Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made further modest losses as today's ECB commentary largely echoed the main messages of yesterday's hawkish policy decision.
- Gilts were little changed despite an upside surprise to UK GDP growth in January and a BoE survey indicating a big pickup in household inflation expectations for the coming couple of years.
- The BoE is likely to raise Bank Rate on Thursday, while the coming week's data includes updates on the UK labour market as well as euro area inflation, IP, goods trade, and investor sentiment.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.405	+0.009
OBL 0 04/27	0.014	+0.029
DBR 0 02/32	0.278	+0.012
UKT 1 04/24	1.343	-0.009
UKT 1¼ 07/27	1.298	-0.004
UKT 4¼ 06/32	1.522	-0.002

*Change from close as at 4:00pm GMT.
Source: Bloomberg

UK

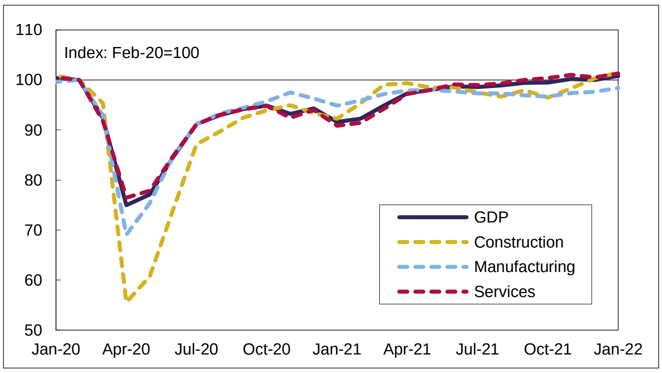
GDP beats expectations in January as threat from Omicron started to wane

Having dipped 0.2%M/M in December as the omicron variant took hold, UK GDP rebounded a larger-than-expected 0.8%M/M in January. That took economic output 0.8% above the pre-Covid level in February 2020. Looking through the month-to-month volatility caused by the ebb and flow of the pandemic, it suggested that the UK's growth trend remained broadly steady, with the 3M/3M growth rate of 1.1% little different to that of the prior four months. And growth was encouragingly broad-based in January. Despite a negative contribution from the Covid-related policy response including vaccinations, services activity rose 0.8%M/M, led by consumer-facing activity such as hospitality and retail as households looked to get back closer to normal in light of the diminished threat from Omicron. That took the level of services activity 1.3% above the pre-Covid level, although consumer-facing services were still down 6.8% against the same benchmark illustrating scope for further catch-up over coming months. Construction output rose 1.1%M/M to be a similar 1.4% above the level in February 2020. Industrial production rose 0.7%M/M thanks to increases in most factory sub-sectors (bar autos and pharmaceuticals) as well as oil and natural gas extraction. However, it was still 2.0% below the pre-Covid level, restrained by supply bottlenecks in manufacturing, not least in the transportation goods sector where the shortfall from before the pandemic was still almost 30%.

Trade data distorted by collection issues, but Brexit-related barriers clearly harmful

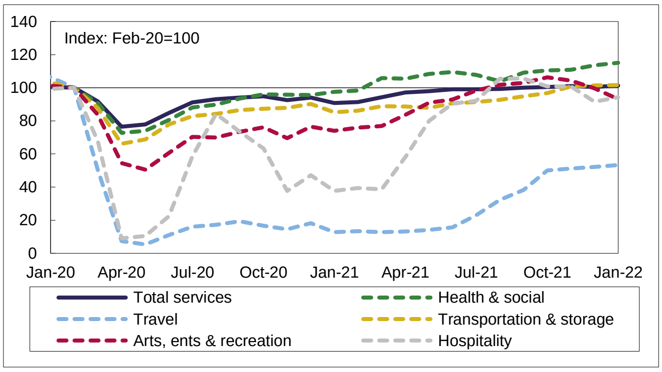
The increase in overall output in January came despite a very weak trade report, whereby the deficit rose to series highs of £26.5bn for goods, and £16.2bn when services are also included, with the deficits with the EU also reaching record highs. The value of goods imports surged 11.0%M/M due to a rise of more than 24%M/M in shipments from the EU, while exports plunged 8.7%M/M largely due to a drop in shipments to the EU. The ONS cautioned that the marked deterioration in performance at the start of the year at least in part reflected changes to the way by which data were collected, which meant that there were fewer days of exports data recorded this month. However, its own fortnightly Business Insights (BICS) survey yesterday highlighted how more than half of firms exporting from and importing to the UK faced challenges coping with extra paperwork, customs duties and levies, and time-consuming checks at the border are also problematic for a large share of traders. With such Brexit-related barriers clearly impeding trade flows in both direction, the reduced openness of the UK economy continues to weigh on business investment and productivity, with consequences for potential growth.

UK: GDP and main sectoral components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Growth in Q1 looks set to be firm, so MPC will have no qualms about raising rates on Thursday

Looking ahead, surveys and high-frequency data largely point to continued economic expansion in February, not least thanks to a further fading of the impact of the Omicron variant on hospitality and leisure, as well as an easing of supply bottlenecks in manufacturing. So, while the current month is likely to be softer as consumer confidence took a big step down ahead of the war in Ukraine, and supply restraints appear to have started to tighten again – e.g. car production at BMW's Cowley plant is currently closed for almost a fortnight – GDP growth of around 1.0%Q/Q in Q1 now looks reasonable. That would be a significantly stronger outcome than the BoE's forecast of no change from Q4 made just last month. So, the MPC will have no qualms about raising rates at Thursday's policy meeting.

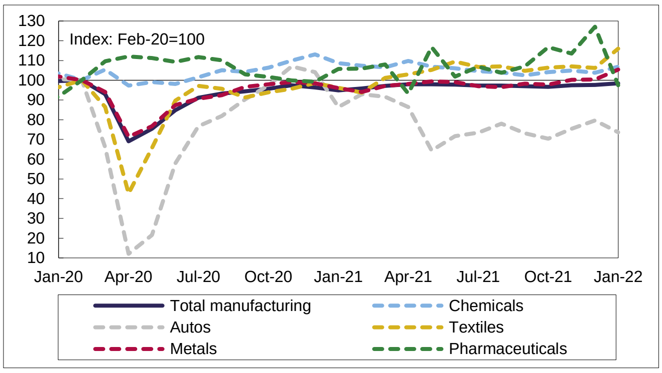
Non-negligible risks of contraction from Q2 suggest limited scope for further tightening thereafter

Prospects for GDP in Q2 look much weaker, however. For a start, an extra public holiday in June for the Queen's Platinum Jubilee is likely to reduce growth by up to 0.4ppt next quarter. Of more lasting importance, the continued slowing of the Covid vaccination programme, together with the end of free coronavirus testing next month, will contribute to a notable fall in health sector output in Q2, probably subtracting ½ppt or more, and restraining growth in such services thereafter. Supply-chain disruption associated with the war in Ukraine seems likely to became a greater constraint on manufacturing and construction. And, crucially, record petrol prices; the increase in household energy bills of more than 50% next month and prospect of a further substantive rise in October; intense inflationary pressures affecting food and other goods; and rising national insurance contributions and interest rates, all seem bound to weigh heavily on consumer spending from Q2 on. Indeed, we expect consumer confidence to fall to contractionary levels this month. Overall, therefore, GDP might be at best unchanged in Q2. And were it not for scope for further normalisation in levels of spending on consumer-facing services, which might be supported by running down some of the savings buffer accumulated by households throughout the pandemic, as well as a possible temporary boost to business capex thanks largely to a tax incentive, we would be forecasting recession.

Household inflation expectations rise sharply but wage expectations are subdued

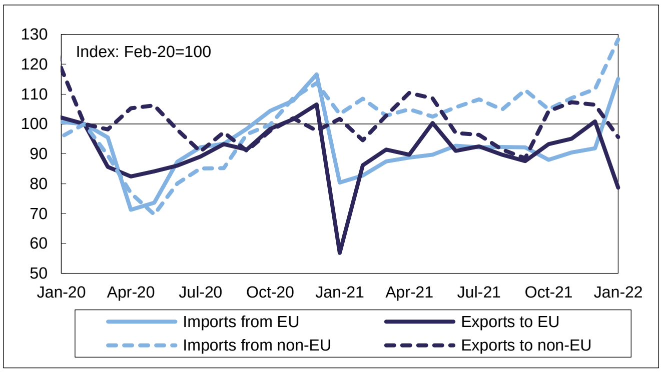
The latest quarterly BoE/Ipsos Inflation Attitudes Survey unsurprisingly reported a step-up in household price expectations for the year ahead compared to three months ago, with the median forecast jumping 1.1ppts in February to 4.3%Y/Y, almost 2ppts higher than the trough last May and the highest since before the global financial crisis. The expected rate of inflation for two years ahead rose 0.8ppt to 3.2%Y/Y, the highest since May 2013. Notably, this survey was conducted before the

UK: Manufacturing output



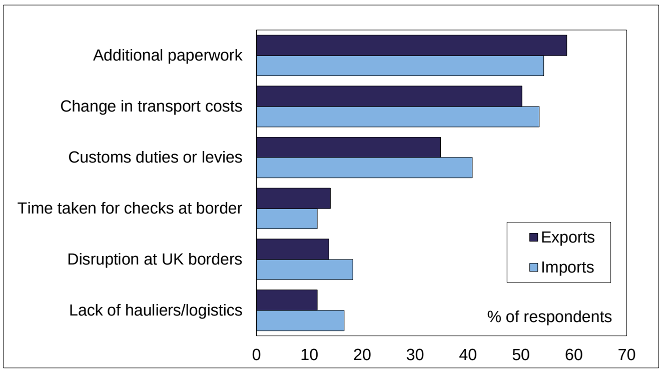
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Goods trade volumes



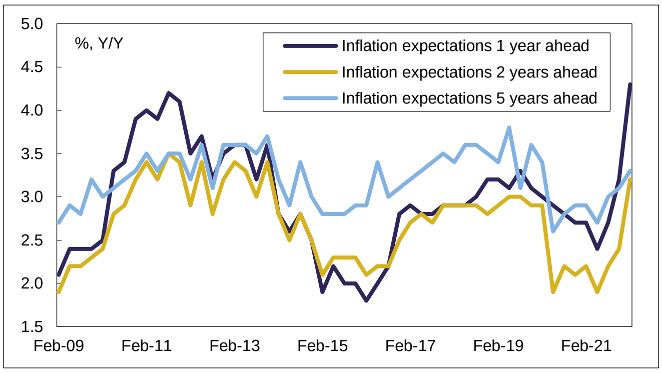
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Main exporting & importing challenges



Source: ONS BICS Survey and Daiwa Capital Markets Europe Ltd.

UK: Household inflation expectations



Source: BoE/Ipsos Inflation Attitudes Survey and Daiwa Capital Markets Europe Ltd.

Russian invasion of Ukraine and subsequent further spike in prices of energy and other commodities. So, we suspect that it will be cited by those MPC members most concerned about a possible de-anchoring of inflation expectations and will thus be used to justify further policy tightening. However, looking further ahead, the survey suggested that expectations for prices in five years' time, which is arguably most significant for monetary policy insofar as it flags risks of longer-lasting second-round effects from current high inflation, remained relatively well anchored. Indeed, the increase of just 0.2ppt on the quarter to 3.3%Y/Y left it still comfortably below rates seen before the pandemic. Moreover, the survey's findings on wage expectations were not consistent with meaningful second-range effects via the labour market. There was a modest rise in the share of respondents who suggested they would demand higher pay to compensate for higher prices. However, the mean labour earnings growth expectation for the coming twelve months was just 2.1%Y/Y while that for the following twelve months was just 2.2%Y/Y. And fewer than one quarter of respondents expected pay to rise by more than 3%Y/Y this year and next, suggesting that wage pressures might be unlikely to sustain inflation at an above-target rate once current energy and supply-chain pressures eventually subside.

The week ahead in the UK

The main event of the coming week in the UK, of course, will be the BoE's latest monetary policy announcements. At last month's meeting, the MPC raised Bank Rate by 25bps to 0.5%. It also started the process of quantitative tightening, ceasing to reinvest maturing Gilts from its holdings and starting a programme of sales of its corporate bond holdings. The rate decision was a close one, with four members out of nine having preferred a hike of 50bps. But the MPC signalled only that "further modest tightening in monetary policy is likely to be appropriate in the coming months". Since that meeting, economic activity appears to have held up well, with an upside surprise to GDP growth of 0.8%Q/Q in January and evidence of an acceleration in February. So, the BoE's forecast that GDP on average would be little changed in Q1 from Q4 looks too conservative, and we expect growth this quarter eventually to come in around 1.0%Q/Q. In addition, the labour market appears to have tightened further with some MPC members alarmed by the BoE agents' survey finding that firms expect pay to rise 4.8%Y/Y this year. And, of course, the risks to the near-term inflation outlook have further deteriorated markedly due to events in global energy and commodity markets, as well as the prospect of a renewed tightening of supply bottlenecks. Moreover, price expectations of financial markets and firms are also now highly elevated with consumer price expectations clearly higher too. Inflation now looks set to rise well above 8.0%Y/Y in April and is likely to average more than 7%Y/Y this year.

The case for a further rate hike of 25bps, let alone 50bps, is not watertight, however. In particular, high inflation will significantly erode real disposable incomes, which this year look set to decline the most in more than 40 years. Consumer confidence deteriorated markedly even before Russia's invasion of Ukraine, further suggesting that the outlook for domestic demand has weakened. And given the impact of the conflict on the EU economy, prospects for external demand over coming quarters have worsened too. So, the probability of a recession sometime this year is non-negligible. Moreover, financial market turbulence should also make some MPC members wary about tightening policy aggressively. Crucially, of course, the economic outlook will depend on the path of the war in Ukraine and its wider consequences, all of which remain highly uncertain. So, while MPC members have remained largely tight-lipped since the Russian invasion, we expect the majority to want to avoid a marked shift in its policy stance and – as is currently priced by the markets – vote for a hike in Bank Rate of 25bps to 0.75%.

In terms of economic data, the week's only new release of note from the UK will be the labour market report (due Tuesday). While employment growth is likely to have remained subdued in January as the latest wave of Covid-19 weighed on activity in the services sector, we expect the unemployment rate to nudge down 0.1ppt to 4.0% in the three months to January. And the labour market seems bound to have remained very tight, with the ratio of unemployed workers to vacancies likely to have remained near the series low reached at the end of last year. Growth in average regular wages is likely to remain below 4%Y/Y in January, suggesting that second-round effects from high inflation on pay were still limited, and meaning that real total labour earnings probably remained down more than 1.0%Y/Y.

Euro area

ECB policymakers echo yesterday's hawkish message

On a quiet end to the week for economic news from the euro area, the dust continued to settle on yesterday's ECB policy decision. Certainly, the detail of the announcement had suggested that the hawks had gained the upper hand for the time being, with a slightly sharper pace of reduction in net asset purchases agreed for the coming quarter, and the door opened to a possible end to net purchases in Q3 and a rate hike thereafter. In what appeared to be a compromise with the doves, policy during the second half of the year was left data-dependent, but the preferred direction of travel was made clear. Reports today underscored the ascendancy of the hawks, with the FT quoting sources suggesting that 15 members of the Governing Council wanted "immediate action on inflation" compared to just 10 "advocating patience". And all of the comments from Governing Council members today were consistent with the ECB's policy statement, suggesting that the compromise continues to hold. Among other things, the previously dovish Portuguese Governor Centeno stated that "monetary policy should seek a more neutral position and less accommodative." But he added that normalisation of monetary policy "should be accompanied by Europe's budgetary dimension", suggesting that the ECB expects governments to step up fiscal support to counter the impact of rising energy prices and cushion the blow to GDP from the Ukraine war.

EU leaders make incremental progress but energy price caps could be in order

Unfortunately, with respect to fiscal issues, in their informal summit in Versailles, EU leaders yesterday evening and today made only incremental progress, leaving plenty of work to do to flesh out practical plans over the coming few months. For example, a clear strategy to reduce dependence on Russian energy remains elusive, with a formal Commission proposal for what will be known as the "RePowerEU" plan due only by the end of May. Nevertheless, the leaders will meet again before the end of this month to discuss how to limit the increase in household energy bills, with many member states keen to cap gas tariffs and apply a windfall tax on the profits of utilities. They also asked the Commission to present options to address rising food prices. And, while the objections of certain fiscally conservative northern member states will not be resolved immediately, a further round of common debt issuance, along lines to the €750bn NextGenerationEU programme, to fund new investments to promote energy independence and common defence initiatives could still eventually get the green light this year.

The week ahead in the euro area

The coming week will be light on top-tier economic data from the euro area. The ZEW investor survey for March (due Tuesday) seems bound to tally with this week's Sentix survey to suggest a marked deterioration in perceptions of the euro area economic outlook. The euro area industrial production report for January (also Tuesday) is set to report little if any growth, as solid expansion of more than 1.0%M/M in Germany and France was offset by declines of more than 3.0%M/M in Italy and Ireland, and more than 1.0%M/M in the Netherlands. In addition, the final euro area inflation report for February (Thursday) is likely to confirm the stronger-than-anticipated flash estimates, which reported a leap of 0.7ppt in the headline rate to 5.8%Y/Y and an increase of 0.4ppt in the core rate to 2.7%Y/Y, with both measures at series highs. Euro area trade data for January (Friday) will likely report a third successive trade deficit, not least due to the unfavourable shift in the terms of trade. And euro area labour cost data for Q4 (also Friday) are likely to reaffirm that second-round effects on wages from high inflation remained absent at the end of last year. The week's data calendar kicks off on a quiet note with the Bank of France's business survey – conducted after the Russian invasion of Ukraine – most notable on Monday. In terms of monetary policy communication, ECB President Lagarde, as well as Executive Board members Lane and Schnabel, and Banca d'Italia Governor Visco, will all speak at the annual ECB Watchers' conference on Thursday, no doubt reiterating the messages from yesterday's policy statement. In this respect, the remarks from the typically dovish Lane and Visco might be most notable, as they could illustrate the possible strength of resistance to pushing ahead with a rate hike by the end of the year if growth momentum weakens significantly.

The next edition of the Euro wrap-up will be published on 15 March 2022

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Final CPI (EU-harmonised CPI) Y/Y%	Feb	**5.1 (5.5)**	5.1 (5.5)	4.9 (5.1)	-
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Feb	**7.6 (7.6)**	7.4 (7.5)	6.1 (6.2)	-
UK	GDP M/M% (3M/3M%)	Jan	**0.8 (1.1)**	0.1 (0.8)	-0.2 (1.0)	-
	Industrial production M/M% (Y/Y%)	Jan	**0.7 (2.3)**	0.1 (1.9)	0.3 (0.4)	-
	Manufacturing production M/M% (Y/Y%)	Jan	**0.8 (3.6)**	0.2 (3.1)	0.2 (1.3)	-
	Index of services M/M% (Y/Y%)	Jan	**0.8 (1.0)**	0.2 (0.9)	-0.5 (1.2)	-
	Construction output M/M% (Y/Y%)	Jan	**1.1 (9.9)**	0.2 (8.9)	2.0 (7.4)	-
	Goods trade balance £bn	Jan	**-26.5**	-12.6	-12.4	-
	BoE/Ipsos inflation expectations, next 12 months %	Q1	**4.3**	-	3.2	-

Auctions

Country	Auction
Italy	sold €2.75bn of 0% 2024 bonds at an average yield of 0.57%
	sold €3bn of 0.45% 2029 bonds at an average yield of 1.47%
	sold €2bn of 0.95% 2037 bonds at an average yield of 2.11%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's data calendar

The coming week's key data releases

Country		GMT	Release	Period	Market consensus/ _Daiwa forecast/actual_	Previous
			Monday 14 March 2022			
France		-	Bank of France industrial sentiment*	Feb	106	106
		07.45	Trade balance €bn	Jan	-	-11.3
Spain		08.00	Retail sales Y/Y%	Jan	6.3	-2.3
			Tuesday 15 March 2022			
Euro area		10.00	Industrial production M/M% (Y/Y%)	Jan	0.0 (-0.7)	1.2
Germany		10.00	ZEW current situation balance (expectations)	Mar	-23.0 (8.0)	-8.1 (54.3)
France		07.45	Final CPI (EU-harmonised CPI) Y/Y%	Feb	3.6 (4.1)	2.9 (3.3)
UK		07.00	Payrolled employees change '000s	Feb	-	108
		07.00	Unemployment claimant count rate % (change '000s)	Feb	-	4.6 (-31.9)
		07.00	Average weekly earnings (excluding bonuses) 3M/Y%	Jan	4.6 (3.7)	4.3 (3.7)
		07.00	ILO unemployment rate 3M%	Jan	4.0	4.1
		07.00	Employment change 3M/3M '000s	Jan	10	-38
			Wednesday 16 March 2022			
Italy		09.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	5.7 (6.2)	4.8 (5.1)
			Thursday 17 March 2022			
Euro area		10.00	Final CPI (core CPI) Y/Y%	Feb	5.8 (2.7)	5.1 (2.3)
		07.00	EU27 new car registrations Y/Y%	Feb	-	-6.0
Spain		08.00	Labour costs Y/Y%	Q4	-	4.9
		09.00	Trade balance €bn	Jan	-	-5.3
UK		12.00	BoE Bank Rate %	Mar	_0.75_	0.50
			Friday 18 March 2022			
Euro area		10.00	Trade balance €bn	Jan	-9.0	-9.7
		10.00	Labour costs Y/Y%	Q4	-	2.5
France		07.45	Final wages Q/Q%	Q4	0.5	0.3
Italy		09.00	Ttrade balance €bn	Jan	-	1.1

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

The coming week's key events & auctions			
Country		GMT	Event / Auction
Monday 14 March 2022			
Euro area		08.00	ECB President Lagarde and Executive Board member Panetta take part in Eurogroup meeting
Tuesday 15 March 2022			
Germany		10.30	Auction: €5.5bn of 2024 bonds
UK		10.00	Auction: £1.2bn of 0.125% 2031 inflation-linked bonds
Wednesday 16 March 2022			
Germany		10.30	Auction: €4bn of 2032 bonds
Thursday 17 March 2022			
Euro area		09.00	ECB's Knot scheduled to speak
		-	ECB's Lagarde, Lane and Schnabel to speak at The ECB and Its Watchers conference
France		09.50	Auction: 0.5% 2026 bonds
		09.50	Auction: 0% 2027 bonds
		09.50	Auction: 0.5% 2029 bonds
		10.50	Auction: 0.1% 2031 inflation-linked bonds
		10.50	Auction: 0.1% 2036 inflation-linked bonds
		10.50	Auction: 0.1% 2053 inflation-linked bonds
Spain		09.30	Auction: 0% 2025 bonds
		09.30	Auction: 1.4% 2028 bonds
		09.30	Auction: 0.7% 2032 bonds
UK		12.00	BoE monetary policy announcement, summary and minutes to be published
		12.00	BoE Agents' summary of business conditions for Q1 to be published
Friday 18 March 2022			
- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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