) |
| | | 09:30 | Auction: To sell 2.9% 2046 bonds (31-Oct-2046) |
| France | | 13.50 | Auction: To sell 0.25% 2026 bonds (25-Nov-2026) |
| | | 13.50 | Auction: To sell 1.25% 2036 bonds (25-May-2036) |
| | | 13.50 | Auction: To sell 3.25% 2045 bonds (25-May-2045) |
| | | 13.50 | Auction: To sell 1.75% 2066 bonds (25-May-2066) |
| UK | | 10:30 | Auction: To sell £2.25bn of 1.75% 2037 bonds (07-Sep-2037) |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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