Euro wrap-up

Overview

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- Bunds made modest losses as euro area inflation in February was revised even higher, but Lagarde reiterated near-term policy flexibility amid the uncertain outlook.
- Gilts rallied as the BoE raised Bank Rate by 25bps but flagged increased risks to the outlook and tempered its forward guidance on the likelihood of further modest tightening.
- Friday will bring just euro area goods trade data for January and labour costs numbers for Q4.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	-0.343	+0.008
OBL 0 04/27	0.106	+0.020
DBR 0 02/32	0.387	-
UKT 1 04/24	1.272	-0.119
UKT 1¼ 07/27	1.309	-0.087
UKT 4¼ 06/32	1.560	-0.066

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

Euro area

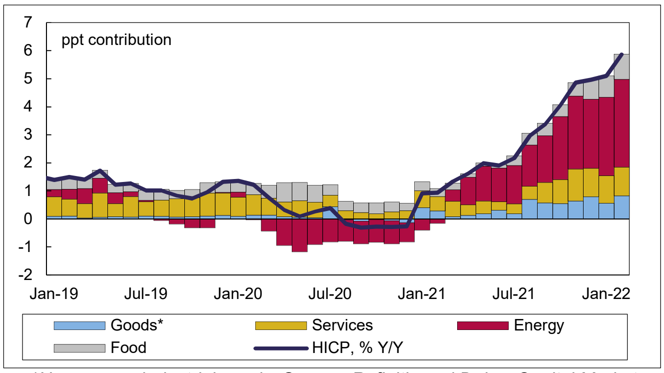
Euro area inflation revised even higher in February

As had been signalled by national releases over the past week, today's final euro area inflation figures brought an upwards revision to the already series-high headline HICP rate in February, by 0.1ppt to 5.9%Y/Y to leave it 0.8ppt higher on the month. The revision in part reflected a higher pace of energy inflation, which was nudged up a further 0.3ppt to 32.0%Y/Y. Prices of electricity (up 3.0%M/M, 34.3%Y/Y), gas (up 1.2%M/M, 41.4%Y/Y) and liquid fuels (up 7.2%M/M, 42.7%Y/Y) all continued to push notably higher to leave energy accounting for more than half of headline inflation (3.1ppts). Food price inflation was also revised slightly higher from the preliminary release to 4.2%Y/Y, the firmest since October 2008, reflecting poor harvests and global market pressures. The rebound in non-energy goods price inflation was also a touch stronger than initially estimated, rising 1ppt on the month to 3.1%Y/Y, as prices rose by the most in any February since the creation of the euro (0.7%M/M) as firms passed on some of their supply-related cost pressures to consumers. Indeed, while the jump in the year-on-year rate was due in part to a bounce-back in clothing inflation reflecting the timing of seasonal discounting, there was further significant upwards pressure on second-hand car prices, with such inflation up a further 1.2ppts to a record-high 8.0%Y/Y. And while the monthly increase in prices of services was broadly normal for the time of year, it still pushed the respective annual rate up 0.2ppt to 2.5%Y/Y, despite ongoing downwards pressure from package holiday and air travel inflation. So, core inflation was confirmed to be up 0.4ppt on the month to a series record of 2.7%Y/Y. And the ECB's 15% trimmed mean jumped a further 0.6ppt to a new high of 4.3%Y/Y.

Lagarde emphasises policy optionality, gradualism and flexibility amid uncertain outlook

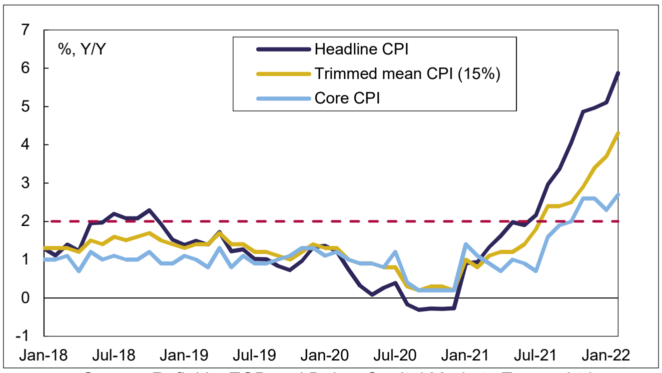
Looking ahead, the euro area inflation outlook remains extremely uncertain. One key variable will be energy prices, which have been impossible to forecast with confidence since the Russian invasion of Ukraine. Indeed, since the start of March, the euro-denominated price of Brent crude initially leapt but subsequently retreated more than 25%, before ticking back up today, leaving the average over the past fortnight more than 21% above the February average. And the average pump price of Euro Super 95 gasoline in the euro area over the first two weeks of the month is up more than 14% from the February average. Given recent market price shifts, we currently expect headline inflation to peak at around 7.0%Y/Y in April and average 6.0%Y/Y in 2022 – almost 1ppt above the ECB's baseline projection published last week. In a speech today to the annual ECB Watchers' conference, however, ECB Chief Economist Philip Lane noted that almost 1.0ppt of inflation of non-energy industrial goods and 0.8ppt of core inflation this quarter could be attributed to the pass-through of oil prices increases through the pipeline. And with wage growth having remained subdued and inflation expectations well anchored, that supports the ECB's (and our) projection that inflation will return back close to the 2% target by the end of the horizon. Of course, with such an uncertain outlook, there remain two-sided risks to that projection. And recognizing the uncertainty, in

Euro area: Consumer price inflation



*Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



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

her speech to the Watchers' conference, President Christine Lagarde repeated that policy from now on would be guided by optionality, gradualism and flexibility. So, she reiterated that policy from Q3 on would be data-dependent, additionally noting that the Governing Council had given itself "extra space if needed after we stop purchasing bonds and before we take the next step towards normalisation". That suggests that rates are unlikely to rise before December if net asset purchases end in Q3. At the same time, should the end of net purchases result in pressures on periphery spreads, Lagarde repeated that reinvestments of maturing PEPP, and perhaps new policy instruments, could be introduced to ease fragmentation risks and support the monetary policy transmission mechanism and thus clear the way for policy normalisation into 2023.

Euro area car sales remain in reverse as supply constraints persist

According to the European Automobile Manufacturers' Association (ACEA), euro area passenger car registrations were down 6.9%Y/Y in February despite the extremely low base a year ago as manufacturers continued to struggle in the face of persisting supply shortages. Indeed, just 617.5k units were sold last month, the weakest result for a February since records began and more than a quarter lower than the pre-pandemic level. On a seasonally adjusted basis, the ECB estimated that new registrations rose by 5.2%M/M in February, but given the very weak start to the year this left sales so far in Q1 trending more than 1% lower than the Q4 average. The performances of the member states were mixed, with the improvement largely driven by Spain (up a seasonally-adjusted 22.9%M/M), while registrations in France rose modestly (1.9%M/M), were broadly unchanged in Germany (0.1%M/M), and fell in Italy (-8.7%M/M). German car sales were trending in the first two months of the year a little more than 8½% above the Q4 average, with Italian registrations also more than 5% higher on an equivalent basis, contrasting with contractions in France (-3.6%) and Spain (-22.1%). Of course, the near-term outlook for the autos sector has been further clouded by Russia's invasion of Ukraine, which has increased risks to the supply of a range of inputs in car production, from wire cable harnesses to palladium for catalytic converters, and nickel ore to semiconductors. And various German car manufacturers, including Volkswagen, BMW and Mercedes, have already cut output over recent weeks.

The day ahead in the euro area

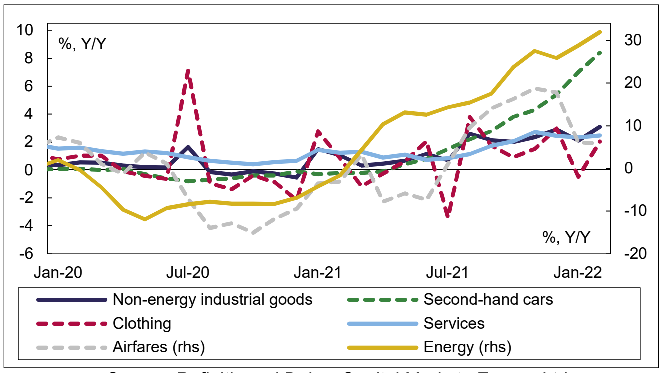
It should be a relatively quiet end to the week for top-tier euro area data releases. Euro area goods trade figures are expected to report a third successive trade deficit, not least due to the unfavourable shift in the terms of trade associated with higher prices of energy and commodities. Meanwhile, euro area labour cost numbers for Q4 will also be published and are expected to confirm that second-round inflationary pressures from employee compensation remain very well contained.

UK

Bank Rate back to pre-Covid level, but MPC acknowledges increased downside risks

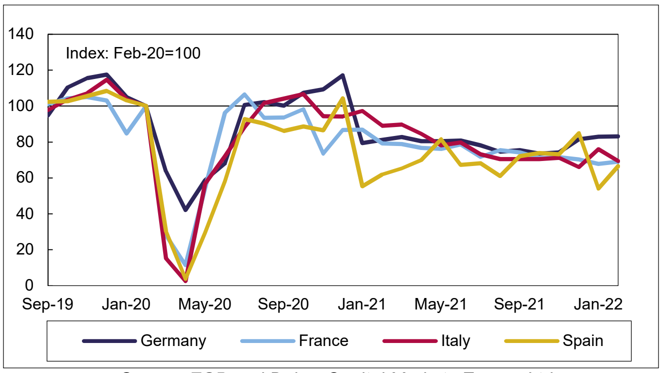
As expected, the BoE's MPC tightened monetary policy for the third successive meeting, with the increase of 25bps taking Bank Rate back to its pre-pandemic level and post-financial crisis peak of 0.75%. But the MPC moderated slightly its forward guidance from February, stating that "some further modest tightening in monetary policy *might be* appropriate in the coming months", rather than "*is likely to be* appropriate". Of course, it had to acknowledge that the economic outlook had evolved since the February policy meeting, principally due to Russia's invasion of Ukraine. Certainly, it judged that the near-term inflation outlook has deteriorated further, and now expects a profile close to our own forecast of an initial peak of 8% (or more) in April and (depending on the path of energy prices) perhaps another peak above that in October. But tallying with the amended guidance, the tone of the statement was more dovish than last month, recognising the intensified squeeze on household incomes that will result from the higher peak in inflation, and hence the weaker outlook for GDP growth and employment. As a result, the MPC was more attuned to the downside risks to the medium-term inflation outlook than it was last month. And while four members had voted for a 50bps hike in February, none did this time around. Moreover, one member – Deputy Governor for financial stability Jon Cunliffe – voted for no change to rates.

Euro area: Selected CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations



Source: ECB and Daiwa Capital Markets Europe Ltd.

Market pricing likely exaggerates extent of BoE tightening to come this year

The majority still voted for a rate hike to reduce the risk that recent trends of higher wages, domestic price-setting, and inflation expectations would continue to strengthen and become embedded. But while the BoE's agents reported higher wage settlements, and measures of market-based, business and household inflation expectations were also judged to have risen further, overall the MPC judged that inflation expectations remained well anchored. So, it saw no need to match the Fed's new hawkishness. Yesterday the FOMC validated market pricing of rate hikes at every policy meeting this year, and signalled its expectation that it will push the fed funds rate above the long-run equilibrium level next year to steer inflation back to target over the medium term. In contrast, while acknowledging the significant uncertainty of the economic outlook, the BoE will likely judge that market pricing of four or five more hikes this year exaggerates the full extent of tightening required to get UK inflation eventually back to target. So, for the time being, we continue to expect only two more hikes of 25bps apiece, in May and August, with the former to be accompanied with a decision to start active sales of Gilts from the BoE's portfolio. And depending in part on what the Chancellor announces next week in terms of additional fiscal support to ease the impact on households and businesses of higher prices of energy and food, even that might be overdoing the full extent of BoE tightening to come.

The day ahead in the UK

The week will end quietly on the UK economic data front, with no top-tier releases scheduled tomorrow.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final CPI (core CPI) Y/Y%	Feb	**5.9 (2.7)**	*5.9 (2.7)*	5.1 (2.3)	-
	EU27 new car registrations Y/Y%	Feb	**-6.7**	-	-6.0	-
Spain	Labour costs Y/Y%	Q4	**4.4**	-	4.9	-
UK	BoE Bank Rate %	Mar	**0.75**	*0.75*	0.50	-

Auctions

Country	Auction
France	sold €2.93bn of 0.5% 2026 bonds at an average yield of 0.2%
	sold €3.90bn of 0% 2027 bonds at an average yield of 0.32%
	sold €3.17bn of 0.5% 2029 bonds at an average yield of 0.50%
	sold €788mn of 0.1% 2031 inflation-linked bonds at an average yield of -1.59%
	sold €531mn of 0.1% 2036 inflation-linked bonds at an average yield of -1.19%
	sold €164mn of 0.1% 2053 inflation-linked bonds at an average yield of -0.98%
Spain	sold €2.08bn of 0% 2025 bonds at an average yield of 0.342%
	sold €1.03bn of 1.4% 2028 bonds at an average yield of 0.764%
	sold €2.49bn of 0.7% 2032 bonds at an average yield of 1.307%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Final CPI (EU-harmonised CPI) Y/Y%	Feb	**5.7 (6.2)**	5.7 (6.2)	4.8 (5.1)	-

Auctions

Country	Auction
Germany	sold €3.43bn of 0% 2032 bonds at an average yield of 0.38%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
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	Trade balance €bn	Jan	-	1.1
Auctions and events						
			- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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