Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses as initial financial sanctions against Russian interests underwhelmed and the latest ifo survey signalled a broad-based improvement in German business optimism.
- Gilts also made losses as a CBI survey suggested a further increase in UK manufacturers' price expectations and the public finances improved further despite a big pickup in government debt interest payments.
- Wednesday will bring updates on the confidence of German consumers and French businesses while BoE Governor and other MPC members will speak publicly.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.417	+0.046
OBL 0 04/27	-0.007	+0.045
DBR 0 02/32	0.241	+0.038
UKT 0⅛ 01/24	1.321	+0.053
UKT 0⅜ 10/26	1.352	+0.055
UKT 0¼ 07/31	1.464	+0.059

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

Euro area

German ifo survey echoes upbeat flash PMIs, for now

After Russian troops were ordered into Eastern Ukraine, risk appetite was initially thin on the ground today. However, while German Chancellor Scholz said that approval of the Nord Stream 2 gas pipeline would be put on hold, the first phase of sanctions proposed by the EU and UK underwhelmed, and so European equity markets largely recovered and government bond yields rose. Of course, an escalation of the crisis, involving a broader Russian offensive, remains a significant risk. Among other things, that would highly likely push oil prices well above $100bbl and European wholesale natural gas prices (which today remained more than 50% below December's peak) back close to recent highs, with highly adverse consequences for GDP growth and inflation. Nevertheless, overlooking those concerns about Ukraine, today's German ifo business survey echoed the optimism of yesterday's flash PMIs. In particular, the headline business climate index rose a further 2.9pts in February to 98.9, a five-month high, with firms more upbeat about the current situation as well as the outlook for the coming six months, with the balance for the latter the highest since July.

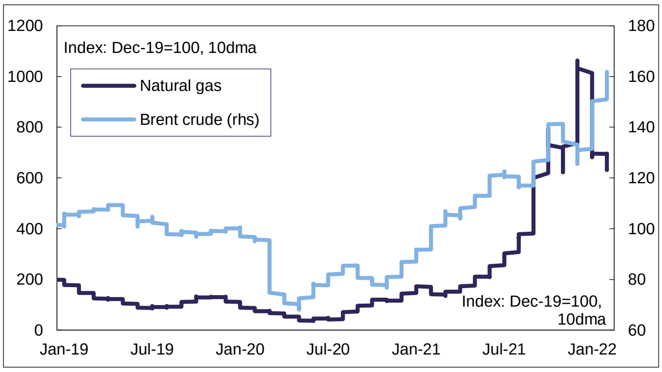
Services happier as pandemic wave peaks, manufacturers happier as bottlenecks gradually ease

Within the detail, there was a sizable improvement in services firms' assessment of current conditions reflecting not least greater optimism in hospitality. However, the overall index for the sector was still well below last summer's highs. Meanwhile, although shortages of materials continued to hamper production, manufacturers were the most upbeat about current conditions since August and construction firms the most positive since the onset of the pandemic as supply bottlenecks were judged to have eased somewhat. In contrast, retailers judged that conditions remained tough. But looking ahead, with the exception of construction, firms in all sectors were more sanguine about the outlook, taking comfort from the planned relaxation of pandemic-related restrictions and (hopeful) peak in coronavirus cases. Nevertheless, the Bundesbank yesterday warned of the risk of technical recession at the turn of the year. Indeed, reflecting not least wide-spread worker absences due to Covid-19, it cautioned that the hit to activity last month was not confined to services. Our current forecast, however, is for German GDP in Q1 to largely reverse the 0.7%Q/Q contraction in Q4.

The day ahead in the euro area

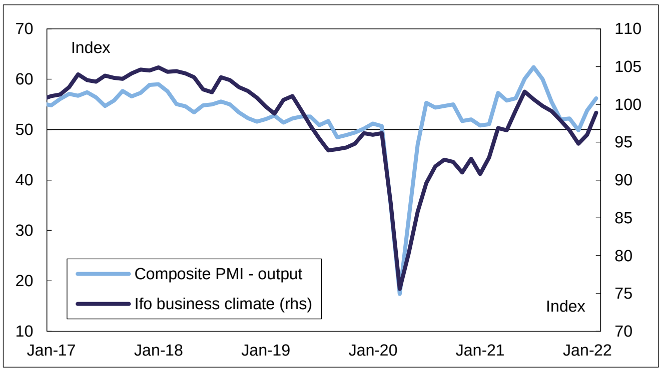
Tomorrow will bring more national sentiment survey results, with the German GfK consumer confidence and French INSEE business indicators due. Final euro area CPI inflation figures for January are also scheduled for release. While the updated Italian figures today revised down the headline HICP rate (by 0.2ppt to 5.1%Y/Y), this followed a modest upwards revision to

Natural gas and Brent Crude futures



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: ifo and PMI indices



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

the equivalent Spanish numbers last week (up 0.1ppt to 6.2%Y/Y). And not least due to rounding, we expect the euro area's headline HICP rate to be confirmed at 5.1%Y/Y in January, a series high and 0.1ppt higher than December. But with the largest pressures once again coming from energy prices, the drop in core inflation of 0.3ppt to 2.3%Y/Y is also likely to be confirmed. The detailed breakdown, to be published for the first time, will give further insight on underlying price pressures.

UK

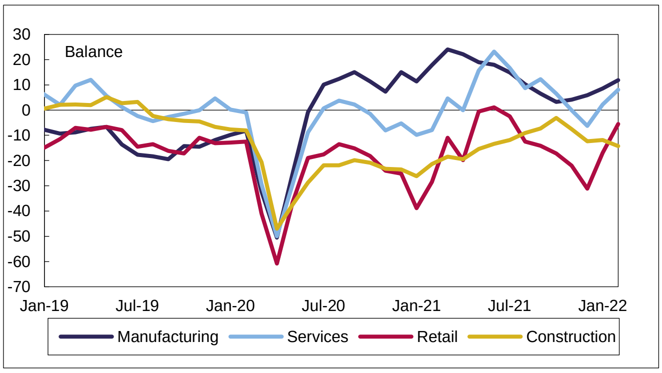
Highest share of manufacturers expecting price rises since 1976

Consistent with yesterday's flash manufacturing PMIs, today's CBI industrial trends survey suggested that output accelerated in the three months to February, with 13 out of 17 subsectors reporting increased growth. While manufacturers continued to cite inadequate inventories for the second successive month, with orders ample (despite still subdued external demand), the share of manufacturers expecting production to expand over the coming three months rose to a three-month high. But the main takeaway from today's survey was the further significant rise in the share of respondents expecting higher prices over the coming three months. Indeed, while yesterday's flash PMIs reported a drop in the output price index to a nine-month low (albeit at a still-elevated 69.1), the CBI survey suggested that more than three-quarters of respondent firms – the highest since December 1976 – expected to increase prices. Against this backdrop, Deputy Governor Dave Ramsden in a speech today noted that the BoE was facing the biggest inflation challenge since becoming independent in 1997, with the recent rise in energy prices not foreseen in its latest forecasts. But he also noted that near-term policy adjustments would not diffuse current pressures in energy and tradeable goods prices. And so, while he was one of the four MPC members voting for a 50bps hike in February, the message of his speech was broadly balanced, reiterating that only "*modest* tightening" will be required over the near term. And he acknowledged that events in Ukraine had increasingly clouded the near-term outlook.

UK government surplus misses forecast in January

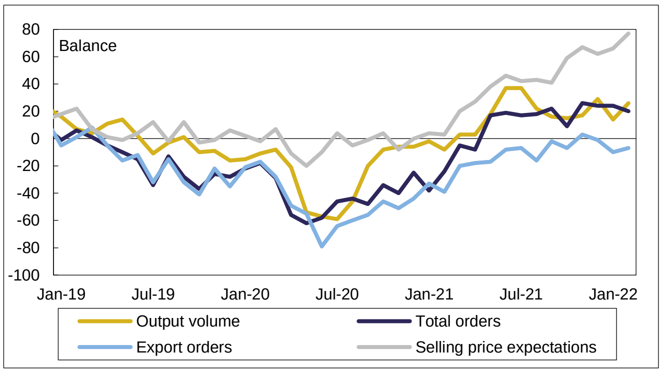
The UK's public finances were not quite as strong as expected in January, with a monthly net surplus (excluding public sector banks) of £2.9bn, about £0.6bn shy of the OBR's forecast. It was also £7.0bn smaller than the surplus in January 2020 ahead of the pandemic, but still marked a drop in net borrowing of £5.4bn from a year earlier. Compared to that benchmark of a year earlier, the improvement entirely reflected developments on the revenue side, with central government receipts up £8.6bn thanks not least to the rebound in economic activity and recovery in the labour market, where both employment and wage growth have exceeded expectations. In contrast, central government expenditure was up about

Germany: ifo expectations indices



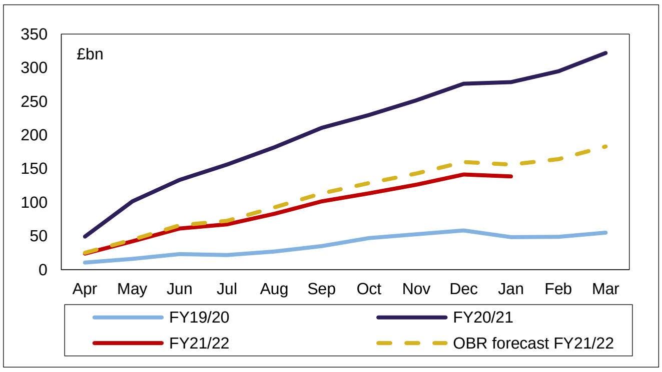
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: CBI industrial trends survey indices



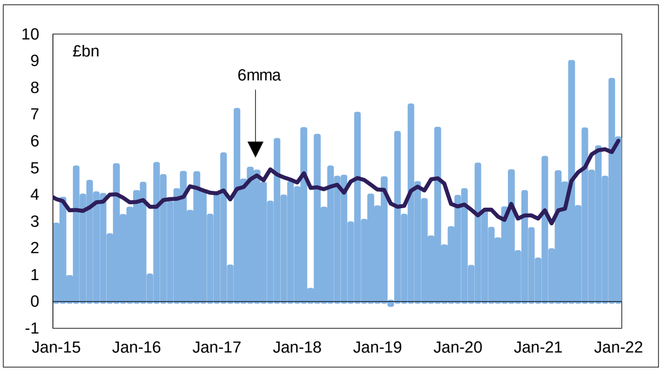
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Public sector net borrowing



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

UK: Central government debt interest payments



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

£0.5bn, with debt interest payments £4.5bn higher than a year earlier to a lofty £6.1bn, the highest January level since the monthly series began and taking year-to-date spending some £8.8bn above the forecast by the OBR in October.

Cumulative borrowing in FY21/22 continues to undershoot expectations (for now)

Cumulative public sector net borrowing excluding the public sector banks (PSNB ex) reached £138.5bn in the financial year-to-January, representing the second-highest level for the period on the series albeit a little less than half of the same period during the first year of the pandemic. And thanks to a surplus of receipts relative to the OBR's forecast profile, borrowing was some £17.7bn (about 0.8% of GDP) less than forecast by the OBR. That might suggest some scope for a modest relaxation of the fiscal stance in the Spring Statement on 23 March to take the edge off the planned increase in national insurance contributions for certain groups, and also tax cuts ahead of the next general election, currently scheduled for May 2024. However, the further leap in retail price inflation – which in January reached a whopping 7.8%Y/Y, the highest since 1991 – as well as increases in Bank Rate and Gilt yields, will put further upwards pressure on debt interest payments over coming months, further eroding the government's room for manoeuvre. The OBR's precise assessment of the scope for giveaways ahead will in part be determined by its updated judgement of long-term scarring of the pandemic on the economy and its potential level of GDP. The continued rise in labour inactivity due not least to long-term sickness, as well as the recent moribund performance of business investment, might call for a conservative assessment in that regard.

The day ahead in the UK

On a day bereft of top-tier UK data, focus tomorrow will turn to the appearance of BoE MPC members, including Governor Bailey, before the Treasury Select Committee. While the narrative will be primarily determined by the Bank's latest Monetary Policy Report, the policy makers are also highly likely to be quizzed on their likely reaction function to unfolding risks associated with Russia and Ukraine.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	ifo business climate index	Feb	**98.9**	96.5	95.7	**96.0**
	ifo current assessment (expectations) balance	Feb	**98.6 (99.2)**	96.5 (96.5)	96.1 (95.2)	**96.2 (95.8)**
Italy	Final CPI (EU-harmonised CPI) Y/Y%	Jan	**4.8 (5.1)**	4.8 (5.3)	3.9 (4.2)	-
UK	Public sector net borrowing, excluding banks £bn	Jan	**-2.9**	-1.2	16.8	**15.3**
	CBI industrial trends survey, total orders (selling prices)	Feb	**20 (77)**	26 (65)	24 (66)	-

Auctions

Country	Auction
- Nothing to report -	

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	Final CPI (core CPI) Y/Y%	Jan	*5.1 (2.3)*	5.0 (2.6)
Germany	07.00	GfK consumer confidence index	Feb	-6.3	-6.7
France	07.45	INSEE business (manufacturing) confidence index	Feb	108 (112)	107 (112)

Auctions and events

Country	GMT	Event
Euro area	11.30	ECB Vice President de Guindos takes part in Q&A session
Germany	10.30	Auction: €1.5bn of 2036 bonds
Italy	10.00	Auction: €3bn of 0% 2023 bonds
UK	09.30	BoE Governor Bailey and Deputy Governor Broadbent testify on Monetary Policy Report to Treasury Select Committee

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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