Daiwa Capital Markets

Euro wrap-up

Overview

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- After a day of volatility amid a scarcity of certain securities, Bunds eventually ended the day higher despite another big increase in euro area producer price inflation and a fall in the euro area unemployment rate to a record low.
- Gilts made further losses as a BoE survey signalled higher business inflation expectations.
- Friday will bring new data for euro area retail sales, German goods trade and French IP.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.672	-0.035
OBL 0 04/27	-0.280	-0.017
DBR 0 02/32	0.015	-0.005
UKT 1 04/24	1.116	+0.068
UKT 1¼ 07/27	1.063	+0.063
UKT 4¼ 06/32	1.306	+0.051

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

Euro area

Another upside surprise to PPI inflation

Just as consumer price inflation accelerated ahead of expectations last month, producer price inflation jumped to a new high well above the consensus forecast at the start of the year. In particular, euro area industrial producer prices rose in January by 5.2%M/M, just 0.2ppt shy of October's series high, to push the annual rate up more than 4ppts to a record high of 30.6%Y/Y, more than 3ppts above the median forecast on the Bloomberg survey. Perhaps inevitably, energy prices again rose most, increasing another 11.6%M/M to be up 85.6%Y/Y. Prices for the production and distribution of gas were up almost 150%Y/Y with electricity up more than 92%Y/Y and petroleum products up 50%Y/Y. Meanwhile, producer prices of intermediate inputs rose just 2.7%M/M to be up at a new high of 20.2%Y/Y. With costs increasingly being passed along the supply chain, capital goods PPI rose 1.0ppt to 5.7%Y/Y. And, in part boosted by higher prices of food products (up 9.1%Y/Y), inflation of consumer goods at the factory gate rose almost 2.0ppts to 6.7%Y/Y.

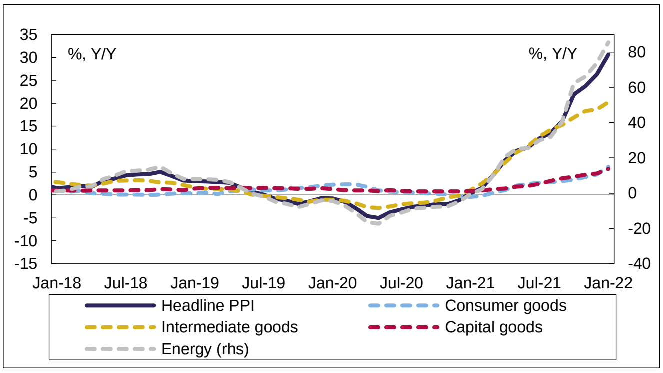
Energy prices reach new highs so inflation is set to move significantly higher still

As western firms try to shun Russian energy supply, Brent oil crude today came within a whisker of $120bbl for the first time since 2012, roughly 40% above the January and February averages. And given concerns of supply disruption, European natural gas futures touched a new record high more than double the averages in the first two months of the year. Prices of agricultural commodities were up again too. So, producer and consumer price inflation is bound to go significantly higher – on current market pricing, by April industrial PPI inflation could well be above 40%Y/Y while CPI inflation is likely to surpass 7.0%Y/Y. In normal times, such a deterioration in the inflation outlook would undoubtedly merit swift monetary policy tightening. And indeed, the account of the ECB's February policy meeting – published today – suggested plans for earlier monetary normalisation were likely to have been agreed this month, not least to avoid the need for more abrupt and damaging tightening further ahead. However, in light of the exceptional circumstances of the Ukraine conflict, and marked hit to confidence and demand that seems likely to ensue, we continue to expect the Governing Council to move cautiously when it meets next week. Indeed, it seems likely to leave its plans for a gradual slowing of asset purchases over the next two quarters little changed.

German car production rose in February, but Ukraine conflict poses big new supply risks

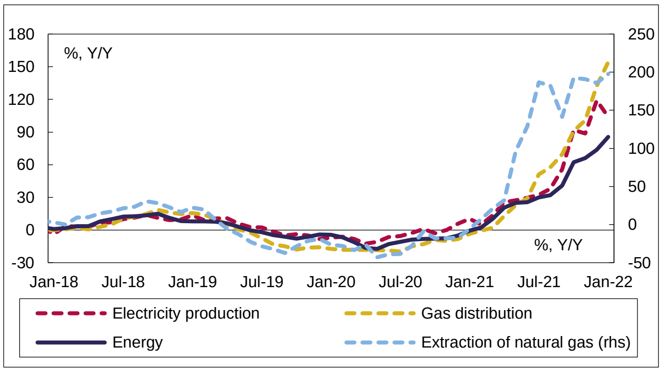
Of course, the extreme price pressures reflect the initial shocks from the Ukraine conflict on prices of energy and commodities, on top of the existing global shocks from Covid-19. And the conflict poses a risk of broader supply shocks over coming months and quarters. The German Association of the Automotive Industry (VDA) yesterday cautioned that the supply

Euro area: Producer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Producer energy price inflation



Source: Eurostat and Daiwa Capital Markets Europe Ltd.

of a range of inputs in car production would be disrupted. Among other things it highlighted the reliance on Ukraine for the supply of cable harnesses, with limited alternative suppliers available over the near term. It flagged concerns about the importance of Ukrainian neon in European semiconductor manufacturing. It warned that one fifth of German palladium imports, required in the production of catalytic converters, as well as a large share of nickel ore used in the production of lithium batteries, comes from Russia. And it noted risks to severe disruption of overland supply routes from China to Europe. Of course, if the supply of Russian gas was also cut disruption would be widespread: the ECB estimates that a 10% reduction in gas supply would reduce euro area gross value added by 0.7%. A complete halt to Russian supplies could knock up to 3% on GVA, sending the region into recession. So, while VDA data today revealed that an easing of supply bottlenecks allowed a rise in German car production in February to its highest level since March 2021 to be down just 1%Y/Y, and new car registrations were up 3%Y/Y, the near-term outlook for production of autos, and many other manufacturing sub-sectors, looks subject to significant downside risks.

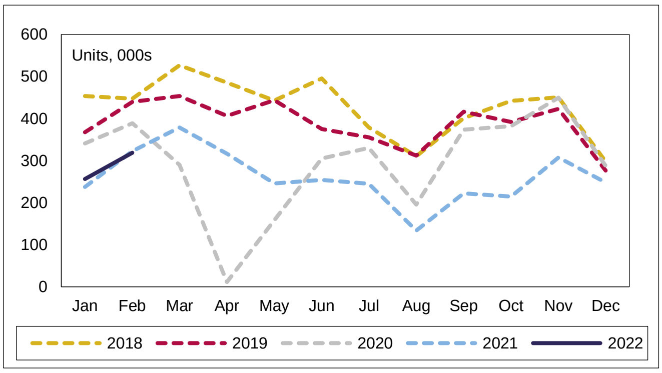
Euro area unemployment continues to fall

While energy prices and other pressures related to supply disturbances will continue to drive inflation higher over the near term, the ECB will consider labour market developments to be key for determining whether high inflation persists into the medium term. Today's jobless numbers suggested that momentum in the labour market remained positive at the start of the year even as the latest pandemic wave impeded growth in the services sector. The euro area unemployment rate fell for the eighth month out of the past nine in January, edging down 0.2ppt to a series low of just 6.8%. The number of people out of work fell a further 214k, to 11.225mn, to be down 2.117mn from a year earlier. Among the large member states, the unemployment rate dropped in Germany by 0.1ppt to match the series low at 3.1%, in France and Italy by 0.2ppt to 7.0% and 8.8% respectively, and in Spain by 0.3ppt to 12.7%, the lowest since the global financial crisis. Of course, in part the low unemployment rate reflects ongoing government job support programmes. Moreover, despite the steady fall in unemployment and survey evidence of skill shortages, wage settlements have remained subdued, in many member states likely reflecting ample spare capacity in the labour market. So, euro area real wage growth seems bound to be highly negative this year, weighing on consumer spending and suggesting that domestically generated inflation will remain modest despite the massive imported inflationary pressures.

Final euro area services PMIs nudged slightly lower, despite rebound in Italy and Spain

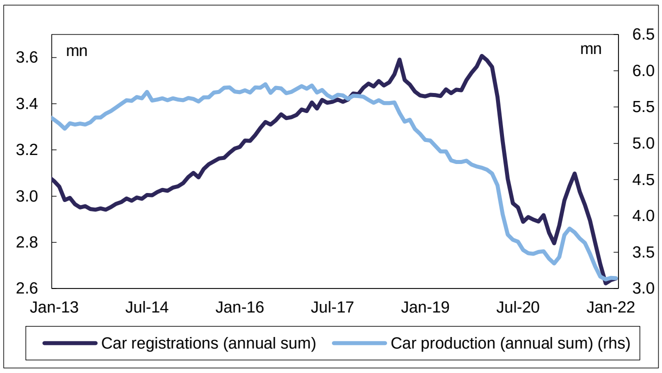
The final euro area services PMIs predictably reaffirmed a marked improvement in conditions in the sector in February as the latest wave of pandemic started to moderate. Despite being revised a touch lower from the preliminary release, the headline euro area activity index was still 4.4pts higher than in January at 55.5, a three-month high and consistent with solid

Germany: Car production



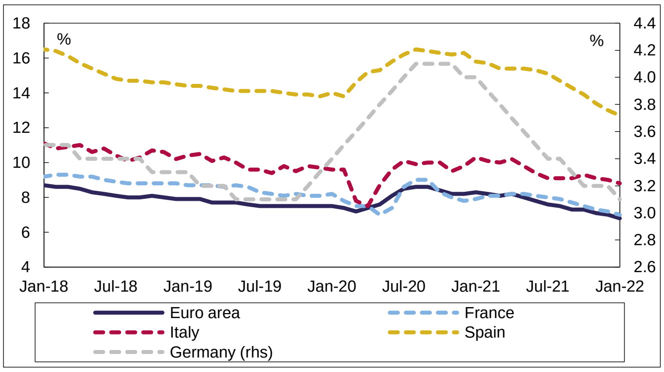
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

Germany: Car production and registrations*



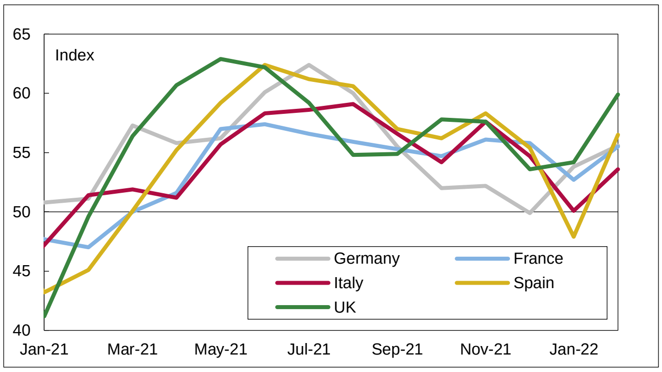
**Annual sum. Source: Bloomberg, VDA and Daiwa Capital Markets Europe Ltd.*

Euro area: Unemployment rates by country



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

Europe: Composite PMIs by country



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

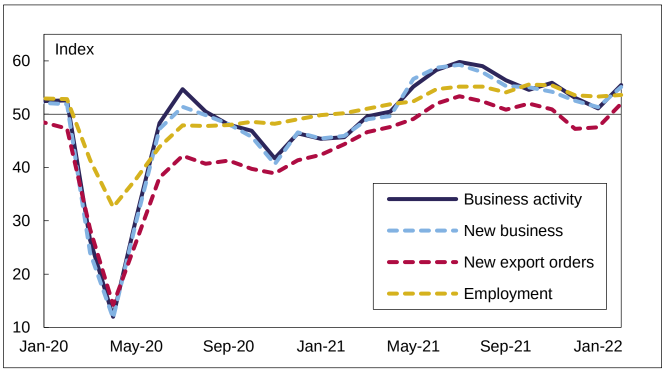
expansion last month. Of course, given the slump in activity around the turn of the year, the services PMI was still trending more than 1pt lower than the Q4 average. Firms were at the time of responding (10-23 February) more upbeat about the near-term outlook too, with the new business PMI rising to a four-month high (55.1) not least reflecting a rebound in tourism and the employment gauge also ticking slightly higher (55.6). But this was also accompanied by higher inflationary pressures in the sector too, with the input and output price PMIs (72.2 and 58.8 respectively) rising to the highest on record. Taken together with the manufacturing survey, the composite output PMI rose 3.2pts in February to 55.5, leaving the average index so far in Q1 (53.9) only marginally lower than the Q4 average (54.3).

There were more sizeable downwards revisions to the final services PMIs from Germany and France, by 0.8pt and 2.4pts respectively, perhaps reflecting increasing concerns with respect to developments in Ukraine. But the respective indices at 55.8 and 55.5 were still up from January, with the former the highest since September. Indeed, the German activity PMI was trending 2.7pts higher than the Q4 average, contrasting with equivalent declines in France (-2.7pts), Italy (-3.1pts) and Spain (-5.8pts). Nevertheless, there were considerable gains in the Italian and Spanish activity PMIs last month, with the former up 4.3pts to 52.8 and the latter up a whopping 10pts to 56.6. And both recorded sharp increases in new business too, with demand in Italy reportedly benefitting from a recovery in tourism – the new export orders PMI rose to its highest since last July.

The day ahead in the euro area

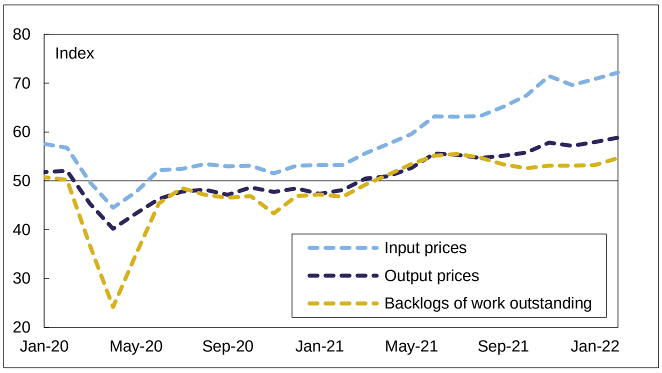
Tomorrow sees the release of euro area retail sales data for January, which are expected to reverse some of the weakness seen in December, as the latest wave of coronavirus cases fell across much of the region and restrictions were eased. Retail sales growth is forecast at 1½%M/M following the 3.0%M/M decline previously, which would leave sales up 4% compared to their pre-pandemic level in February 2019. Similarly, French industrial production figures are expected to show a modest increase at the start of the year, with output forecast to rise 0.5%M/M in January, after falling 0.2%M/M in December, although that would still leave it down 4.8% compared to its pre-pandemic level. Other releases due to be published tomorrow include German trade data for January, updated Italian GDP numbers for Q421, and the construction PMIs for the euro area and larger member states for February.

Euro area: Services PMIs – demand side



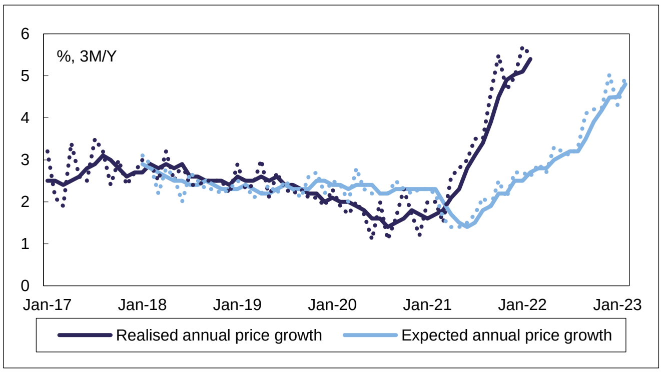
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs – supply side



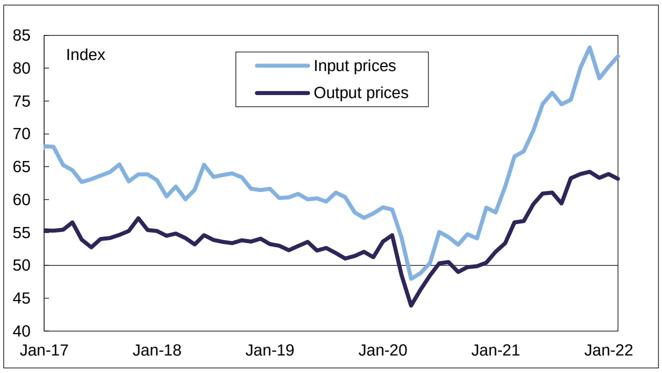
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: BoE DMP survey - output price inflation*



**Dotted lines are single-month estimates. Source: BoE Decision Maker Panel survey and Daiwa Capital Markets Europe Ltd.*

UK: Composite price PMIs



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

UK

BoE surveys suggest a notable jump in inflation and wage expectations

After BoE MPC members Mann and Saunders this week signalled their intention to vote for further tightening over the months ahead, Deputy Governor Cuncliffe and external member Tenreyro yesterday evening failed to give a clear indication of how the new risks from the Ukraine confilict might be reflected in the near-term path of monetary policy. Admittedly, they acknowledged the potentially big impact on the economic outlook and non-negligible financial stability risks. But Tenreyro (who until recently has arguably been the most dovish member of the Committee) also noted her surprise at the jump in wage expectations recently implied by the BoE's Agents annual pay survey – on average, firms expect pay growth of 4.8% this year, with reports of some pay settlements of 5-7%, and some companies offering mid-year salary adjustments to retain staff. Moreover, another the BoE survey, reporting the views of its Decision Maker Panel, today showed a further notable rise in output price inflation in the three months to February, by 0.3ppt to 5.4%Y/Y. And while Tenreyro suggested that bottlenecks had eased somewhat at the turn of the year, the DMP survey showed that firms have revised higher their expectations for selling prices over the coming twelve months, by 0.7ppt to 5.0%Y/Y, a figure that now seems bound to go higher over coming months in light of the Ukraine conflict.

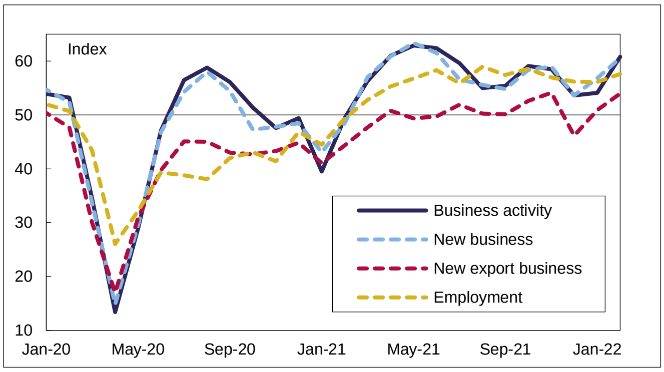
Final UK services PMI signals strong recovery last month

Like in the euro area, the modest downwards revision to the UK's final headline services PMI did nothing to alter the overall message, that activity rebounded strongly last month even as inflationary pressures intensified. Indeed, the activity index still stood at 60.5 in February, some 6.4pts higher than in January and the firmest reading since June. Moreover, the services new business component was revised higher from the flash to 61.5, with a more sizeable revision to the new export business PMI, which at 54.3 was the joint-highest reading since added to the survey in 2014, as an easing in restrictions reportedly boosted tourism from Europe and the US. As such, firms continued to expand their workforces, with the employment PMI rising to a four-month high (57.8). But with salaries, energy and other key material costs continuing to rise, the survey suggested that roughly one-third of firms raised their selling prices last month – indeed, the output price PMI rose to a fresh series high (64.5). Taken together with the manufacturing survey, today's release left the composite PMI up 5.7pts in February to 59.9, similarly an eight-month high. So far in Q1, the composite output index was trending some 0.7pt above the Q4 average at 57.2.

The day ahead in the UK

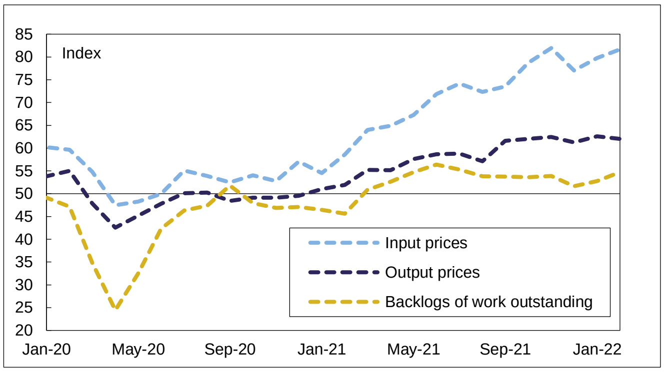
The UK's economic data calendar ends the week relatively quietly with the release of the February construction PMIs and new car registrations figures. Having risen to a six-month high of 56.3 in January, the activity PMI should point to ongoing expansion in the sector, although persisting supply constraints and extreme weather in the second half of the month might limit any further recovery. Supply bottlenecks and the associated weakness in production in the autos sector are also likely to have kept new car registrations well below the pre-pandemic levels.

UK: Services PMIs – demand side



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

UK: Services PMIs – supply side



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

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final services (composite) PMI	Feb	**55.5 (55.5)**	55.8 (55.8)	51.1 (52.3)	-
	PPI M/M% (Y/Y%)	Jan	**5.2 (30.6)**	2.8 (27.3)	2.9 (26.2)	**3.0 (26.3)**
	Unemployment rate %	Jan	**6.8**	7.0	7.0	-
Germany	Final services (composite) PMI	Feb	**55.8 (55.6)**	56.6 (56.2)	52.2 (53.8)	-
	New car registrations (production) Y/Y%	Feb	**3.2 (-1.2)**	-	8.5 (8.1)	-
France	Final services (composite) PMI	Feb	**55.5 (55.5)**	57.9 (57.4)	53.1 (52.7)	-
Italy	Services (composite) PMI	Feb	**52.8 (53.6)**	52.5 (53.6)	48.5 (50.1)	-
Spain	Services (composite) PMI	Feb	**56.6 (56.5)**	51.6 (52.0)	46.6 (47.9)	-
UK	Final services (composite) PMI	Feb	**60.5 (59.9)**	60.8 (60.2)	60.8 (60.2)	-

Auctions

Country	Auction
France	sold €6.34bn of 0% 2032 bonds at an average yield of 0.52%
	sold €1.87bn of 3.25% 2045 bonds at an average yield of 1%
	sold €1.79bn of 0.75% 2053 bonds at an average yield of 1.18%
Spain	sold €2.0bn of 0% 2025 bonds at an average yield of 0.065%
	sold €2.07bn of 0.8% 2029 bonds at an average yield of 0.664%
	sold €1.0bn of 1% 2042 bonds at an average yield of 1.471%
	sold €553mn of 0.7% 2033 inflation-linked bonds at an average yield of -1.036%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	08.30	Construction PMI	Feb	-	56.6
	10.00	Retail sales M/M% (Y/Y%)	Jan	1.5 (9.2)	-3.0 (2.0)
Germany	07.00	Trade balance €bn	Jan	5.5	6.6
	08.30	Construction PMI	Feb	-	54.4
France	07.45	Industrial production M/M% (Y/Y%)	Jan	0.5 (-3.2)	-0.2 (-0.5)
	07.45	Manufacturing production M/M% (Y/Y%)	Jan	-	0,.1 (-0.3)
	08.30	Construction PMI	Feb	-	52.0
Italy	09.00	Final GDP Q/Q% (Y/Y%)	Q4	0.6 (6.4)	2.6 (3.9)
	08.30	Construction PMI	Feb	-	68.2
UK	09.00	New car registrations Y/Y%	Feb	-	27.5
	09.30	Construction PMI	Feb	57.5	56.3

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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