Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- While Spanish and Portuguese inflation data again surprised on the upside, euro area government bonds rallied as the Ukraine conflict persisted, sanctions generated financial instability in Russia, and ECB policymakers flagged concerns about the risks to the outlook.
- Gilts also rallied despite another upbeat survey of UK businesses.
- Tuesday brings flash estimates of German and Italian inflation in February as well as final manufacturing PMIs and UK bank lending figures.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.530	-0.134
OBL 0 04/27	-0.151	-0.144
DBR 0 02/32	0.144	-0.082
UKT 1 04/24	1.054	-0.149
UKT 1¼ 07/27	1.067	-0.137
UKT 4¼ 06/32	1.425	-0.066

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

Euro area

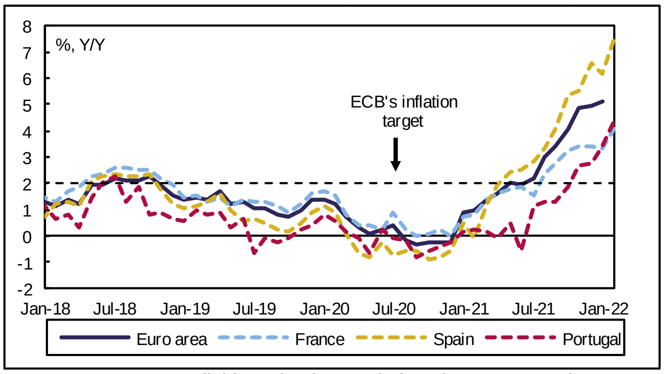
Iberian inflation stronger than expected in February

After Friday's upside surprise to France's flash February inflation figures, today's data also suggested a significant intensification of price pressures in Iberia. In Spain, the EU-harmonised HICP measure of inflation came in well above expectations, rising 1.3ppts to 7.5%Y/Y, a new series high. The national CPI measure similarly saw headline inflation rise 1.3ppts to 7.4%Y/Y, the joint-highest rate since comparable statistics began in 1986. While there was no detailed breakdown, the Spanish statistical office noted that there was a broad-based increase in inflation in February, pushing the national core CPI measure up 0.6ppt to 3.0%Y/Y, the highest since September 2008. In Portugal, meanwhile, HICP inflation jumped 1.0ppt to 4.4%Y/Y, the highest for almost a decade. And on the national measure, headline inflation rose 0.9ppt to 4.2%Y/Y, the highest since September 2011, with core inflation also up 0.8ppt to 3.2%Y/Y, the highest for almost 16 years. The data from Belgium and Slovenia suggest a notable step-up in pressure in February too. So, while we will have greater clarity after tomorrow's flash German and Italian estimates, we have nudged up our forecast for euro area inflation, with the headline rate likely to rise 0.5ppt to 5.6%Y/Y, a new euro-era high. And with price pressures from pandemic-related adjustments and supply bottlenecks seemingly having become broader based, we expect core inflation to rebound by at least 0.3ppt to 2.6%Y/Y.

Inflation outlook continues to deteriorate but so too does outlook for demand and financial stability

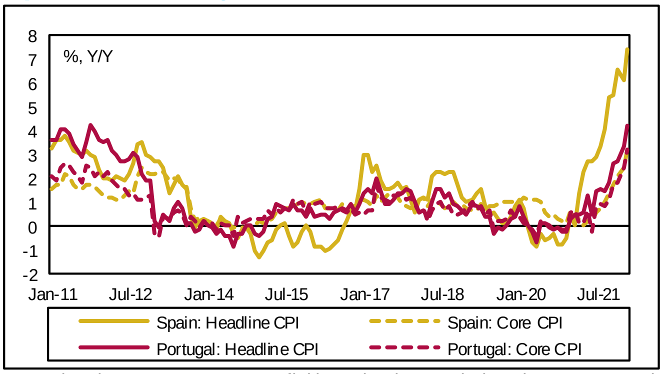
Given the conflict in Ukraine, sanctions against Russia, and their resulting impact on energy and commodity prices, euro area inflation is now set to continue rising well above the path set out by the ECB in its December forecasts. While inflation was expected to have peaked in Q421 at 4.6%Y/Y, a peak next quarter well above 6% now seems likely. And should Russia retaliate against western sanctions by squeezing the supply of energy and other commodities, the peak would be significantly higher still and inflation remain more than double the ECB's 2% target well into 2023. At the same time, by significantly eroding household purchasing power and weighing on confidence, this imported inflation would further depress demand. And while the euro area's direct trade and banking sector exposures with Russia are relatively limited, the consequences of economic and financial stress within Russia itself pose further risks to economic demand and financial stability. Of course, events in Ukraine and their political and financial consequences now remain impossible to predict with any accuracy. So, the economic outlook is now acutely uncertain. With developments in an extreme state of flux, President Christine Lagarde this afternoon cancelled a planned speech while Bundesbank Governor Nagel did likewise for his scheduled press conference on Wednesday. And those members of the Governing Council who spoke publicly today were mindful of the extreme uncertainty of the outlook, suggesting that it merited a more cautious approach to monetary policy ahead.

Euro area: HICP inflation by selected country



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Spain and Portugal: Headline and core inflation*



National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

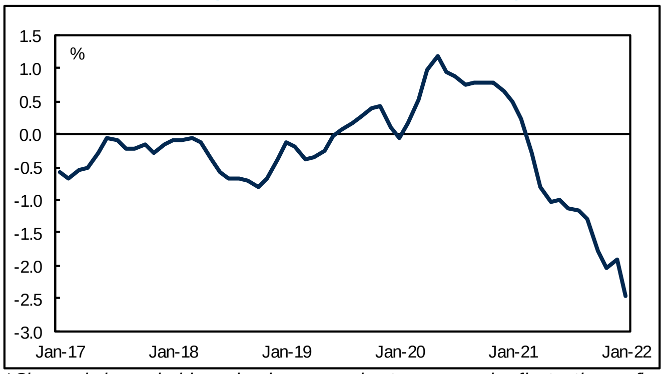
ECB unlikely to pre-commit to continuous policy tightening as risks from Ukraine mount

Most notably, ECB Executive Board member Fabio Panetta – admittedly usually one of the most dovish members of the Governing Council – judged that the Ukraine conflict is already weighing negatively on both supply and demand, generating greater financial volatility in the short term, and exacerbating medium-term inflation risks on both sides. As such, he argued that it would be "unwise [for the ECB] to pre-commit on future policy steps until the fallout from the current crisis becomes clearer." Rather than react prematurely to high inflation and risk suffocating the recovery, he added that the ECB's "immediate priority [should be] to protect the functioning of the financial sector and bolster confidence, in order to contain the impact of the shock on the economy and keep in place the conditions for the smooth implementation of monetary policy". Moreover, the current circumstances merited a "light touch, taking moderate and careful steps as the fallout from the current crisis becomes clearer". He also argued that "a key lesson from the previous crisis is not only that rates should not be raised prematurely, but also that doing so without the right framework in place can lead to renewed financial fragmentation" – in other words, rate hikes should wait, and when they eventually come should only do so with adequate provisions in place for renewed asset purchases if necessary. While he didn't go quite as far as Panetta, in an interview with Bloomberg, Portuguese Governor Centeno argued that the new uncertainties could justify sticking to the path of asset purchases agreed in December, rather than pushing ahead with a faster phasing out of QE. And although many Governing Council members might disagree with that, all should agree that the current circumstances merit a gradual and flexible approach at the ECB, with changes to policy made only in small steps, as events in Ukraine unfold. In light of the heightened financial risks, we would not rule out new initiatives in due course to add liquidity. And it is well within the bounds of possibility that the ECB's net asset purchases will persist into 2023, while rate hikes now seem unlikely to occur before next year too.

The day ahead in the euro area

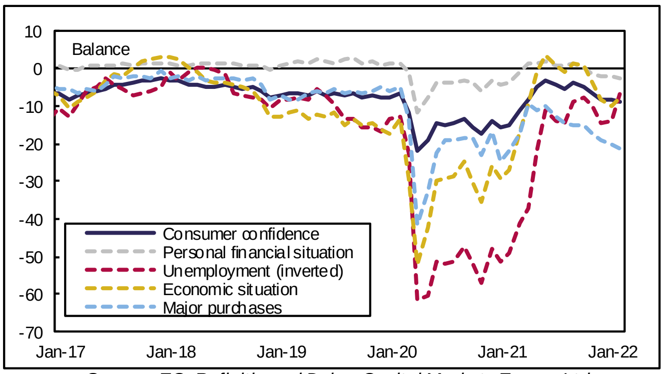
Ahead of the euro area's flash CPI estimate for February on Wednesday, the data highlight tomorrow will be the equivalent inflation figures from Germany and Italy. The current consensus forecast is for a modest increase in the German EU-harmonised measure, by 0.3ppt to 5.4%Y/Y, while the equivalent Italian rate is forecast to rise 0.4ppt to a record-high 5.5%Y/Y. But risks to these forecasts are skewed to the upside. Tomorrow will also bring the final manufacturing PMIs for the euro area, Germany and France as well as survey results for Italy and Spain. The flash survey revealed a modest increase in the euro area manufacturing output PMI, up 0.2pt to 55.6, the third increase out of the past four months and the highest reading since September. Other data due include French, Italian and Spanish new car registrations data for February.

Euro area: Energy impact on purchasing power*



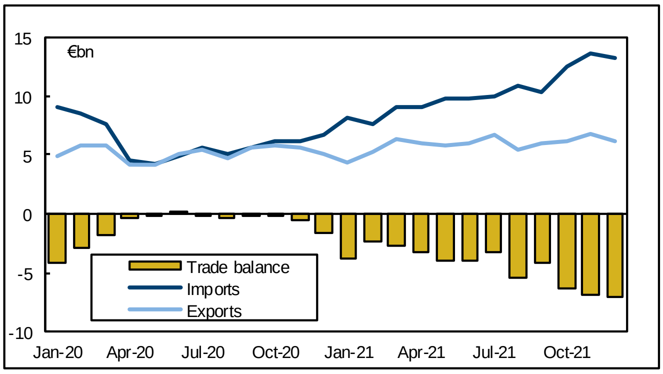
*Change in household purchasing power due to energy price fluctuations reflects year-on-year percentage change in the real price of energy, weighted by the nominal energy expenditure share. Source: ECB, Eurostat, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer confidence



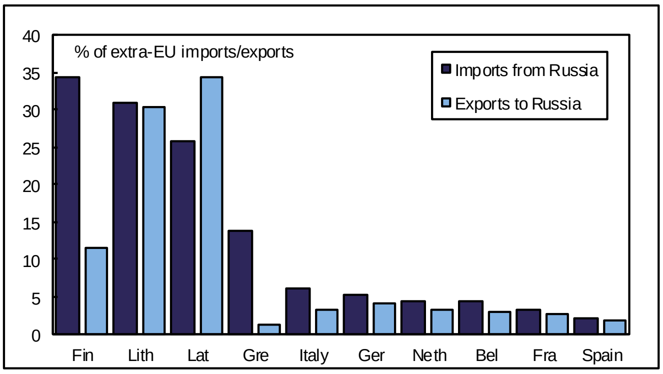
Source: EC, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade with Russia



Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Importance of goods trade with Russia



Source: Eurostat and Daiwa Capital Markets Europe Ltd.

UK

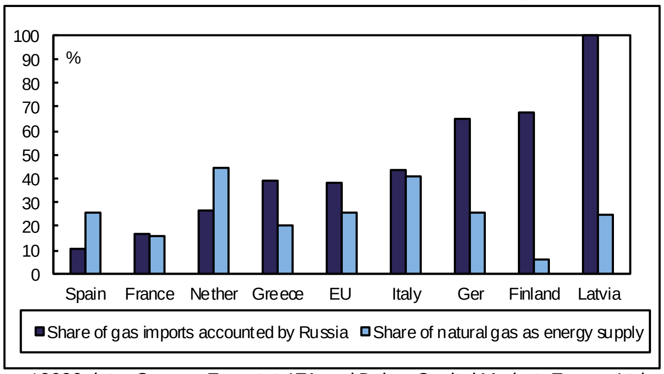
Lloyds business barometer points to stronger confidence, wages and price pressures

Consistent with the more upbeat tone of the flash PMIs, the latest Lloyds business survey signalled a rebound in sentiment in the first half of February, with the headline confidence barometer rising 5pts to 44%, a five-month high. This reflected improvements in both the current business assessment compared with three months ago (up to a five-month high) and outlook over the year ahead, with the respective indicator rising to its highest since 2017. Within the sector breakdown, there were notable increases in the manufacturing and construction sentiment indices, by 11pts to 54% and 18pts to 51% respectively, both the highest since the start of the pandemic. And while retailing sentiment was a touch firmer (up 3pts to 47%), services sentiment was unchanged at its lowest reading (38%) since last summer, contrasting with the jump in the services activity PMI this month. Firms were more positive with respect to their hiring intentions, with more than 50% noting an expectation to increase headcount over the coming twelve months. But they also cited a further modest increase in pay pressures, with one quarter of firms expecting pay growth of between 1-2% over the coming year, with 23% expecting growth of 2-3%. Against this backdrop, almost half of firms expected to pass on higher costs to consumers this year. But after the BoE raised Bank Rate to 0.5% earlier this month, and with more tightening expected over coming months, a little more than one third of respondent firms expressed concerns about interest rates rising to 1%, with that share rising to 57% if Bank Rate reached 2%.

The day ahead in the UK

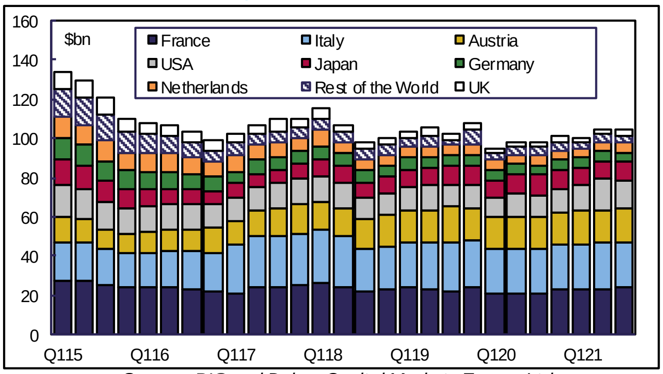
In the UK, likely of most interest tomorrow will be speeches by MPC members Saunders and Mann, both of which voted for a 50bps hike in February, with commentary to be watched for their assessment of the likely impact of the Ukraine conflict on UK GDP and inflation and hence what that could mean for monetary policy. On the data front, tomorrow sees the release of bank lending figures. Consistent with stronger retail sales last month, we would expect to see a further increase in consumer credit in January, while demand for secured lending likely remained robust in line with ongoing strength in the housing market. Like in the euro area, the final UK manufacturing PMI is expected to align with the flash release, which revealed that the manufacturing output PMI rose for the fourth consecutive month, and by 2.2pts to 56.7, a seven-month high, boosted by an easing in supply-side constraints.

Euro area: Reliance on Russian natural gas*



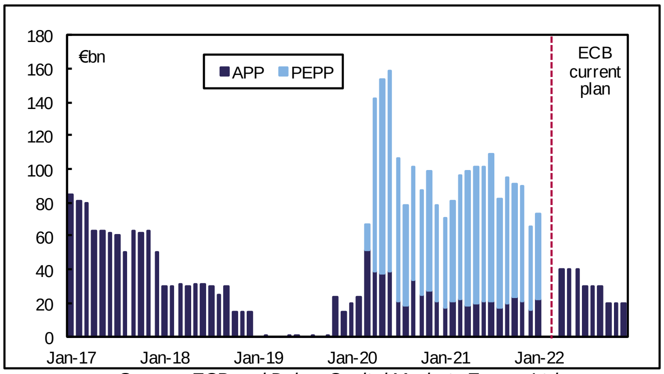
*2020 data. Source: Eurostat, IEA and Daiwa Capital Markets Europe Ltd.

Euro area: Banking exposure to Russia by country



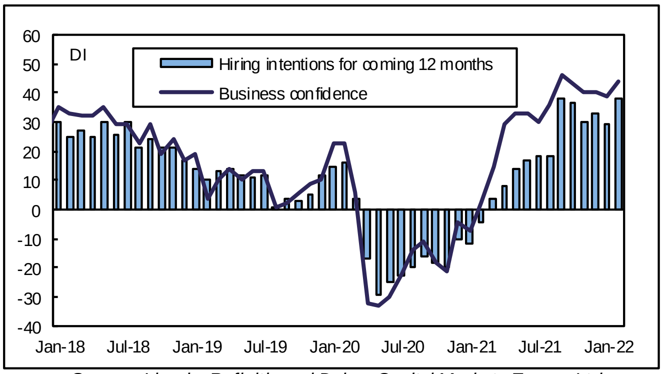
Source: BIS and Daiwa Capital Markets Europe Ltd.

Euro area: ECB monthly net asset purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

UK: Business sentiment and hiring intentions



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

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	7.4 (7.5)	7.1 (7.0)	6.1 (6.2)	-
UK	Lloyds business barometer	Feb	44	-	39	-

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	09.00	Final manufacturing PMI	Feb	58.4	58.7
Germany	08.55	Final manufacturing PMI	Feb	58.5	59.8
	13.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	5.0 (5.3)	4.9 (5.1)
France	08.50	Final manufacturing PMI	Feb	57.6	55.5
	-	New car registrations* Y/Y%	Feb	-	-18.6
Italy	08.45	Manufacturing PMI	Feb	58.0	58.3
	10.00	Preliminary CPI (EU-harmonised CPI) Y/Y%	Feb	5.3 (5.4)	4.8 (5.1)
	17.00	New car registrations Y/Y%	Feb	-	-19.7
Spain	08.15	Manufacturing PMI	Feb	56.0	56.2
	-	New car registrations* Y/Y%	Feb	-	1.0
UK	09.30	Net consumer credit £bn (Y/Y%)	Jan	1.0 (-)	0.8 (1.4)
	09.30	Net mortgage lending £bn (mortgage approvals '000s)	Jan	4.0 (72.0)	3.6 (71.0)
	09.30	Final manufacturing PMI	Feb	57.3	57.3

Auctions and events

Country	GMT	Event
Euro area	-	ECB's Panetta takes part in virtual G7 meeting of finance ministers and central bank governors
UK	18.30	BoE's Saunders scheduled to speak
	19.00	BoE's Mann scheduled to speak on a panel on 'Inflation and monetary policy'

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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