Euro wrap-up

Overview

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- Bunds made big losses and periphery bonds significantly underperformed as the ECB slowed its pace of net purchases in Q2 more abruptly than previously planned, and gave itself an option to end purchases in Q3 and raise rates before year-end.
- Gilts made sizeable gains at the short end of the curve despite surveys suggesting that the UK's housing and labour markets remain very tight.
- While the EU leaders' summit kicks off this evening, Friday will bring UK GDP data for January, surveys of UK consumer price expectations and French business, and final German inflation data for February.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.414	+0.109
OBL 0 04/27	-0.016	+0.105
DBR 0 02/32	0.266	+0.056
UKT $0^{1}/_{8}$ 01/24	1.328	-0.069
UKT $0^{3}/_{8}$ 10/26	1.289	-0.026
UKT 0¼ 07/31	1.521	-0.002

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

Euro area

ECB slows net purchases more abruptly than planned, but leaves room for manoeuvre on rates

Taking the opportunity to respond for the first time to the range of shocks triggered by Russia's invasion of Ukraine, today's ECB decisions on the immediate path of monetary policy came from the more hawkish end of the spectrum of possibilities. In light of the recent marked deterioration in the near-term inflation outlook, and a new assessment that inflation is likely to settle back close to the 2.0% target over the medium term however events unfold this year, the Governing Council decided to slow its net asset purchases a little more abruptly than previously planned. Whereas it earlier intended to reduce the pace of net purchases to €40bn in each month of Q2, it will now make net purchases of €40bn only in April, before slowing them further to €30bn in May and €20bn in June. Net purchases in Q3 (previously set to be €30bn per month) will now be data-dependent and recalibrated at a future date. However, the Council stated that if the medium-term inflation outlook does not weaken over coming months, the net purchases will be brought to an end that quarter. So, the ECB today made room for a rate hike before the end of the year. Nevertheless, the Governing Council also dropped a previous pledge to end the net purchases "shortly" before rate lift-off, instead insisting that any adjustments to interest rates will take place "some time after the end of the net purchases and will be gradual". Therefore, the policymakers gave themselves greater room for manoeuvre (or "optionality") regarding both the path of net purchases in the second half of the year and the timing of the first rate hike, which will be determined by the inflation outlook in accordance with its earlier forward guidance.

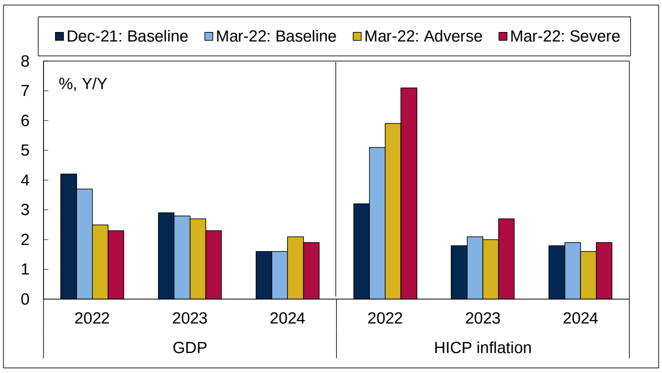
Optionality on future policy reflects need for compromise as well as uncertain outcome

In part, the agreement on optionality regarding the path of policy from Q3 onwards reflected the wide range of views of Governing Council members, which would have limited scope for reaching consensus today. Indeed, the wording of the policy statement bore the hallmarks of a tortuous negotiation, whereby the hawks got their way on a sharper pace of withdrawal of net asset purchases over the coming three months, but only by conceding flexibility to the doves regarding policy thereafter. Of course, the optionality regards policy in the second half of the year is also appropriate given the extremely uncertain economic outlook, which is to a large extent dependent on developments in Ukraine, sanctions and other policy responses – and is therefore ultimately unforecastable with any degree of precision.

Baseline growth outlook only moderately softer, inflation much higher in 2022

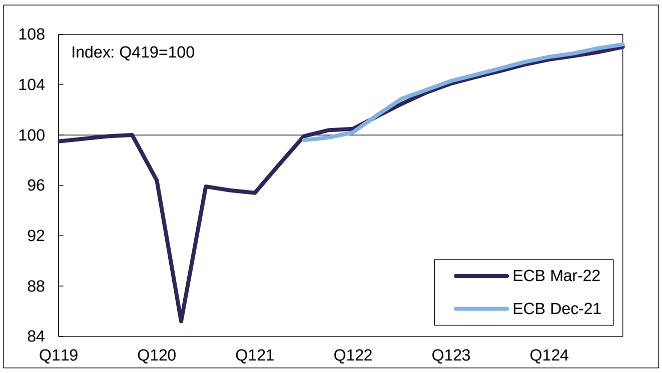
For what it's worth, despite the magnitude of recent shocks to wholesale energy and commodity prices, the downwards revisions to the ECB's baseline GDP outlook from December's projections were relatively moderate. The ECB nudged down by 0.5ppt to 3.7%Y/Y its forecast for growth in 2022 and by just 0.1ppt to 2.8%Y/Y next year, with the relative optimism in

ECB: GDP and HICP inflation forecast scenarios



Source: ECB and Daiwa Capital Markets Europe Ltd.

ECB: Baseline GDP forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

part reflecting the greater-than-expected resilience to the omicron variant and strong labour market performance. The upwards revision to the baseline inflation outlook for 2022 was much larger, of 1.9ppt to 5.1%Y/Y. But the revisions to the baseline inflation outlook for the next two years were modest, with headline and core HICP measures both projected to be 1.9%Y/Y in 2024, broadly in line with the ECB's target. Ultimately, we expect the near-term path of inflation to be much higher and the near-term path of GDP to be lower than specified in the ECB's baseline scenario.

ECB's alternative scenarios look more likely than its baseline scenario

Admittedly, to better reflect the uncertainty of the economic outlook – and illustrate the downside skew to the growth outlook and upside skew to the inflation outlook – the Governing Council considered alternative "adverse" and "severe" scenarios for the impacts of the war, according to which economic activity would be much softer due to a steeper rise in energy and commodity prices and more forceful hit to trade and sentiment. According to the "severe" scenario, compared to the baseline, in 2022 average GDP growth would be almost 1½ppt softer this year and average inflation would be some 2ppt higher. While the full detail of the alternative scenarios was not published today, we suspect that they will prove to be a better match to the eventual reality. Certainly, the baseline scenario's inflation peak of 5.4%Y/Y in Q1 and Q2 looks too low to us. Oil prices are currently on track to overshoot significantly the path assumed– today's futures prices were on average more than 14% higher than the assumption for the remainder of 2022 and more than 7% higher in 2023. And average "Euro Super 95" petrol prices in the euro area were up more than 12% in the week to 7 March alone, a week after the ECB projection cut-off date. We also expect the full hit to real incomes, confidence and demand this year to be more substantive than reflected in the baseline GDP scenario. And by the second half of the year, it is well within the realms of possibility that the euro area economy will have slid into recession, rendering a rate hike or even an end to the net purchase programme to be inappropriate.

The day ahead in the euro area

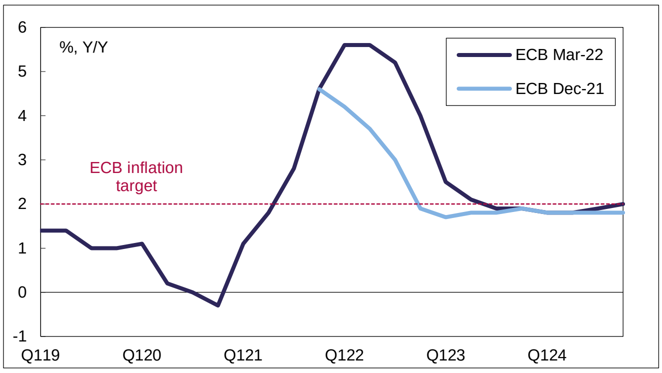
Attention this evening turns to the Versailles summit, where EU leaders will discuss how to reduce energy dependency on Russia and bolster defence capabilities. We expect the leaders to hold an initial discussion on a tentative suggestion, seemingly advocated by France, for common EU bond issuance, along similar lines to borrowing under the Next Generation EU programme, to fund new initiatives in these areas. Not least given German reticence, we certainly do not expect a decision on substantive action tomorrow. Instead, the leaders are likely to agree to study options to be discussed in more detail later this month. The summit will continue tomorrow with a discussion of economic growth and investment in which ECB President Lagarde will participate. Data-wise, the week will end with the Bank of France's business survey, which will provide an update on the strength of French economic activity last month, and should also reflect firms' initial assessment of the near-term economic outlook in the aftermath of Russia's invasion of Ukraine. The final estimates of German consumer price inflation in February are also due – according to the preliminary figures, the national CPI measure rose 0.2ppt to 5.1%Y/Y while the EU-harmonised HICP measure rose a steeper 0.4ppt to 5.5%Y/Y. Within the detail, the increase was due largely to energy prices, which on the national measure rose a further 2ppts to new series high of 22.3%Y/Y.

UK

UK residential property prices remain under upwards pressure on supply-demand imbalances

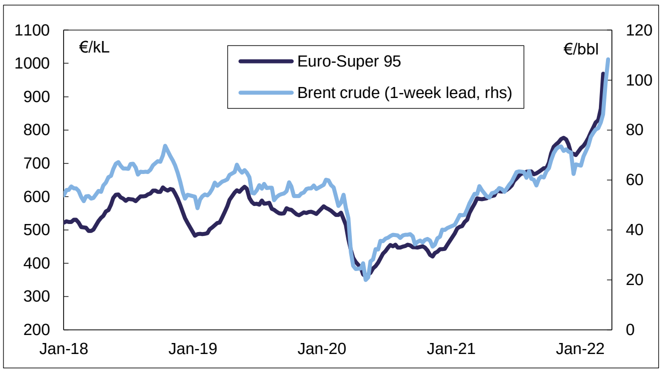
The RICS residential market survey of chartered surveyors suggested that the UK housing market continued last month to see solid demand and rising prices despite the recent dip in consumer confidence, declining disposable incomes and the prospect of further hikes in Bank Rate over coming months. Surveyors suggested that the number of new buyer enquiries rose in February to the highest since last May, with a sizeable jump in London. But with new vendor instructions continuing to fall (although the relevant survey index was the highest for fourteen months), and the stock of properties on surveyors' books at near-record lows, the dearth of supply placed further upwards pressure on house prices. Indeed, the share of surveyors

ECB: Baseline HICP inflation forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Petrol and Brent Crude prices*



**Consumer prices of petroleum products net of duties and taxes, euro area weighted average. Source: European Commission, Bloomberg and Daiwa Capital Markets Europe Ltd.*

reporting higher prices rose 5pts to 79%, the highest since June, with the equivalent in London (60%) the highest for almost eight years. And not least reflecting the persisting supply-demand imbalance, responding surveyors remained upbeat about prospects for the housing market over the year ahead, with price expectations rising to a new record high.

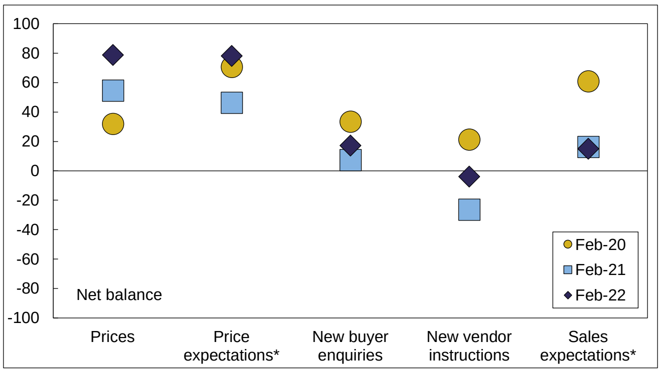
UK starting salaries rise sharply on marked labour market tightness

The KPMG/REC UK Report on Jobs suggested that ongoing supply constraints in the labour market continued to put upwards pressure on starting salaries. Recruitment consultancies signalled a further increase in hiring activity in February as new business picked up and vacancies rose, although the pace of permanent job placements was the softest for eleven months. But this principally reflected a limited pool of candidates, due in part to ongoing pandemic-related uncertainty and fewer foreign applicants. And with competition for workers intensifying, pay pressures continued to rise, with the survey suggesting that permanent starter salaries were rising at the second-sharpest pace since the series began in 1997. The ONS' latest business insights report similarly suggested that pay pressures have picked up, with the share of firms reporting higher wages than normal having risen 3ppts to 12% over the past month, with that share jumping to 27% when excluding businesses with fewer than 10 employees. Pressures were strongest in the hospitality sector, where more than one third of businesses reported higher than normal wages.

The day ahead in the UK

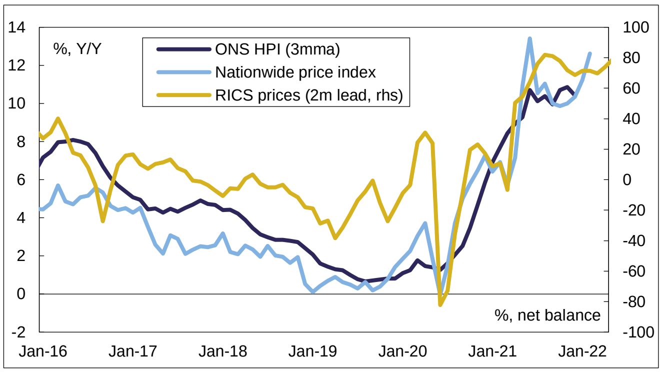
Tomorrow brings the UK's monthly GDP report for January. Following a modest dip of 0.2%M/M in December as the latest pandemic wave gained momentum, GDP appears to have returned to growth at the start of the year, supported not least by a rebound in retail sales, which rose 1.9%M/M. With output in manufacturing, construction and services also probably a touch firmer, while the contribution to growth from Covid-19 vaccinations and the test-and-trace programme turned negative, we expect to see GDP growth of 0.2%M/M in January. That would leave overall output up more than 9%Y/Y and a touch above its pre-pandemic level. Tomorrow will also see the release of goods trade data for January, which was the first month in which a full post-Brexit Customs declaration was required for goods imported to the UK from the EU. Given the significant further increase in red tape, imports are expected to have taken a hit and exports are expected to remain well down on the pre-pandemic level. Finally, the results of the latest quarterly BoE/Kantar Inflation Attitudes Survey will be watched for signs of increased consumer price expectations

UK: RICS housing market survey indicators



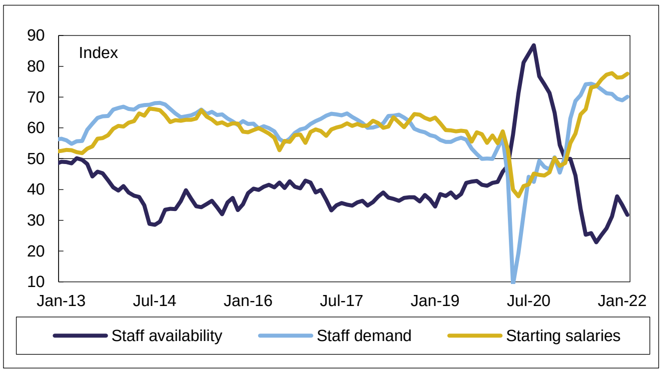
*12 months ahead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



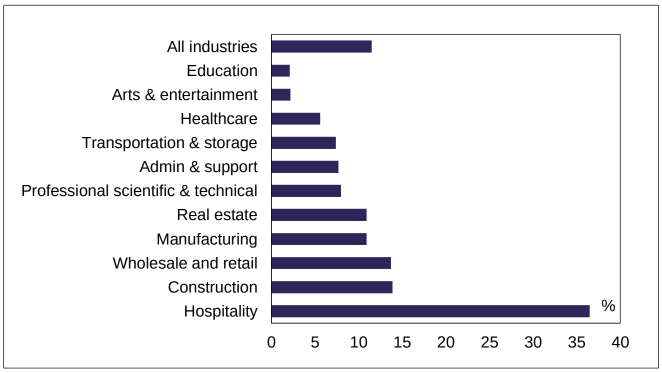
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: KPMG/REC labour market survey indicators



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

UK: Hourly wages vs normal, by sector*



*7 Feb – 6 Mar. Source: ONS 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	ECB refinancing rate %	Mar	**0.00**	*0.00*	0.00	-
	ECB deposit rate %	Mar	**-0.50**	*-0.50*	-0.50	-
Italy	PPI M/M% (Y/Y%)	Jan	**12.4 (41.8)**	-	0.9 (27.8)	**1.3 (28.3)**
UK	RICS house price balance %	Feb	**79**	73	74	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Final total (private sector) payrolls Q/Q%	Q4	**0.4 (0.6)**	0.4 (0.5)	1.1 (0.5)	-
Italy	Industrial production M/M% (Y/Y%)	Jan	**-3.4 (-2.6)**	-0.5 (3.2)	-1.0 (4.4)	**-1.1 (4.8)**

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
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	0.1 (0.8)	-0.2 (1.1)
	07.00	Industrial production M/M% (Y/Y%)	Jan	0.1 (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 (0.8)	-0.5 (1.2)
	07.00	Construction output M/M% (Y/Y%)	Jan	0.5 (9.1)	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

Auctions and events

Italy	10.00	Auction: €2.75bn of 0% 2024 bonds
	10.00	Auction: €3bn of 0.45% 2029 bonds
	10.00	Auction: €2bn of 0.95% 2037 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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