Euro wrap-up

Overview

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- Ahead of the Fed and ECB policy announcements, Bunds made very modest losses on a quiet day for economic news in the euro area.
- Gilts made larger losses at the short end of the curve as UK inflation surprised on the upside yet again.
- Thursday will see the ECB its plans for asset purchases in the New Year and the BoE decide whether or not to hike Bank Rate, while the December flash PMIs are also due.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/23	-0.694	+0.007
OBL 0 10/26	-0.590	+0.010
DBR 0 08/31	-0.366	+0.007
UKT 0⅛ 01/24	0.458	+0.035
UKT 0⅜ 10/26	0.572	+0.018
UKT 0¼ 07/31	0.727	+0.006

*Change from close as at 4:00pm GMT.
Source: Bloomberg

UK

Further upside surprise to inflation maintains uncertainty about tomorrow's MPC decision

Following yesterday's mixed bag of labour market data, which reported solid job creation but moderating wage growth, today's UK inflation figures were stronger than anticipated in every respect, maintaining the possibility of a hike in Bank Rate tomorrow despite the spread of Omicron. However, the rise in inflation also underscores the fact that real labour incomes are now falling, which will weigh on demand over coming months. And with consumer-facing services set for another challenging festive season amid tighter pandemic restrictions and the highest number of new coronavirus cases since last winter, on balance, we maintain our view that the MPC will wait until updated projections are available in February before raising rates for the first time this cycle. Of course, given the mismatch between prior communication and subsequent policy action at the November MPC meeting, nothing can be taken for granted about tomorrow's BoE rate announcement.

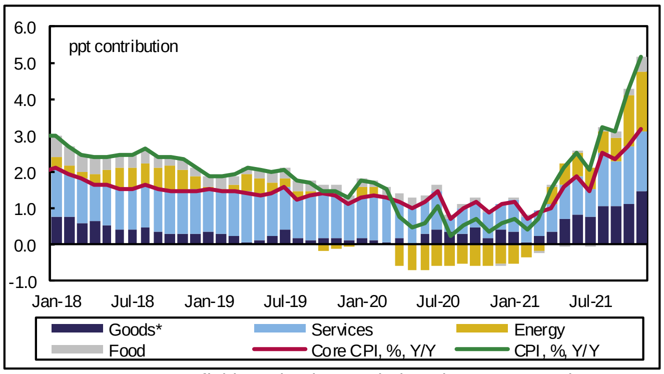
Annual CPI rate up to decade high driven by petrol and second-hand cars

Strikingly, headline CPI inflation rose 0.9ppt in November to 5.1%Y/Y, 0.3ppt above the consensus forecast and well above the BoE's forecast of 4½%Y/Y at the time of last month's MPC decision. This took the cumulative rise in inflation over the past two months to 2ppts. While in October regulated prices of household electricity and gas were the main driver, in November transport items made the largest contribution, rising 2.6ppts to 12.5%Y/Y to account for more than one third of the rise in CPI inflation. In part, that reflected higher prices of petrol, inflation of which accelerated 7ppts to 29.5%Y/Y against the backdrop of elevated global oil prices. But given the hit to new car production amid global supply bottlenecks, second-hand car prices also rose again, to be up more than 30% since April and make their largest contribution on the series.

Broad-based rise in inflation still in part reflects shifts in pricing due to the pandemic

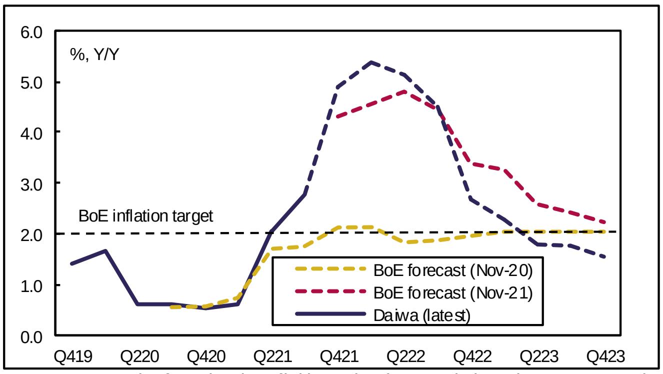
While transport prices made the largest contribution, several other items – goods and services alike – also added to inflation in November to give the impression of broad-based pressures. However, in many cases these reflected a return to more normal seasonal price patterns following unusual pricing in 2020 amid lockdowns. So, while cost pressures undeniably remain strong – today's producer price data also exceeded expectations with the output PPI rate up 0.5ppt to 9.1%Y/Y and input PPI up 0.6ppt to 14.3%Y/Y – the BoE cannot yet conclude that we are seeing second-round effects from high inflation. For example, while inflation of clothing and footwear leapt almost 4ppts in November to 3.5%Y/Y, the highest since 2018, that reflected a more regular increase this November after prices were discounted a year earlier as Covid-19 took its toll. But with prices of furniture and other household items also higher, non-energy industrial goods inflation jumped more than 1.0ppt to a decades-high 4.7%Y/Y. In addition, inflation of food and drink also rose significantly in part reflecting base effects while

UK: CPI inflation and contributions



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation forecasts



Source: Bank of England, Refinitiv and Daiwa Capital Markets Europe Ltd.

tobacco prices picked up due to the rise in duty in the government's Autumn Budget. Jointly, food, beverages and tobacco jointly added about ¼ppt to the increase in CPI inflation last month. And due to higher inflation in recreation and culture – many prices of which simply weren't available a year ago and hence had been imputed by the statisticians – services inflation ticked higher, to 3.4%Y/Y, the highest since 2013, despite a drop back in the component for restaurants and hotels.

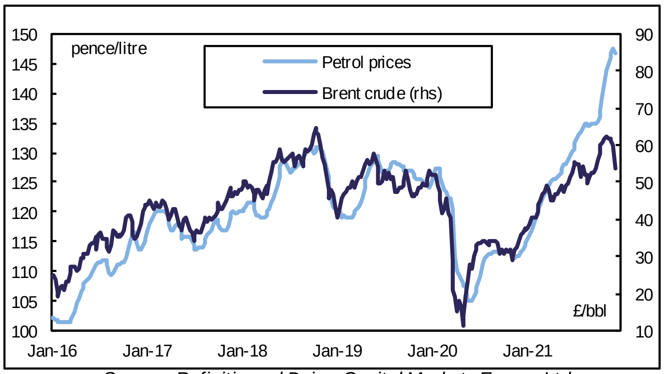
Inflation to remain above BoE target in 2022, but probably fall below 2% throughout 2023

Looking ahead, the new wave of Covid-19 raises even more uncertainty about the near-term inflation outlook. With oil prices well down from October's highs, prices of petrol at the pump are also now moving away from their peak. And prices of consumer-facing services and clothing might well fall back in response to softer demand. However, pressures on wholesale gas prices mean that household energy prices are bound to rise significantly further in April. And renewed disruption to global supply chains could mean that price pressures in non-energy industrial goods persist for longer than previously anticipated. So, we think that headline inflation has a little further to rise, probably to 5½%Y/Y or above by April. And the decline in inflation from May 2022 will likely initially be gradual so that the annual CPI rate will remain above 2%Y/Y a year from now. However, with wage growth expected to moderate further, we also predict headline inflation eventually to fall below the BoE's target and stay there in 2023 as energy prices and a rebound in global goods supply contribute negatively.

Case for BoE tightening less compelling this month than last

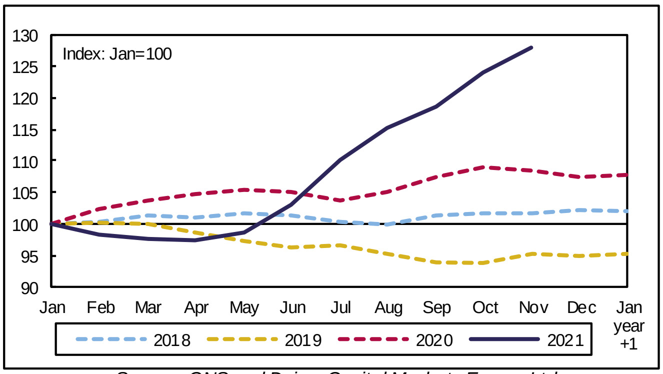
The aforementioned BoE rate decision will be the main focus on Thursday. Despite today's big upside surprise to inflation in November, and evidence of continued firm job growth following the end of the government's furlough scheme, the case for tightening policy is now less convincing than in November when the MPC voted 7-2 against a modest first 15bps hike in Bank Rate to 0.25%. While it will likely again signal that rates are probably going to have to rise in due course to ensure that the 2% inflation target is met at the end of the policy horizon, the MPC will be mindful of the fact that economic output continued to slow ahead of the new wave of Covid-19, with GDP up a much weaker-than-expected 0.1%M/M in October. The government's decision last Wednesday to tighten pandemic restrictions by implementing its Plan B – including encouraging working from home wherever possible, and limiting access to nightclubs and large gatherings to the vaccinated – is highly likely to weigh on demand for consumer-facing services over the all-important festive season. And while the government's Recovery Loan Scheme will support finance for SMEs affected by the new rules, there will be no job furlough scheme to support employee incomes. So, consumer and business confidence will likely be adversely impacted. With the BoE also traditionally reluctant to hike rates ahead of Christmas for fear of being portrayed as Scrooge, we therefore expect the

UK: Petrol prices



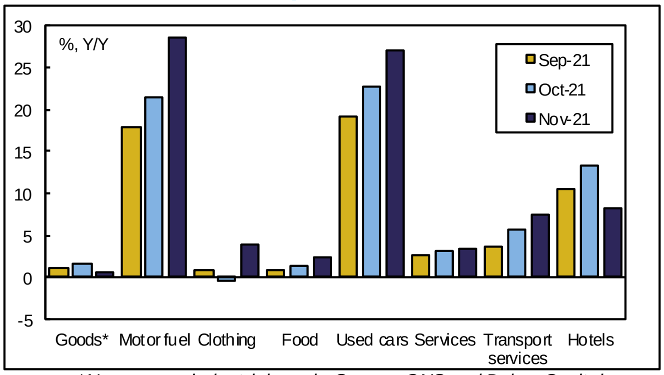
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Used car prices



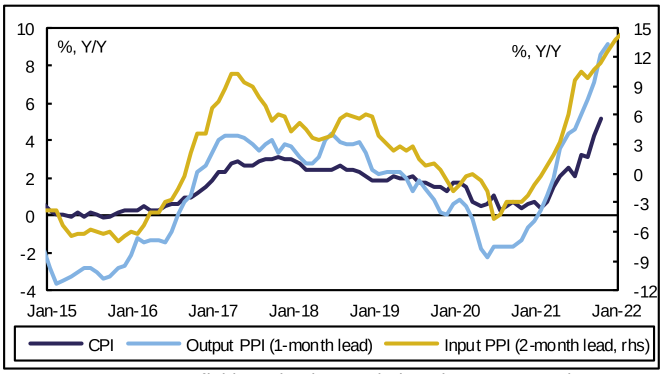
Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Selected CPI components



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

UK: PPI and CPI inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

majority of MPC members again to vote to leave rates unchanged. Instead of moving this month, the Committee will probably await updated economic projections in February before nudging Bank Rate up to 0.25%. As has long been expected, however, the MPC is bound to confirm the end of its net asset purchases this month, when the stock of government bond purchases will have reached the target set in November 2020 of £875bn and the total target stock of asset purchases reached £895bn.

Flash PMIs unlikely to reflect full impact on services of Covid Plan B

Data-wise, tomorrow brings the release of the preliminary manufacturing, services and composite PMIs for December, which are unlikely to reflect the full impact of last week's tightening of pandemic restrictions and this week's marked acceleration in the spread of Covid-19. So, the PMIs seem likely to suggest another month of positive growth in output and jobs amid ongoing price pressures. However, having edged down 0.2pt to a still strong 57.6 in November, the composite output PMI is expected to drop a little more than 1pt in December to a level that would still be more than 1pt above the respective readings in August and September.

Euro area

ECB to confirm slowdown in net purchases in Q1

As in the UK, the main event in the euro area will obviously be the ECB's announcements, which among other things will bring a degree of clarity on its asset purchases in the New Year. With government net borrowing to drop in 2022 and a large stock of bonds already accumulated (about €4.7trn in total under the various purchase programmes), the ECB will seek to slow the pace of net PEPP purchases in Q1 as long as market conditions (e.g. in light of Fed moves to tighten) and political developments (e.g. in France and Italy) continue to allow. While it will not specify an explicit amount, net PEPP purchases somewhere in the range of €40-50bn per month in Q1, down from the average close to €65bn per month since the September Governing Council meeting, seems reasonable.

Net PEPP purchases to end in March

Although Covid-19 continues to spread rapidly across the euro area, the ECB will likely also judge that the downward impact of the pandemic on the inflation outlook has now eased significantly. So, Christine Lagarde is highly likely to repeat that the net PEPP purchases are still expected to end in March. But she might also make clear that, from April, the ECB will have to increase net purchases under the PSPP to compensate somewhat. Reports suggest two options have been under consideration. The first would see the Governing Council approve a new purchase envelope for the PSPP, available up to the end of 2022 but with no compulsion to buy the full amount if it was not needed. The agreement of such an envelope could postpone debates about whether the ECB was tapering purchases. The alternative would commit to a temporary increase in PSPP purchases once the net PEPP purchases end, while making it clear that the volume would be adjusted (most likely lower) over time. Whichever path is chosen the Governing Council may be wise to leave some of the detail of its plans from April onwards to be determined in due course. Certainly, Lagarde will likely insist that it remains "flexible", and thus will retain "optionality" for either more hawkish or dovish pivots if the outlook shifts in the course of 2022. That, however, might dilute the impact on yields from the announcement of an envelope of possible additional PSPP purchases. Meanwhile, beyond the asset purchase plans, the ECB might well announce a new long-term liquidity policy to take the place of the TLTRO-iii programme, the last operation of which is being conducted this week.

Revisions to GDP projections to be modest

Unlike the BoE, the ECB will also publish updated economic projections tomorrow, which should provide information about the Governing Council's expected path of rates ahead. Given the current wave of Covid-19 and associated tightening of restrictions, restraints on economic activity caused by supply bottlenecks, and the erosion of real incomes by high inflation, the ECB will revise down its near-term projection for euro area GDP. However, while it will acknowledge additional downside risks to economic output from the Omicron variant, it will take comfort from evidence that it typically does not cause severe symptoms as well as the increasing resilience of activity to each successive wave of pandemic. So, it will still predict that the pre-pandemic level of GDP will be surpassed in the current quarter, and that the economic recovery will be sustained throughout next year. And the revisions to full-year GDP growth from its September projections, of 5.0%Y/Y and 4.6%Y/Y in 2021 and 2022 respectively, should be minimal.

Euro area inflation outlook to be revised higher and close to (but not quite at) 2% target in 2024

More importantly, the ECB will revise up significantly its forecast for inflation. In September, it expected the annual CPI rate to peak at 3.1%Y/Y in the current quarter before falling back below 2.0%Y/Y from Q222 on. But inflation leapt to a 30-year high of 4.9%Y/Y in November. And while it will take a step down in January, higher prices of energy and the pass-through of cost pressures in non-energy industrial goods and services will keep inflation above 2.0%Y/Y at least through to Q322. The ECB will also be wary that the impact of Omicron on supply will mean bottlenecks persist throughout next year, adding to price pressures. So, while it will continue to suggest that headline and core inflation will average less than 2.0%Y/Y in 2023, it could well nudge up its forecasts for that year to above 1½%Y/Y. Moreover, its projections for 2024 – to be published for the first time – will likely suggest that inflation will have returned close to (albeit – according to a Bloomberg report yesterday

– still below) the 2.0%Y/Y target that year. And it will judge risks to the inflation outlook to be skewed to the upside. Given the preconditions set out in its forward guidance, that is unlikely to be consistent with rate hikes in 2022. But take off in 2023 might seem more credible if upside risks start to crystallise.

Flash December PMIs to suggest a softening a growth momentum amid pandemic resurgence

After a quiet day for euro area economic data today – which brought confirmation of the flash estimates of French inflation in November but also downwards revisions of 0.1ppt in the estimates of Italian and Spanish inflation to 3.9%Y/Y and 5.5%Y/Y respectively on the EU headline measures – ahead of the ECB announcements tomorrow will also bring arguably the most noteworthy figures of the week in the shape of the December flash PMIs. The final services PMIs in November recorded a deterioration in conditions compared with the flash release as the resurgence of the Delta variant and reintroduction of restrictions dented confidence and demand. And the subsequent emergence of the Omicron variant and further tightening of lockdown measures in certain member states seems likely to have weighed further on services sentiment this month. Meanwhile, manufacturers are expected to report only modest growth in output as supply-chain disruption continues to weigh on the sector. Also to be published tomorrow are October trade numbers and Q3 labour costs data for the euro area, as well as the French INSEE business confidence indices for December.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**2.8 (3.4)**	2.8 (3.4)	2.6 (3.2)	-
Italy	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**3.7 (3.9)**	3.8 (4.0)	3.0 (3.2)	-
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Nov	**5.5 (5.5)**	5.6 (5.6)	5.4 (5.4)	-
UK	CPI (core CPI) Y/Y%	Nov	**5.1 (4.0)**	*4.9 (3.7)*	4.2 (3.4)	-
	PPI input prices (output prices) Y/Y%	Nov	**14.3 (9.1)**	13.1 (8.1)	13.0 (8.0)	**13.7 (8.6)**
	House price index Y/Y%	Oct	**10.2**	11.2	11.8	**12.3**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Tomorrow's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		09.00	Preliminary manufacturing (services) PMI	Dec	57.8 (54.3)	58.4 (55.9)
		09.00	Preliminary composite PMI	Dec	54.2	55.4
		10.00	Trade balance €bn	Oct	5.8	6.1
		10.00	Labour costs Y/Y%	Q3	-	-0.1
		12.45	ECB refinancing rate %	Dec	*0.00*	0.00
		12.45	ECB marginal lending facility rate %	Dec	*0.25*	0.25
		12.45	ECB deposit rate %	Dec	*-0.50*	-0.50
Germany		08.30	Preliminary manufacturing (services) PMI	Dec	56.9 (51.0)	57.4 (52.7)
		08.30	Preliminary composite PMI	Dec	51.1	52.2
France		07.45	INSEE business confidence	Dec	113	114
		07.45	INSEE manufacturing confidence (production outlook)	Dec	109 (15)	109 (20)
		08.15	Preliminary manufacturing (services) PMI	Dec	55.4 (56.0)	55.9 (57.4)
		08.15	Preliminary composite PMI	Dec	55.0	56.1
UK		09.30	Preliminary manufacturing (services) PMI	Dec	57.6 (57.0)	58.1 (58.5)
		09.30	Preliminary composite PMI	Dec	56.3	57.6
		12.00	BoE Bank Rate %	Dec	*0.10*	0.10
		12.00	BoE Gilt purchase target £bn	Dec	*875*	875
		12.00	BoE Corporate bond target £bn	Dec	*20*	20
Auctions and events						
Euro area		10.30	ECB announces allotment of final TLTRO III operation			
		12.45	ECB monetary policy announcement			
		13.30	ECB President Lagarde speaks at post-Governing Council press conference			
		12.00	BoE monetary policy announcement, publication of MPC meeting summary and minutes			
		12.00	BoE publishes Q4 Agents' summary of business conditions			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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