Daiwa Capital Markets

Euro wrap-up

Overview

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- Ahead of the FOMC decision, Bunds made losses as a speech by ECB President Lagarde pointed to the likelihood of further tightening in May.
- Gilts made larger losses as UK inflation surprised on the upside, with record increases in food, services and core goods prices for the month of February.
- The BoE's monetary policy decision is likely to bring a final 25bps hike, taking Bank Rate to 4.25%. The Commission's flash consumer confidence index is also due.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 03/25	2.683	+0.095
OBL 2.2 04/28	2.363	+0.064
DBR 2.3 02/33	2.323	+0.039
UKT 0⅝ 06/25	3.510	+0.230
UKT 1⅝ 10/28	3.389	+0.174
UKT 3¼ 01/33	3.468	+0.101

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

Euro area

Lagarde's updated reaction function points to further tightening in May

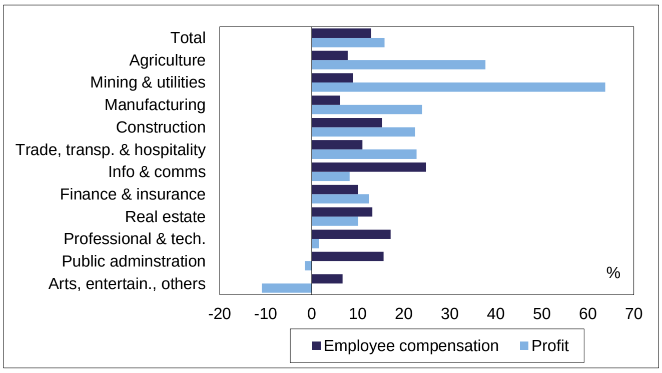
In light of the heightened uncertainty generated by recent financial market turbulence and banking sector stress, following last week's Governing Council meeting ECB President Lagarde failed to give any clear guidance about the likely future path of policy. In today's speech to the annual ECB Watchers' Conference, she reiterated that the outlook remained highly uncertain and that the next steps for rates would be data-dependent. Indeed, she stated that "we are neither committed to raise further nor are we finished with hiking rates." But her discussion of the ECB's reaction function suggested that additional tightening remains likely next quarter. Unsurprisingly, Lagarde flagged the importance of developments with respect to underlying inflation and the monetary policy transmission mechanism as drivers of policy over the coming months.

- In terms of underlying inflation, Lagarde emphasised that the Governing Council still needs to see a sustained downward turn in key indicators before ending the tightening cycle. While she acknowledged that some relevant measures were now falling, she noted that many others – including those that were particularly sensitive to the business cycle or had low import content – were still strengthening. And while she acknowledged that firms in many sectors had exploited the current inflation shock to increase margins, she also argued that the main driver of persistence going forward, particularly in services, would be wages.

- In terms of the monetary policy transmission mechanism, Lagarde insisted that policy still needs to be restrictive. She noted evidence that the impact of monetary tightening on financing and monetary conditions was already "substantial". But she also highlighted uncertainty with respect to how that would affect demand and inflation, not least given recent structural changes as well as unfolding developments in the financial sector. So, Lagarde noted that, as well as underlying inflation, the Governing Council will now pay close attention to a range of indicators of credit availability and credit pricing, such as the monthly data on money and credit flows, as well as the ECB's own surveys of bank lending and access to finance for small and medium-sized enterprises.

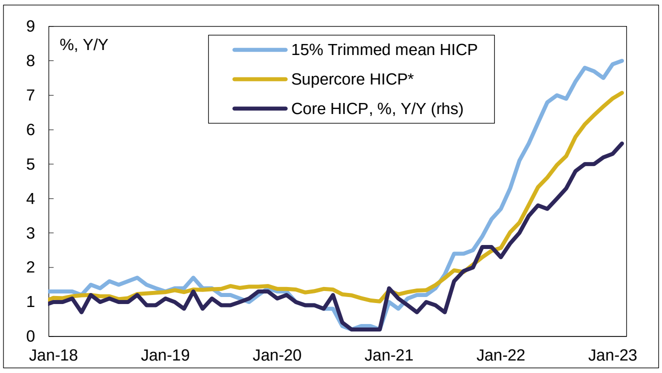
By the time the Governing Council holds its next monetary policy meeting on 4 May, it will have received two further months of inflation data – for March and April – to digest, as well as updates on wage growth. Those might seem unlikely yet to suggest the "sustained downturn" in underlying inflation that the policymakers will need to see to justify a pause (or ultimate halt) in tightening. But the ECB's latest bank lending survey results are also due two days ahead of that meeting, and might well suggest a more potent monetary transmission. So, we think that the Governing Council will slow its pace of tightening to 25bps that month, and expect no more than one more hike of 25bps thereafter.

Euro area: Sectoral wage and profit developments*



*Q422-Q419 % change.
Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



*Based on HICP basket items sensitive to slack, excluding food, energy & package holidays. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Tomorrow will bring the Commission's flash consumer confidence index for March. After the index rose in February for a fifth successive month to a twelve-month high, the latest result might well suggest that recovery momentum in sentiment paused this month amid increased financial market uncertainties.

UK

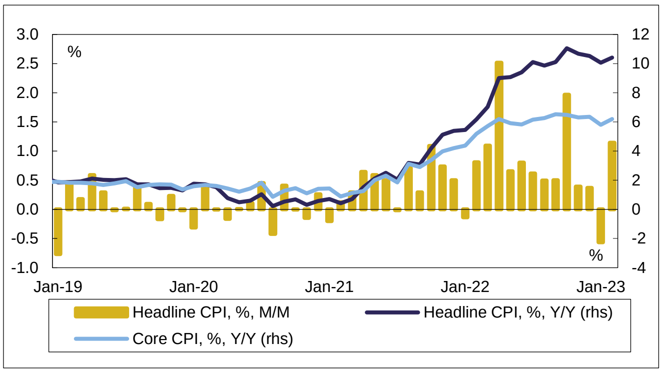
UK inflation unexpectedly rose in February

Ahead of tomorrow's BoE monetary policy announcement, today's UK inflation figures for February reinforced our expectation that the majority on the MPC will favour a 25bps hike to take Bank Rate to 4.25%. In particular, consumer prices rose a much stronger-than-expected 1.1%M/M – the most in any February since comparable figures begin in the late 1980s – to push the annual CPI rate higher for the first month in five and by 0.3ppt to 10.4%Y/Y. While this remains well below last October's peak (11.1%Y/Y), the average rate in the first two months of 2023 (10.2%Y/Y) is now trending above the BoE's forecast of a drop to 9.7%Y/Y in Q1. Moreover, prices of core items were also up an above-normal 1.2%M/M in February, to leave the annual core rate up 0.4ppt at 6.2%Y/Y, largely reversing the decline recorded in January.

Record monthly prices increases in food, services and core goods

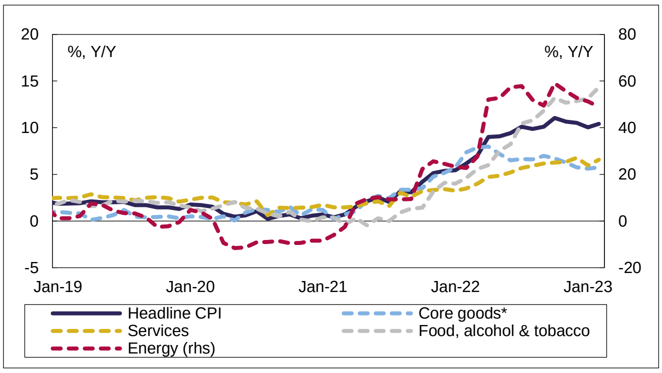
Within the detail, there was a third consecutive monthly fall in energy prices (-0.5%M/M), driven by a further drop in petrol prices. But each of the other major components of the inflation basket posted record monthly price increases for February. In particular, food and non-alcoholic drinks prices rose a further 2.1%M/M, to take the annual rate of this component to 18.0%Y/Y, the highest for 45 years, due not least to the reported shortages of salad produce, with vegetable inflation the highest for 14 years. Core goods inflation also ticked higher (up 0.1ppt to 5.7%Y/Y), with a pickup in clothing inflation offsetting a further moderation in furniture and persisting deflation of second-hand cars as supply constraints continue to ease. But more importantly for the BoE, services inflation jumped 0.6ppt to 6.6%Y/Y. While this remains below December's peak of 6.8%Y/Y, the MPC's preferred measure of core services inflation (excluding airfares, package holidays and education) rose 0.6ppt in February to 6.7%Y/Y. That was led by a jump in hospitality to 12.1%Y/Y, the highest since July 1991, amid upwards pressures on prices of alcohol served in restaurants, cafes and pubs, as well as weather-related pressures on fruit and vegetable prices. But it might also be suggestive of second-round effects of strong wage growth in this sector.

UK: Consumer price inflation



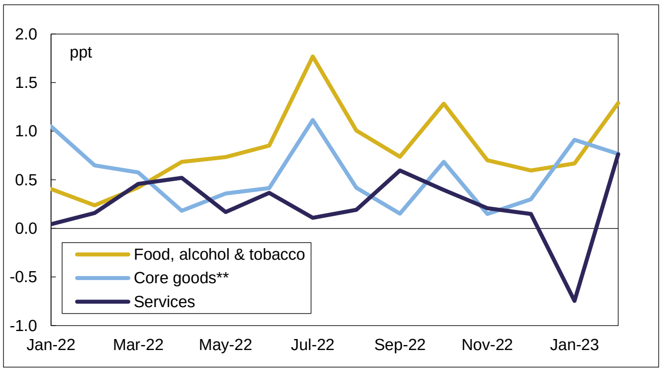
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation



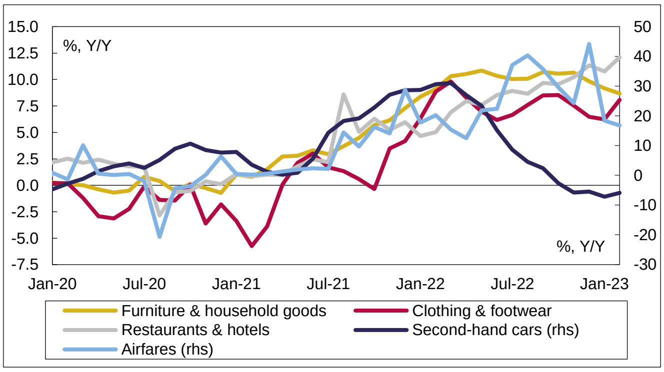
**Non-energy industrial goods inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Deviations from long-run average price change*



**Difference in monthly consumer price change from pre-pandemic long-run average. **Non-energy industrial goods inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Inflation to fall back as easing supply-side pressures start to feed through

Looking ahead, we expect headline inflation to resume a downwards trend in March. Indeed, the energy component will continue to provide a downwards impulse from April as the government's energy price guarantee is extended at the current rate for a further three months though to July. And with wholesale natural gas prices having more than halved since the start of the year and contract prices for this summer period almost one fifth lower than a month ago, we expect Ofgem to announce a meaningful reduction in the household energy bill cap in July and possibly October too. In addition, today's PPI release reported the first year-on-year fall in input prices of crude oil (-2.6%Y/Y) since the start of 2021, allowing output price inflation of producer petroleum products to halve (12.6%Y/Y). And overall producer output price inflation fell a further 1.4ppts to 12.1%Y/Y, the lowest in a year. That, in due course, should help consumer goods inflation to moderate gradually over coming months. While services inflation might well remain stickier, there are signs that the tightness in the labour market is becoming less acute and so pay settlement growth is expected to moderate as the year goes on. Moreover, persisting lacklustre demand should also in due course weigh on prices as supply shocks unwind. Overall, we expect headline inflation to fall steadily to below 3%Y/Y by the end of this year and to below the Bank's 2% target by the middle of next year. Admittedly, the moderation in core inflation will be more gradual, but we expect it to return to 2% by the start of 2025.

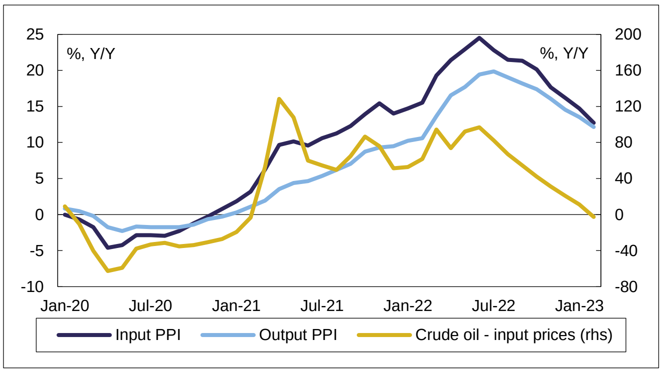
CBI manufacturing survey signals a notable easing in selling prices amid weak demand

Today's CBI industrial trends survey further illustrated that cost pressures in the manufacturing sector continue to ease. Indeed, the survey's index for expected selling prices over the coming three months fell sharply in March, by 15pts to 25, a two-year low and some 55pts below last year's peak. In addition to lower input cost burdens, today's survey reported softer demand. In particular, a further decline in orders this month was reflected in a drop in the respective index (-20) to its weakest for more than two years while export orders continued to decline, albeit at a slightly softer pace than in February. Although manufacturers expressed greater optimism about the outlook for output over the coming three months, it is notable that actual output has repeatedly failed to match their expectations over recent months.

House prices fall for a second successive month

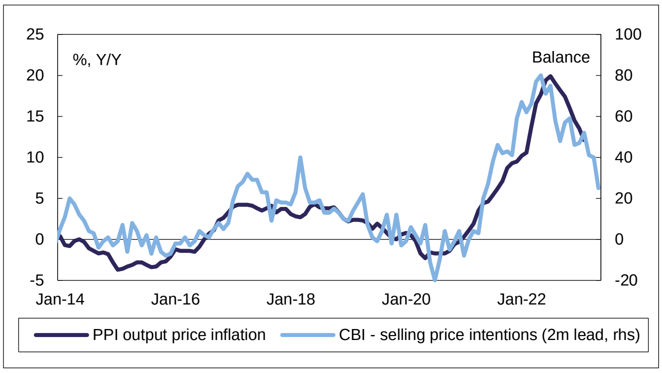
According to the ONS, UK house prices fell for a second successive month in January, by 0.6%M/M, the most since 2011, excluding months that were affected by distortions associated with government incentives during the pandemic. This left annual home price inflation down for a third successive month and by 3ppts to 6.3%Y/Y, the softest pace since November 2020 and almost 8ppts below last year's peak. Inevitably given the sharp rising in borrowing costs since September, an

UK: Producer price inflation



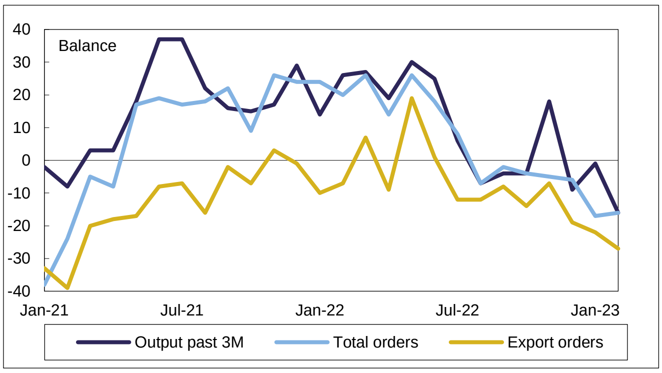
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: PPI and manufacturer selling prices



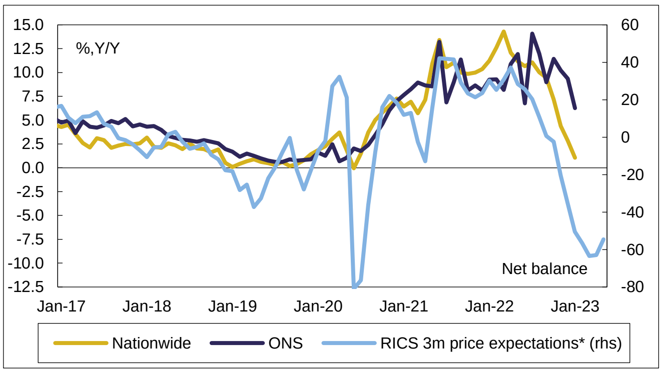
Source: CBI, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends survey indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



**Three-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

ongoing decline in households' disposable income, and the marked deterioration in housing affordability, the weakness was broad-based, with prices down between 1-2% from the peak (with the exception of the North East and the Midlands where prices were still rising modestly, at least for now). If surveys are to be believed, further notable adjustments in prices are likely over coming months. Certainly, the RICS residential survey index for house prices has become extremely negative since September, falling in February (-48) to its lowest since the global financial crisis in early 2009. And while the latest survey offered tentative signs of an improvement in demand and sales, estate agents remained extremely pessimistic about price expectations over the coming year, with the respective survey indices suggesting a possible peak-to-trough percentage drop in house prices of up to 10%.

The day ahead in the UK

The main event tomorrow will be the BoE's monetary policy announcement. While the MPC again hiked Bank Rate by 50bps at the previous meeting in February, its updated forward guidance and economic projections – which suggested that inflation will fall significantly below the 2% target from Q224 on – made clear that the end of the tightening cycle might be near. Notably, its guidance suggested that news with respect to services prices and wage settlements would be key to determining the future path of rates. Last week's BoE public inflation attitudes survey pointed to a moderation in price expectations to the lowest rates since 2021, and an additional easing in expectations for wage growth over the coming twelve months, while wariness at possible adverse spillovers from recent stress in certain US banks and Credit Suisse, and associated financial market turbulence, would also call for caution on interest rates. However, taken together with the significant relaxation of the overall fiscal stance in the Budget, today's inflation numbers – particularly with respect to services – will likely have been strong enough to convince the majority on the MPC that additional monetary tightening is required. As such, while we will again see at least two members voting to keep rates unchanged, and might still see at least one member vote for another hike of 50bps, we expect the majority on the MPC to vote to slow the pace of rate increase to 25bps, taking Bank Rate to 4.25%, where we still think the current tightening cycle will conclude.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB current account balance €bn	Jan	**17.1**	-	15.9	13.3
UK	CPI M/M% (Y/Y%)	Feb	**1.1 (10.4)**	*0.5 (9.7)*	-0.6 (10.1)	-
	Core CPI Y/Y%	Feb	**6.2**	*5.6*	5.8	-
	PPI output prices M/M% (Y/Y%)	Feb	**-0.3 (12.1)**	0.1 (12.4)	0.5 (13.5)	-
	PPI input prices M/M% (Y/Y%)	Feb	**-0.1 (12.7)**	-0.2 (12.0)	-0.1 (14.1)	0.4 (14.7)
	House price index Y/Y%	Jan	**6.3**	6.5	9.8	9.3
	CBI industrial trends, total orders (selling prices)	Mar	**-20 (25)**	-15 (37)	-16 (40)	**-**

Auctions

Country	Auction
Germany	sold €4.22bn of 2.300% 2033 bonds at an average yield of 2.320%
UK	sold £3.50bn of 4.125% 2027 bonds at an average yield of 3.746%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	15.00	Preliminary consumer confidence	Mar	-18.2	-19.0
UK	12.00	BoE Bank Rate %	Mar	*4.25*	4.00

Auctions and events

Country	GMT	Event
Euro area	16.00	ECB Chief Economist Lane participates in a panel – Post-1973 currency regime and inflation experiences
UK	12.00	BoE monetary policy announcement, statement and minutes to be published

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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