Euro wrap-up

Overview

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- Bunds made sizeable losses as the ECB ignored recent market turmoil to hike its deposit rate by a further 50bps to 3.00%, but the Governing Council offered little guidance on the path ahead.
- Gilts followed the global trend lower on day bereft of UK economic data.
- Friday will bring final February euro area inflation figures, as well labour costs data for Q4. A BoE household inflation attitudes survey is also due.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/25	2.573	+0.204
OBL 2.2 04/28	2.303	+0.184
DBR 2.3 02/33	2.280	+0.162
UKT 0⅝ 06/25	3.378	+0.117
UKT 1⅝ 10/28	3.317	+0.107
UKT 3¼ 01/33	3.418	+0.105

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

Euro area

ECB ignores market turmoil to hike by 50bps but offers little guidance on the path ahead

Despite the intense financial market turbulence of recent days, and uncertainties about the health of banks both sides of the Atlantic, the ECB today pressed ahead with the 50bps rate hike that it had signalled last month. So, its deposit rate was raised to 3.00%, taking the cumulative tightening since July to 350bps. In her press conference, President Lagarde insisted that the Governing Council had not discussed an alternative policy option of a smaller rate increase, noting that a "very large majority" had supported the rate hike, and that only "three or four" members had preferred to wait for more time to assess how events unfold. Nevertheless, unlike recent meetings, the ECB today refrained from offering any clear guidance on the likely path of rates ahead. Instead, acknowledging heightened uncertainty about the outlook, it emphasised that policy decisions would be data dependent. Inevitably, the ECB insisted that rates would be determined by an assessment of the inflation outlook based on the economic data and evidence on the dynamics of underlying inflation. But while it clearly needs to see underlying inflation dynamics start to weaken, its reaction function will also now explicitly take account of financial data and evidence on the strength of monetary policy transmission, in tacit recognition that evolving events in the banking sector could yet require a change in direction on rates. The Governing Council also made clear that it can provide more liquidity to the financial sector to ease strains if required.

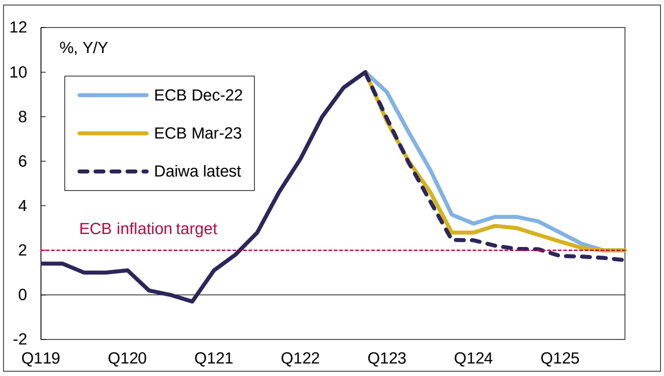
ECB judges euro area banking sector to be resilient and inflation outlook still too high

Lagarde suggested in her press conference that policymakers would be mindful of the ECB's past misjudgments, having previously (foolishly) raised rates in 2008 and 2011 in the midst of the global financial crisis and euro crisis respectively. But given the speed of recent events in the markets, the Governing Council had been unable yet to make any initial firm conclusions about the likely impact of events in the financial sector. And it still considered the euro area banking sector on the whole to be resilient, with liquidity and capital positions (and supervision) strong, exposures to Credit Suisse and troubled US banks limited, and improved profitability able to offset any losses resulting from fixed income markets. So, with inflation projected in the ECB's updated forecasts to "remain too high for too long" – seemingly in part as firms in some sectors have exploited the inflation shock to boost margins – most Governing Council members had no qualms about tightening policy further today.

ECB's new projections point to further hikes to come but are probably already out of date

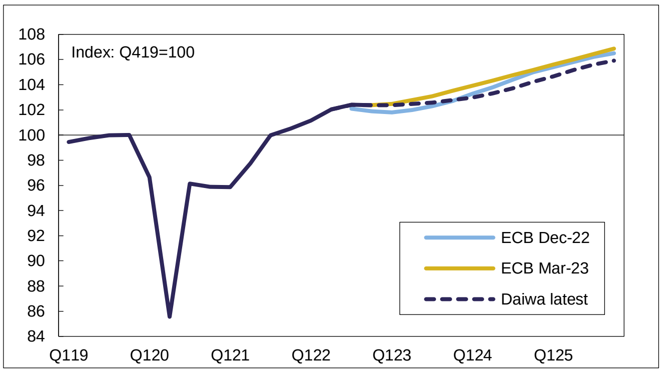
In her press conference, Lagarde stated that, if market conditions stabilise, the ECB's updated projections suggest that further rate hikes would still be required. Nevertheless, the baseline forecast for headline inflation was revised down to below

Euro area: Inflation forecasts



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

Euro area: GDP forecasts



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

3.0%Y/Y by Q4 this year and just 2.1%Y/Y by Q225. While the outlook for GDP this year was nudged up, and the profile for core inflation was revised higher across the horizon, the updated projections also suggest a non-negligible probability that inflation will be below 2.0%Y/Y in 2025. And crucially, the projections are already out of date, having been finalised early this month on the basis of financial market prices up to the middle of February, well before the stresses in the banking sector crystallised. So, in our view, the risks to those forecasts for both growth and inflation must be skewed significantly to the downside. And with core inflation anyway likely very soon to be falling, we now think that ECB rates have reached the peak this cycle and expect the deposit rate to remain at 3.00% into 2024.

The day ahead in the euro area

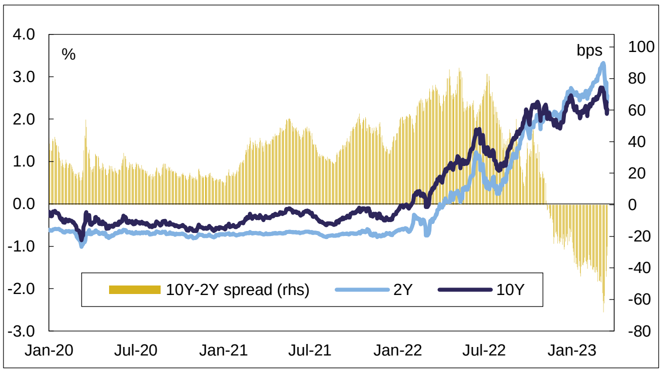
Looking ahead, tomorrow's euro area economic data releases might be of interest to policy-makers, with final February CPI and Q4 labour costs numbers due. With only minimal amendments to the final member state estimates – unrevised in Germany (9.3%Y/Y), 0.1ppt higher in France (7.3%Y/Y) but 0.1ppt lower in Italy (9.8%Y/Y) and Spain (6.0%Y/Y) – the aggregate euro area inflation figures should align with the flash estimates, which saw the headline HICP rate edge slightly lower for the fourth consecutive month, by 0.1ppt to 8.5%Y/Y. But given the record increases in services and non-energy industrial goods prices for the month of February, core inflation leapt to a new record high of 5.6%Y/Y. Tomorrow's release will provide more granular detail, allowing for the calculation of other measures of underling price pressures. Meanwhile, the labour cost figures will be watched for any evidence of second-round effects from recent elevated inflation, although a marked acceleration is highly unlikely at this stage.

UK

Chancellor takes advantage of improved fiscal position with a range of giveaways

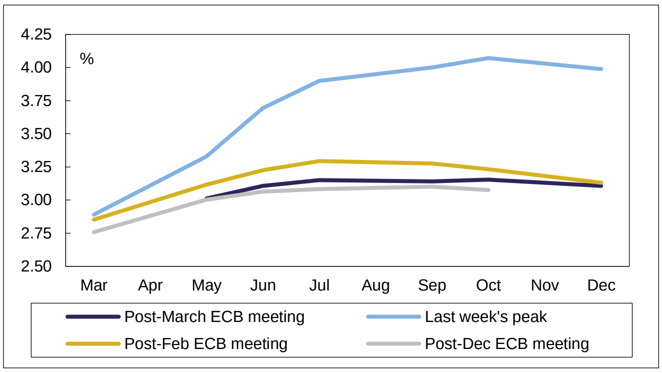
As has been expected given the improvement in the outlook for the UK's public finances from four months ago, with the impact of the Truss-Kwarteng debacle having faded and wholesale gas prices significantly lower, yesterday's Spring Budget announcement confirmed plans for several fiscal giveaways. These included the widely-anticipated decisions to maintain the energy price guarantee for households at its current level and extend energy price support for businesses into 2023/24, a freezing of fuel duty for another twelve months, new temporary capital allowance tax incentives to encourage business investment after the termination of the super-deduction this month, and measures to increase childcare support and tax allowances on pension contributions to encourage labour force participation. Indeed, with public sector net borrowing forecast in the current financial year to be £24.8bn below the OBR's expectation in November, not least thanks to lower-than-

Germany: 2Y and 10Y Bund yields



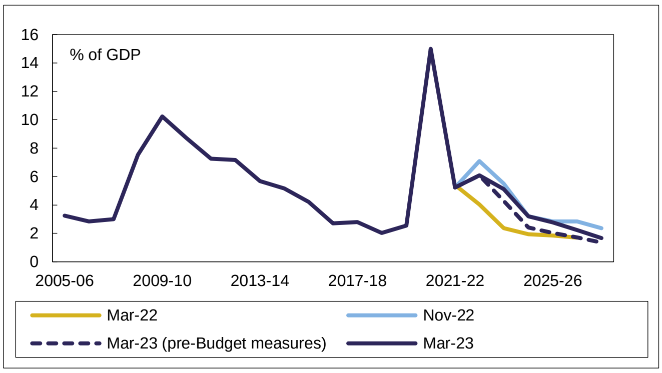
Source: Refinitiv Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Market-implied path for ECB deposit rate



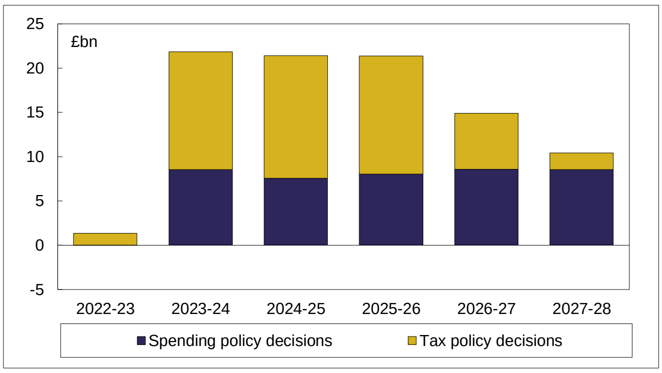
Source: Refinitiv Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Impact on PSNB of Budget measures



Source: HMT and Daiwa Capital Markets Europe Ltd.

anticipated spending on energy support measures and debt interest, the Chancellor's Budget measures will increase borrowing by an average £15.6bn a year (0.6% of GDP). Admittedly, a larger share of this will be front-loaded with borrowing set to be more than £20bn higher in the coming three years than would have been the case had policy been left unchanged. This represents a significant loosening from the planned consolidation presented in November, when borrowing was forecast to be cut by £55bn (around 2% of GDP) by the end of the forecast horizon. Nevertheless, while the OBR expects public sector net borrowing to rise in 2022/23 to £152.4bn (6.1% of GDP), it is then forecast to decline steadily over the forecast period to £49.3bn (1.7% of GDP) in FY27/8, some £20bn lower than forecast in November, albeit still some £50bn higher than forecast a year ago. Overall the OBR still expects public sector net debt to remain above 100% of GDP through to 2024/25 and underlying debt (excluding the impact of BoE QE) to rise to 94.5% of GDP in 2026/27, a 63-year high.

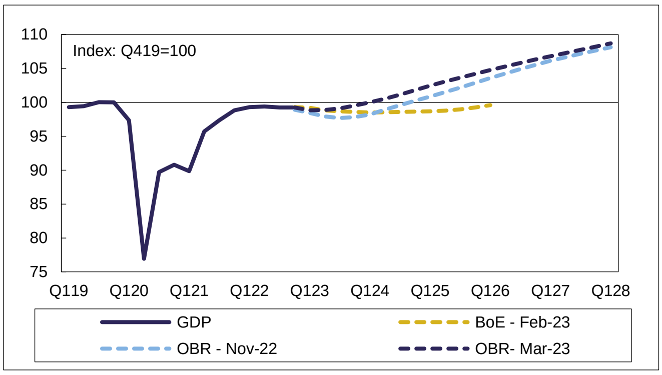
Fiscal policy outlook strengthens case for rate hikes, notwithstanding impact of market turbulence

The scope for fiscal giveaways in part reflects a less downbeat economic forecast than was the case four months ago. Admittedly, the OBR still expects the economy to have contracted in FY22/3 (-0.2%Y/Y), not least reflecting weak household consumption as real household disposable income is forecast to cumulatively decline by a record 5.7% over this year and next. But the downturn has been milder than was anticipated in November, with the OBR expecting the economy to avoid a technical recession, a more favourable picture than presented in the BoE's most recent projections. Indeed, most striking is the relatively strong recovery projected by the OBR over the forecast horizon, with average annual GDP growth forecast to be a little more than 2%Y/Y between 2024 and 2027 despite a still very subdued profile for business investment. This would leave the level of output more than 4½% above the BoE's end-horizon forecast in Q126 and some 8.7% above the pre-pandemic level in Q128 at the end of the OBR's forecast horizon. That reflects the OBR's unchanged and perhaps implausibly high estimate of potential growth (1¾%), which remains well above that of the BoE (just 0.7%). With respect to inflation the OBR judged that the fiscal measures would knock some 0.7ppt off headline CPI this coming year but add 0.4ppt next year. And so, notwithstanding the possible negative impact of current financial market instability on the growth and inflation outlook, other things being equal yesterday's fiscal loosening strengthened the case for more monetary tightening over the near term.

The day ahead in the UK

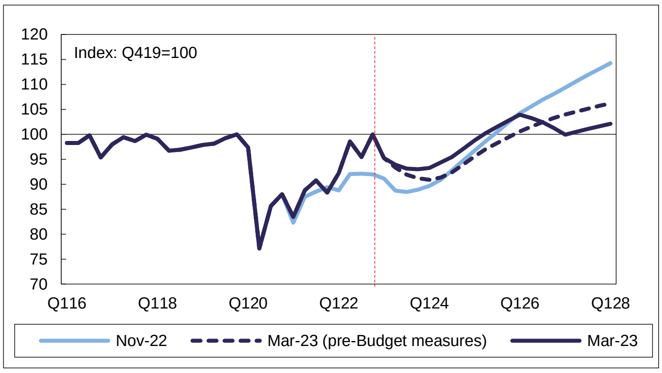
After a day bereft of economic data today, of interest for policy-makers ahead of next week's monetary policy decision will be tomorrow's results from the BoE's latest quarterly inflation attitudes survey. In December, the survey reported a modest uptick in inflation expectations two and five years ahead, to 3.4%Y/Y and 3.3%Y/Y, with the former the joint-highest since 2011.

UK: GDP forecasts



Source: BoE, OBR and Daiwa Capital Markets Europe Ltd.

UK: OBR business investment forecast



Source: OBR 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 Deposit (Refi) Rate %	Mar	**3.00 (3.50)**	*3.00 (3.50)*	2.50 (3.00)	-
Italy		Final HICP (CPI) Y/Y%	Feb	**9.8 (9.1)**	*9.9 (9.2)*	10.7 (10.0)	-
Spain		Labour costs Y/Y%	Q4	**4.2**	-	4.0	-
		Trade balance €bn	Jan	**-4.0**	-	-4.5	-

Auctions

Country		Auction
France		sold €3.46bn of 2.5% 2026 bonds at an average yield of 2.7%
		sold €4.17bn of 0.75% 2028 bonds at an average yield of 2.66%
		sold €4.37bn of 0.75% 2030 bonds at an average yield of 2.67%
		sold €756mn of 0.10% 2029 index-linked bonds at an average yield of 0.14%
		sold €450mn of 0.10% 2036 index-linked bonds at an average yield of 0.32%
		sold €270mn of 0.10% 2053 index-linked bonds at an average yield of 0.45%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Industrial production M/M% (Y/Y%)	Jan	**0.7 (0.9)**	*0.0 (0.1)*	-1.1 (-1.7)	-1.3 (-2.0)
France		Final HICP (CPI) Y/Y%	Feb	**7.3 (6.3)**	*7.2 (6.2)*	7.0 (6.0)	-

Auctions

Country		Auction
Germany		sold €754mn of zero-coupon 2050 bonds at an average yield of 2.24%
		sold €1.23bn of 1.8% 2053 bonds at an average yield of 2.32%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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