Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Mantas Vanagas
+44 20 7597 8318

- Bunds were little changed as updated euro area inflation data provided no surprises while construction figures turned for the better.
- Gilts were also little changed on a quiet day for UK economic news.
- Thursday will be quiet for notable new European economic data while Friday brings UK retail sales and euro area balance of payments figures.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/19	-0.605	-
OBL 0 10/22	-0.129	-0.002
DBR 0½ 08/27	0.495	-0.002
UKT 1¾ 07/19	0.571	-0.008
UKT 0½ 07/22	0.840	+0.004
UKT 4¼ 12/27	1.307	+0.004

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

Euro area

Inflation unrevised from the flash

While the equivalent figures from France and Spain released at the end of last week had raised the possibility of a downwards revision, today's final euro area inflation data for December left the main rates unchanged from the flash estimates. So, most notably, the figures confirmed the drop of 0.1ppt in annual CPI inflation to 1.4%Y/Y, just below the average for the year. However, the rounding concealed a near-miss – to three decimal places, a downwards revision to 1.3%Y/Y was avoided by just 0.003ppt. Meanwhile, with services inflation unrevised at 1.2%Y/Y, and non-energy goods inflation unrevised at 0.5%Y/Y, the core rate was confirmed at its disappointingly weak flash estimate of 0.9%Y/Y, unchanged from October and November.

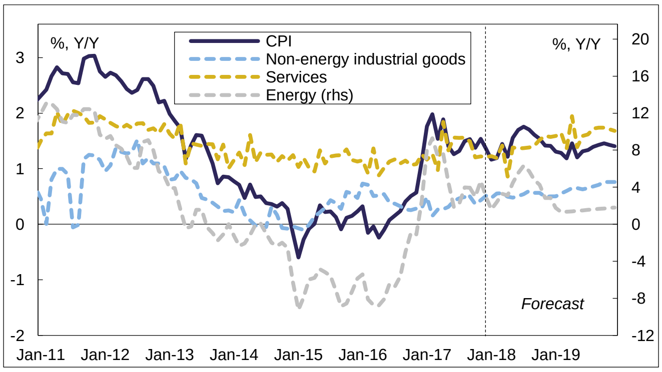
ECB watching market shifts

Looking ahead, recent market shifts have had a notable bearing on the inflation outlook. In particular, the upwards trend in oil prices – with the price of Brent crude rising well above the ECB's assumption for the year ($61.6pb), and surpassing $70pb at the start of the week for the first time since 2014 – means that energy inflation is likely to be higher than previously anticipated over the coming year. However, the euro's appreciation trend could act to suppress prices of non-energy industrial goods prices well into 2019. Indeed, the nominal trade-weighted exchange rate is now more than 6% above its level a year ago and more than 1% above the level for the current year implied by the ECB's more recent forecast, while the euro exchange rate against the dollar is more than 4% above the $1.17 level assumed in the ECB's arithmetic. That is undeniably a source of concern for some members of the Governing Council, two of the more prominent of whom (Constâncio and Nowotny) today echoed concerns expressed yesterday by Bank of France President Villeroy de Galhau, who argued that recent forex market movements required monitoring due to their potential impact on import prices. So, we expect the policy statement to be issued at the conclusion of next week's Governing Council meeting to repeat the wording used in September, i.e. that 'recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability'.

A choppy outlook for inflation

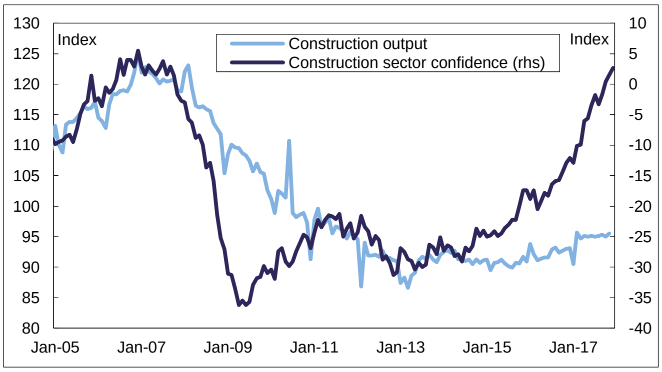
In our view, the likely near-term path for inflation will be a choppy one. Due particularly to base effects associated with past shifts in the oil price, headline CPI inflation is likely to drop in January and February to about 1.2%Y/Y, which will be the lowest rate in more than one year, before rising above 1½%Y/Y for several months between May and year-end. Given the strength of the euro, however, inflation of non-energy industrial goods will remain well below 1%Y/Y through to the end of 2019. And so,

Euro area: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Construction and confidence*



**European Commission construction confidence indicator. Source: EC, Thomson Reuters and Daiwa.*

while services inflation might edge up as the tightening labour market facilitates a gradual pickup in wage growth, core inflation seems likely to inch higher only very slowly, and to remain below 1½%Y/Y even by the end of next year. We now forecast average headline and core inflation at 1.5%Y/Y and 1.0%Y/Y in 2018 (versus the ECB's most recent forecast of 1.4%Y/Y and 1.1%Y/Y) and just 1.3%Y/Y and 1.3%Y/Y in 2019 (versus the ECB's forecast of 1.5%Y/Y and 1.5%Y/Y). Given the additional downside risks posed by the exchange rate as well as a still-unpredictable political outlook, that profile is one that will lead the ECB to adjust its main policy tools only very gradually over the coming couple of years.

Construction output picks up at last

Following a disappointing previous six months, when output in the sector trended broadly sideways, the construction data for November released today showed an increase of 0.5%M/M, the biggest rise since last February. Output in Germany, up 1.5%M/M, recovered after a calendar-distorted drop of 1.1%M/M in October. But the results from the other large member states were less impressive. France recorded a decline of 0.6%M/M while Spain's increase of only 0.3%M/M followed a 1.0%M/M fall in October. And the average level in October and November was still only 0.1% higher compared to Q3. So, despite the strongest sentiment in the sector for a decade, output growth was 2.7% higher compared to a year ago, relatively decent reading but still one of the weaker in 2017, we might be unlikely to see a meaningful positive contribution to GDP growth until the current quarter. Certainly, fundamentals in the sector, including rising property prices, increased mortgage lending, and faster growth in business investment, all appear consistent with a stronger pace of growth.

The coming two days in the euro area and US

It should be a relatively uneventful end to the week for economic data from the euro area, with no top-tier releases on Thursday and just the ECB's balance of payments report for November and German PPI figures for December due on Friday. Most notably, with the goods trade balance having improved in November by more than €3bn to €22.5bn on an adjusted basis, the current account surplus seems bound to rebound having narrowed to €30.8bn in October. And that should leave the surplus on a twelve-month basis still above 3% of GDP. Meanwhile, ECB Governing Council members Cœuré, Weidmann and Villeroy de Galhau will speak publicly, with any utterances on FX trends likely to be noted by investors. Finally, in the markets, tomorrow France will sell 3Y, 5Y and 7Y bonds while Spain will sell 5Y, 15Y and 30Y bonds.

In the US, Thursday will bring the results of the Philadelphia Fed's manufacturing survey for the current month as well as housing starts and building permits data for December. Friday will bring the University of Michigan's preliminary consumer survey results for January. Investor attention will also remain on political efforts in Congress to pass a stop-gap public spending bill to avoid a government shutdown after Friday. Meanwhile, before the blackout period begins ahead of the 31 January monetary policy announcement, on Friday Atlanta Fed President Bostic – a voting FOMC member in 2018 – will speak publicly on the economic outlook. In the markets, the Treasury will sell 10Y TIPS tomorrow.

UK

The coming two days in the UK

After a quiet day today, with no notable economic data and external MPC member Saunders predictably signalling that he expects to vote to raise rates again before too long, the only UK economic data release of note tomorrow will be the latest RICS Residential Market Survey. Having inched down to 0% in November, the survey's headline index for house prices is expected to ease further to register the first negative reading since early 2013. Meanwhile, the end of the working week on Friday brings the latest retail sales data for the month of December. Major retailers reported mixed festive-season results, and with the BRC survey suggesting that retail spending in nominal terms that month rose broadly in line with the average of the past year, December's sales appear to have been unimpressive: a decline in volume terms of around 1.0%M/M, which would follow a steep increase in November, when Black Friday discounting helped to boost sales. Nevertheless, given that sales fell particularly sharply in December 2016, we will probably see the annual rate rising from 1.6%Y/Y in November.

The next edition of the Euro wrap-up will be published on 19 January 2018.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		EU27 new car registrations Y/Y%	Dec	**-4.9**	-	5.9	**-**
		Construction output M/M% (Y/Y%)	Nov	**0.5 (2.7)**	-	-0.4 (2.0)	**-0.3 (2.2)**
		Final CPI (final core CPI) Y/Y%	Dec	**1.4 (0.9)**	*1.4 (0.9)*	1.5 (0.9)	**-**

Auctions

Country		Auction
Germany sold		€1.3bn of 1.25% 2048 bonds (15-Aug-2048) at an average yield of 1.28%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		00:01	RICS house price balance %	Dec	-1	0

Auctions

Country		GMT	Auction / Event
EMU		14:30	ECB's Couré scheduled to speak in Frankfurt
France		09:50	Auction: To sell 0% 2023 bonds (25-Mar-2023)
		09:50	Auction: To sell 0% 2021 bonds (25-Feb-2021)
		09:50	Auction: To sell 2.25% 2024 bonds (25-May-2024)
		10:50	Auction: To sell 0.25% 2024 index-linked bonds (25-Jul-2024)
		10:50	Auction: To sell 0.1% 2028 index-linked bonds (01-Mar-2028)
		10:50	Auction: To sell 0.7% 2030 index-linked bonds (25-Jul-2030)
Spain		09:30	Auction: To sell 0.45% 2022 bonds (31-Oct-2022)
		09:30	Auction: To sell 2.35% 2033 bonds (30-Jul-2033)
		09:30	Auction: To sell 2.9% 2046 bonds (31-Oct-2046)
UK		10:30	Auction: To sell £2.5bn of 0.75% 2023 bonds (22-Jul-2023)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's data releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09:00	Current account balance €bn	Nov	-	30.8
Italy		09:30	Current account balance €bn	Nov	-	6.6
Spain		09:00	Current account balance €bn	Nov	-	-2.5
UK		09:30	Retail sales excluding petrol M/M% (Y/Y%)	Dec	-1.0 (2.6)	1.2 (1.5)
		09:30	Retail sales including petrol M/M% (Y/Y%)	Dec	-0.9 (2.6)	1.1 (1.6)

Auctions

Country	GMT	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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