Euro wrap-up

Overview

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- Bunds followed USTs lower at the longer end of the curve despite weaker-than-expected Q4 GDP data from the euro area, Germany and Italy.
- Gilts also made modest losses at the long end but outperformed as UK inflation data surprised on the downside.
- Wednesday brings euro area trade data and the latest UK labour market report.

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.800	-0.003
OBL 0 04/22	-0.420	+0.011
DBR 0¼ 02/27	0.366	+0.034
UKT 1¼ 07/18	0.116	-0.002
UKT 3¾ 09/21	0.510	+0.006
UKT 1½ 07/26	1.310	+0.017

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

Euro area

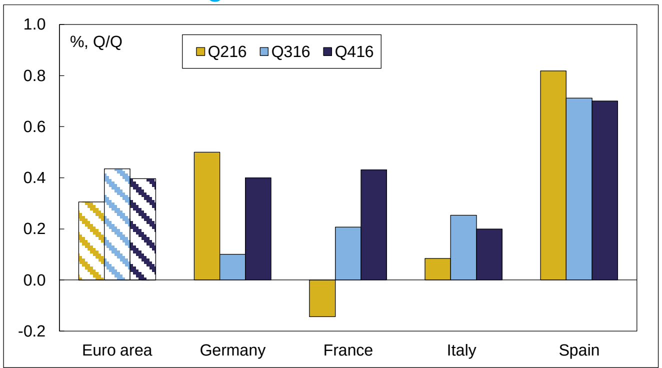
Euro area GDP growth revised down

Today's GDP data for Q416 were disappointing, with a downwards revision made to the estimate of euro area growth and the preliminary estimates for Germany and Italy also coming in weaker than expected. Most notably, euro area GDP growth was revised down by 0.1ppt to 0.4%Q/Q, matching the reading for Q3 and thus confounding the signals from economic surveys which had suggested acceleration towards year-end. Indeed, on an annual basis, GDP growth slowed by 0.1ppt to 1.7%Y/Y, matching the full-year figure for 2016 and leaving the overall picture to be one of steady rather than strengthening expansion. The downwards revision to Q4 GDP did not come out of the blue – national industrial production figures released last week showed a marked weakening in December and the equivalent euro area data released today confirmed a drop of 1.6%M/M, the biggest since 2012. That decline, however, looks highly likely to be reversed in the New Year, and euro area industrial production still rose 0.8%Q/Q in the fourth quarter, up from 0.5%Q/Q in Q3. Moreover, although there was no full expenditure breakdown of GDP released today, the national data strongly suggest that domestic demand was the principal driver – with private consumption and investment, as well as government spending, likely making a positive contribution – which should help to ensure that the economic recovery will be sustained over the near term. Indeed, economic surveys, such as the ZEW investor sentiment indices released today as well as the more reliable Commission economic sentiment indices and PMIs, point to euro area GDP growth being maintained at a similar pace of 0.4%Q/Q in Q117. And given heightened political risks affecting the economic outlook, that growth rate is arguably not to be sniffed at.

German and Italian GDP data miss expectations

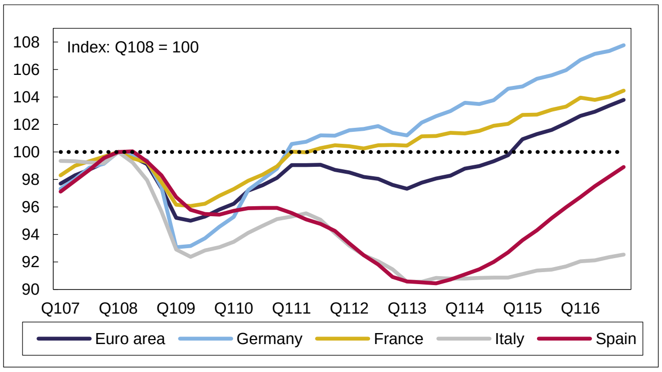
While the first estimate of German GDP in Q4 came in a touch softer than expected, it was nevertheless consistent with stronger momentum towards year-end, with growth picking up to 0.4%Q/Q from a downwardly revised 0.1%Q/Q the previous quarter. No expenditure breakdown was provided, although the authorities asserted that growth in the final quarter was driven principally by domestic demand, with strong government spending growth accompanied by increased construction investment. Despite elevated consumer confidence and further declines in unemployment to new post-reunification lows, however, reportedly there was only a slight gain in private consumption. In addition, with growth of imports outpacing that of exports, net trade appears to have subtracted from German GDP growth for the second successive quarter. Italian GDP growth also disappointed, slowing to 0.2%Q/Q in Q4 from 0.3%Q/Q previously. Once again, there was no expenditure breakdown, although the statistical institute stated that growth had been boosted by inventories while net trade subtracted, suggesting that final domestic demand had been largely flat. The annual rates of growth were unchanged in Q416 in both Germany and Italy, at 1.7%Y/Y and 1.1%Y/Y respectively. And surveys suggest that we are likely to see little change to momentum in either country in the first quarter of 2017 too.

Euro area: GDP growth



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

Euro area: GDP levels



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

The day ahead in the euro area and US

Wednesday will bring euro area goods trade data for December along with the final estimate of Spanish inflation for January. In particular, following the weaker German export figures released last week, we expect to see the euro area trade surplus narrow from November's reading of €22.7bn to below €22bn, the average of the previous six months. Meanwhile, just as today we saw the equivalent measure of German inflation confirmed at the flash estimate of 1.9%Y/Y, Spanish CPI on the EU-harmonised measure is expected to be confirmed at the preliminary estimate of 3.0%Y/Y, up 1.6ppt from December and the highest rate since end-2012.

In the US tomorrow, Fed Chair Yellen will repeat her semi-annual monetary policy testimony before the House Financial Services Committee. Data-wise, Wednesday brings the most noteworthy US releases of the week with CPI inflation, industrial production and retail sales figures for January due. Given higher energy prices, consumer prices are expected to have risen for the sixth consecutive month at the start of 2017 to take the year-on-year rate to a near-five-year high of 2.4%Y/Y. Meanwhile, manufacturing production and retail sales (excluding autos) are forecast to have edged slightly higher in January.

UK

Inflation rose less than expected

Today's CPI inflation figures surprised on the downside, with the headline rate for January coming in at 1.8%Y/Y, up 0.2ppt from December but 0.1ppt lower than expected. The increase on the month was driven by food and energy prices. Indeed, food inflation rose above zero for the first time in two years, while energy inflation jumped from 4.3%Y/Y to 7.5%Y/Y, the highest since April 2012. In contrast, core CPI remained unchanged, at 1.6%Y/Y, mainly thanks to a downward contribution from clothing and footwear prices, as a higher proportion of items were discounted during the January sales this year than last, suggesting that some retailers in that sector might be struggling to pass on rising costs to consumers. Nevertheless, with today's PPI data showing that input prices increased by more than 20%Y/Y, we expect CPI to rise to the BoE's target of 2%Y/Y in February and to continue to rise over coming months.

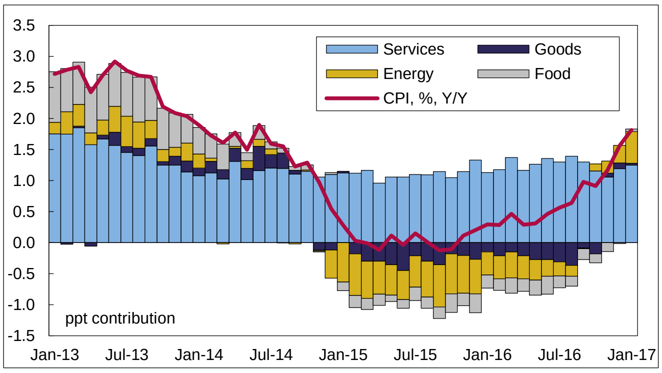
Housing market maintained momentum in December

While there has been an increasing number of reports suggesting a significant downward adjustment in prices in prime London areas, today's ONS/Land Registry house price index suggested that overall price momentum in the UK housing market is much firmer than some observers might have hoped or feared. The data showed that average price growth accelerated at the end of the last year from 6.1%Y/Y to 7.2%Y/Y, the highest rate since July, with all major regions including the capital reporting higher annual rates. However, while prices continued to rise, market activity remained low due not least to the effects of last year's changes to Stamp Duty taxes and a lack of new properties coming onto the market. For example, in October – the most recent month with reliable data – the level of transactions in England was almost 35% lower than a year earlier, while the other Home Nations saw declines of 15% or more. Looking forward, despite limited new supply and the likely continued low level of turnover, house price growth looks set to moderate this year as lower real income growth and Brexit risks deter potential buyers.

The day ahead in the UK

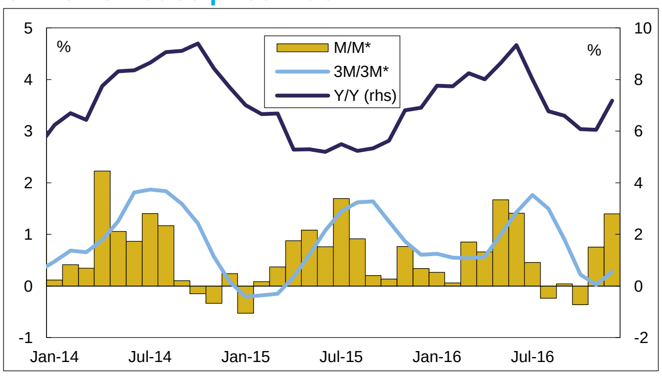
All eyes in the UK tomorrow will be on the latest labour market figures. However, we suspect that these will not be very exciting, with the headline unemployment rate expected to have remained unchanged at 4.8% and earnings growth expected to have remained steady at 2.8%3M/Y. And although the headline three-month employment growth rate seems likely to have risen slightly, the one-month change in December is likely to have been negative following a strong previous month. And, overall, while the labour market will need to be closely watched over coming months, these latest figures seem unlikely to shift the BoE's judgement on the outlook for growth and inflation just yet.

UK: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: ONS house price index



**Seasonally adjusted.*
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	Industrial production M/M% (Y/Y%)	Dec	**-1.6 (2.0)**	-1.5 (1.7)	1.5 (3.2)	**-**
	ZEW expectations balance	Feb	**17.1**	-	23.2	**-**
	GDP – second release Q/Q% (Y/Y%)	Q4	**0.4 (1.7)**	*0.5 (1.8)*	0.4 (1.8)	**-**
Germany	GDP – first release Q/Q% (Y/Y%)	Q4	**0.4 (1.7)**	*0.5 (1.8)*	0.2 (1.7)	**0.1 (-)**
	Final EU-harmonised CPI Y/Y%	Jan	**1.9**	1.9	1.7	**-**
	ZEW current assessment balance (expectations)	Feb	**76.4 (10.4)**	77.0 (15.0)	77.3 (16.6)	**-**
Italy	GDP – preliminary release Q/Q% (Y/Y%)	Q4	**0.2 (1.1)**	*0.3 (1.0)*	0.3 (1.0)	**- (1.1)**
UK	PPI input (output) price inflation Y/Y%	Jan	**20.5 (3.5)**	18.5 (3.2)	15.8 (2.7)	**17.0 (2.8)**
	CPI (core CPI) inflation Y/Y%	Jan	**1.8 (1.6)**	*1.9 (1.7)*	1.6 (1.6)	**-**
	House price index Y/Y%	Dec	**7.2**	6.5	6.7	**-**

Country	**Auction**
UK	BoE APF operation purchased £775mn of 15Y+ Gilts (3.87 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	10:00	Trade balance €bn	Dec	22.0	22.7
Spain	08:00	Final EU-harmonised CPI Y/Y%	Jan	3.0	1.4
UK	09:30	Average earnings incl. bonuses (excl. bonuses) 3M/Y%	Dec	*2.8 (2.7)*	2.8 (2.7)
	09:30	ILO unemployment rate 3M%	Dec	*4.8*	4.8
	09:30	Employment change 3M/3M '000s	Dec	*30*	-9
	09:30	Claimant count rate % (change 000s)	Jan	2.3 (0.5)	2.3 (-10.1)

Auctions and events

Country	GMT	Auction / Event
UK	10:30	Auction: To sell £1.25bn of 0.125% 2026 index-linked bonds (22-Mar-2026)
	14:50	BoE APF operation: To purchase 7-15Y Gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ Daiwa forecast	Previous	**Revised**
EMU	ECB public sector asset purchases €bn	Weekly	**16.9**	*17.5*	17.3	-

Country	**Auction**
Italy sold	€2.75bn of 0.05% 2019 bonds (15-Oct-2019) at an average yield of 0.25%
	€2.5bn of 0.65% 2023 bonds (15-Oct-2023) at an average yield of 1.59%
	€1bn of 0.7% 2020 bonds (01-May-2020) at an average yield of 0.37%
	€1.3bn of 2.7% 2047 bonds (01-Mar-2047) at an average yield of 3.43%
	€986mn of 5% 2039 bonds (01- Aug-2039) at an average yield of 3.31%
UK	BoE APF operation purchased £775mn of 3-7Y Gilts (3.2 cover ratio)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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