

Euro wrap-up

Overview

- 10Y Bund yields briefly reached zero percent for the first time in almost three years, while euro area construction output was on track for growth in Q4 and final German inflation data for December provided no surprises.
- Gilts made more significant losses as UK CPI inflation beat expectations, rising to the highest rate in 30 years.
- Tomorrow brings the ECB account from the December meeting that saw the Governing Council agree to reduce its asset purchases this year. Final euro area inflation and a UK housing market survey are also due.

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Daily bond market movements

Bond	Yield	Change
BKO 0 12/23	-0.584	+0.004
OBL 0 10/26	-0.347	+0.004
DBR 0 02/32	-0.016	+0.007
UKT 0 ¹ / ₈ 01/24	0.889	+0.036
UKT 0 ³ / ₈ 10/26	1.048	+0.033
UKT 0 ¹ / ₂ 07/31	1.253	+0.038

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

Euro area

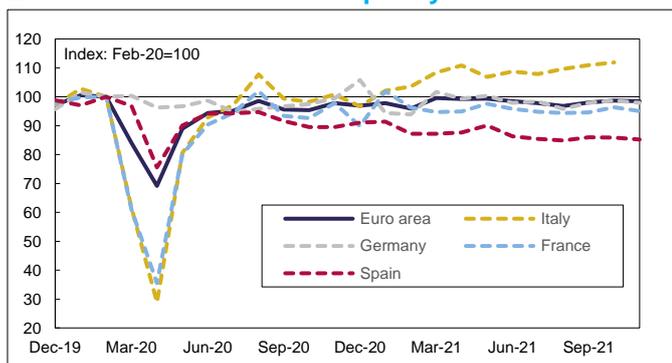
Euro area construction output slips back in November, but still trending higher in Q4

Contrasting with the pickup in manufacturing in November, today's euro area construction numbers suggested that activity slipped back slightly due primarily to weakening output in Germany (-0.8%M/M), France (-1.4%M/M) and Spain (-0.7%M/M). But thanks to solid growth in the Netherlands, Portugal and Austria, the overall decline in euro area construction output was relatively modest at -0.2%M/M. Despite growth being revised lower in October (by 1ppt to 0.6%M/M), output in the first two months of Q4 was still trending 1% higher than the Q3 average. Nevertheless, construction activity still remains 1½% below the pre-pandemic level, with building work and civil engineering below their respective Feb-20 levels despite a rise in the latter in November to its highest since March. Of course, the sector's subdued post-pandemic recovery continues to be restrained by supply-chain challenges. Indeed, the Commission's December economic survey implied that a little less than one third of firms had indicated material and labour shortages as factors limiting building activity. Nevertheless, like the construction PMIs, the survey also pointed to a modest pickup in activity last month. And with order books at record high levels, and house price growth still rapid (8.8%Y/Y in the euro area in Q3), as and when supply bottlenecks ease, we would expect output to accelerate.

Final German inflation matches flash estimates to suggest peak has now passed

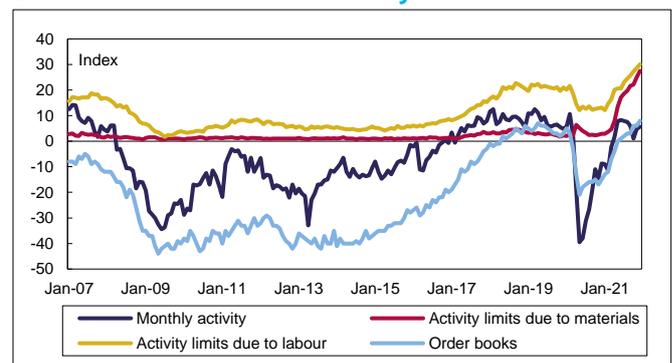
Today's final data for German inflation in December aligned with the flash estimates to suggest that it has now passed its peak. In particular, the headline rate on the EU harmonised HICP measure fell in December by 0.3ppt to 5.7%Y/Y, ahead of what will be a bigger drop this month as base effects associated with tax changes fall out of the calculation. Admittedly, the rise in the national CPI rate of 0.1ppt to 5.3%Y/Y was also confirmed. But the pickup was marginal and this measure will also fall significantly this month in January. Within the detail on the national measure, there was a notable easing in energy inflation last month, by 3.8ppts to 18.3%Y/Y, which, given the slightly larger energy weight in the harmonised measure, explains much of the discrepancy. In contrast, food inflation jumped 1.5ppts to 6.0%Y/Y, the highest for more than thirteen years. And non-energy industrial goods inflation rose 0.5ppt to 2.7%Y/Y, the highest since the series began in the early 1990s, with notable upwards pressure from clothing inflation (up 4.4ppts to 6.2%Y/Y). There were further signs of supply-side pressures with prices of used cars up by more than 2%M/M for the third month out of the past four to be up 11.7%Y/Y, while inflation of computers jumped 2.5ppts to 4.6%Y/Y. Services inflation rose 0.2ppt to 3.1%Y/Y, the highest since 1997, with a notable jump in package holiday prices by 25%M/M December to be up almost 12%Y/Y, the most since mid-2018. As such, the national measure of core inflation rose 0.4ppt in December to 3.7%Y/Y, but the HICP core rate eased 0.2ppt to 3.9%Y/Y. National inflation for 2021 as a whole stood at 3.1%Y/Y, from 0.5%Y/Y in 2020, the highest for almost 30 years.

Euro area: Construction output by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction survey indicators



Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

The focus in the euro area tomorrow will be on the publication of the account of the [ECB monetary policy meeting](#) of 16 December, when the Governing Council decided to slow its net asset purchases steadily over the course of this year. In particular, the account will likely confirm that the decision to end the net PEPP purchases at the end of March was widely endorsed but that a range of views existed with respect to the plans for regular APP purchases thereafter. The account will also probably highlight differing views regarding the chances that the preconditions for a rate hike might be met later this year or – more likely – in 2023. Data-wise, final euro area CPI data are expected to align with the flash figures, which suggested that headline inflation edged up 0.1ppt in December to a new series high of 5.0%Y/Y, while core CPI held steady at 2.6%Y/Y, also a record high. Other data to be published tomorrow include German PPI figures for December and the French INSEE business sentiment numbers for this month.

UK

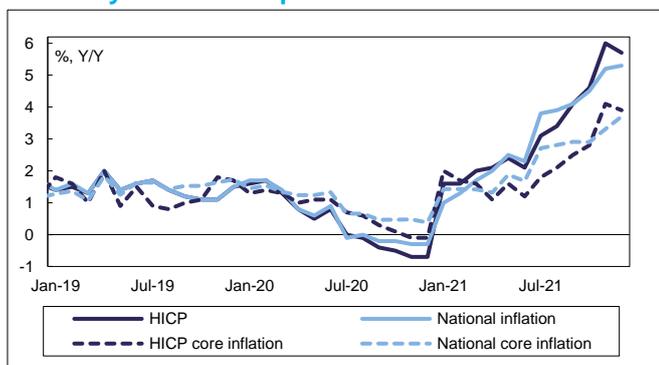
Broad-based pressures push inflation to 30-year high

UK consumer price inflation in December again exceeded most expectations and the projection in the BoE's most recent Monetary Policy Report, rising 0.3ppt to 5.4%Y/Y, the highest since 1992. The pressures on inflation at the end of the year appeared to be broad-based. Some of these came from non-core items, with food inflation up 2.1ppts to 4.5%Y/Y to be the principal driver of the increase from November. However, for a change, with prices of petrol unchanged on the month, inflation of energy eased back somewhat, down 1ppt to 24.5%Y/Y. Meanwhile, despite the latest wave of coronavirus, inflation in restaurants and hotels jumped 0.8ppt to 6.0%Y/Y, contributing to an increase of 0.1ppt in services inflation to 3.4%Y/Y, the highest since 2013. Moreover, amid ongoing supply-chain disruption, inflation of furniture and other household items rose 1.2ppts to 7.3%Y/Y, and inflation of second-hand cars was up 1.5ppts to 28.6%Y/Y. With clothing and footwear inflation up 0.7ppt to 4.2%Y/Y as prices rose in December in contrast to the usual seasonal pattern, the non-energy industrial goods component increased a further 0.5ppt to 5.2%Y/Y, the highest since the early 1990s. So, with signs that pipeline pressures continued to be passed on to consumers, core inflation rose 0.2ppt to 4.2%Y/Y, also the highest in 30 years.

Energy and supply bottlenecks to keep inflation higher for longer

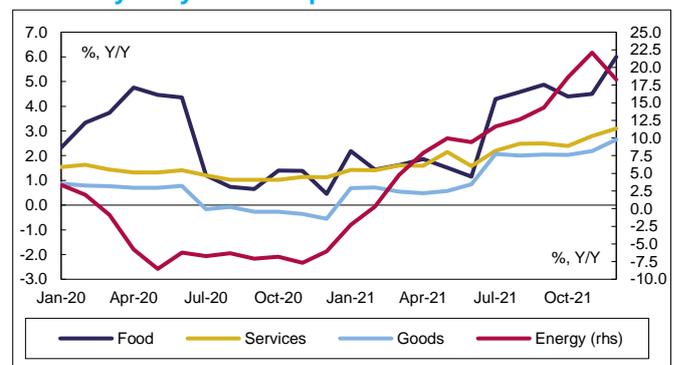
While softer than in November, the biggest contributions to the annual rate of inflation in December still came from household utilities (22.7%Y/Y), petrol (27.8%Y/Y) and other motor fuels, and certain transport services (e.g. air fares were up 28.8%Y/Y) – all items affected by pressures in wholesale energy markets. With prices of Brent crude up this week to above

Germany: Consumer price inflation



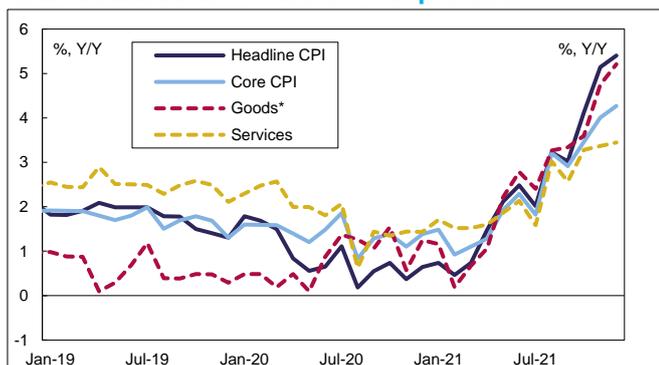
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Key CPI components



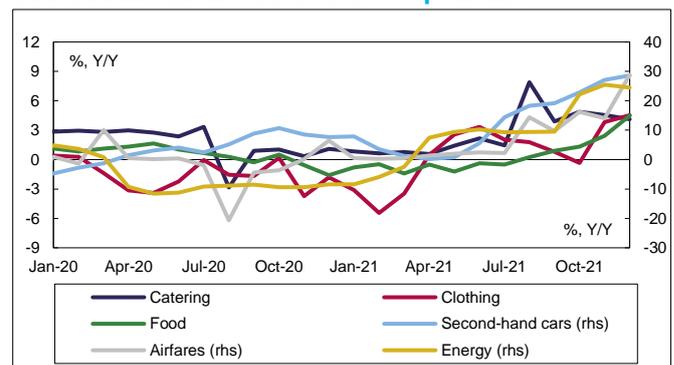
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation – selected components



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

UK: CPI inflation – selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

\$88 per barrel, the highest since 2014, petrol prices are unlikely to offer relief for a while yet. And while wholesale UK natural gas prices have fallen over the past month and are expected to take a step down in the spring and drop further again next year, they remain well above levels three months ago not least due to tensions on the Ukraine-Russia border. So, Ofgem's regulated energy price cap will rise very significantly in April and perhaps again in October. And it remains to be seen whether or not the government will cut VAT on home energy bills or take other measures to offset some of the pain. Regardless, energy inflation seems likely to take another step up at the start of Q2 before easing back gradually over the remainder of the year in the absence of further wholesale price pressures. And with additional scope for further pass-through from producer price inflation over coming months (the output PPI rate edged down just 0.1ppt to 9.3%Y/Y in December), and risks of extra pressures from supply bottlenecks as the Omicron variant spreads across Asia, overall CPI inflation is likely to peak at 6.0%Y/Y or more in April, and fall back only gradually over subsequent quarters, and will remain well above the 2.0%Y/Y target by the end of the year.

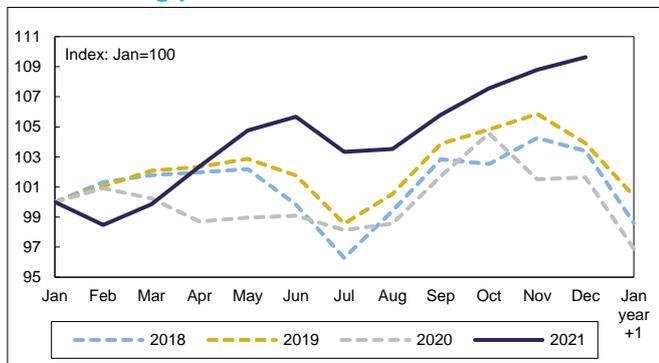
BoE likely to raise rates again next month as English pandemic restrictions are set to expire

It is highly uncertain which side of the 2.0% target inflation will settle on in 2023. Indeed, partly due to the difficulty forecasting energy prices over the horizon, the BoE has for a while acknowledged that there are two-sided risks around the medium-term inflation outlook. And much will depend on the trajectory of wages, which do not yet point to large-scale second-round effects from recent price pressures and suggest that real disposable incomes will fall this year and next. Nevertheless, BoE Governor Bailey today emphasised that he thought that the [labour market](#) was now very tight, with labour supply restricted by both the pandemic and Brexit and anecdotal evidence of pressures on wage settlements in certain sectors. And with the MPC last month having stated that further modest tightening of monetary policy will likely be required, [November's GDP data](#) having beaten expectations, and coronavirus restrictions in England set to expire on 26 January, the expected near-term profiles for economic activity (firm enough) and inflation (very high) are likely to persuade the BoE's MPC to raise rates by a further 25bps in February to 0.5%.

The day ahead in the UK

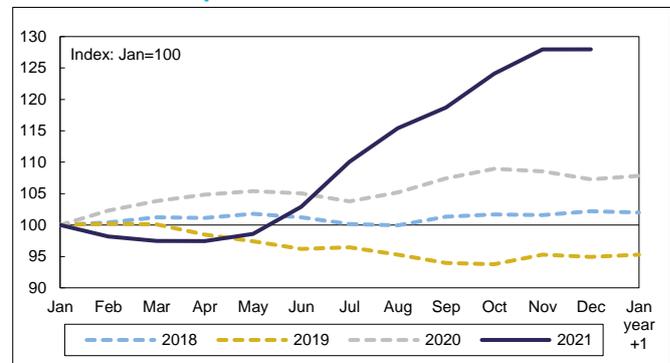
Looking ahead, it should be a relatively quiet day in the UK tomorrow with the RICS residential survey for December due to flag ongoing demand-supply imbalances in the housing market, which continue to support solid house price growth.

UK: Clothing price indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Used cars price indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Construction output M/M% (Y/Y%)	Nov	-0.2 (0.5)	-	1.6 (4.4)	0.6 (3.6)
Germany	 Final CPI (EU harmonised CPI) Y/Y%	Dec	5.3 (5.7)	<u>5.3 (5.7)</u>	5.2 (6.0)	-
UK	 CPI (core CPI) Y/Y%	Dec	5.4 (4.2)	<u>5.4 (4.0)</u>	5.1 (4.0)	-
	 PPI input prices (output prices) Y/Y%	Dec	13.5 (9.3)	13.7 (9.4)	14.3 (9.1)	15.2 (9.4)
	 House price index Y/Y%	Nov	10.0	10.0	10.2	9.8

Auctions

Country	Auction
Germany	 sold €1.3bn of 0% 2036 bonds at an average yield of 0.15%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	 10.00	Final CPI (core CPI) Y/Y%	Dec	<u>5.0 (2.6)</u>	4.9 (2.6)
Germany	 07.00	PPI M/M% (Y/Y%)	Dec	0.8 (19.3)	0.8 (19.2)
France	 07.45	INSEE business (manufacturing) confidence	Jan	109 (112)	110 (111)
Spain	 09.00	Trade balance €bn	Nov	-	-3.4
UK	 00.01	RICS house price balance %	Dec	69	71

Auctions and events

Euro area	 12.30	ECB publishes account of 16 December Governing Council meeting
France	 09.50	Auction: 0% 2025 bonds
	 09.50	Auction: 0% 2027 bonds
	 09.50	Auction: 0.75% 2028 bonds
	 09.50	Auction: 0.1% 2026 inflation-linked bonds
	 09.50	Auction: 0.1% 2031 inflation-linked bonds
	 09.50	Auction: 0.1% 2032 inflation-linked bonds
Spain	 09.30	Auction: 0% 2027 bonds
	 09.30	Auction: 0.5% 2030 bonds
	 09.30	Auction: 1.2% 2040 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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