Euro wrap-up

Overview

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- Ahead of tomorrow's ECB announcement, Bunds made modest losses as euro area inflation was confirmed at a more than 3-year high.
- Gilts were also a touch weaker as the latest UK wage growth picked up ahead of expectations.
- The conclusion of the ECB's latest Governing Council meeting is expected to see policy left unchanged, while Draghi will likely maintain a relatively dovish tone.

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.717	+0.019
OBL 0 10/21	-0.471	+0.023
DBR 0¼ 08/27	0.350	+0.028
UKT 1¼ 07/18	0.181	+0.007
UKT 3¾ 09/21	0.556	+0.017
UKT 1½ 07/26	1.331	+0.023

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

Euro area

Euro area inflation confirmed at more than 3-year high

When the ECB's Governing Council meets tomorrow, policy makers should be somewhat encouraged by the improvement in economic conditions since they last met. Certainly, activity data and surveys have pointed to an acceleration in euro area GDP growth in Q416, with this positive momentum likely maintained into the New Year too. And December's inflation figures were also more positive, with today's final reading of euro area CPI confirming that the headline rate rose to 1.1%Y/Y, the highest since September 2013. Indeed, at 1.14% to two decimal places, the headline rate was within a whisker of being upwardly revised. The increase was driven principally by higher prices of energy (up 2.6%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 for the fifth consecutive month (0.3%Y/Y), services inflation rose to a nine-month high (1.3%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.

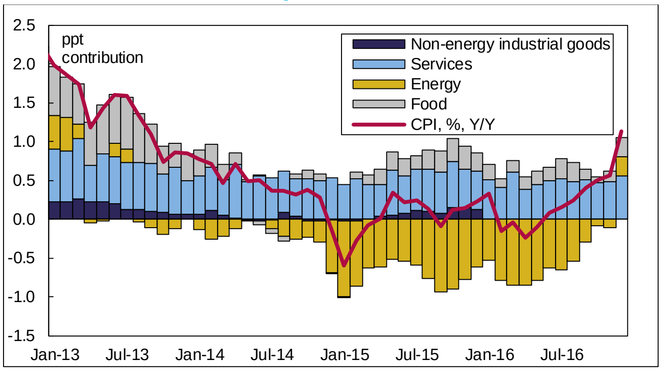
German inflation set to outpace the euro area average

Within the country breakdown, headline inflation has now returned to positive territory in all member states with the exception of Ireland. And, perhaps unsurprisingly, Germany is providing the most significant inflationary impulse. Indeed, the final data confirmed that German inflation rose 1ppt to 1.7%Y/Y, a 3½-year high, with the core rate up 0.4ppt to 1.5%Y/Y, the firmest since April 2014. While it remains to be seen whether some of this pickup will be reversed in January, given the country's more advanced cyclical position we expect German inflation in the coming year to be consistent with the ECB's target of below but close to 2%Y/Y. However, while we forecast headline CPI in the euro area to take a further step up to average about 1½%Y/Y in the current quarter and – in the absence of shocks – to continue to oscillate around 1½%Y/Y over the remainder of the year, given the lack of underlying price pressures, core CPI will likely remain more subdued with an average rate closer to 1%Y/Y in 2017.

Euro area construction output continues to rise gradually

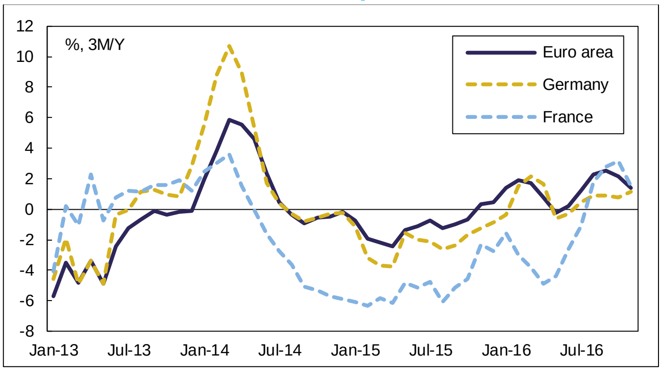
Today also brought the release of euro area construction output figures for November, which continued to signal that that sector provided ongoing support to the recovery in the fourth quarter of last year, albeit at a more moderate pace than of late. In particular, total construction activity rose for the sixth month out of the past seven and by 0.4%M/M to its highest level since January. There was a further modest increase in building works (0.4%M/M), while civil engineering (1.0%M/M) broadly reversed the decline in October. But while construction output continued to post a modest increase on a three-month basis,

Euro area: Consumer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

growth of just 0.2% was down from 1.4% in September. Once again, construction work in Germany remained robust in November, rising for the second successive month and by 1½%M/M, but this was partially offset by a drop in France (-0.2%M/M) and Spain (-0.8%M/M), albeit the former followed a notable increase in October. Moreover, with construction firms in December reporting overall conditions to have been at their most favourable since mid-2008, output from the sector is likely to have continued to trend higher at the end of 2016.

The day ahead in the euro area and US

Tomorrow will bring the main event of the week in the euro area, with the conclusion of the ECB's latest Governing Council meeting. But despite the recent notable improvement in the economic data, this seems bound to be a non-event. Indeed, policy was effectively pre-set for 2017 at December's meeting, with the Council committing to an extension of its asset purchase programme through to the end of the year, albeit at a reduced monthly pace from April. And with no new staff economic forecasts available, ECB President Mario Draghi might well continue to adopt a relatively dovish tone during his press conference. In due course, however, as a sign that the debate surrounding its monetary policy has started to shift, the ECB might well decide to amend its forward guidance, retracting its signal that its policy rates might be cut further. But this is highly likely to come no sooner than the Governing Council's March meeting, when updated economic forecasts will be available.

Data-wise, Thursday will also bring the latest euro area balance of payments figures for November, which are likely to report an improvement in the current account surplus on the back of the higher goods trade balance that month. In the US, meanwhile, tomorrow sees the release of December housing starts figures as well as the Philly Fed index for January. Supply-wise, France and Spain will sell bonds with various maturities, while the US Treasury will auction 10Y TIPS.

UK

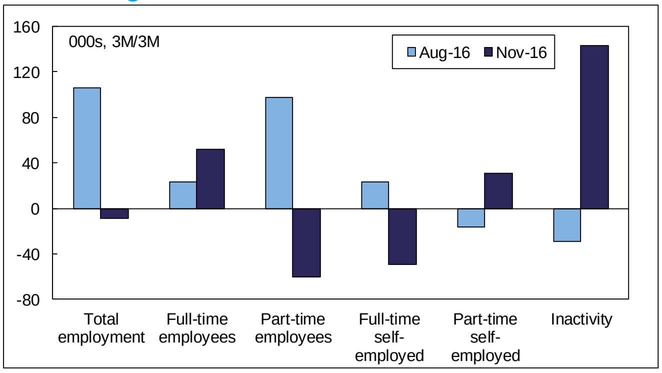
Labour market is set to weaken in 2017

The headline figures from today's UK labour market release were, on the whole, stronger than expected. Headline three-month employment growth in November came in above expectations, but the level still fell by 9k3M/3M, only slightly above the October rate of decline. But that hid the 546k rise on the month in November, the third largest since records began in 1992. It did, however, follow notable falls of 144k and 282k in the previous two months. And while the breakdown by employment type showed an increase in the level of full-time jobs and a fall in part-time jobs in the three months to November, the equivalent figures for the self-employed showed the opposite, pointing to a rise in underemployment among the self-employed. Meanwhile, the headline unemployment rate remained at 4.8%, the lowest level since 2005, while the number of unemployed fell by 52k3M/3M. But there was also a significant increase in inactivity, which gained 143k3M/3M, representing the steepest rise in more than two years. There were also small falls in average weekly hours worked and the level of vacancies compared to three months ago. Meanwhile, news on wages was mostly positive, with the headline rate ticking up by 0.2ppt to 2.8%3M/Y, a pace not seen in over a year. But with inflation rising more sharply, this still means a squeeze on real income growth, which we expect will be for a key driver of lower GDP growth this year.

The day ahead in the UK

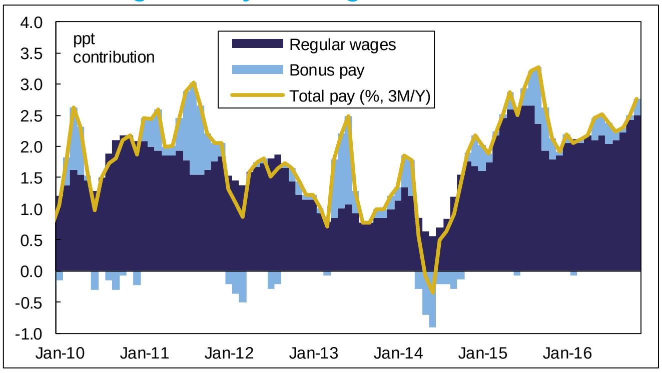
Tomorrow's RICS Residential Market survey is set to signal that house prices rose at a steady pace at the end of 2016, with an unchanged net balance of 30% of respondents expected to have reported an increase.

UK: Changes in the labour market indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Average weekly earnings



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		Construction output M/M% (Y/Y%)	Nov	**0.4 (0.0)**	-	0.8 (2.2)	**0.4 (1.8)**
		Final CPI (core CPI) Y/Y%	Dec	**1.1 (0.9)**	*1.1 (0.9)*	0.6 (0.8)	**-**
Germany		Final EU-harmonised CPI Y/Y%	Dec	**1.7**	*1.7*	0.7	**-**
UK		Average earnings incl. bonuses (excl. bonuses) 3M/Y%	Nov	**2.8 (2.7)**	*2.7 (2.7)*	2.5 (2.6)	**2.6 (-)**
		ILO unemployment rate 3M%	Nov	**4.8**	*4.8*	4.8	**-**
		Employment change 3M/3M '000s	Nov	**-9**	*-120*	-6	**-**
		Claimant count rate % (change 000s)	Dec	**2.3 (-10.1)**	2.3 (5.0)	2.3 (2.4)	**- (1.3)**
Country		**Auction**					
UK sold		£2.75bn of 0.5% 2022 bonds (22-Jan-2022) at an average yield of 0.785%					
		BoE APF operation purchased £1bn of 7-15Y Gilts (3.01 cover ratio)					

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

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09:00	Current account balance €bn	Nov	-	28.4
		12:45	ECB refinancing rate %	Jan	*0.00*	0.00
		12:45	ECB deposit rate %	Jan	*-0.40*	-0.40
Italy		09:30	Current account balance €bn	Nov	-	6.1
Spain		09:00	Trade balance €bn	Nov	-	-1.8
UK		00:01	RICS house price balance %	Dec	30	30
		15:00	BoE corporate bond purchases £bn	Weekly	-	4.91

Auctions and events

Country		GMT	Auction / Event
France		09:50	Auction: To sell 0% 2020 bonds (25-Feb-2020)
		09:50	Auction: To sell 0% 2022 bonds (25-May-2022)
		10:50	Auction: To sell 0.1% 2021 index-linked bonds (25-Jul-2021)
		10:50	Auction: To sell 1.85% 2027 index-linked bonds (25-Jul-2027)
		10:50	Auction: To sell 0.1% 2047 index-linked bonds (25-Jul-2047)
Spain		09:30	Auction: To sell 0.25% 2019 bonds (31-Jan-2019)
		09:30	Auction: To sell 0.4% 2022 bonds (30-Apr-2022)
		09:30	Auction: To sell 4.4% 2023 bonds (31-Oct-2023)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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