Euro wrap-up

Overview

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- As investors responded to signs of financial stress at SVB, Bunds followed USTs sharply higher, while final German inflation data for February provided no surprises.
- Gilts also rallied hard despite a modest upside surprise to UK GDP growth in January.
- While the ECB will raise rates again by 50bps on Thursday, attention will be on its updated guidance and inflation projections. The UK Budget statement is also scheduled, while final euro area inflation and UK labour market data are due.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/25	3.053	-0.196
OBL 2.2 04/28	2.620	-0.164
DBR 2.3 02/33	2.493	-0.141
UKT 0⅝ 06/25	3.608	-0.183
UKT 1⅝ 10/28	3.502	-0.174
UKT 3¼ 01/33	3.627	-0.164

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

Euro area

Final German inflation data align with flash estimates confirming rise in food and services pressure

The final estimates of German consumer price inflation in February aligned with the flash data, thus thankfully avoiding the confusion that had reigned over January's figures. So, the EU-harmonised HICP rate was confirmed at 9.3%Y/Y in February, up 0.1ppt from the start of the year, while the national CPI rate was unchanged from January at 8.7%Y/Y. The detail on the national measure confirmed that food inflation was a key driver, up a further 1.6ppts to a new series high of 21.8%Y/Y, with exceptionally high rates recorded in staples such as dairy, eggs, bread, cereals and sugar. In contrast, energy inflation dropped more than 4ppts to a thirteen-month low of 19.1%Y/Y, benefiting from the government's utility charge freeze as well as softer petrol price inflation. Meanwhile, services inflation rose 0.2ppt to a new high of 4.7%Y/Y. And so, while non-energy industrial goods inflation moderated very slightly, the core CPI rate (excluding food and energy) rose 0.1ppt to a new high of 5.7%Y/Y. The absence of a revision to the German figures increases the likelihood that the euro area inflation data, due one week today, will also align with the flash estimates (8.5%Y/Y headline, 5.6%Y/Y core).

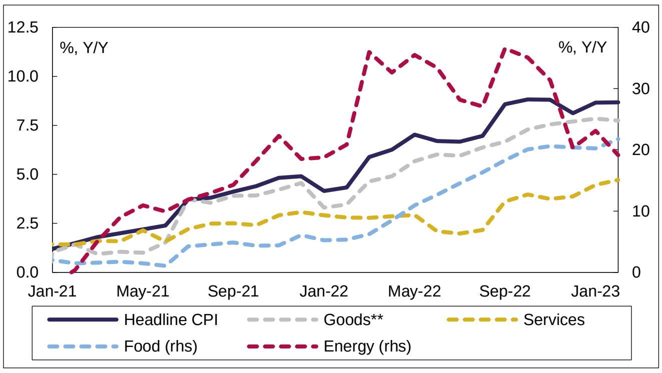
German inflation set to drop from March on; household inflation expectations fall on ECB survey

Given the significant base effect last March, related to the rise in energy prices of 15.1%M/M and overall increase in the CPI of 2.0%M/M – both series highs – German inflation is bound to take a significant step down next month. And we expect it continue to trend steadily lower as the year goes on as food and other goods prices stabilise. Of course, the stickiness of core inflation will be the main concern among the ECB's hawks. But when pondering risks of second-round effects, they might note this week's findings of the ECB's January household survey. In particular, the median German household inflation expectation three years ahead dropped 1.0ppt to an eleven-month low of 2.0%. And the equivalent figure for the euro area also fell back, albeit by 0.5ppt to an eight-month low of 2.5%.

ECB likely to signal further "significant" tightening ahead after 50bps hike on Thursday

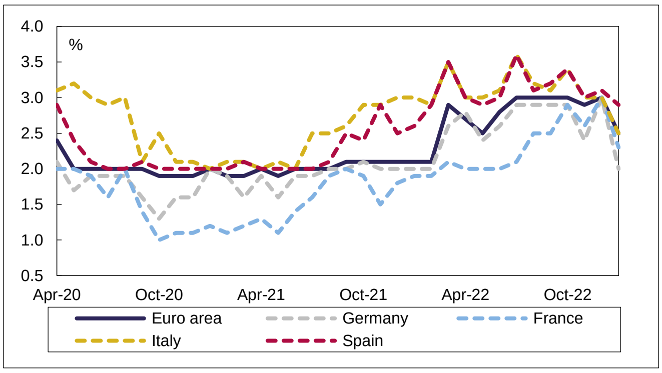
When its Governing Council meeting concludes on Thursday, there is no doubt that the ECB will announce a further 50bps hike in all of its main policy rates. That decision, which was all but pre-agreed last month, will take its deposit rate to 3.00%, and the cumulative tightening since July to 350bps. While the latest policy decision was effectively pre-announced, however, the outcome of the coming meeting will not be without interest. Indeed, the ECB's updated forward guidance on the next steps for rates is far from certain. The doves on the Governing Council will want to leave flexibility to respond to incoming economic and financial data, which will provide greater evidence of the effects of recent rate hikes and, in due course, the impact of quantitative tightening, which only got underway this month. Certainly, the doves will insist on maintaining the text

Germany: Consumer price inflation*



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

Euro area: 3-year consumer inflation expectations



Source: ECB Consumer Expectations Survey & Daiwa Capital Markets Europe Ltd.

in the monetary policy statement that “future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach”. However, that text might be considered relatively inconsequential, as it was effectively contradicted by last month’s announcement of an expectation of a 50bps rate hike at the forthcoming meeting. Recent public remarks suggest that the Governing Council’s hawks will be keen at the coming meeting to signal further “significant” rate hikes (i.e. of at least 50bps) to come. And given the unwelcome rise in core inflation in February to a new series high of 5.6%Y/Y, which suggested increased risks of underlying inflation persistence not least as firms are maintaining and in some sectors increasing margins, we suspect that the hawks will again be in the majority. So, we expect a signal that a further 50bps of monetary tightening in May is likely (if not yet a done deal).

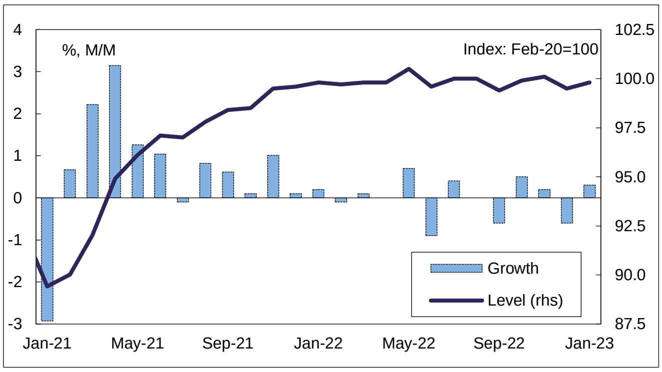
ECB projections to revise down profile for headline inflation despite persistence in core pressures

Nevertheless, the ECB’s updated macroeconomic projections are highly likely to revise down the profile of headline inflation over the horizon. Given falls in energy prices, the annual rate of HICP inflation in the first two months of the year, at 8.6%Y/Y, was already 0.5ppt below the ECB’s December baseline forecast. Moreover, gas and oil futures point to a markedly lower path for energy prices over the remainder of the year than was assumed in December. Short-term interest rates are about 100bps higher and 10-year bond yields are around 50bps higher than when the ECB’s last projections were finalised, with the euro exchange rate stronger too. But while the new forecasts could well suggest that the 2.0% inflation target will be met by the end of 2024, they will also likely suggest that core inflation will on average remain above 2.0% in 2025, justifying additional monetary tightening. With respect to economic growth, while the level of GDP was unchanged in Q4, it was still higher than anticipated by the ECB. The significant tightening of financial conditions imposed since December is likely in due course to be more forcefully felt in the real economy. But while economic growth might struggle to get above zero again in Q1, with economic sentiment currently firmer than expected, the adverse shock to the euro area’s terms of trade less potent, and external demand probably somewhat stronger than the ECB had anticipated, we suspect that the ECB might be tempted to nudge up its growth forecast of 0.5% this year, even if it revises down somewhat its forecast of 1.9% for 2024.

The week ahead in the euro area: Economic data

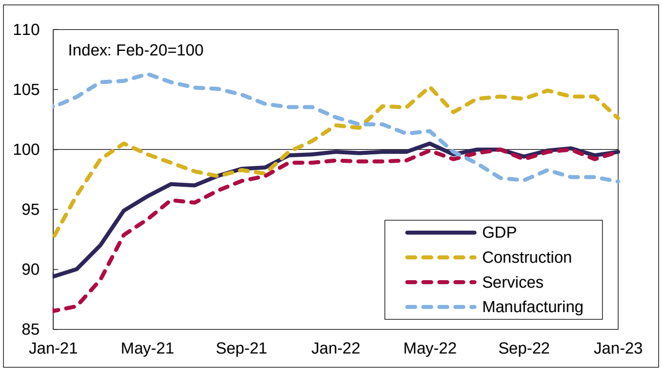
With respect to economic data, likely of most interest for the Governing Council in the coming week will be Friday’s release of final euro area February CPI and Q4 labour costs numbers. In the absence of significant revisions to the equivalent releases from Spain (Tuesday), France (Wednesday) and Italy (Thursday), the aggregate euro area inflation figures should align with the flash estimates. They saw the headline HICP rate edge slightly lower for the fourth consecutive month, by 0.1ppt to 8.5%Y/Y in February, but core inflation leap to a new record high of 5.6%Y/Y. The labour cost figures will be watched for any evidence of second-round effects from recent elevated inflation, although we do not expect a marked

UK: GDP growth and level



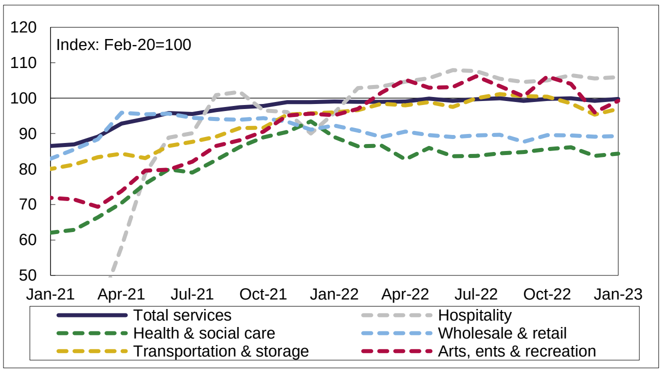
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP level and sector components



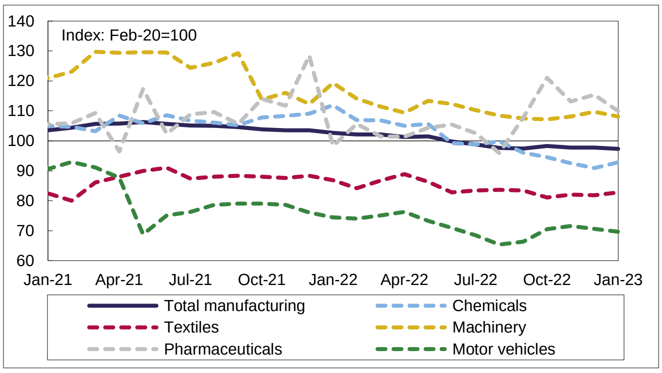
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

acceleration. In terms of economic activity, euro area industrial production numbers for January are due Wednesday. While there was a rebound in German output at the start of the year, this appears to have bucked the trend in the region, with notable declines recorded in France (-1.9%M/M), Spain (-0.9%M/M), the Netherlands (-4.3%M/M) and Belgium (-4.1%M/M). So, while the euro area's figure will largely depend on the Irish outcome (Monday), there appears to be a good chance of a negative print.

UK

GDP beat expectations in January on services rebound but underlying trend flat

Following the drop of 0.5%M/M in December, UK GDP reversed only some of that lost ground in January. The increase of 0.3%M/M was a touch firmer than had been expected. But it left the three-month rate at zero, suggesting that the underlying trend is at best flat. And the level of GDP in January was still 0.2% below the pre-pandemic level of February 2020. Growth at the start of the year came from the services sector, where activity rose 0.5%M/M following the drop of 0.8%M/M the prior month to be similarly unchanged on a three-month basis. Indeed, growth in the tertiary sector in January largely reflected the reversal of special factors, including the return of more children to school following high levels of absenteeism before Christmas, the resumption of a full schedule in English football's Premier League following the pause for the FIFA World Cup, and increased postal deliveries following strike-related disruption the prior month. With modest growth also reported in hospitality, retail, ICT and financial services, real estate was the only one of the major services subsectors to contract in January, reflecting the adjustment in the housing market as higher interest rates took a greater toll.

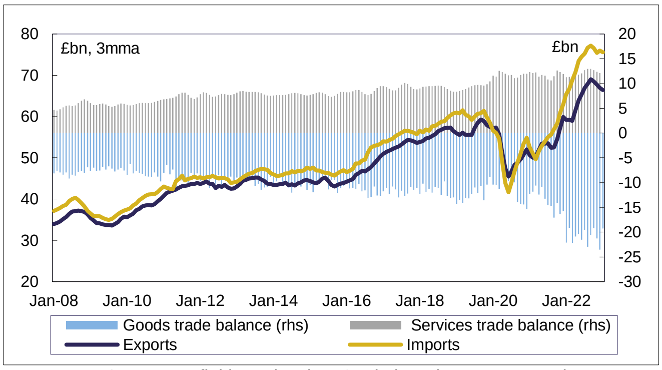
IP and construction contract in January, outlook for remainder of quarter still weak

Beyond the services sector, industrial production in January fully reversed the prior month's growth of 0.3%M/M but was up 0.3%3M/3M. Within the detail, declines at the start of the year in output of pharmaceuticals, machinery and transport equipment were only partly offset by growth in chemicals, rubber and plastics and clothing. Extraction of crude oil and natural gas fell too. And following no change the prior month, construction dropped 1.7%M/M in January to an 11-month low, to be down 0.7%3M/3M. Looking ahead, with February having seen increased strike action, not least in schools, and consumer budgets still under pressure from declining real incomes, we expect services output to decline once again. And with construction likely to remain a source of weakness due to housing market weakness, and surveys suggesting no major cause for optimism in manufacturing, we maintain our forecast that GDP will drop 0.2%Q/Q in Q1 and remain extremely subdued in Q2.

Underlying trade deficit widens to 8-month high as exports and imports remain weak

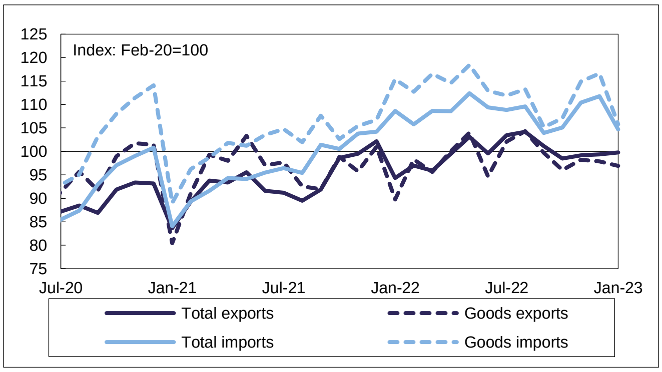
On the demand side, economic growth at the start of the year appears to have benefited from net trade, but only because imports fell more than exports. In particular, excluding precious metals which typically distort the underlying picture, goods import volumes fell a steep 9.3%M/M while goods export volumes dropped a much smaller 1.0%M/M. The drop in imports reflected a fall in machinery and transport equipment, particularly from Germany, seemingly as payback for strength in December. The drop in exports reflected weakness in shipments of fuels, chemicals and materials to the EU. On a similar basis, services imports were estimated to have fallen 0.3%M/M while services exports dropped a slightly larger 0.6%M/M. Of course, the trade data are notoriously volatile from month to month, while shifts in relative prices also impact the overall trade balance. On a three-month basis, excluding precious metals, despite a lower price of imported gas, the deficit in goods trade widened by £1.4bn to £64.1bn in January, as the drop in exports (-4.0%3M/3M) outpaced that of imports (-2.7%3M/3M). The services trade surplus also deteriorated, narrowing by £2.1bn to £36.5bn, with exports down 2.3%3M/3M but imports down 0.3%3M/3M. So, the overall trade deficit (excluding precious metals) widened to £27.6bn, the biggest in eight months. And the underlying trends with respect to exports and imports alike remain underwhelming, impeded not least by Brexit-related non-tariff barriers and weighed by subdued demand at home and from abroad.

UK: Trade balance and components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Export and import volumes



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Budget to target energy bills, business capex, labour supply and public sector pay

Ahead of the BoE's next monetary policy announcement on 23 March, the main event in the UK in the coming week will be the announcement of the Government's new fiscal policy plans in its Budget announcement on Wednesday. With public sector net borrowing in the first ten months of the current fiscal year running about £30bn on a like-for-like basis below the OBR's forecast profile, the Chancellor would appear to have significant scope for fiscal loosening. Indeed, not least given the sharp drop in wholesale gas prices since the autumn, the near-term economic growth outlook – while still downbeat – looks somewhat improved, while the fiscal cost of the Government's energy bill support has fallen significantly. The scope for fiscal giveaways, however, will be constrained if – as would be appropriate – the OBR revised down its estimate of potential GDP growth (1¾%Y/Y by the forecast horizon) closer to that of the BoE (0.7%Y/Y). Nevertheless, we expect the Chancellor to confirm that he will not go ahead with the further increase in the average household energy bill to £3000 from April – a measure that will ensure a faster decline in inflation from Q2 onwards. He is also likely to scrap plans to increase fuel duty. Moreover, he will announce new corporation tax incentives to encourage business investment once the current super-deduction ends at the end of this month, as well as measures to encourage labour force participation among older workers. And he is also likely to announce funds for increased public sector pay, in an attempt to bring an end to strike action affecting key public services.

The week ahead in the UK: Economic data

In terms of the economic data flow, the week's labour market numbers will be noteworthy. Despite an anticipated further increase in employment in the three months to January, the unemployment rate is expected to have ticked slightly higher, by 0.1ppt to 3.8%, the highest for seven months but nevertheless still consistent with a tight labour market. Moreover, with average regular wage growth expected to have remained close to December's series high (outside of the height of the pandemic period) of 6.7%3M/Y, this release will likely further support the case for further modest tightening this month. Also of relevance for the monetary policy decision will be the results from the BoE's latest inflation attitudes survey on Friday.

Daiwa economic forecasts

	2022		2023				2022	2023	2024
	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	%, Q/Q						%, Y/Y		
Euro area	0.4	0.0	0.0	0.2	0.1	0.2	3.5	0.6	1.0
UK	-0.2	0.0	-0.2	-0.1	-0.1	0.0	4.0	-0.4	0.3
Inflation, %, Y/Y									
Euro area									
Headline HICP	9.3	10.0	7.4	5.4	3.7	2.0	8.4	4.6	2.2
Core HICP	4.4	5.1	5.1	4.1	3.2	2.5	3.9	3.7	2.1
UK									
Headline CPI	10.0	10.7	9.6	8.7	7.3	4.9	9.1	7.6	2.7
Core CPI	6.3	6.4	5.5	4.5	3.6	2.8	5.9	4.1	2.6
Monetary policy, %									
ECB									
Refi Rate	1.25	2.50	3.50	4.25	4.25	4.25	2.50	4.25	3.75
Deposit Rate	0.75	2.00	3.00	3.75	3.75	3.75	2.00	3.75	3.25
BoE									
Bank Rate	2.25	3.50	4.25	4.25	4.25	4.25	3.50	4.25	3.25

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 14 March 2023

European calendar

Today's results							
Economic data							
Country	Release		Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Germany	Final HICP (CPI) Y/Y%		Feb	**9.3 (8.7)**	_9.3 (8.7)_	9.2 (8.7)	-
France	Trade balance €bn		Jan	**-12.9**	-	-14.9	-14.7
Italy	PPI Y/Y%		Jan	**11.6**	-	39.2	--
Spain	Retail sales Y/Y%		Jan	**5.5**	-	4.0	4.8
UK	GDP M/M% (3M/3M%)		Jan	**0.3 (0.0)**	0.1 (0.0)	-0.5 (-0.3)	-
	Industrial production M/M% (Y/Y%)		Jan	**-0.3 (-4.3)**	0.0 (-3.9)	0.3 (-4.0)	-
	Manufacturing production M/M% (Y/Y%)		Jan	**-0.4 (-5.2)**	0.0 (-5.0)	0.0 (-5.7)	-
	Index of services M/M% (3M/3M%)		Jan	**0.5 (0.0)**	0.1 (-0.1)	-0.8 (0.0)	-
	Construction output M/M% (Y/Y%)		Jan	**-1.7 (0.6)**	0.1 (2.7)	0.0 (3.7)	-
	Goods trade balance (excl. precious metals) £bn		Jan	**-17.9 (-19.3)**	-18.5 (-)	-19.3 (23.6)	**-**
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 13 March 2023			
		- Nothing scheduled -			
		Tuesday 14 March 2023			
Italy	09.00	Industrial production M/M% (Y/Y%)	Jan	-0.4 (2.9)	1.6 (0.1)
Spain	08.00	Final HICP (CPI) Y/Y%	Feb	_6.1 (6.1)_	5.9 (5.9)
UK	07.00	Unemployment claimant count rate % (change '000s)	Feb	-	3.9 (-12.9)
	07.00	ILO unemployment rate 3M%	Jan	3.8	3.7
	07.00	Employment change 3M/3M '000s	Jan	50	74
	07.00	Average weekly earnings (excluding bonuses) 3M/Y%	Jan	5.7 (6.6)	5.9 (6.7)
		Wednesday 15 March 2023			
Euro area	10.00	Industrial production M/M% (Y/Y%)	Jan	_0.0 (0.1)_	-1.1 (-1.7)
France	07.45	Final HICP (CPI) Y/Y%	Feb	_7.2 (6.2)_	7.0 (6.0)
		Thursday 16 March 2023			
Euro area	13.15	ECB Deposit (Refi) Rate %	Mar	_3.00 (3.50)_	2.50 (3.00)
Italy	09.00	Final HICP (CPI) Y/Y%	Feb	_9.9 (9.2)_	10.7 (10.0)
Spain	08.00	Labour costs Y/Y%	Q4	-	4.0
	09.00	Trade balance €bn	Jan	-	-4.5
		Friday 17 March 2023			
Euro area	10.00	Final (core) CPI Y/Y%	Feb	_8.5 (5.6)_	8.6 (5.3)
	10.00	Labour costs Y/Y%	Q4	-	2.9
Italy	09.00	Trade balance €bn	Jan	-	1.7
UK	09.30	BoE inflation expectations, next 12M, Y/Y%	Feb	-	4.8

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		GMT	Event / Auction
			Monday 13 March 2023
			- Nothing scheduled -
			Tuesday 14 March 2023
Germany		10.30	Auction: €5.0bn of 2.2% 2028 bonds
Italy		10.00	Auction: €4.0bn of 3.8% 2026 bonds
		10.00	Auction: €3.0bn of 3.85% 2029 bonds
		10.00	Auction: €2.0bn of 4% 2035 bonds
		10.00	Auction: €750mn of 2.15% 2072 bonds
UK		10.00	Auction: £3.0bn of 3.25% 2033 bonds
			Wednesday 15 March 2023
Germany		10.30	Auction: €1.0bn of zero-coupon 2050 bonds
		10.30	Auction: €1.5bn of 1.8% 2053 bonds
UK		10.00	Auction: £3.0bn of 4.125% 2027 bonds
		12.30	UK Chancellor Hunt presents Spring Budget to Parliament
			Thursday 16 March 2023
Euro area		13:15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds press conference following the Governing Council meeting
France		09.50	Auction: 2.5% 2026 bonds
		09.50	Auction: 0.75% 2028 bonds
		09.50	Auction: 0.75% 2030 bonds
		09.50	Auction: 0.10% 2029 index-linked bonds
		09.50	Auction: 0.10% 2036 index-linked bonds
		09.50	Auction: 0.10% 2053 index-linked bonds
			Friday 17 March 2023
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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