Daiwa Capital Markets

Euro wrap-up

Overview

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- While core inflation maintained its downtrend, Bunds made significant losses as the flash estimates of headline German inflation in December rose sharply due to a temporary energy base effect.
- Gilts also made losses as a UK survey signalled a pickup in wage expectations while the final December PMIs were revised up to signal a modest rise in GDP in Q4.
- Friday will bring flash euro area inflation data for December as well as German retail sales figures for November.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.500	+0.096
OBL 2.4 10/28	2.035	+0.097
DBR 2.6 08/33	2.102	+0.080
UKT 3½ 10/25	4.150	+0.085
UKT 4½ 06/28	3.658	+0.089
UKT 3¼ 01/33	3.702	+0.068

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

Euro area

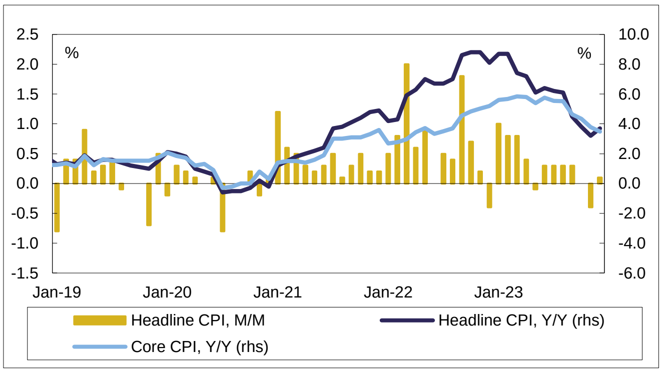
German inflation jumps due to temporary energy base effect but underlying disinflation persists

According to today's flash estimate, German inflation rose a touch less than expected in December. While the increases in the headline rates might have disappointed some observers, they largely reflected a temporary base effect related to the government's energy bill intervention at the end of 2022. And the detail of the data strongly suggest that the disinflationary trend remained intact at the end of last year. In particular, while the EU-harmonised HICP inflation rate rose a hefty 1.5ppts to a three-month high of 3.8%Y/Y, prices on that basis rose just 0.2%M/M leaving the annualised rate for the second half of 2023 at just 1.4%. The increase in the national CPI inflation rate of 0.5ppt took it to a similar two-month high of 3.7%Y/Y. But the rise in prices on the national measure of 0.1%M/M left the respective annualised rate for the second half of 2023 at just 1.0%, half the ECB's target. In terms of the major inflation components on the national measure, the only significant positive impulse to the annual rate came from energy, for which inflation rebounded a huge 8.6ppts to 4.1%Y/Y. That reflected the record drop of 10.0%M/M in December 2022 due primarily to the government's one-off household bill subsidies that month. In contrast, energy prices fell a more modest 1.9%M/M last month, declining in part due to lower petrol prices. Meanwhile, prices of food and non-alcoholic beverages were unchanged on the month, allowing the annual rate to drop 1.0ppt to 4.5%Y/Y. Most importantly, however, services inflation maintained its downtrend, declining 0.2ppt to a 16-month low of 3.2%Y/Y. Non-energy industrial goods inflation appears to have inched up 0.1ppt to 4.0%Y/Y, still the second-lowest rate in 15 months. So, core CPI inflation fell 0.3ppt to a 17-month low of 3.5%Y/Y, with the annualised rate for the second half of 2023 at 1.8%. As the energy subsidy base effect wears off, German headline inflation on both the HICP and CPI measures should fall to 2½%Y/Y or less in January. And core inflation should fall below 3.0%Y/Y underscoring the marked change in price pressures from a year ago.

French inflation edges up on energy and transport services prices

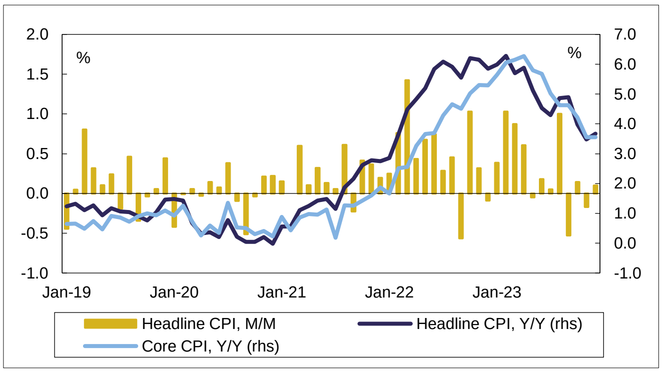
French inflation also increased in December, although the EU harmonised and national measures rose just 0.2ppt apiece to 4.1%Y/Y and 3.7%Y/Y respectively. Like in Germany the upwards impulse in part reflected base effects in energy prices, with the monthly drop last month (-1.2%M/M) just one third of that in December 2022. As such, the annual rate of that component jumped 2½ppts to 5.6%Y/Y. However, within the core categories, services prices rose a stronger-than-normal 0.6%M/M as the decline in transport services costs in November was largely reversed. That left the annual rate up 0.3ppt to 3.1%Y/Y, just above the average for the past year and hence disappointingly sticky. But reflecting the global downtrend in producer prices amid softer demand and inventory adjustments, manufactured goods prices were notably weaker in December, with the decline of 0.3%M/M some 0.4ppt below the norm for the time of year. And so, inflation of that component fell a further 0.5ppt to just 1.4%Y/Y, some 3.4ppts below February's peak and the softest rate for almost two years. Overall,

Germany: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: Consumer price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

today's figures suggest that core HICP inflation likely moved sideways at November's 20-month low of 2.9%Y/Y. Elsewhere, HICP inflation was unchanged in Spain at 3.3%Y/Y and fell 0.4ppt in Portugal to 1.8%Y/Y. But it rose 1.3ppt in Belgium to 0.5%Y/Y and 0.7ppt in Ireland to 3.2%Y/Y. So, overall, we now expect tomorrow's flash euro area figures to show a rise of 0.4ppt to 2.8%Y/Y, with the core rate declining 0.2ppt to 3.4%Y/Y.

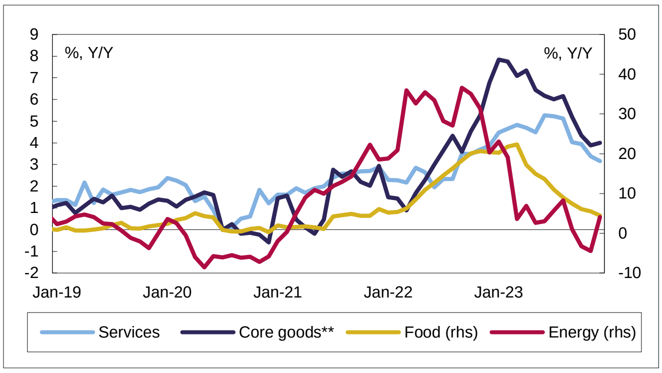
German labour market continues to soften gradually towards year-end

While the inflation data are paramount for the ECB, conditions in the labour market will also have an important bearing on the timing of any pivot to easier monetary policy. This week's figures suggest that the German labour market continues gradually to become less tight. On a seasonally adjusted basis, German jobless claims rose for the eleventh successive month in December, surpassing 2.7mn for the first time since May 2021. As a result, the claimant count unemployment rate edged up to 5.9% (from a revised November figure), similarly the highest in more than 2½ years, up 0.4ppt from February and 0.9ppt above the level at end-2019 ahead of the pandemic. Surveys, such as this week's final PMIs, suggest that firms in manufacturing and services were looking to cut headcount at the end of last year. And importantly, having picked up over the summer as workers sought compensation for recent high inflation, growth in negotiated wages (excluding bonuses) slowed 0.6ppt in December to just 1.9%Y/Y, below the long-run average, below the range in the three years ahead of the pandemic, and below rates that should be a concern for the ECB. With aggregate demand set to remain subdued, and significant structural and cyclical adjustments set to continue in energy-intensive industry and construction respectively, the German labour market seems highly likely to weaken further over coming quarters, ensuring that wage growth remains no risk to the achievement of the ECB's inflation target over the medium term.

Final services and composite PMIs revised up but still consistent with recession in H223

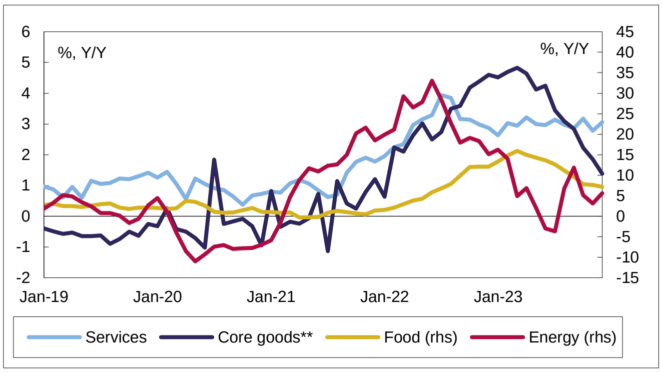
With respect to economic output, today's final services and composite PMIs for December brought moderate upwards revisions from the flash estimates for both Germany and the euro area as a whole. But they still suggested no meaningful improvement from November, and instead pointed to mild contraction in services and – given the more significant weakness in manufacturing – a somewhat larger drop in overall economic activity at year-end. Indeed, the euro area composite output PMI averaged just 47.2 in Q4, down 0.3pt from Q3 when GDP contracted 0.1%Q/Q, and the weakest quarterly reading since the first wave of Covid-19 in Q220, to point to mild technical recession in H223. Among the member states in Q4, the equivalent indices for Germany (47.0), France (44.7) and Italy (47.9) were similarly all consistent with a drop in overall economic output last quarter. In contrast, Spain's (50.1) was consistent with stagnation while only Ireland's (51.2) suggested expansion. The sectoral PMIs provided a similar picture for services across the member states, with only the Greek indices pointing to growth in manufacturing. Within the detail, the new orders indices suggested that demand continues to decline, and at an accelerated pace for new export business, with work backlogs continuing to fall too. More happily perhaps, firms'

Germany: Key CPI components*



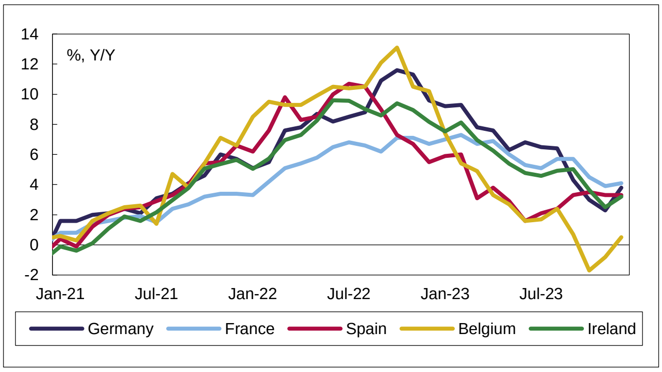
*National measure.**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: Key CPI components*



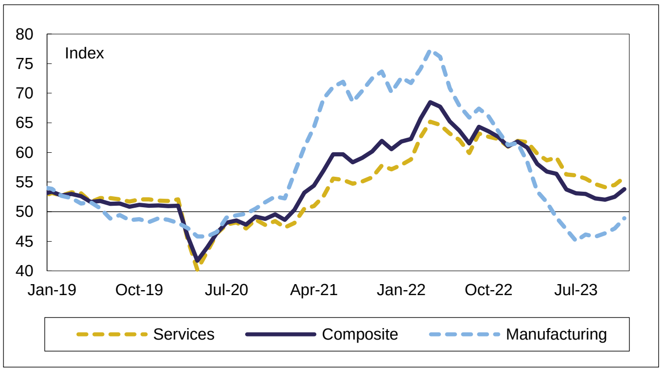
*National measure. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: HICP inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Output price PMIs



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

optimism about the coming twelve months rose to a seven-month high, albeit remaining below the long-run average. That might reflect a renewed softening of input cost pressures, for which the respective PMI for services dropped to a four-month low (61.6) and the composite index fell to its lowest since July (56.6). Firms reportedly took the opportunity to boost margins, with the aggregate output price PMI rising to its highest in six months (55.6). Nevertheless, that index remained firmly below the range throughout 2022 and the first half of 2023 suggesting a notable easing of price pressures amid the soft demand environment.

The day ahead in the euro area

Aside from the aforementioned euro area inflation data, tomorrow also brings the release of the construction PMIs for December, which are expected to suggest that activity in the sector continued to subtract from growth in Q423. The headline euro area activity index is likely to remain in contractionary territory for a 20th successive month and close to November's level of 43.4, which was only a fraction below the six-month average.

UK

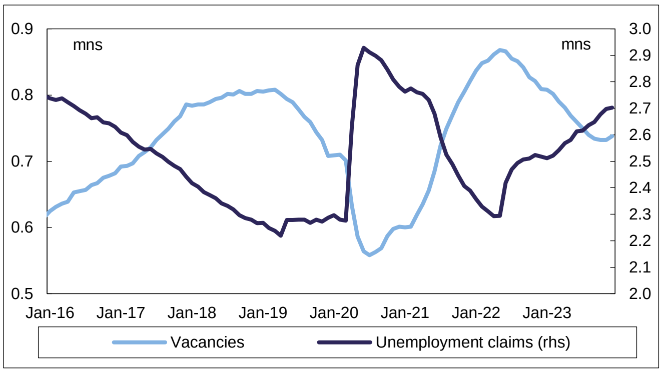
Firms' inflation expectations ease, but higher wage expectations might be a concern for the BoE

While the MPC remains concerned about sticky inflation, the BoE's latest Decision Maker Panel (DMP) survey results suggest that businesses expect the disinflationary trend to be maintained over the coming year as weak demand limits pricing power and many cost pressures moderate. Indeed, firms reported that their own output price inflation had slowed 0.7ppt to 5.9%Y/Y in December, the lowest on the survey since March 2022 and more than 2ppts below last February's peak. And their expectations for their own inflation over the coming twelve months moderated slightly further to 4.2%Y/Y, the lowest since September 2021, albeit still almost 2ppts above the average in the year before the pandemic. Meanwhile, one-year ahead CPI inflation expectations also moderated in December, by 0.4ppt to 4.0%Y/Y, more than 5ppts below last year's peak. And encouragingly, three-year ahead CPI inflation expectations fell 0.3ppt to 2.9%Y/Y, almost 2ppts below the peak in September 2022. But the MPC will have been discouraged to see a pickup in firms' expectations for wage growth over the year ahead to a nine-month high of 5.4%Y/Y. While this was a little more than 1 ½ ppts below survey respondents' estimate of realised wage growth in December (7.0%Y/Y), it remains well above rates that would be judged consistent with achievement of the BoE's 2% inflation target over the medium term.

Final services PMIs signal improving economic momentum, but firmer price pressures too

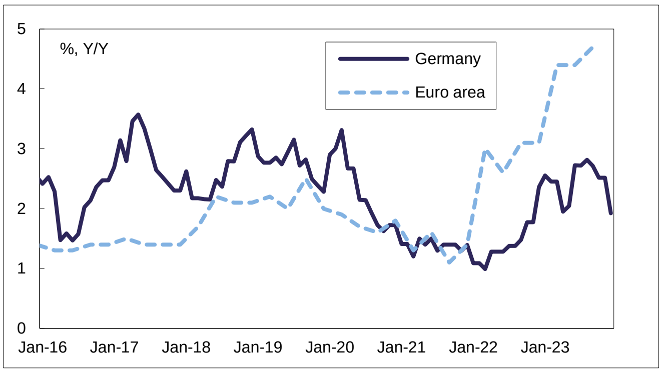
The final services PMIs for December might also have lowered expectations for near-term monetary policy easing. Certainly, the upwards revision to the prices charged component – by 0.9pt from the flash release to a five-month high of 58.6 – would

Germany: Labour market



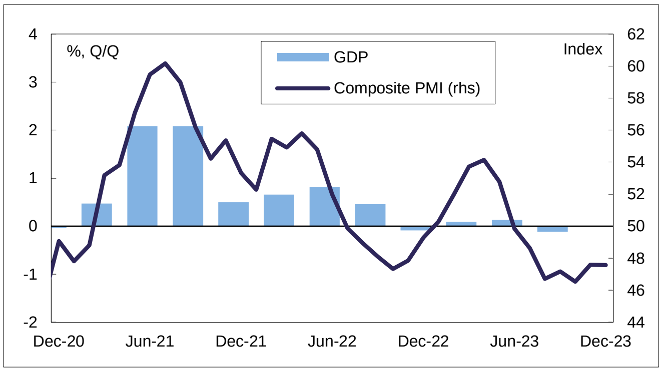
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area & Germany: Negotiated wages*



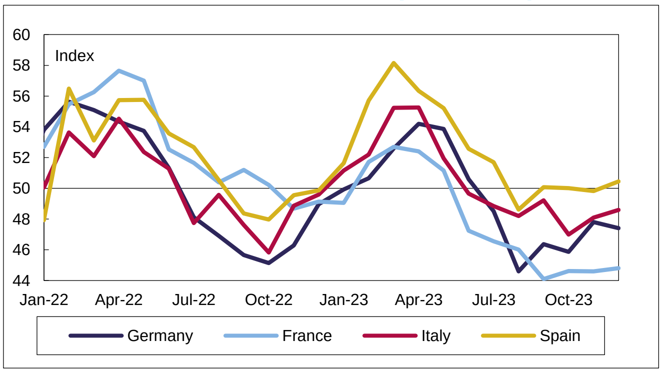
**German figures exclude special payments. Source: Destatis, ECB and Daiwa Capital Markets Europe Ltd.*

Euro area: GDP growth & composite output PMI



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite output PMIs



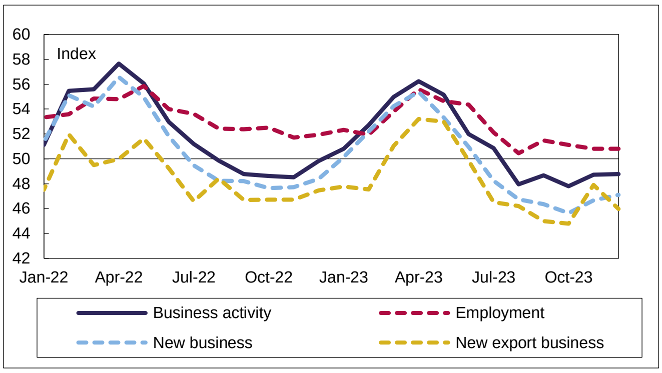
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

have disappointed expectations of moderating price pressures in the sector. And the input price PMI rose to a three-month high (64.5) as wages reportedly remained the overwhelming driver of elevated cost burdens. Against this backdrop, firms reportedly cut headcount slightly for a third month out of the past four. (The DMP survey also suggested a slowing in employment growth over the coming twelve months in the three months to December.) This notwithstanding, today's services PMIs were more upbeat with respect to economic output. Indeed, a sizeable upwards revision to the headline activity index left it up 2.5pts on the month in December at a six-month high of 53.7, reportedly reflecting stronger-than-expected consumer spending on leisure and hospitality, as well as increased demand for technology and financial services. And the new business component (up 2.4pts to 52.8) suggested positive momentum heading into 2024 too, with business optimism about the coming twelve months at its highest since May. So, overall, despite the ongoing drag from manufacturing, the composite PMI similarly signalled a rebound in economic activity at the end of last year. Indeed, the 1.5pt increase in December to a six-month high of 52.1 left the quarterly average in Q4 up 1.1pt from Q3 at 50.5, supporting our view that GDP just about returned to growth for the first quarter in three. And the further improvement in the new orders PMI (up 2.2pts to a seven-month high of 51.8) suggests this modestly positive momentum was maintained at the start of 2024 too.

Consumer credit jumps in November, but mortgage and business lending remains very weak

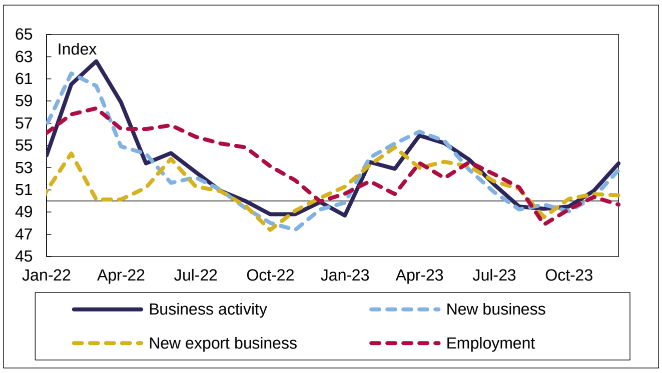
Despite a pickup in borrowing costs, today's bank lending figures reported the strongest monthly rise in consumer credit in November since March 2017, with the net increase of £2.0bn comparing with the pre-pandemic five-year average rise of £1.4bn. This left the stock of consumer credit up 9%3M/3M, the most in more than five years, consistent with a (possibly temporary) rebound in consumer spending heading towards year end. In contrast, however, net mortgage lending was zero in November, following a modest net repayment in October, to leave the annual growth rate at just 0.3%Y/Y, the lowest since the monthly series began in March 1994. Admittedly, this might well mark the trough, with mortgage approvals having increased for a second successive month in November to 50.1k, albeit remaining some 16k below the average in the five years before the pandemic. But with repayments likely to remain elevated, despite the recent easing in mortgage interest rates, we suspect net mortgage lending will remain lacklustre over the near term. Meanwhile, non-financial corporations made a net debt repayment of £1.6bn in November, to leave growth in the stock of outstanding loans in negative territory for the sixth successive month, with lending to SMEs down almost 5%Y/Y.

Euro area: Services PMIs



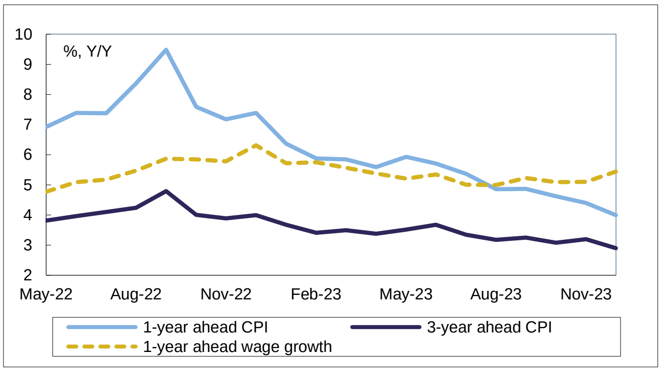
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs



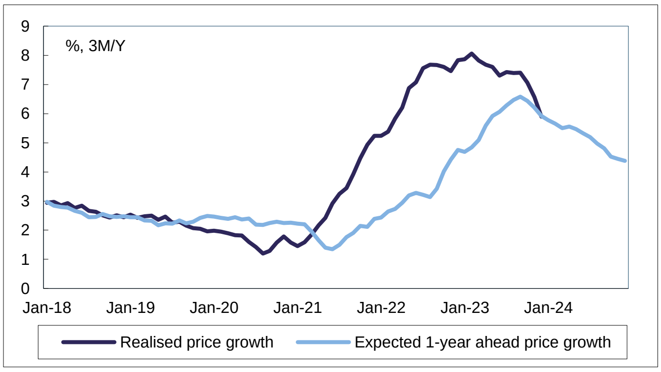
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Firms' inflation & wage expectations



Source: Macrobond, BoE DMP survey and Daiwa Capital Markets Europe Ltd.

UK: Firms' output price expectations

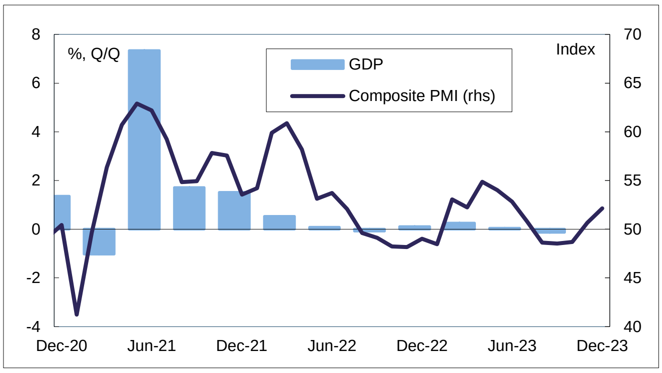


Source: Macrobond, BoE DMP survey and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

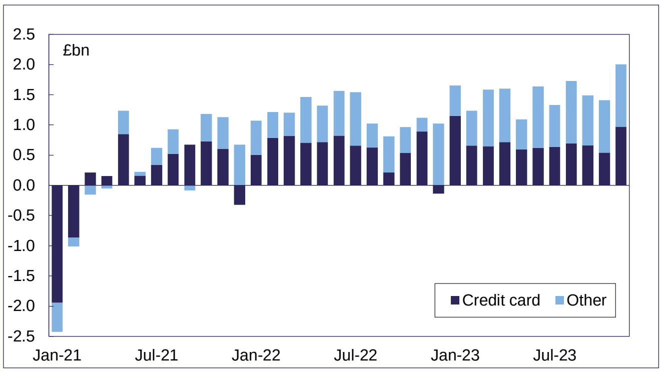
Tomorrow sees the release of the UK construction PMIs for December, which, like in the euro area, are expected to indicate a disappointing end to the year for activity in the sector. The headline construction PMI will likely hover close to 45 to mark the fourth successive sub-50 reading. Also to be published tomorrow are UK new car registrations data for the same month.

UK: GDP growth & composite output PMI



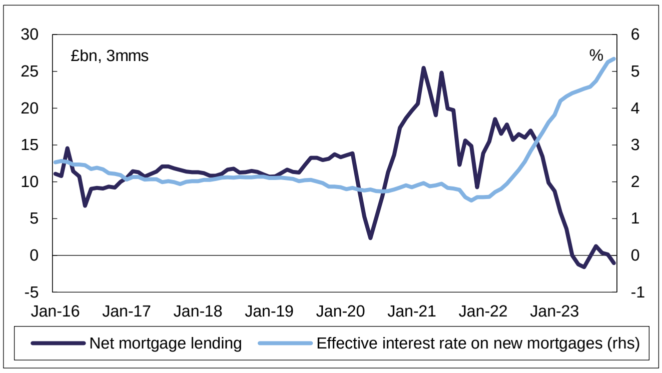
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Consumer credit



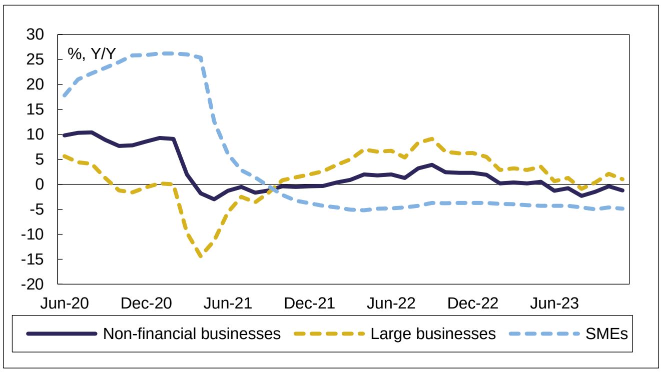
Source: Datastream Refinitv and Daiwa Capital Markets Europe Ltd.

UK: Mortgage lending & interest rate



Source: Datastream Refinitv, and Daiwa Capital Markets Europe Ltd.

UK: Business lending



Source: BoE 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	Final services (composite) PMI	Dec	**48.8 (47.6)**	*48.1 (47.0)*	48.7 (47.6)	-
Germany	Final services (composite) PMI	Dec	**49.3 (47.4)**	*48.4 (46.7)*	49.6 (47.8)	-
	Preliminary HICP (CPI) Y/Y%	Dec	**3.8 (3.7)**	3.9 (3.7)	2.3 (3.2)	-
France	Final services (composite) PMI	Dec	**45.7 (44.8)**	*44.3 (43.7)*	45.4 (44.6)	-
	Preliminary HICP (CPI) Y/Y%	Dec	**4.1 (3.7)**	4.1 (3.7)	3.9 (3.5)	-
Italy	Services (composite) PMI	Dec	**49.8 (48.6)**	50.0 (48.2)	49.5 (48.1)	-
Spain	Services (composite) PMI	Dec	**51.5 (50.4)**	51.2 (-)	51.0 (49.8)	-
UK	Final services (composite) PMI	Dec	**53.4 (52.1)**	*52.7 (51.7)*	50.9 (50.7)	-
	Net consumer credit £bn (Y/Y%)	Nov	**2.0 (8.6)**	1.4 (-)	1.3 (8.1)	1.4 (8.2)
	Net mortgage lending £bn (approvals '000s)	Nov	**0.0 (50.1)**	0.2 (48.5)	-0.1 (47.4)	- (47.9)
	BoE's DMP 1Y CPI expectations Y/Y%	Dec	**4.0**	-	4.4	-

Auctions

Country	Auction
France	sold €7.24bn of 3.50% of 2033 bonds at an average yield of 2.59%
	sold €2.64bn of 1.25% of 2038 bonds at an average yield of 2.88%
	sold €2.09bn of 3.00% of 2054 bonds at an average yield of 3.13%
Spain	sold €2.68bn of 2.5% of 2027 bonds at an average yield of 2.582%
	sold €2.16bn of 3.5% of 2029 bonds at an average yield of 2.621%
	sold €1.46bn of 1.9% of 2052 bonds at an average yield of 3.693%
	sold €599mn of 0.65% of 2027 index-linked bonds at an average yield of 0.83%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Unemployment change '000s (rate %)	Dec	**5.0 (5.9)**	20.0 (5.9)	22.0 (5.9)	21.0 (5.8)
Spain	Unemployment change '000s	Dec	**-27.4**	-	-24.6	-

Auctions

Country	Auction
Germany	sold €3.56bn of 3.1% 2025 bonds at an average yield of 2.44%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data					
Euro area	08.30	Construction PMI	Dec	-	43.4
	10.00	Preliminary headline HICP (core HICP) Y/Y%	Dec	*2.8 (3.5)*	2.4 (3.6)
	10.00	PPI Y/Y%	Nov	-0.1 (-8.6)	-9.4
Germany	07.00	Retail sales M/M% (Y/Y%)	Nov	-0.5 (-0.5)	1.2 (0.1)
	08.30	Construction PMI	Dec	-	36.2
France	08.30	Construction PMI	Dec	-	44.6
Italy	10.00	Preliminary HICP (CPI) Y/Y%	Dec	0.5 (0.7)	0.6 (0.7)
	08.30	Construction PMI	Dec	-	52.9
UK	09.00	New car registrations Y/Y%	Dec	-	9.5
	09.30	Construction PMI	Dec	-	45.5
Auctions and events					
- Nothing scheduled -					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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