Euro wrap-up

Overview

- Bunds followed the global trend notably lower, as they partially reversed yesterday's massive gains, while Italian IP numbers started the year on the backfoot.
- Gilts similarly made large losses, while UK wage growth moderated slightly amid a still relatively tight labour market.
- Wednesday will bring the UK government's updated fiscal plans, while Thursday's ECB announcement seems likely deliver the pre-committed 50bps hike, but likely leave forward guidance on rate more ambiguous.

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/25	2.902	+0.246
OBL 2.2 04/28	2.538	+0.224
DBR 2.3 02/33	2.447	+0.200
UKT 0⅝ 06/25	3.518	+0.144
UKT 1⅝ 10/28	3.432	+0.149
UKT 3¼ 01/33	3.526	+0.157

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

Euro area

Italian IP fell back at the start of the year, in line with most other member states

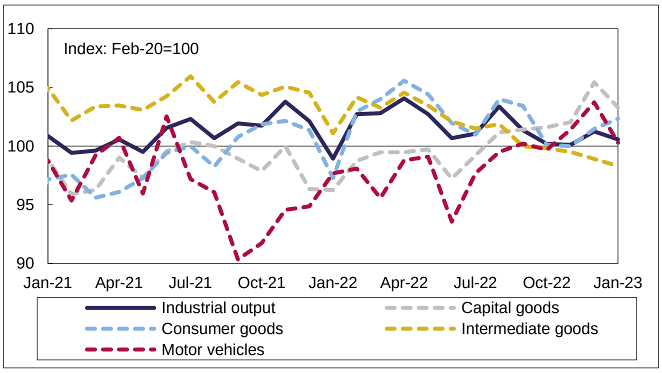
The improvement in German manufacturing output at the start of the year appears to have bucked the trend in the euro area. Certainly, today's figures from Italy followed the downtrend reported in other large member states in January, with industrial output down 0.7%M/M, to be broadly flat compared with the Q4 average. The weakness was driven by the first decline in production of capital goods in seven months (-2.0%M/M), due to sharp contractions in machinery (-4.7%M/M) and transport equipment (-3.3%M/M). Meanwhile, production of intermediate goods fell for the fifth consecutive month (-0.6%M/M) to the lowest level since September 2020. But this was in part offset by a bounce back in consumer goods output (3.7%M/M), not least reflecting a pickup in the food subsector. While the manufacturing PMIs signalled a notable pickup in activity in the sector in February, this contrasted with more subdued survey results published by ISTAT.

The coming two days in the euro area

The key focus in the euro area over the coming two days will be the ECB's policy announcement on Thursday. While the Governing Council effectively pre-committed at its February meeting to a 50bps hike this week, the ECB will be wary of the impact of the fallout from the SVB collapse on financial stability in the euro area. On balance, we continue to see this rate hike going ahead, taking the Deposit Rate to 3.00% and the cumulative tightening this cycle to 350bps, not least due to persisting pressures in core inflation. However, the ECB's updated forward guidance on the next steps for rates is far from certain. Despite ongoing concerns of the hawks about potential second-round effects of inflation, they will be mindful of the likely net tightening of financial conditions in the aftermath of the SVB downfall. And with the doves on the Governing Council having already called for some flexibility to respond to incoming economic developments, the text in the monetary policy statement seems bound to maintain that "future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach". And it might be prudent for the Governing Council to remove the reference to "raising interest rates significantly at a steady pace" to allow sufficient ambiguity going forward. Whether the hawks will be persuaded, however, remains uncertain.

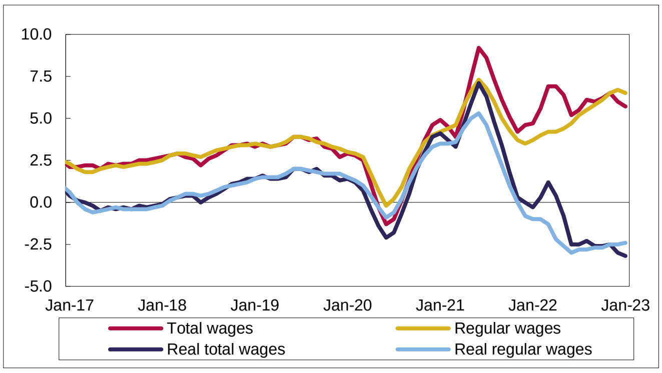
Nevertheless, the ECB's updated macroeconomic projections are highly likely to revise down the profile of headline inflation over the horizon. Given falls in energy prices, the annual rate of HICP inflation in the first two months of the year, at 8.6%Y/Y, was already 0.5ppt below the ECB's December baseline 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. 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, arguably justifying additional monetary tightening.

Italy: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Nominal & real wage growth



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

In terms of the dataflow, tomorrow will bring euro area industrial production numbers for January. 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), Italy (-0.7%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 (with the postponed release now also due tomorrow), there appears to be a good chance of a negative print. Meanwhile, ahead of Friday's release of euro area final inflation figures, the equivalent French and Italian numbers are due tomorrow and Thursday respectively.

UK

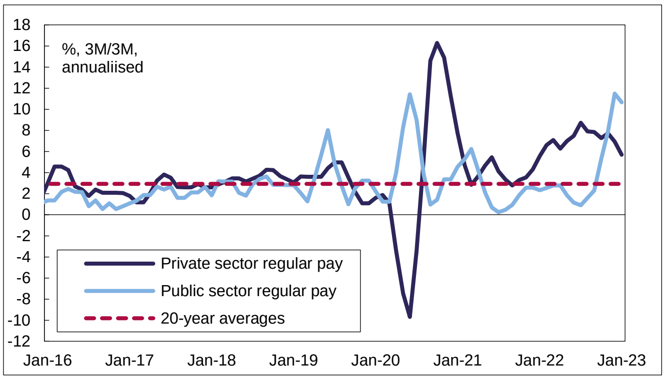
Wage growth moderated in January, but still too high for BoE's comfort

Ahead of the BoE's latest policy-setting announcement on 23 March, and given the MPC's persisting concerns about second-round inflationary effects from wages, there were somewhat encouraging signs in the latest labour market figures. Indeed, total wage growth moderated in the three months to January, by 0.3ppt to 5.7%3M/Y, with regular pay growth similarly easing to 6.5%3M/Y. Admittedly, this still marked the second-strongest pace in regular wages outside of the initial pandemic period and continues to remain well above levels consistent with the BoE achieving its 2% target. Amid a backdrop of ongoing staff shortages and industrial action, public sector regular wage growth accelerated 4.8%3M/Y, the most in almost seventeen years outside of the height of the pandemic period. But the quarterly rate of pay slowed slightly, down 0.2ppt to 2.6%3M/3M, suggesting that January might mark the peak in the annual rate. Moreover, private sector regular pay moderated for the second successive month, by 0.3ppt to 1.4%3M/3M, the softest for a year, to leave the annual rate down 0.2ppt to 7.0%3M/Y, albeit still more than double the average rate in the two years ahead of the pandemic. The slowdown was led by the retail, hospitality, construction and manufacturing sectors, while wage growth in the financial and business services sector continued to trend higher. Of course, in real terms, total pay fell 3.2%3M/Y, the most since the three months to April 2009, underscoring the likelihood of continued weakness in household spending.

Some signs that the labour market is gradually becoming less tight

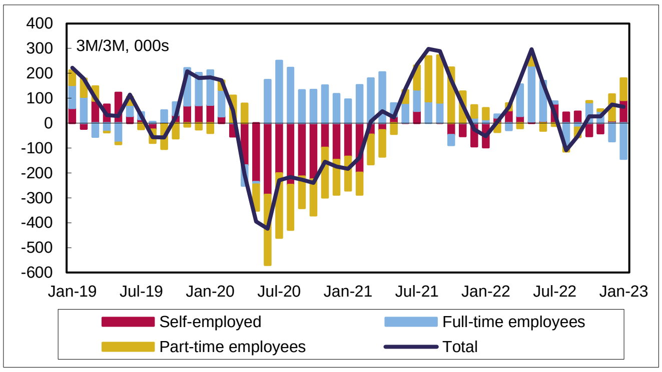
Above-trend wage growth continues to be driven by the tightness in the jobs market. Contrasting with an expected increase, the unemployment rate moved sideways in the three months to January at 3.7%, with the number of people in employment rising a stronger than expected 66k. But this was more than fully accounted for by an increase in part-timers (+196k), with full-time employees down a steep 143k, the most since the three months to October 2011, likely reflecting the uncertain

UK: Private & public sector regular pay growth



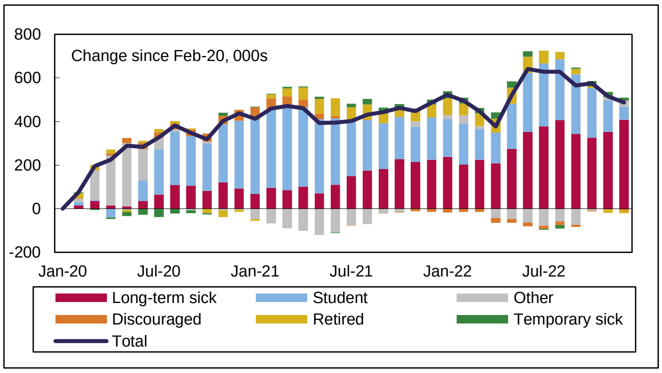
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Employment growth



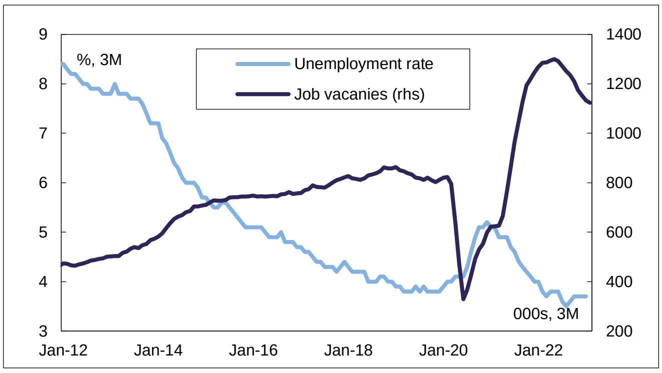
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Reasons for inactivity



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Unemployment and job vacancies



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

economic outlook. There was, however, also a welcome further fall in the inactivity rate, of 0.2ppt on the quarter to an eight-month low of 21.3% in the three months to January. That largely reflected a decline in economic inactivity among students and to some extent the retired. The number of people seeking a job also rose by the most in seven months, perhaps in response to the cost-of-living pressures. And while the job vacancy ratio (3.7%) remained high by historical standards, the softening of labour demand was reflected in an eighth successive quarterly decline in the number of job vacancies in the three months to February, suggesting that the slightly improved demand-supply balance might well continue over coming quarters.

The coming two days in the UK

Ahead of the BoE's next monetary policy decisoin, tomorrow's announcement of the Government's new fiscal policy plans in its Spring Budget will also be of note. 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 next edition of the Euro wrap-up will be published on 16 March 2022

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy		Industrial production M/M% (Y/Y%)	Jan	**-0.7 (1.4)**	-0.4 (2.9)	1.6 (0.1)	1.2 (-0.9)
Spain		Final HICP (CPI) Y/Y%	Feb	**6.0 (6.0)**	*6.1 (6.1)*	5.9 (5.9)	-
UK		Unemployment claimant count rate % (change '000s)	Feb	**3.8 (-11.2)**	-	3.9 (-12.9)	3.8 (-30.3)
		ILO unemployment rate 3M%	Jan	**3.7**	3.8	3.7	-
		Employment change 3M/3M '000s	Jan	**65**	50	74	-
		Average weekly earnings (excluding bonuses) 3M/Y%	Jan	**5.7 (6.5)**	5.7 (6.6)	5.9 (6.7)	**6.0 (-)**

Auctions

Country		Auction
Germany		sold €4.2bn of 2.2% 2028 bonds at an average yield of 2.43%
Italy		sold €4.0bn of 3.8% 2026 bonds at an average yield of 3.71%
		sold €3.0bn of 3.85% 2029 bonds at an average yield of 3.98%
		sold €2.0bn of 4% 2035 bonds at an average yield of 4.40%
		sold €750mn of 2.15% 2072 bonds at an average yield of 4.20%
UK		sold £3.0bn of 3.25% 2033 bonds at an average yield of 3.495%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Upcoming releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Wednesday 15 March 2023			
Euro area		10.00	Industrial production M/M% (Y/Y%)	Jan	*-0.1 (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

Auctions and events

Country		GMT	Event
			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
			Wednesday 15 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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs