Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Euro govvie yields surged today after Christine Lagarde strongly suggested that the ECB's policy path will be recalibrated next month, implying a more aggressive slowing of net purchases and probable rate lift-off this year.
- Gilt yields also leaped as the BoE raised rates by 25bps and four out of nine members voted for a hike of 50bps, suggesting that extra tightening is highly likely over the near term.
- Tomorrow's data-flow includes euro area retail sales, German factory orders and French IP, all for December.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.352	+0.125
OBL 0 04/27	-0.051	+0.135
DBR 0 02/32	0.144	+0.108
UKT 0⅛ 01/24	1.143	+0.125
UKT 0⅜ 10/26	1.228	+0.124
UKT 0¼ 07/31	1.380	+0.126

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

Euro area

ECB leaves policy unchanged for now, but recalibration to come next month

As expected, the ECB's Governing Council left all of its policy settings unchanged today. So, for example, it reaffirmed the proposed profile for QE up to the start of Q4. Net PEPP purchases will certainly conclude at the end of next month. And for the time being, net purchases under the regular APP are still set to double to €40bn per month in Q2, before slowing to €30bn per month in Q3 and further to €20bn per month from October. However, while economic activity has been unfolding as the Governing Council had expected, the policy statement acknowledged that inflation in January had further surprised to the upside. And in her press conference, President Lagarde underscored that "the situation has changed". So, the December projections are now obsolete and no longer offer a reliable guide to policy. Instead, Lagarde made clear that the expected policy path will be recalibrated next month on the basis of the ECB's updated projections.

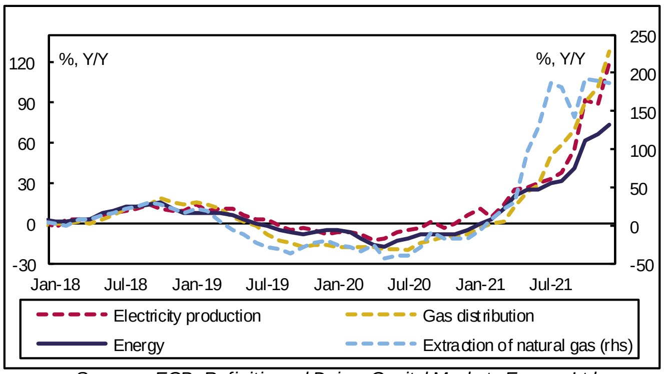
Net asset purchases to be slowed more aggressively from next month

With respect to the sequencing of policy tightening, in her press conference, Lagarde restated that the ECB's net asset purchases would have to be phased out before interest rates can be hiked. However, understandably given recent data, she refused to repeat her previous assessment that a rate hike this year is "highly unlikely". Indeed, in the absence of major downside surprises, it is likely that the ECB's updated projections next month will nudge up the inflation forecasts for 2023 and 2024 to the 2.0% Y/Y target, suggesting that the preconditions for a rate hike have been met. So, we expect the Governing Council then to decide to slow its net asset purchases more aggressively than currently scheduled. While it would be too risky to end them as soon as Q2, the Governing Council might consider it to be desirable to bring them to an end by September. And that would open the door to at least one rate hike before the end of the year.

Expect a rate hike by year-end but outlook remains highly uncertain

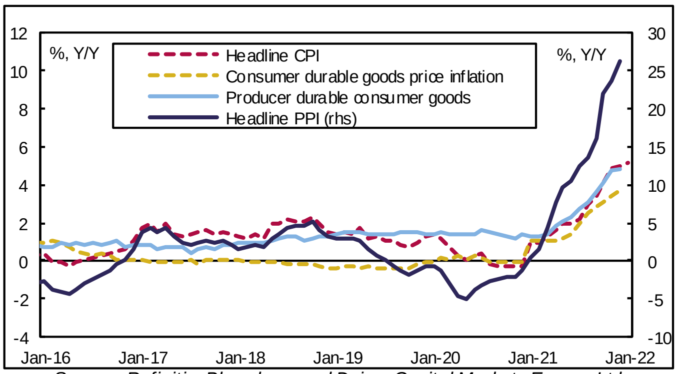
Given yesterday's inflation data and today's press conference, we now forecast a first increase in the deposit rate of 25bps in December to -0.25%. After that, we might expect a further increase of 25bps in the deposit rate and repo rate, to zero percent and 0.25% respectively in March 2023. But we would not rule out rate lift-off starting as soon as September, allowing for two hikes in the deposit rate before year-end. The only thing that is clear is that the outlook is undeniably extremely uncertain, tainted as much by geopolitical (Russian) and political (Italian) risks as those associated with the pandemic (new variants), economics (bottlenecks, wages, etc.) and markets (shifts in prices of oil and natural gas, and the extent of widening of periphery spreads). Even if the ECB is able to press ahead with additional tightening into 2023 and push the deposit rate well into positive territory, we would not be surprised if it subsequently had to shift to an easing bias later next year in response to a weakening economy and an eventual marked drop in inflation.

Euro area: Producer energy price inflation



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

Euro area: Consumer and producer price inflation



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

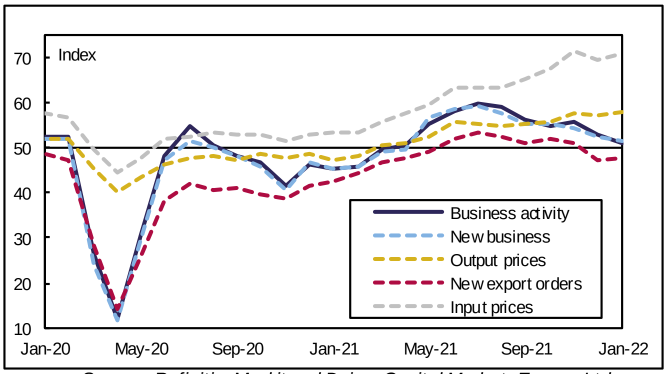
Euro area PPI inflation up to new high as energy prices soar

Data-wise, today's producer price inflation figures highlighted the significant pressures up the supply chain at the end of 2021. After the flash euro area CPI estimate yesterday saw consumer price inflation jump to a record high of 5.1%Y/Y – of which energy accounted for more than 3.0ppts – producer output prices rose by almost 3%M/M in December, admittedly below the near-5½%M/M increase in October, but still the third-strongest on record. This took the annual PPI inflation rate up a further 2.5ppts to a whopping 26.2%Y/Y, a fresh series high. Energy remained the main driver, with prices up 7.0%M/M to push the annual rate up to 73.4%Y/Y. And producer prices of electricity and gas distribution rose by almost 120%Y/Y and 130%Y/Y respectively. Elsewhere, perhaps reflecting a modest easing in supply bottlenecks of certain key manufacturing inputs, the monthly increase in prices of intermediate items rose 'just' 0.7%M/M, the softest pace for a year, albeit taking the annual rate up a further 1.4ppts to a new euro-era high of 18.6%Y/Y. There was also evidence of increased pass-through to other categories, with producer inflation of consumer goods up to a new high of 4.5%Y/Y.

Services PMIs flag a significant hit to activity in Italy and Spain

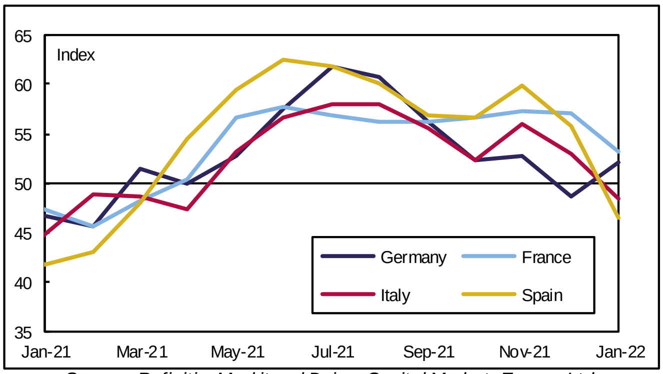
Today's services PMIs also continued to flag extremely elevated inflationary pressures in the sector. Indeed, input costs reportedly rose at the second-strongest pace on the survey, surpassed only by November's peak. And today's results also implied a further acceleration in output prices charged at the start of the year, with the respective PMI (57.9) rising to a fresh series high. This was in spite of the sizeable slowing of activity in the sector, with the final headline PMI revised a touch lower from the flash reading to be 2pts weaker than in December at a nine-month low of 51.1. And new business was weighed by weaker domestic and overseas demand as uncertainty about the near-term outlook increased. This was particularly striking in Italy and Spain, where the respective new business PMIs fell 7.1pts to a nine-month low (48.3) and 8.7pts to an eleven-month low (47.1). The hit to services activity in January was more evident in the periphery countries too, with the headline PMIs implying contraction in the sector at the start of the year – Italy's index declined 4.5pts to 48.5, while Spain's index fell a whopping 9.2pts to 46.6. Taken together with the manufacturing survey, the Italian composite PMI (50.1) was consistent with stagnation at the start of the year. And in Spain, the respective index declined by the most since April 2020 (a sharp 7.5pts) to 47.9, consistent with a contraction in GDP. In contrast, the final German survey pointed to a return to growth in services at the start of the year (the headline index rose 3.5pts to 52.2), to leave the composite PMI (53.8) at a four-month high. And while France reported a weaker performance in January, its final services and composite activity PMIs (53.1 and 52.7 respectively) were still consistent with ongoing moderate recovery in early 2022.

Euro area: Services PMIs by selected components



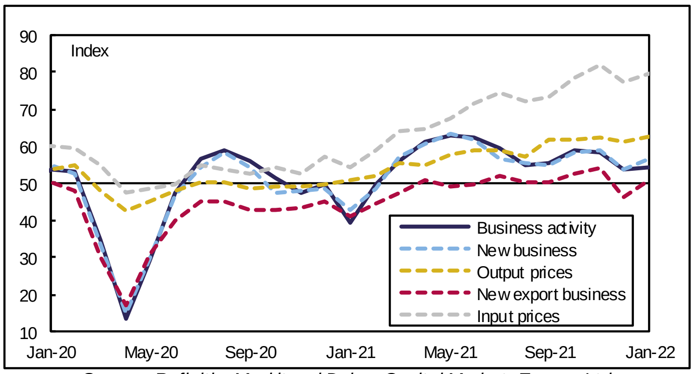
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs by selected country



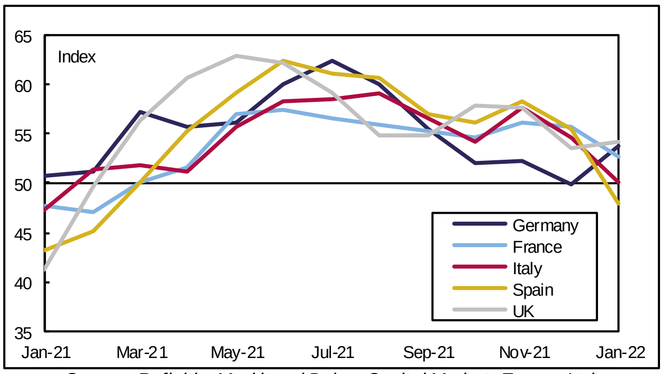
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs by selected components



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

Europe: Composite PMIs by selected country



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

The day ahead in the euro area

Tomorrow brings the release of data for euro area retail sales in December, which are expected to have fallen for the first time in five months amid more stringent pandemic-related restrictions and following strong growth in November. Expectations are for a decline of 0.9%M/M, almost fully reversing November's 1.0%M/M increase, and resulting in a quarterly rise of 0.9%Q/Q in Q4 matching the increase in Q3. Of course, total consumption will have slowed more substantially reflecting the hit to services during the latest pandemic wave. Other releases due to be published tomorrow include German factory orders and French industrial production data for December. Orders are expected to have risen slightly further at the end of last year following a rebound in November, while French IP is forecast to have reversed the 0.4%M/M drop in November. The January construction PMIs for the euro area and large member states are also due.

UK

BoE raises Bank Rate again and starts quantitative tightening

The BoE's MPC today agreed to raise Bank Rate for the second meeting in a row. The increase of 25bps to 0.50% was universally anticipated. However, four members of the nine-person Committee – including one deputy governor (Ramsden) and three external members (Haskel, Mann and Saunders) – voted for a hike of 50bps, suggesting that another rate hike is going to be along very shortly. Moreover, with the key threshold of 0.5% reached for Bank Rate, the MPC followed through on its earlier guidance and agreed unanimously to start quantitative tightening by ceasing the reinvestments of principal as and when its bond holdings mature, starting with the redemption of £27.9bn of Gilts in March. It also decided immediately to start actively selling its corporate bonds from its portfolio, with the objective to unwind that stock (£20bn) fully "no earlier than towards the end of 2023". The MPC also reaffirmed that it will consider to actively sell Gilts once it increases Bank Rate to 1.0%, a threshold that now seems extremely likely to be reached before the end of the year – and most likely by the end of the next quarter.

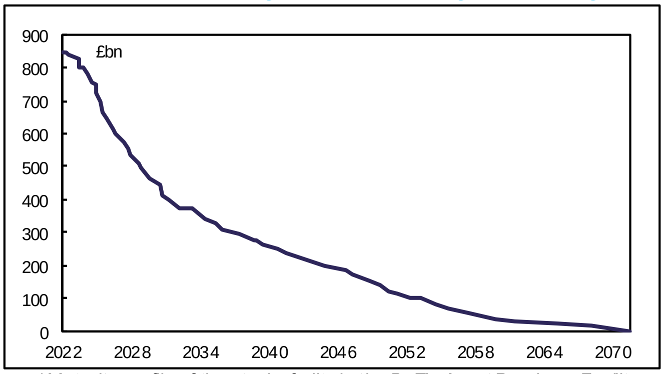
A very weak outlook for GDP growth as real labour incomes decline

The case for raising rates again was based on the BoE's updated economic projections. But it was certainly not driven by the forecast for GDP growth. While economic activity is expected to rebound briefly from the recent Omicron shock in February and March and into Q2, growth is now expected by the MPC to slow again close to a zero quarterly rate by the end of the year, and be subdued at around 1.0%Y/Y thereafter. As result, by the end of the forecast period, the unemployment rate is expected to rise to around 5%, with spare capacity opening up to around 1% of GDP. The cause of the expected slowdown, of course, is the jump in energy and goods prices, which are judged to represent an adverse terms of trade shock for the UK economy and will erode real incomes. Indeed, the BoE's updated forecast predicts a drop in real post-tax labour income of 2%Y/Y in 2022 and a further ½%Y/Y in 2023. And the marked deterioration in the standard of living will weigh on consumer spending even as a further drop in the savings ratio cushions the impact somewhat.

Inflation expected to surpass 7%Y/Y in April before falling back close to target by 2025

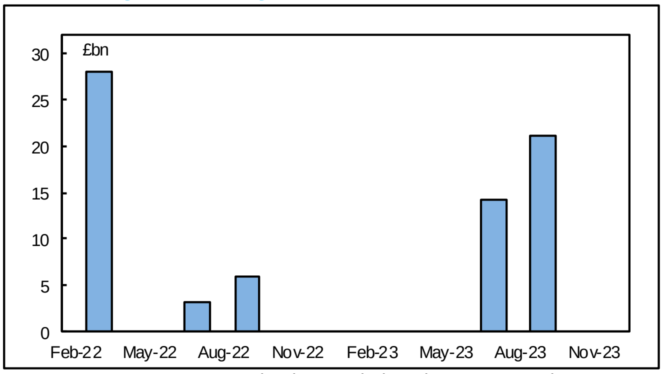
In normal times, the BoE would not tighten policy in anticipation of such a weak growth outlook. But, of course, these times are not normal. Inflation is expected to rise even further than previously feared, to close to 6%Y/Y in February and March, before peaking in April at around 7¼%Y/Y, some 2 percentage points higher than expected by the BoE just three months ago. Assuming an easing of supply bottlenecks and stable energy prices in six months' time, inflation would then be expected to fall back, particularly from next year on as unemployment picks up and underlying wage growth slows. Based on its assumption of a market-implied path for Bank Rate, rising to 1½% by the middle of 2023, the BoE's forecast suggested that inflation would still be above the 2% target in two years' time but will then fall to about 1.7%Y/Y by Q125. But assuming that Bank Rate remains unchanged at 0.5%, inflation would fall to just above the target (2.1%Y/Y) by the end of the forecast horizon.

UK: BoE outstanding stock of APF gilt holdings*



**Maturity profile of the stock of gilts in the BoE's Asset Purchase Facility.*
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE gilt holdings due to mature



Source: BoE and Daiwa Capital Markets Europe Ltd.

Further tightening likely over the near term

The MPC's statement noted that "some further modest tightening in monetary policy is likely to be appropriate in the coming months". The implication of the BoE's economic projections was that Bank Rate might peak at about 1.00% to ensure that inflation stabilizes close to target over the medium term. However, the outlook remains exceptionally uncertain. The MPC made clear that, given some survey evidence that higher inflation expectations are becoming embedded in wage settlements, the near-term risks to inflation are judged to be skewed to the upside. By the same token, forward markets suggest that energy prices might be significantly lower in 2023 and 2024, implying that the medium-term risks to the inflation outlook are skewed to the downside. Moreover, there are plenty of unknowns – not least those related to supply bottlenecks, energy prices and geopolitics, including events at the Ukraine-Russia border. And the BoE's forecasts are already, to some extent, out of date. The energy regulator Ofgem today confirmed a rise of 54% in its household energy price cap from April, so that average bills will rise by £693 annually. Admittedly, the Bank's forecast assumed a similar rise close to 50%. But in response, the UK government announced a temporary discount on all electricity bills worth £200 from October, to be clawed back in instalments over the coming five years. And it also announced a council tax rebate worth £150 per year, for many households. The net impact on the medium-term path of inflation, however, is not clear.

Will rate cuts be on the table by end-2023?

Overall, therefore, the outlook for the UK economy and BoE monetary policy remains highly uncertain. However, we now look for further hikes of 25bps apiece at the next two MPC meetings in March and May, to take Bank Rate to 1.0%. That might also trigger the start of active BoE gilt sales before the summer. At least one further hike in the second half 2022 might also be forthcoming. However, with economic growth expected to be weak thereafter, if energy prices follow the path set out in forward markets, we would then not be surprised to see Bank Rate cut before the end of 2023 and into 2024.

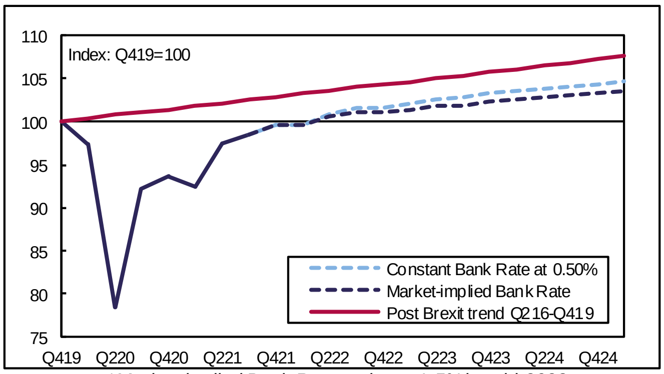
Services output prices up most in 25 years, activity also firmer in January

The further upwards revision to the MPC's inflation forecast is entirely consistent with recent data and surveys. After yesterday's BRC survey reported that shop-price inflation jumped in January to the highest since 2012, today's final PMI surveys suggested that efforts to pass on higher cost burdens – including from rising energy, transport and wages bills – led to the steepest rate of prices charged by services firms since the survey began in mid-1996. Indeed, the output price PMI rose to 62.6, almost 5pts higher than the average level in 2021. There were also some signs of stabilisation in activity as restrictions across England were relaxed in the final week of January – indeed, the headline PMI was upwardly revised from the flash estimate by 0.8pt to 54.1, to leave it 0.5pt higher than in December. That was still below the average last year (56.0) as consumer-facing services were still adversely impact by the latest pandemic wave. But firms reported improved demand from home and overseas. And so, the survey's employment component implied ongoing solid job growth, although respondents reported increased quits due to higher pay offered elsewhere and ongoing difficulties recruiting suitably skilled. Taken together with improved manufacturing conditions, the composite output PMI rose 0.6pt in January to 54.2, admittedly still more than 2pts lower than the Q4 average but nevertheless pointing to stabilisation at the start of the year.

The day ahead in the UK

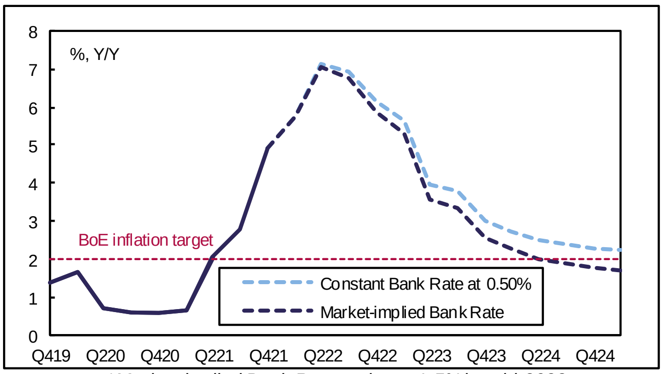
In the UK tomorrow we will get the release of new car registrations data for January. Car manufacturers continue to battle persistent supply-side challenges reflecting the global semiconductor shortage and staff absences due to the pandemic. As such, UK car registrations are expected to have remained very subdued at the start of this year. The UK construction PMI for January will also be published, while BoE Deputy Governor Broadbent and Chief Economist Pill will brief BoE agents' contacts about today's Monetary Policy Report and policy decision.

UK: BoE GDP forecast*



**Market-implied Bank Rate to rise to 1.5% by mid-2023.*
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE inflation forecast*



**Market-implied Bank Rate to rise to 1.5% by mid-2023.*
Source: BoE and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final services (composite) PMI	Jan	**51.1 (52.3)**	51.2 (52.4)	53.1 (53.3)	-
	PPI M/M% (Y/Y%)	Dec	**2.9 (26.2)**	2.4 (26.1)	1.8 (23.7)	-
	ECB refinancing rate %	Dec	**0.00**	*0.00*	0.00	-
	ECB deposit rate %	Dec	**-0.50**	*-0.50*	-0.50	-
Germany	Final services (composite) PMI	Jan	**52.2 (53.8)**	52.2 (54.3)	48.7 (49.9)	-
France	Final services (composite) PMI	Jan	**53.1 (52.7)**	53.1 (52.7)	57.0 (55.8)	-
	Services (composite) PMI	Jan	**48.5 (50.1)**	50.0 (52.3)	53.0 (54.7)	-
Spain	Services (composite) PMI	Jan	**46.6 (47.9)**	51.9 (52.7)	55.8 (55.4)	-
UK	Final services (composite) PMI	Jan	**54.1 (54.2)**	53.3 (53.4)	53.6 (53.6)	-
	BoE Bank Rate %	Feb	**0.50**	*0.50*	0.25	-

Auctions

Country	Auction
France	sold €3.3bn of 0% 2030 bonds at an average yield of 0.3%
	sold €3.4bn of 0% 2032 bonds at an average yield of 0.45%
	sold €2.8bn of 0.5% 2044 bonds at an average yield of 0.85%
	sold €2.0bn of 0.75% 2053 bonds at an average yield of 1.05%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	Retail sales M/M% (Y/Y%)	Dec	-0.9 (5.0)	1.0 (7.8)
Germany	07.00	Factory orders M/M% (Y/Y%)	Dec	0.3 (3.0)	3.7 (1.3)
	08.30	Construction PMI	Jan	-	48.2
France	07.45	Preliminary private sector payrolls Q/Q%	Q4	0.4	0.5
	07.45	Preliminary wages Q/Q%	Q4	-	0.3
	07.45	Industrial production M/M% (Y/Y%)	Dec	0.5 (0.5)	-0.4 (-0.5)
	07.45	Manufacturing production M/M% (Y/Y%)	Dec	0.8 (-)	-0.6 (-1.2)
	08.30	Construction PMI	Jan	-	50.9
Italy	08.30	Construction PMI	Jan	-	64.4
UK	09.00	New car registrations Y/Y%	Jan	-	-18.2
	09.30	Construction PMI	Jan	54.3	54.3

Auctions and events

Country	GMT	Event
Euro area	09.00	ECB publishes its survey of professional forecasters
	16.00	ECB's Villeroy scheduled to speak at an online event
UK	12.15	BoE Deputy Governor Broadbent and Chief Economist Pill brief BoE's agents' contacts about monetary policy decision

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs