Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Amid concerns about the safety of Ukraine's nuclear facilities, Bunds rallied, while data on euro area retail sales and German trade disappointed.
- Gilts also rallied while UK car sales remained weak but a construction survey pointed to firm growth.
- At Thursday's ECB policy meeting, the Governing Council has to decide whether to respond to the marked deterioration in the inflation outlook or be more mindful of the weakening growth outlook; given extreme uncertainty surrounding Ukraine we expect it to leave its asset purchase plans unchanged.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.757	-0.088
OBL 0 04/27	-0.381	-0.105
DBR 0 02/32	-0.077	-0.089
UKT 1 04/24	1.041	-0.066
UKT 1¼ 07/27	0.971	-0.083
UKT 4¼ 06/32	1.205	-0.091

*Change from close as at 5.00pm GMT.
Source: Bloomberg

Euro area

Outlook too uncertain to provide basis for sudden monetary policy shift

The forthcoming ECB policy meeting on Thursday will have to gauge the likely impact of events in Ukraine on the euro area economic outlook and determine how the Governing Council should respond. However, events continue to unfold rapidly, whether in terms of developments in the conflict zone, sanctions against Russia, and the response of energy, commodity and financial markets. Moreover, the precise path and duration of the conflict, and impact of sanctions and countermeasures, are impossible to predict with confidence, with a wide range of plausible scenarios. As illustrated by today's concerns about a fire at Europe's largest nuclear power plant, which had been hit by shelling and subsequently taken control by Russian troops, many of the possible scenarios are very grave indeed. So, while the ECB delayed the preparation of its updated economic projections to better reflect conditions after the Russian invasion, those forecasts will not be able to provide a reliable guide to the outlook. And so, they are also unlikely to provide a sound basis for a sudden shift in the ECB's monetary policy stance.

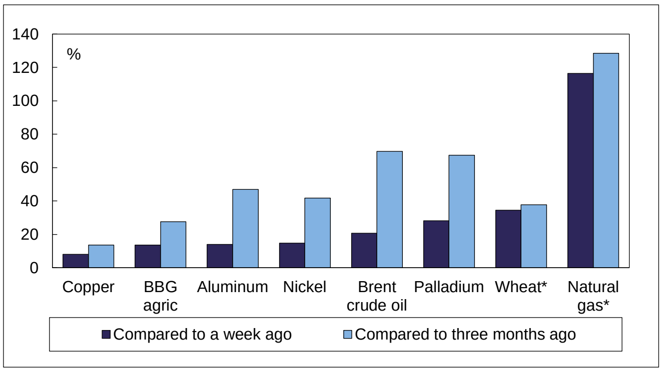
Inflation outlook has deteriorated markedly further, with double-digit rates plausible

Before the Russian invasion, the Governing Council had looked set this month to reach a consensus for a much faster reduction in its net asset purchases, providing scope for a rate hike by year-end. That reflected the big upwards surprise to euro area inflation in January, which highlighted the sudden shift in skew of risks to the price outlook to the upside. So, the account of the February Governing Council meeting was hawkish, among other things noting that "the main risk was no longer of tightening monetary policy too early but too late. An earlier monetary policy normalisation would reduce the risk of abrupt tightening later on". Since then, the price outlook has deteriorated markedly further, with another big upside surprise to the flash estimate of inflation in February and major shifts in wholesale energy and commodity prices due to the Ukraine conflict and sanctions. At the time of writing, European one-month natural gas futures had risen above €200/MWh, more than double the levels a week ago and in early December. Brent crude around $115bbl was up almost 20%W/W and 65% from early December. Paris wheat contracts were close to €400/MT, up almost 40%W/W and the same rate from three months ago. And the euro was down more than 3% on the week close to $1.09. With other producer price pressures still to be passed on to consumers, HICP inflation could well rise above 7% by April. And if recent trends continue, double-digit rates this year are not implausible.

ECB to moderate asset purchases but keep options open in light of Ukraine risks

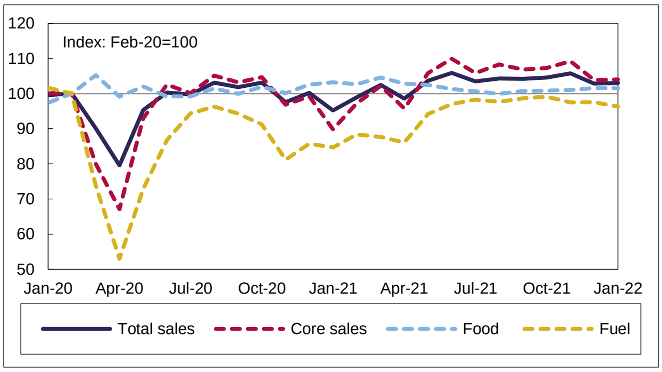
While inflation is set to accelerate further, economic growth is bound to slow. In the absence of timely surveys reflecting economic sentiment post-invasion, however, the ECB will have little idea quite how big that hit to GDP will be over the near

Selected energy and commodity price indices



*Benchmark European contracts. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales



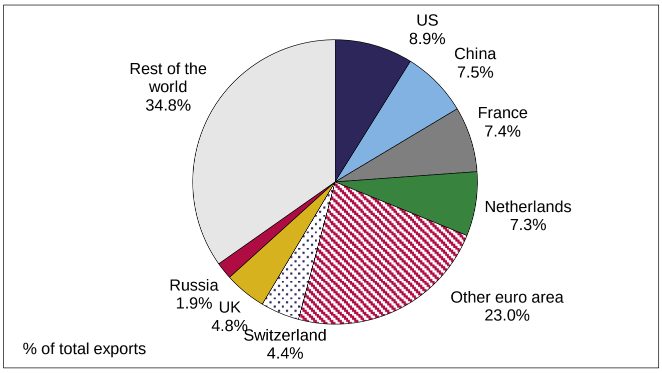
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

term. And the duration of the weakness will depend at least in part on the path for the conflict. Certainly, the erosion of real incomes and dent to confidence will impact private consumption, which could well grind to a halt or worse in the second half of the year. Business investment will slow. Trade will be affected by lower demand from Russia and Ukraine, while new impediments to imports will aggravate supply bottlenecks. At the same time, fiscal policy – whether via household energy subsidies, increased public spending on military and energy infrastructure, or support for Ukrainian asylum-seekers – could help to soften the blow. While initial ECB estimates reported last week suggested a net negative impact on euro area GDP this year of 0.3-0.4% in a central scenario, and up to 1% in an adverse scenario, we suspect the eventual impact will be higher than that, particularly if natural gas needs to be rationed. NIESR simulations using its own NIGEM econometric model this week suggested a hit to euro area GDP this year of more than 0.5% this year and 1.5% in 2023. And if so, notwithstanding uncertainties about the path of energy and commodity prices, with wage growth still very subdued, euro area inflation two-to-three years ahead would likely fall back below the ECB's 2% target. However, at the coming meeting, we expect the ECB to set out a range of plausible scenarios. And given the extreme uncertainty, we expect it to be cautious in terms of policy, leaving unchanged its plan to reduce its monthly net asset purchases to €40bn in Q2 and €30bn in Q3.

Retail sales post minimal growth in January after big end-year dip; weakness to persist

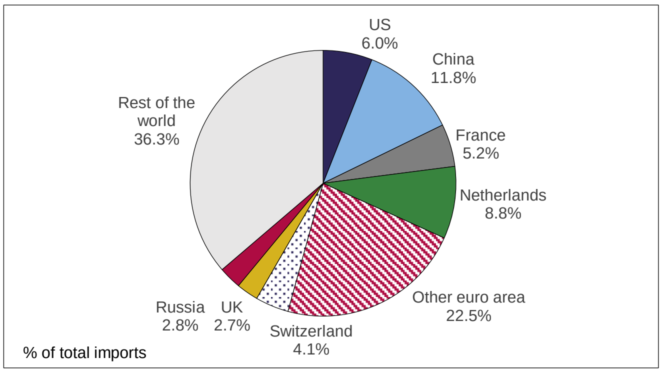
Paling into insignificance against events in Ukraine and ongoing shifts in prices of energy and commodities, today's economic data nevertheless provided a snapshot of various aspects of euro area economic activity at the start of the year. Overall, the figures suggested patchy economic growth momentum in January, somewhat at odds with the continued positive trend in the labour market reported yesterday. For a start, having dropped a revised 2.7%M/M in December to the lowest level since April, euro area retail sales in January could only muster a minimal rise of 0.2%M/M, well below the expected growth of about 1½%M/M. German sales were up 2.0%M/M after a fall of 4.6%M/M the prior month, but that growth was largely negated by weakness in France (-0.9%M/M despite New Year discounting) and probably also Italy and Spain (whose data were not published). Within the detail, core (i.e. non-food and non-fuel) sales also rose just 0.2%M/M following a sharp decline of almost 5%M/M in December. And sales of food, drink and tobacco were unchanged from the end of the year. Given diminished mobility due to the pandemic, sales of auto fuel fell 1.1%M/M but online shopping provided modest support (up 1.0%M/M). While overall sales were still a little more than 3% above the pre-pandemic level, they were also 1.3% below the Q4 average. Recent easing in the pandemic is likely to have supported stronger sales this month. But the adverse impact of high inflation on real disposable incomes and associated hit to confidence is likely to cause retail sales to decline over Q1 as a whole. And if wholesale energy and food prices remain around current levels, sales could well decline over coming quarters too.

Germany: Key export partners*



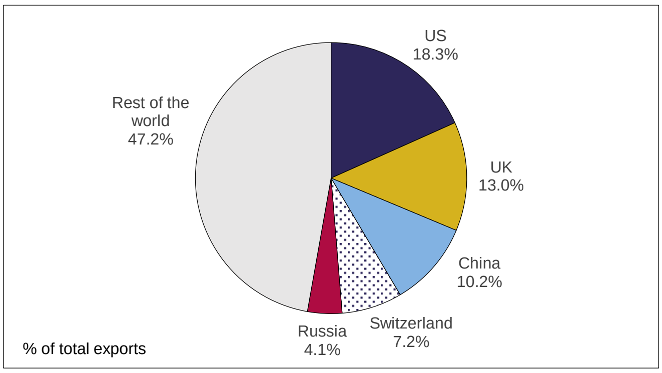
*2021 data. Source: Destatis and Daiwa Capital Markets Europe Ltd.

Germany: Key import partners*



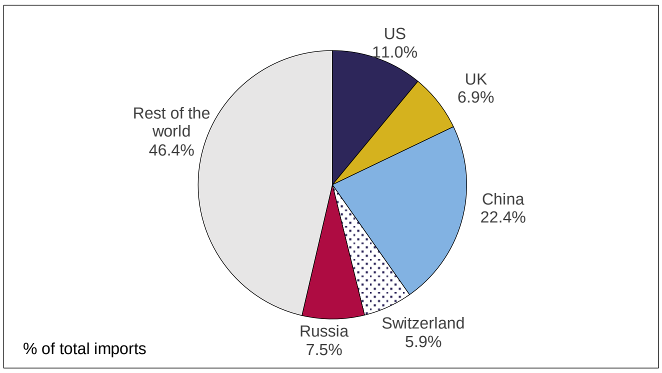
*2021 data. Source: Destatis and Daiwa Capital Markets Europe Ltd.

EU: Key export partners*



*2021 data. Extra-EU exports. Source: Eurostat and Daiwa Capital Markets Europe Ltd.

EU: Key import partners*



*2021 data. Extra-EU imports. Source: Eurostat and Daiwa Capital Markets Europe Ltd.

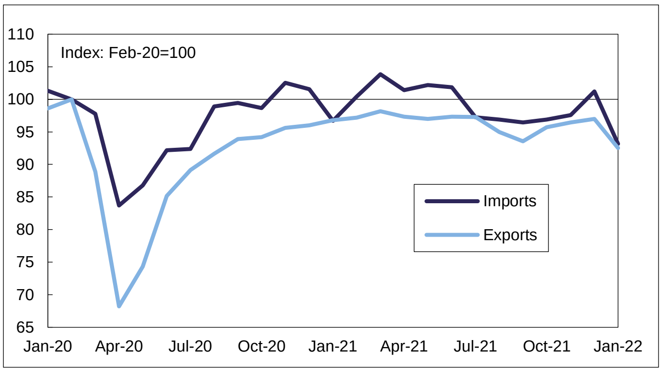
German goods trade much weaker at start of the year; Ukraine conflict to hit exports from now on

Reflecting ongoing restraints from supply bottlenecks, German goods trade flows fell back at the start of the year. Despite continued price pressures, the value of exports on a seasonally adjusted basis dropped 2.8%M/M after rising a cumulative 6.9% over the preceding three months. Weakness was concentrated in shipments to other EU countries with exports beyond the region higher, including growth of 14.4%M/M to Russia and growth of a similar rate to China. Meanwhile, the value of imports fell a larger 4.2%M/M having risen more than 12% over the previous three months. So, having plunged in December to the lowest in two decades bar the initial wave of Covid, Germany's trade surplus rose €1.3bn to €9.4bn, still well below the range from mid-2020 to December last year. Of course, the headline export and import values are both flattered by price effects: import prices rose 4.3%M/M and a hefty 26.9%Y/Y while export prices were up 'just' 1.8%M/M and 11.9%Y/Y. In volume terms, and on a seasonally adjusted basis, shipments of exports fell 4.6%M/M to be down 7.5% from the pre-pandemic level and the lowest since August 2020. And imports fell a much sharper 7.9%M/M, to be 6.8% below the pre-pandemic level and the lowest July 2020. From now on, Russian sanctions, as well as the disruption to trade with Ukraine and overland shipments to and from Asia, will hit German and euro area trade flows. Russia accounted for 1.9% of German exports and 2.8% of German imports in 2021, with the equivalent figures for EU extra-regional trade of 4.1% and 7.5% respectively. Overall, we expect an adverse impact on the trade balance and overall GDP growth, as exports to Russia dry up but imports of natural gas are maintained (at least for the time being).

French IP rebounds at the start of the year, but supply restraints will tighten over coming months

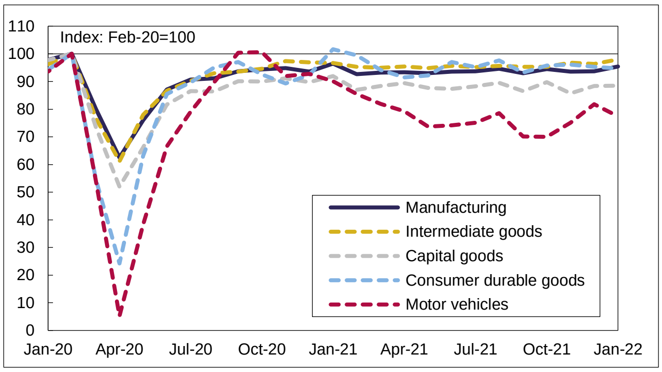
In contrast to the German trade flows, there was a welcome pickup in French industrial production at the start of the year. Output rose a stronger-than-expected 1.6%M/M in January, the fastest monthly growth for a year, to leave the level more than 1% higher than the Q4 average. Admittedly, this still left output almost 4% lower than the pre-pandemic level. Manufacturing output rose a robust 1.6%M/M, while construction activity surged 6.0%M/M following a cumulative decline of more than 5% in the previous two months. The detail of the report suggested significantly contrasting performances among the various subsectors. The pickup was underpinned by solid monthly growth in production of pharmaceuticals (21.5%), rubber and plastics (4.9%) and basic metals (3.5%). And output of intermediate goods rose 1.7%M/M to a post-pandemic high, albeit still 2% below the pre-Covid level. But there was renewed weakness in autos production (-5.4%) leaving it down more than 22% from the pre-pandemic. Production of machinery and equipment was down 0.5%M/M to be 4.0% below the February 2020 level, likely reflecting persisting disruption from supply bottlenecks. And with the supply of components and materials likely to be disrupted further in light of the Ukraine conflict, risks to production of autos and other items over coming months look to be firmly to the downside.

Germany: Goods trade volumes



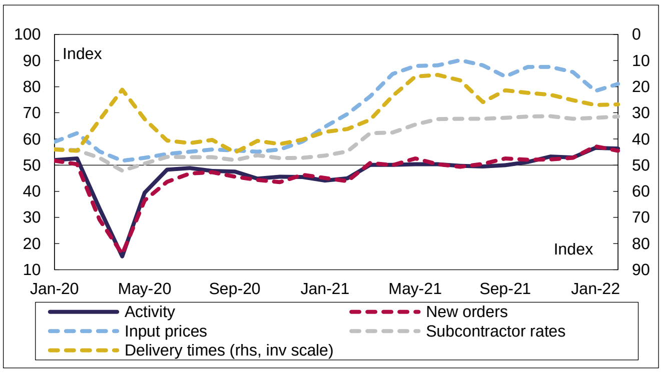
Source: Refinitiv and Daiwa Capital Markets Europe Ltd. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Manufacturing production



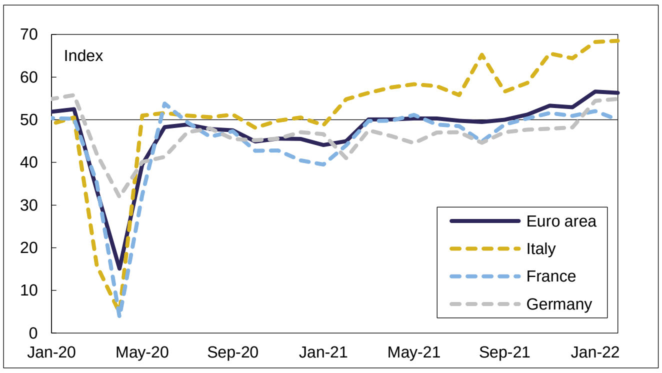
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



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

Euro area: Construction PMIs, by country



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

Construction PMIs signal strong expansion despite supply constraints

Having declined sharply at the end of last year, euro area construction sector activity has started 2022 on a firmer footing, at least according to the latest PMIs. Admittedly, the headline euro area index fell back slightly in February, by 0.3pt, albeit from a four-year high (56.6) in January. While the respective housing PMI slipped back, it continued to imply solid expansion. And the commercial building and civil engineering indices signalled the fastest growth since January 2018. Among the country detail, Italian builders continued to lead the recovery, with that country's activity PMI up 0.3pt to a series-high 68.5, underpinned by government tax policy. There was also a sustained upturn in the German PMI, rising 0.5pt to 54.9, a two-year high, to leave the index trending so far in Q1 some 6.7pts higher than the Q4 average. But following the more positive start to the year, the PMIs suggest that French construction stagnated last month (down 2pts to 50.0, a five-month low). Looking ahead, new orders in the sector in the euro area continued to rise at a robust pace. And so the survey suggested that firms looked to increase their workforces by the most since the start of 2018. But there were still reports of widespread disruption to supply chains, although delivery times were reportedly the shortest in ten months. And while the input price PMI eased slightly last month, at 78.3 it continued to signal significant cost burdens in the sector.

The week ahead in the euro area

Data-wise, a somewhat quieter week than of late kicks off with arguably the most insightful release, with the euro area Sentix investor confidence survey for March to be published on Monday. Having been conducted between 3-5 March, this will be the first survey to reflect Russia's invasion of Ukraine and seems bound to report a marked deterioration in both the current and expectations indices. The Bank of France's business survey and economic update (due Friday) will similarly reflect developments since the conflict intensified. Monday will also bring German factory orders data for January, which will be followed by the release of industrial production figures for Germany and Spain on Tuesday and Italy on Wednesday. The German data are expected to reveal modest growth in industrial output reflecting not least a rebound in construction activity following the marked decline in December, as supply bottlenecks eased modestly. Updated euro area Q4 GDP and employment numbers on Tuesday will include a detailed expenditure breakdown for the first time. GDP growth in Q421 slowed sharply to 0.3%Q/Q from 2.3%Q/Q in Q3 as the latest wave of coronavirus weighed on household consumption. Other data due include final German and Spanish CPI numbers for February on Friday.

UK

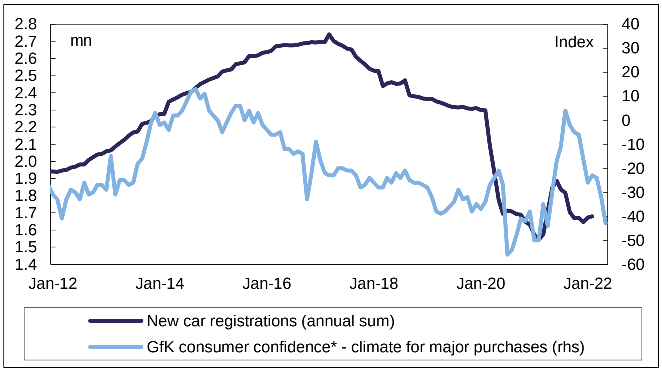
UK car registrations still well below pre-pandemic levels

It was a relatively quiet end to the week for UK economic releases, with the latest car registrations figures for February suggesting that supply bottlenecks and the associated weakness in production kept new sales well below the pre-pandemic levels. While these showed that sales were 15% higher than a year ago, this principally reflected a particularly low base a year ago when car showrooms were closed. Indeed, this still marked the third-lowest February reading since the series began in 1962. So, registrations were still down by roughly one quarter compared with the pre-pandemic level. While this principally reflects the persisting global shortage in semi-conductors, the recent hit to consumer confidence and declining real incomes are highly likely to impact demand in due course.

Construction PMI points to ongoing firm growth in the sector

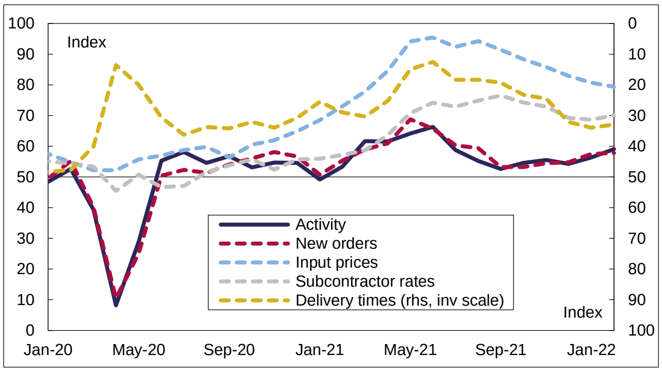
Like autos manufacturers, UK construction firms have also been hampered by ongoing supply challenges. But despite a renewed pick up in supplier delivery times, and adverse weather conditions towards the back end of last month, today's PMI survey signalled an acceleration in activity in the sector in February. In particular, the headline activity index rose a further 2.8pts to 59.1, an eight-month high, reflecting broad-based growth – indeed, the survey detail signalled acceleration in housing (61.5), commercial building (58.4) and civil engineering (57.5). Looking ahead, new orders in the sector continued to

UK: Car registrations and consumer confidence



*3-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Construction PMIs



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

rise at a robust pace – the relevant index rose to a six-month high (57.8). And almost half of survey respondents forecast an increase in output over the coming twelve months, while only 9% expected a fall. But although firms again sought to increase recruitment, given difficulties sourcing staff subcontractor rates remained extremely elevated. Moreover, while the rate of increase in input prices reportedly eased to an eleven-month low, it remained very high indeed with the respective index at 79.4.

The week ahead in the UK

Ahead of the BoE's MPC meeting on 17 March, the coming week's monthly GDP report for January on Friday will be of interest. Having held up relatively well in December despite the latest pandemic wave, high frequency data suggest that private sector services activity moved broadly sideways at the start of the year. But with retail sales in January rising 1.9%M/M, and a modest pickup in manufacturing output also anticipated, we expect to see GDP growth of around 0.2%M/M in January, reversing December's decline of the same amount. That would leave overall output up more than 9%Y/Y and a touch above its pre-pandemic level. Friday will also see the release of January trade data. Ahead of this we will get February's BRC retail sales monitor (Tuesday), the REC/KPMG report on jobs and the RICS residential survey (Thursday).

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Construction PMI	Feb	**56.3**	-	56.6	-
	Retail sales M/M% (Y/Y%)	Jan	**0.2 (7.8)**	1.5 (9.2)	-3.0 (2.0)	**-2.7 (2.1)**
Germany	Trade balance €bn	Jan	**3.5**	5.5	7.0	**6.6**
	Construction PMI	Feb	**54.9**	-	54.4	-
France	Industrial production M/M% (Y/Y%)	Jan	**1.6 (-1.5)**	0.5 (-3.2)	-0.2 (-0.5)	**-0.1 (0.0)**
	Manufacturing production M/M% (Y/Y%)	Jan	**1.8 (-1.1)**	-	0.1 (-0.3)	**0.2 (0.2)**
	Construction PMI	Feb	**50.0**	-	52.0	-
Italy	Final GDP Q/Q% (Y/Y%)	Q4	**0.6 (6.2)**	0.6 (6.4)	2.6 (3.9)	-
	Construction PMI	Feb	**68.5**	-	68.2	-
UK	New car registrations Y/Y%	Feb	**15.0**	-	27.5	-
	Construction PMI	Feb	**59.1**	57.5	56.3	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 07 March 2022			
Euro area		09.30	Sentix investor confidence	Mar	5.6	16.6
Germany		07.00	Factory orders M/M% (Y/Y%)	Jan	0.8 (5.5)	2.8 (5.5)
		07.00	Retail sales M/M% (Y/Y%)	Jan	*2.0 (10.3)*	-4.6 (0.8)
			Tuesday 08 March 2022			
Euro area		10.00	Final GDP Q/Q% (Y/Y%)	Q4	*0.3 (4.6)*	2.3 (3.9)
		10.00	Final employment Q/Q% (Y/Y%)	Q4	*0.5 (2.1)*	1.0 (2.1)
Germany		07.00	Industrial production M/M% (Y/Y%)	Jan	0.5 (-1.9)	-0.3 (-4.1)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jan	1.0 (2.7)	-2.6 (1.3)
UK		00.01	BRC retail sales monitor, like-for-like Y/Y%	Feb	-	8.1
			Wednesday 09 March 2022			
France		06.30	Final total (private sector) payrolls Q/Q%	Q4	0.4 (0.5)	1.1 (0.5)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jan	-0.5 (3.3)	-1.0 (4.4)
			Thursday 10 March 2022			
Euro area		12.45	ECB refinancing rate %	Mar	*0.00*	0.00
		12.45	ECB deposit rate %	Mar	*-0.50*	-0.50
Italy		09.00	PPI M/M% (Y/Y%)	Jan	-	0.9 (27.8)
UK		00.01	RICS house price balance %	Feb	73	74
			Friday 11 March 2022			
Germany		07.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	*5.1 (5.5)*	4.9 (5.1)
France		-	Bank of France industrial sentiment	Feb	106	106
Spain		08.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	*7.4 (7.5)*	6.1 (6.2)
UK		07.00	GDP M/M% (3M/3M%)	Jan	0.2 (0.9)	-0.2 (1.1)
		07.00	Industrial production M/M% (Y/Y%)	Jan	0.2 (1.9)	0.3 (0.4)
		07.00	Manufacturing production M/M% (Y/Y%)	Jan	0.2 (3.1)	0.2 (1.3)
		07.00	Index of services M/M% (Y/Y%)	Jan	0.2 (0.9)	-0.5 (1.2)
		07.00	Construction output M/M% (Y/Y%)	Jan	0.2 (8.9)	2.0 (7.4)
		07.00	Goods trade balance £bn	Jan	-12.6	-12.4
		09.30	BoE/Kantar inflation expectations, next 12 months %	Mar	-	3.2

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 07 March 2022
			- Nothing scheduled -
			Tuesday 08 March 2022
Euro area		10.00	OECD publishes interim economic outlook
Germany		10.30	Auction: €250mn of 2030 inflation-linked bonds
		10.30	Auction: €500mn of 2033 inflation-linked bonds
UK		10.00	Auction: £1.5bn of 1.25% 2051 bonds
			Wednesday 09 March 2022
			- Nothing scheduled -
			Thursday 10 March 2022
Euro area		12.45	ECB monetary policy announcement
		13.30	ECB President Lagarde speaks at post-Governing Council meeting press conference
UK		00.01	KPMG/REC report on UK jobs
			Friday 11 March 2022
Italy		10.00	Auction: 3Y and 7Y bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.