Euro wrap-up

Overview

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- With the exception of the short end of the curve, Bunds made modest gains as data confirmed a third successive quarterly decline in euro area construction output in Q4.
- Gilts made modest gains across the curve despite an upside surprise in the latest UK inflation data.
- Thursday will bring the flash estimate of euro area consumer confidence and UK retail sales data for January, as well as the account of the ECB's most recent policy meeting.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/21	-0.654	+0.006
OBL 0 04/25	-0.625	-0.004
DBR 0 02/30	-0.418	-0.008
UKT 3¾ 09/21	0.513	-0.002
UKT 1 04/24	0.467	-0.006
UKT 0⅞ 10/29	0.601	-0.007

*Change from close as at 4:30pm GMT.
Source: Bloomberg

Euro area

End-year construction drop likely to prove temporary

Euro area construction output in December fell 3.1%M/M, the most since 2013. That left it down 3.7%Y/Y, marking the steepest annual drop since Q117. It also sealed a third successive quarterly decline, with the drop of 0.9%Q/Q in Q4 the sharpest since Q118. Weakness was most pronounced in building work, down 3.6%M/M in December and 1.0%Q/Q in Q4. Meanwhile, civil engineering output fell 1.4%M/M to be up 0.2%Q/Q. The sharp retrenchment in output came as no surprise given the marked drops already reported in Germany (8.7%M/M) and France (2.8%M/M). We expect the data for Germany – and thus also the euro area – to be revised up significantly in due course. That, however, still seems bound to leave the euro area growth figures – whether on a monthly, quarterly or annual basis – in negative territory.

Fundamentals and confidence remain favourable

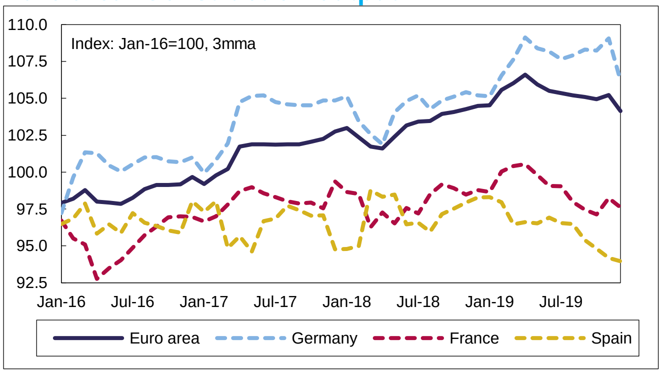
Nevertheless, we continue to expect a return to positive growth in construction output in January and Q1, and over 2020 as a whole. Admittedly, a subdued outlook for business capex will likely weigh on new investments in structures. But record low mortgage rates, ample credit availability, steady growth in real disposable incomes, and rising house prices should support residential construction output. Additionally, increased public investment should give impetus to civil engineering activity. Indeed, the European Commission's most recent business survey suggested an improvement in confidence in the sector in January to a seven-month high, well above the long-run average, supported in part by increased activity. And the index for order books also improved to the best since June and close to the series high reached in April.

The day ahead in the euro area and US

Thursday will bring the flash February estimate of the Commission's euro area consumer confidence index. In January the index moved sideways at -8.1, matching December's near-three-year low. And a slight deterioration is expected in the current month. The latest German GfK consumer confidence survey will be released earlier in the day. The final estimates of French inflation in January – for which the flash estimate on the EU measure remained unchanged at 1.6%Y/Y – are also due. Beyond the economic data, the ECB will publish its account of the January monetary policy meeting when its strategic policy review was officially launched. In addition, ECB Vice President Luis de Guindos will speak publicly. In the markets, France will sell 3Y, 5Y and 7Y bonds, while Spain will sell 5Y and 10Y bonds.

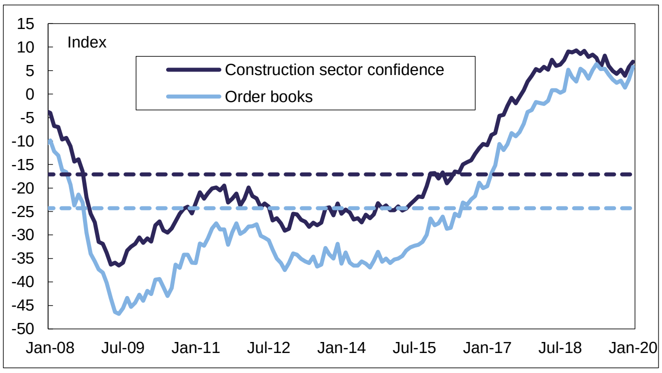
In the US, the usual weekly jobless claims data are due along with the Philadelphia Fed business survey results for February and the Conference Board coincident and leading indicators for January. In the markets, the Treasury will sell 30Y TIPS.

Euro area: Construction output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Construction sector sentiment*



**Dashed lines represent respective long-run averages.*
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK

Inflation beats expectations in January

Having fallen to a three-year low in December, headline CPI inflation rose a larger-than-expected 0.5ppt in January to a six-month high of 1.8%Y/Y. To some extent the increase reflected higher inflation of fuel and energy, which leapt more than 5ppts, the most since April, to 4.8%Y/Y, the highest rate since May. But via their impact on items such as airfares and other transportation costs, higher fuel prices also contributed to an increase of 0.2ppt in services inflation to 2.3%Y/Y. In addition, non-energy industrial goods inflation rose 0.2ppt to 0.5%Y/Y due to a modest rebound in apparel inflation following two very weak months. So, core inflation similarly increased a larger-than-expected 0.2ppt, to 1.6%Y/Y.

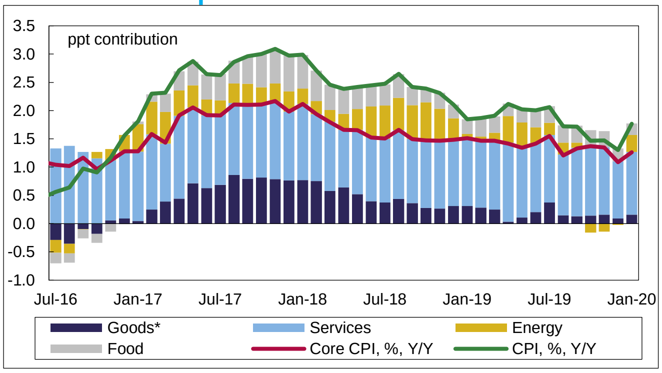
Inflation to fall to Q3 before heading higher again

The rise in inflation in January will not have come as a surprise to the BoE, which last month had forecast the headline rate to rise 0.4ppt from Q4 to 1.8%Y/Y in Q1. Given base effects associated with past shifts in fuel prices, as well as a further cut in the regulator's domestic energy price cap and lower water bills from April, the BoE expects inflation to fall back to about 1¼%Y/Y in Q3. Thereafter, it expects inflation to rise gradually due not least to rising domestically generated price pressures from the labour market. We expect inflation to follow a similar path. But with the price of Brent crude having fallen below $60bpp, we see risks that the headline CPI rate will fall below 1.0%Y/Y in July. By the same token, however, we are also concerned about additional price pressures caused by the end of the Brexit transition from the start of 2021. In particular, even if a new free trade agreement is adopted to avoid the imposition of tariffs, new non-tariff barriers and administrative costs related to trade with the EU are likely to increase prices of a range of goods from January on. And the UK government's restrictive new immigration proposals, unveiled today and also to be implemented in the New Year, risk significantly increasing labour shortages and associated costs, particularly in the services sector. So, while we are more downbeat than the BoE about the outlook for economic growth, we share the Bank's assessment that inflation is likely to rise above 2.0%Y/Y by the end of 2021.

The day ahead in the UK

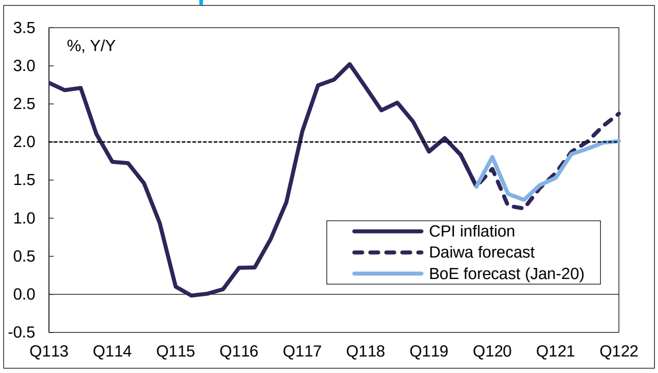
Thursday will bring January's retail sales figures. Sales (whether including or excluding auto fuel) are expected to post positive growth on the month for the first time since July. However, the consensus forecast of about ¾%M/M would still leave sales down about 1.0%3M/3M, matching the equivalent rate in December, to suggest no improvement in momentum in the New Year. In the bond markets, the DMO will sell 6Y Gilts.

UK: Consumer price inflation



*Non-energy industrial goods. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation forecasts*



*BoE forecast is conditioned on a previously market-implied path for Bank Rate, averaging close to 0.5% over the forecast horizon. 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	Current account balance €bn	Dec	**32.6**	-	33.9	**32.4**
	Construction output M/M% (Y/Y%)	Dec	**-3.1 (-3.7)**	-	0.7 (1.4)	**-**
UK	CPI (core CPI) Y/Y%	Jan	**1.8 (1.6)**	1.7 (1.5)	1.3 (1.4)	**-**
	PPI output prices (input prices) Y/Y%	Jan	**1.1 (2.1)**	1.0 (-0.1)	0.9 (-0.1)	**- (0.9)**
	ONS house price index Y/Y%	Dec	**2.2**	2.5	2.2	**1.7**

Auctions

Country	Auction
Germany	sold €975mn of 1.25% 2048 bonds at an average yield of 0.07%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	15.00	Preliminary consumer confidence	Feb	-8.0	-8.1
Germany	07.00	GfK consumer confidence	Mar	9.8	9.9
	07.00	PPI Y/Y%	Jan	-0.4	-0.2
France	07.45	Final CPI (EU-harmonised CPI) Y/Y%	Jan	1.5 (1.6)	1.5 (1.6)
UK	09.30	Retail sales including fuel M/M% (Y/Y%)	Jan	0.7 (0.6)	-0.6 (0.9)
	09.30	Retail sales excluding fuel M/M% (Y/Y%)	Jan	0.8 (0.5)	-0.8 (0.7)
	11.00	CBI industrial trends survey, total orders	Feb	-20	-22

Auctions and events

Country	GMT	Auction / Event
EMU	10.30	ECB Vice President Guindos scheduled to speak
	12.30	ECB's account of January's Governing Council meeting published
France	09.50	Auction: 0% 2023 bonds
	09.50	Auction: 0% 2025 bonds
	09.50	Auction: 0.25% 2026 bonds
	10.50	Auction: 0.1% 2025 index-linked bonds
	10.50	Auction: 0.1% 2029 index-linked bonds
	10.50	Auction: 0.1% 2036 index-linked bonds
Spain	09.40	Auction: 2025 bonds
	09.45	Auction: 0.5% 2030 bonds
UK	10.30	Auction: £3.25bn of 1.5% 2026 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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