Daiwa Capital Markets

Euro wrap-up

Overview

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- Euro area government bonds followed USTs lower as the February services and composite PMIs were revised up but German car production and sales data disappointed.
- Gilts made losses as the UK Government announced near-term fiscal support for the economy before tightening in two years' time, and gave an environmental objective for the BoE's monetary policy.
- Thursday will bring new data for euro area retail sales and unemployment, as well as the construction PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/23	-0.693	+0.012
OBL 0 04/26	-0.611	+0.039
DBR 0 02/31	-0.295	+0.060
UKT 0⅛ 01/23	0.069	+0.033
UKT 0⅛ 01/26	0.353	+0.060
UKT 4¾ 12/30	0.770	+0.086

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

Euro area

German car sales and production weak in February, expected to bounce back over near term

Just as in France, Italy and Spain, new car registrations in Germany last month remained well below their level a year earlier. In particular, with the reversal of the temporary VAT cut compounding weakness associated with pandemic containment restrictions, German new car registrations fell 19%Y/Y in February having dropped a steep 31%Y/Y in January, to be down a little more than 25%YTD/Y. Total new vehicle registrations were down 17%Y/Y and 23%YTD/Y. Meanwhile, according to the VDA, car production was also weak last month, falling 17%Y/Y having dropped 23%Y/Y in January to be down 23%YTD/Y. Nevertheless, according to the February ifo business climate survey, German automakers were somewhat less downbeat last month, with the survey measure of current conditions up more than 5pts to a broadly neutral -2.3. And despite weak demand last month, only a slight improvement reported in order books and inventories of finished goods relatively elevated, firms in the sector were more optimistic about the outlook. Indeed, buoyed partly by expectations of stronger demand abroad, the index of production expectations for the coming three months rose from -0.5 to a four-month high of 35.3, suggesting that output in the sector should rebound over the near term.

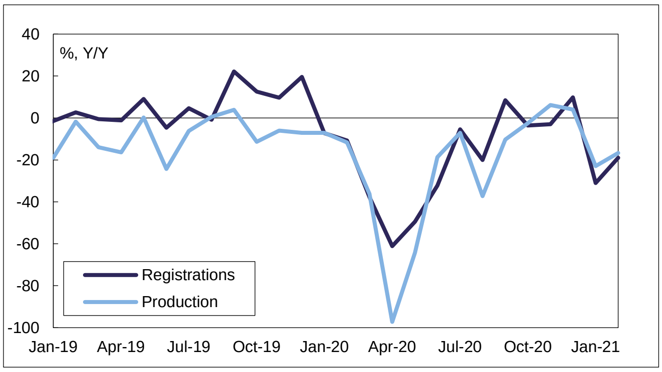
Euro area services PMI revised up to suggest moderation in contraction

The final services and composite PMIs for February provided somewhat better news than their flash estimates suggesting a slowing pace of contraction and a somewhat greater ability of firms to cope with ongoing restrictions in affected sectors. The euro area services activity PMI was revised up a full point from the initial estimate, which had been a three-month low, to 45.7, marking a modest improvement from January and a level above the Q4 average. A notable improvement in the assessment of new business pointed to a slightly slower pace of contraction over the near term too. And with the manufacturing output PMI earlier this week having been marginally revised up too, the euro area composite PMI was revised up 0.7pt to 48.8, 1pt above January's level and also above the Q4 average.

Composite PMIs suggest Italy is faring best in Q1

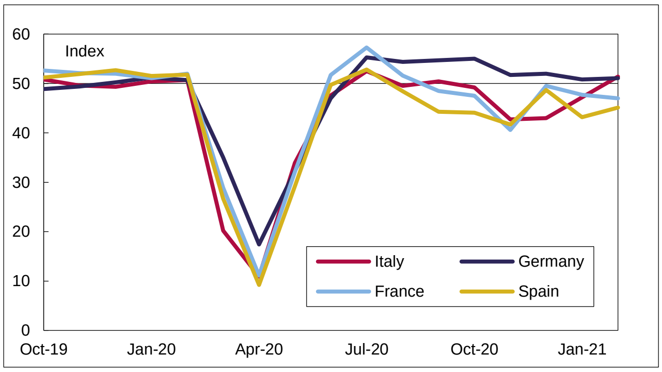
At the country level, all of the services PMIs except Germany's (which was revised down from the flash to 45.7) implied a modest slowing in the pace of contraction in February, with Italy faring best (up more than 4pts to 48.8). And when the manufacturing sector was taken into account, Italy also registered the highest composite PMI, up more than 4pts to 51.4, to suggest modest expansion in the middle of Q1. But Italian GDP in Q1 as a whole will be weak. Indeed, with tighter pandemic containment restrictions set to take effect from 6 March, the government is already looking to increase fiscal support over the near term. Elsewhere, supported by strengthening manufacturing, the German composite PMI also rose further to 51.1. But

Germany: Car production and new registrations



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMIs by member state



Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

the weakness in retail sales reported yesterday all but guarantees a contraction in GDP in Q1, as does the extension of most pandemic containment restrictions (with a few exceptions, such as the reopening of bookshops and florists) to 28 March. And the composite PMIs of France and Spain still clearly suggest that economic output continues to decline.

Input price pressures still largely absorbed by margins

Given the step up in inflation since the start of the year, the pricing PMIs are currently arguably of greater interest than usual. In services, the survey measure of input cost inflation in February was unchanged from January's five-month high with Markit reporting higher prices for a range of goods and services. However, given the ongoing weakness of demand in services, the PMIs suggested that output prices in the sector were cut for a twelfth successive month, with downward pressure reported in all of the large member states. When incorporating the more acute price pressures in manufacturing – related to supply-chain pressures as well as rising prices of commodities, energy and freight transport – the composite PMIs reported the strongest input cost inflation since November 2018 (the respective index rose 1.5pts to 58.7). And while firms' margins continued to absorb the lion's share of those price pressures, output prices at the whole-economy level reportedly rose for the first time since last February, albeit only minimally, with the respective PMI up 1.7pts to a still soft 50.3.

The day ahead in the euro area

Looking ahead, tomorrow will bring the release of the latest euro area retail sales data, which are expected to report a fall of 1.6%M/M and 1.5%Y/Y in January as pandemic restrictions continued to weigh on household spending. Meanwhile, the euro area's labour market figures, also to be published tomorrow, are expected to report than the unemployment rate was unchanged at 8.3% in January, still representing a relatively modest increase from the pre-pandemic rate of 7.2% in February last year. Survey-wise, the latest euro area construction PMIs are expected to point to a continued contraction in activity in three of the four larger euro area economies, with the Italian PMI forecast to reveal that activity moved broadly sideways last month.

UK

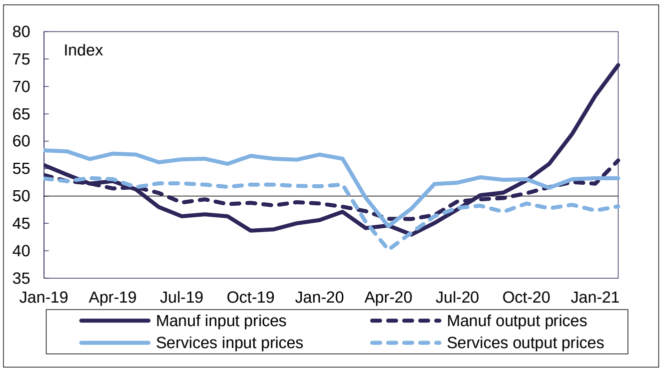
Government extends business support programmes in line with reopening strategy

As expected, today's UK Budget statement extended and in some cases expanded the government's pandemic support to align more closely with its economic reopening strategy. So, for example, the Job Retention Scheme, which was still supporting incomes of 4.7mn workers at end-January, will be extended in current format for a further three months to end-June, before being tapered through to end-September. Similar assistance for the self-employed will also be extended through to September as will the VAT cut for the hospitality sector and temporary increase in the Universal Credit welfare benefit payments. And the temporary stamp duty holiday will be phased out between June and September too while new support for first-time buyers will be introduced. Tarnishing somewhat its environmental credentials, the government will also again forego its planned increase in fuel duty.

Near-term GDP profile supported by new measures, peak in inflation delayed to year-end

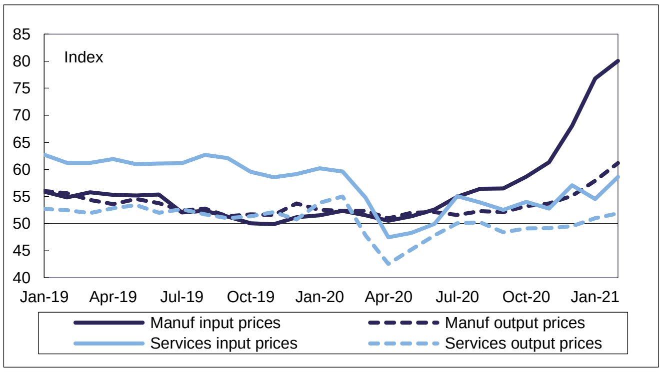
Overall, the near-term measures to boost public spending and reduce taxes – worth a further £65bn in FY21/22, equivalent to 3.1% of 2020 GDP – should give a near-term boost to GDP. Indeed, the independent OBR revised up its GDP forecast to 4.0%Y/Y in 2021 and 7.3%Y/Y in 2022 closer to our own forecast of 4.5%Y/Y this year and 6.9%Y/Y next year. So, it judged that the pre-Covid level of GDP will now be reached in Q221. The OBR also revised down its forecast for unemployment, although the number of jobless workers is still expected to rise by about 500k in 2021 to peak at 6.5% around year-end. Not least given the extension of the hospitality VAT cut, today's policy announcements will also push the peak in inflation to the back end of the year.

Euro area: PMI price indices



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: PMI price indices



Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

Moderate stimulus this year to be followed by fiscal tightening

While the government announced additional near-term fiscal support for the economy today, the extra stimulus pales into comparison with that currently being pushed through Congress in the US. So, while Gilts made significant losses today, the new measures might be unlikely to prompt the BoE to suddenly become more hawkish. Indeed, the HM Treasury representative would likely have briefed the MPC at last month's meeting on what to expect in today's Budget. And we note that the BoE GDP forecast is more upbeat than that of the OBR. Moreover, while it will be the economic recovery rather than policy measures that reduce the budget deficit over the near term, the Government also announced a shift to a tighter fiscal stance from FY23/24 onwards, in part via a 6ppt increase in the headline corporation tax rate to 25% from April 2023. While that tax increase will be substantive, the rate is likely to remain relatively competitive in comparison to other industrialised nations, and will be sweetened by a temporary 'super deduction' tax relief for businesses to encourage investment over the next two years. However, the longer-term attractiveness of the UK as a destination for significant foreign investment – already harmed by Brexit – might suffer further.

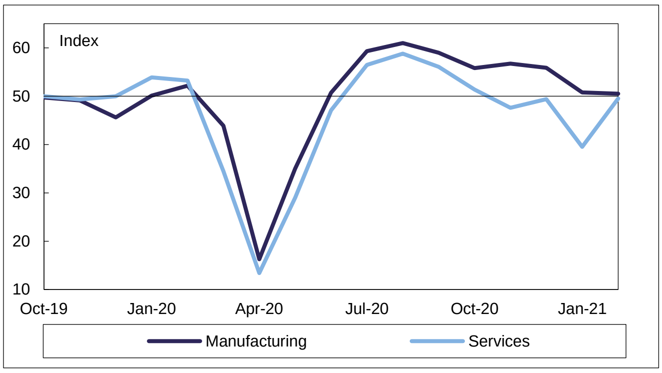
Public sector net debt to peak close to 110% of GDP in FY23/24

With tax revenues having fared better than expected over recent months, the OBR was always going to revise down its forecast for net public sector borrowing in the current fiscal year. But while that peak has now been reduced by £39bn to £355bn (still a peace-time record of 16.9% of GDP), the extra support announced today led the OBR to revise up its forecast for borrowing for FY21/22 to £234bn (10.3% of GDP). Given the fiscal tightening thereafter, borrowing is subsequently expected to fall further than previously thought, to £85bn and 3.5% of GDP in FY23/24 just ahead of the next general election, and just below £75bn and 3% of GDP in the following couple of years. Public sector net debt is forecast to rise from 100.2% of GDP in the current fiscal year to peak at 109.7% of GDP in FY23/24, more than 30ppts higher than the OBR projected just one year ago.

BoE monetary policy remit extended to include environmental goals

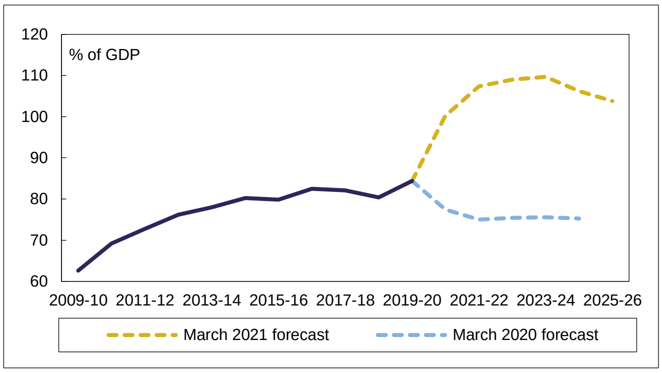
Among the many other policy announcements made today, the Chancellor re-set the BoE's monetary policy remit. While the symmetric inflation target was predictably reconfirmed at 2.0%Y/Y on the CPI measure, the remit was extended to reflect the government's objective that growth be environmentally sustainable and consistent with the transition to a net zero economy. That arguably opens the door for the BoE to implement a greener QE policy, a greener term funding scheme and a greener collateral policy in the BoE's liquidity operations.

UK: Headline PMIs



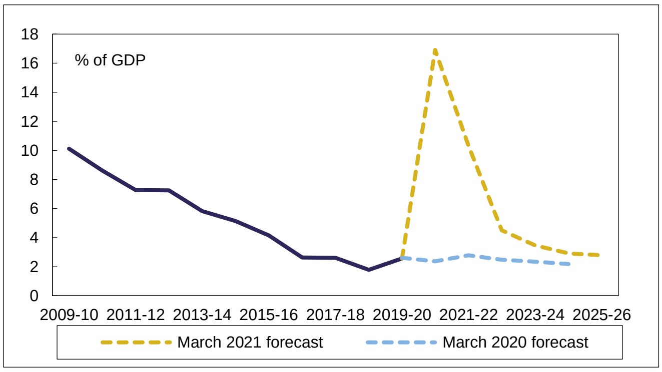
Source: Markit, Refinitv and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt – OBR forecasts



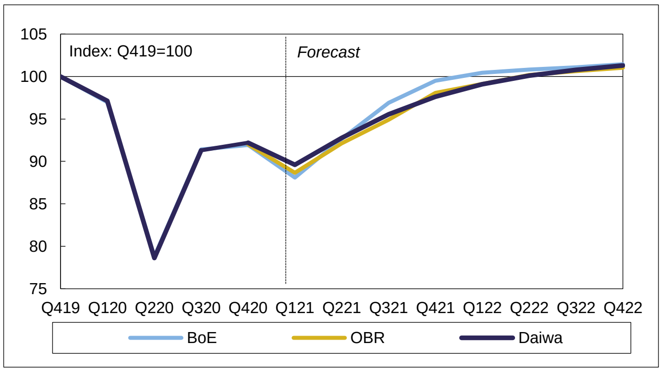
Source: ONS, OBR and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing – OBR forecasts



Source: ONS, OBR and Daiwa Capital Markets Europe Ltd.

UK: GDP forecast comparison



Source: OBR, BoE and Daiwa Capital Markets Europe Ltd.

Final services and composite PMIs suggest stable but subdued output in Q1

The final UK services and composite PMIs for February showed only modest downwards revisions from the flash estimates and thus still suggested a stabilisation of economic activity after a very weak start to the first quarter. In particular, having dropped almost 10pts in January to an eight-month low of 39.5, the services activity PMI rebounded last month to 49.5. The PMI for new business in services also reversed the drop of 5pts at the start of the year to rise back to 48.5. But while it was 1pt stronger than the initial estimate, the equivalent index for new export business in the sector still rose an unimpressive 3.3pts to just 44.4, suggesting a continued adverse impact from new barriers to trade with the EU. Meanwhile, the stabilisation of conditions in the services sector helped the composite PMI rise 8.4pts in February to 49.6, still down from December but consistent with an economy that was moving broadly sideway in the middle of Q1. Inflation-wise, however, given particular pressures in manufacturing but also rising pressures in services, the final February PMIs again suggested that input prices rose the most since October 2018 (with a respective index up almost 4pts to 62.0) and the firmest rise in output prices (53.4) in one year.

The day ahead in the UK

Thursday will be a quiet day on the data front in the UK with only new car registrations data and the construction PMIs for February due.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Final services (composite) PMI	Feb	**45.7 (48.8)**	45.0 (47.5)	46.4 (49.1)	-
		PPI Y/Y%	Jan	**0.0**	0.1	-1.1	-
Germany		Final services (composite) PMI	Feb	**45.7 (51.1)**	46.8 (50.8)	47.0 (52.0)	-
		New car registrations Y/Y%	Feb	**-19**	-	-31	-
France		Final services (composite) PMI	Feb	**45.6 (47.0)**	46.5 (47.0)	49.1 (49.5)	-
Italy		Final GDP Q/Q% (Y/Y%)	Q4	**-1.9**	-2.0	15.9	-
		Services (composite) PMI	Feb	**48.8 (51.4)**	39.5 (42.0)	39.7 (43.0)	-
Spain		Services (composite) PMI	Feb	**43.1 (45.1)**	43.0 (45.0)	48.0 (48.7)	-
		BRC shop price index Y/Y%	Feb	**-2.4**	-	-2.2	-
UK		Final services (composite) PMI		**49.5 (49.6)**	38.8 (40.6)	49.4 (50.4)	-
Auctions							
Country		Auction					
Germany		sold €2.539bn of 0% 2036 bonds at an average yield of -0.006%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	08.30	Construction PMI	Feb	-	44.1
EMU	10.00	Retail sales M/M% (Y/Y%)	Jan	-1.4 (-1.2)	2.0 (0.6)
	10.00	Unemployment rate %	Jan	8.3	8.3
Germany	08.30	Construction PMI	Feb	-	46.6
France	08.30	Construction PMI	Feb	-	40.5
Italy	08.30	Construction PMI	Feb	-	50.5
UK	09.00	New car registrations Y/Y%	Feb	-	-39.5
	09.30	Construction PMI	Feb	51.0	49.2
Auctions and events					
EMU	08.10	ECB's Knot scheduled to speak			
France	09.50	Auction: 0% 2030 bonds			
	09.50	Auction: 0.5% 2040 bonds			
	09.50	Auction: 0.75% 2052 bonds			
Spain	09.30	Auction: 0% 2026 bonds			
	09.30	Auction: 1.4% 2028 bonds			
	09.30	Auction: 1% index-linked 2030 bonds			
	09.30	Auction: 0.1% 2031 bonds			
	09.30	Auction: 1.85% 2035 bonds			
UK	09.30	BoE publishes February Decision Maker Panel data			
	10.00	Auction: £2.75bn of 0.25% 2031 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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