Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses even as data confirmed that euro area inflation momentum moderated significantly in December.
- Gilts made big losses as UK inflation exceeded expectations, but nevertheless continued to undershoot the BoE's projection.
- Thursday will bring the ECB account of December's Governing Council meeting, with euro area construction output data and results from UK housing and credit conditions surveys also due.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.677	+0.089
OBL 2.1 04/29	2.225	+0.078
DBR 2.2 02/34	2.301	+0.046
UKT 3½ 10/25	4.331	+0.199
UKT 4½ 06/28	3.885	+0.224
UKT 3¼ 01/33	3.965	+0173

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

Euro area

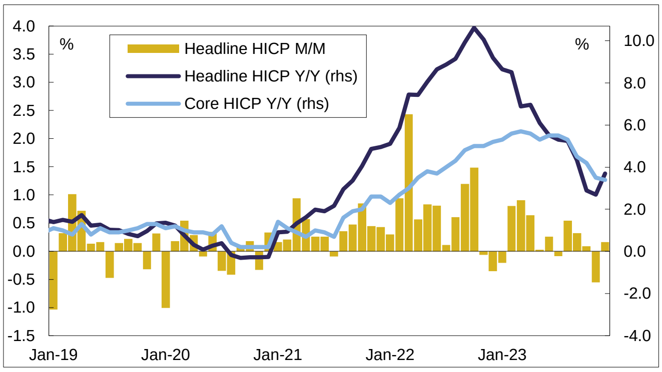
Headline inflation higher in December due to energy base effects

Today's final consumer price inflation data for December confirmed the flash estimates, which had originally reported a notable pickup in headline inflation that month but also a further moderation in underlying price pressures. So, for example, today's figures reaffirmed the 0.5ppt increase in the headline HICP rate to 2.9%Y/Y. This merely reversed the sharp drop in November, therefore leaving inflation at its second lowest rate since July 2021 and 7.7ppts below the October 2022 peak. The increase was driven by energy inflation, which jumped almost 5ppts to -6.7%Y/Y, reflecting the base effect associated with one-off German government payments to reduce household utility bills a year earlier. Indeed, while gas prices fell the most on the series (-9.7%M/M) in December 2022, they rose 1.3%M/M last month. The other major components gave no cause for alarm. With prices of food, alcohol and tobacco declining on the month for the first time in more than two years, the respective inflation component dropped 0.8ppt to a 21-month low of 6.1%Y/Y. And more importantly, today's release also reaffirmed the further moderation in the core HICP rate, by 0.2ppt to 3.4%Y/Y, the lowest since March 2022 and 2.3ppts below the series high reached in March last year. Overall, today's figures meant that both headline and core inflation in Q4 were 0.1ppt below the ECB's forecasts published in the middle of last month.

Inflation momentum continues to slow sharply

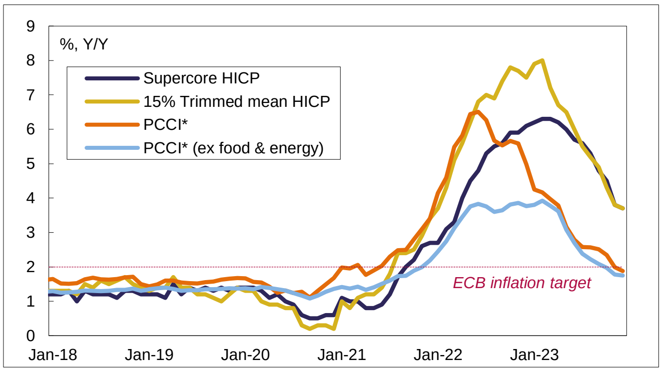
Within the core components, services inflation merely moved sideways in December at 4.0%Y/Y, still elevated but 1½ppts below the peak six months earlier. In part, the relatively high level reflects the higher basket weight of certain items in 2023. Compared to the prior month, however, the impact of a pickup in airfares towards year end was offset by easing inflation of accommodation and package holidays. And, overall, there was a further notable improvement in momentum, with services prices rising by less than the norm for the third month out of the past four. That left services inflation on a 3M/3M annualised basis slowing 0.6ppt to 2.2%, the lowest since September 2021 and a marked 3½ppts below the peak. Meanwhile, given weak demand, an ongoing easing of supply constraints and diminished cost pressures in the industrial sector, inflation of non-energy industrial goods fell for a tenth consecutive month, by 0.4ppt to 2.5%Y/Y, the lowest for more than two years. The downtrend was widespread across a range of goods, including major household appliances, furniture, as well as new and second-hand cars. And notably, core goods prices were unchanged on a three-month annualised basis in December, the softest such rate in three years. As a result, core inflation momentum slowed more than 2ppts over the quarter to just 1.4%3M/3M annualised, the softest since Q221. Today's data revealed a significant easing in several other measures of underlying inflation too. The share of items with inflation of 2.0% or more fell below 70% for the first time since February 2022. Moreover, the ECB's model-based measure of persistent and common component of inflation (PCCI), which the

Euro area: Consumer price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Selected measures of underlying inflation



**Persistent and Common Component of Inflation. Source: ECB, Macrobond, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Governing Council believes can provide one of the more reliable guides to future inflation, fell to its lowest rate (1.9%3M/Y) since May 2021, with the core PCCI rate even further below target at just 1.7%3M/Y.

A highly uncertain near-term price outlook

Despite the significant easing in underlying inflation momentum, the near-term inflation outlook remains highly uncertain. In part, uncertainty relates to the regular reweighting of the inflation basket in the New Year, which will reduce the share taken by (low-inflation) core goods and increase the share taken by (higher-inflation) services. More importantly, it reflects the continued withdrawal of government support for household utility bills in several member states, which will add to energy inflation over coming months and probably push it above zero in Q2. Supply-side disruption due to events in the Red Sea, which has already impacted production at factories such as those of Tesla and Volvo in Berlin and Ghent respectively, and increased the costs of shipping freight from Asia into Europe, also risks a further new impulse via prices of imported goods.

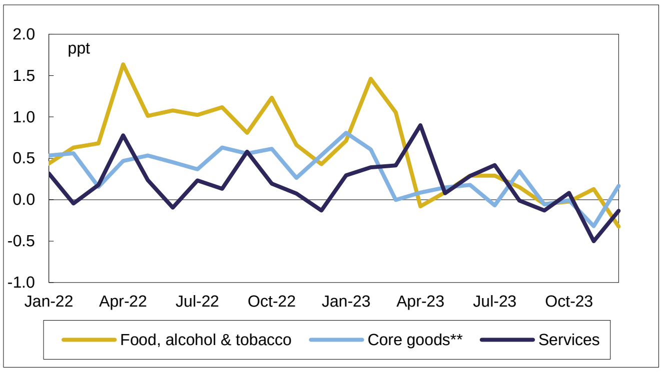
But inflation looks on track to return to target, perhaps by end-Q2

However, ECB President Lagarde recently downplayed the inflationary risks posed by Houthi rebel activity, likely not least as the recent rise in shipping freight costs remains very modest compared to the pandemic-related spike in 2021 and 2022. Moreover, given persistent weakness in producer output goods prices, which fell for the eighth successive month in November to be down 0.5%Y/Y, core consumer goods inflation should remain relatively subdued over coming months. Wholesale energy forward prices are currently undershooting significantly the assumptions used in the ECB's December projections, which might offset some of the impact of reduced government subsidies. And most importantly, with wage settlement growth seemingly having peaked, other cost pressures in the sector having eased, and margins squeezed by soft demand, services inflation should continue to subside over coming months, perhaps to 2.0%Y/Y or less by end-Q2.

Lagarde acknowledges that a rate cut is likely to come by the summer

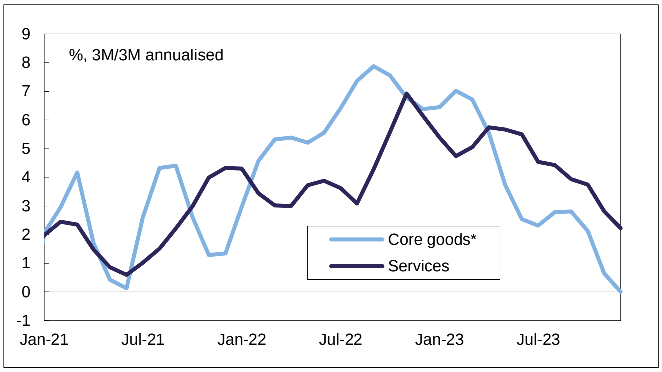
Indeed, judging from recent price momentum, the headline and core inflation rates also look on track to fall to or below target by the end of the second quarter. Certainly, the ECB is highly likely to revise down its inflation projection in March. Given lingering concerns about potential upside risks, as well as the intrinsic hawkishness of a large share of Governing Council members, that month looks too soon to prompt a first rate cut. Nevertheless, in an interview with Bloomberg today, notwithstanding her insistence that decisions will remain data dependent, Lagarde acknowledged that a majority in favour of a rate cut currently looked likely to be in place on the Governing Council "by the summer if not in the summer".

Euro area: Deviations from long-run price change*



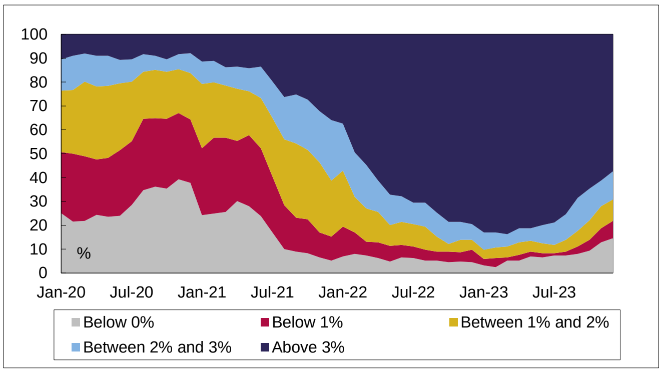
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum



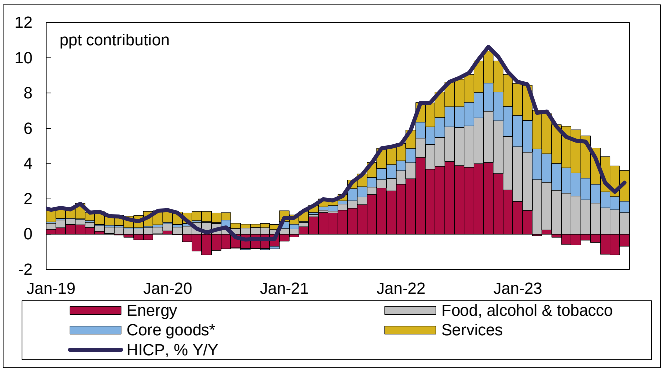
*Non-energy industrial goods. Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Share of HICP basket by inflation rate



Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation & contributions



*Non-energy industrial goods. Source: Refinitv Datastream and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

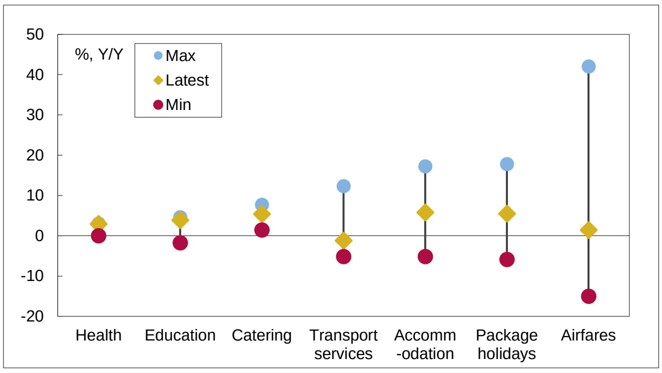
Tomorrow brings the release of the account from the ECB's December policy-setting meeting, which might well provide further colour on Governing Council members' readiness to respond over coming months to the recent weakening in economic activity and easing of inflation pressures. They might also give greater insight into the debate over last month's decision to accelerate quantitative tightening, by halving the reinvestments of its proceeds from maturing PEPP bond holdings from July. Datawise, Thursday will bring euro area construction output data for November. In line with recent downbeat surveys, and given sharp drops in Germany (-2.9%M/M) and France (-1.0%M/M), these are highly likely to report a third successive monthly decline in production in the sector. Euro area new car registration numbers for December are also due.

UK

Inflation exceeds expectations in December on erratic items

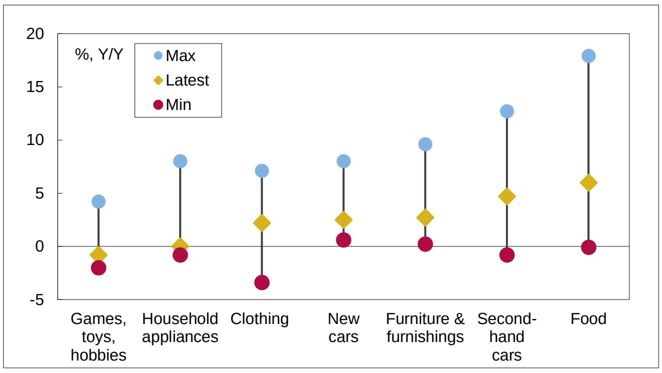
Contrary to expectations of a further decline, CPI inflation rose in December for the first time since February, inching up 0.1ppt to 4.0%Y/Y. The principal causes of the increase, however, were items that are typically erratic. And so, today's data did not significantly change the big picture, i.e. that inflation continues to trend significantly below the BoE's projection published in November. The largest source of upwards pressure came from alcohol and tobacco, the latter related to the increase in duty announced by the government in November, for which the annual rate rose 2.7ppts to add more than 0.1ppt to overall inflation. However, inflation of food and non-alcoholic beverages continued to slow to the softest rate since April 2022 (8.0%Y/Y). In addition, thanks to a further fall in petrol prices, energy inflation fell to a new series low (-17.3%Y/Y). Within the core goods category, the rates for toys and games, clothing and footwear and certain household appliances ticked up. But thanks in part to a drop in used cars, non-energy industrial goods inflation maintained its downtrend, falling for a seventh successive month to 3.1%Y/Y, the lowest since July 2021. Of course, inflation of services remains most important as far as the BoE is concerned. And that component edged up 0.1ppt to 6.4%Y/Y. While pressures continued to ease in certain consumer-facing sectors such as restaurants and personal care, inflation in entertainments and car maintenance and repair picked up, while the contributions from erratic items such as airfares and package tours were little changed. Overall, core inflation was unchanged at 5.1%Y/Y, 2.0ppts below May's peak, and underlying inflation in services (excluding erratic items) also appears to have been steady.

Euro area: Services inflation – selected components



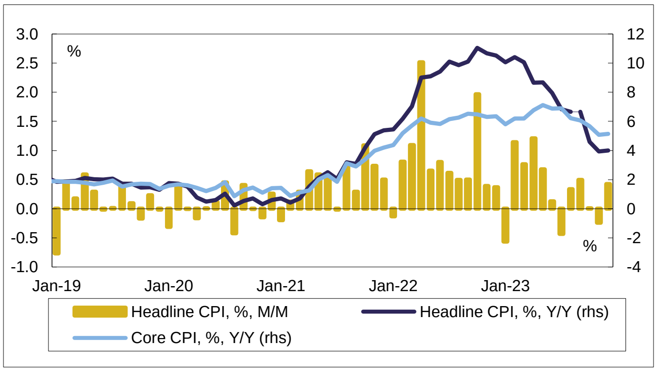
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods inflation – selected components



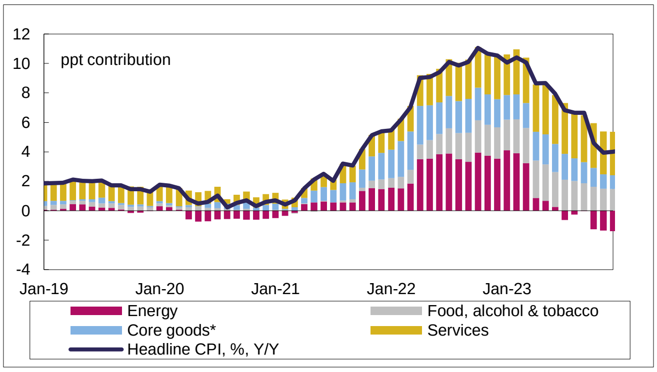
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation & contributions



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

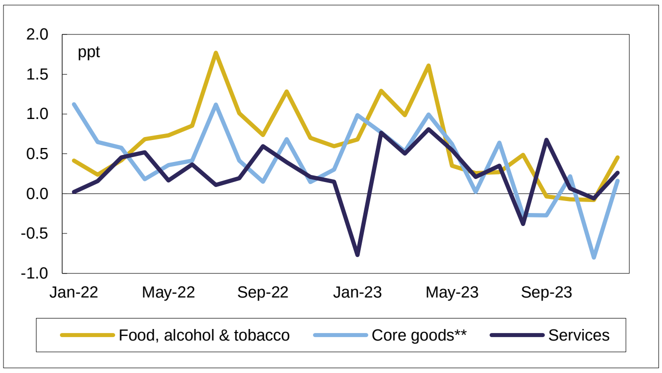
BoE will revise down its inflation projection next month

Despite the upside surprise with respect to the market consensus in December, inflation continued significantly to undershoot the BoE's projections published in November. Indeed, the headline CPI rate in December was still 0.6ppt below the BoE's forecast for the month, with the Q4 average (4.2%Y/Y) almost 0.5ppt below the BoE's projection. Likewise, services inflation in December was 0.5ppt below the BoE's forecast with underlying inflation in that category likely softer than it had anticipated. Looking ahead, inflation at the start of the New Year looks bound to rise not least due to the 5ppt increase in the household energy price cap. And services inflation will also probably take a significant step up, not least as the sharp declines in hospitality prices a year earlier are unlikely to be repeated. However, with pay momentum significantly lower and domestic demand soft, we expect the downtrend in services – both in headline and underlying terms – to resume from February on. There is a strong likelihood that the increase in the household energy price cap will be much more than fully reversed in April. And today's PPI data reported a further drop in food product inflation to just 1.8%Y/Y, the lowest since March 2021, and core output producer goods inflation steady at just 0.1%Y/Y, the lowest since September 2020. So, notwithstanding supply-related risks associated with events in the Red Sea, non-energy goods inflation should fall steadily further from January.

In the absence of shocks, door should be open for a rate cut in May

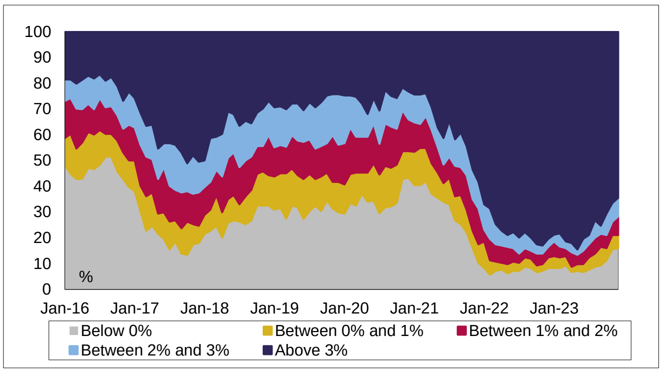
Overall, therefore, headline and underlying inflation should continue to undershoot the BoE's projections, which we expect to be revised down significantly next month. Indeed, headline inflation looks on track to temporarily fall below 2.0%Y/Y in Q2 for the first time since April 2021. And while core inflation will remain above target for longer, the likelihood of continued sluggish domestic demand and moderating pay growth means that it should be back below 2.0%Y/Y by 2025. So, notwithstanding uncertainty regarding the extent of fiscal policy loosening to be announced in the March Budget, and in the absence of new shocks, a first rate cut from the BoE in May still looks a decent bet to us.

UK: Deviations from long-run price change*



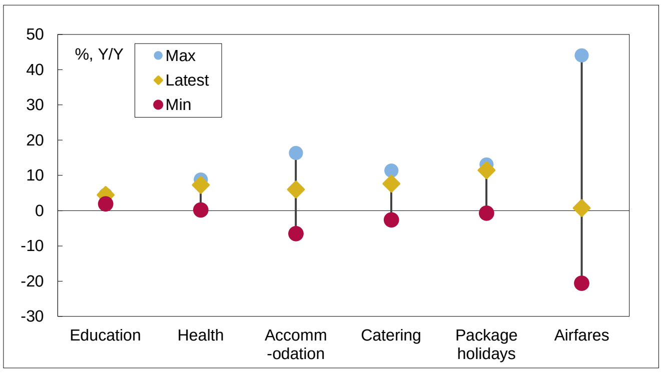
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Share of basket items by inflation rate



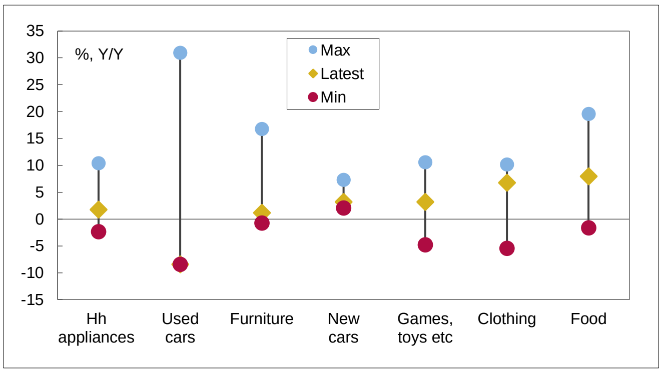
Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Services inflation – selected components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Goods inflation – selected components

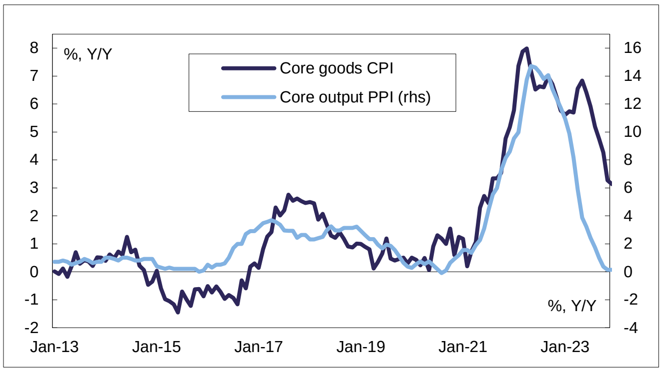


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

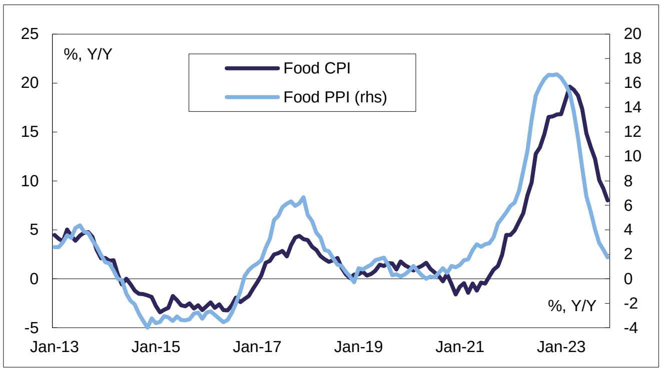
Tomorrow brings the release of the RICS residential survey for December, which is expected to report a further decline in the proportion of surveyors reporting falling prices, adding to expectations of some stabilisation in the housing market. However, the BoE's latest credit conditions survey will likely continue to illustrate the persisting impact of the BoE's monetary policy tightening cycle on credit standards and loan demand.

UK: Producer & consumer goods inflation*



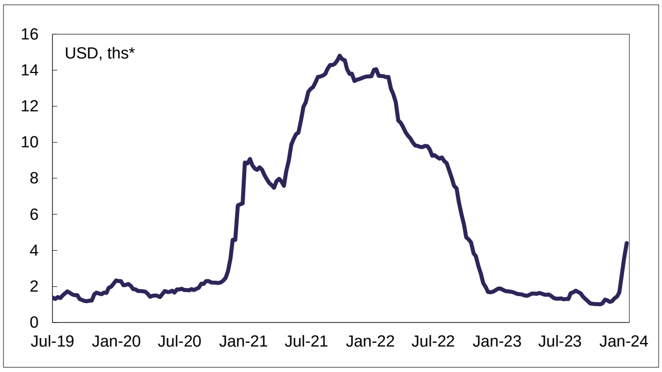
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Producer & consumer food inflation



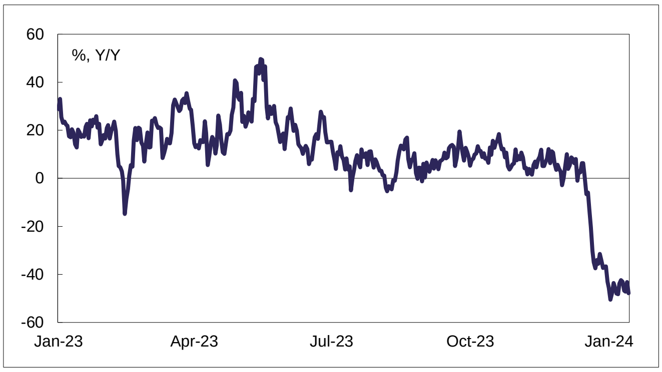
Source: ONS and Daiwa Capital Markets Europe Ltd.

Shanghai to Rotterdam shipping freight price index



*Rate per 40ft box. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Transit trade volume via Bab el-Mandeb Strait



Source: IMF PortWatch 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 HICP (core HICP) Y/Y%	Dec	**2.9 (3.4)**	*2.9 (3.4)*	2.4 (3.6)	-
UK	CPI (core CPI) Y/Y%	Dec	**4.0 (5.1)**	*3.8 (5.0)*	3.9 (5.1)	-
	PPI output (input) prices Y/Y%	Dec	**0.1 (-2.8)**	0.4 (-1.9)	-0.2 (-2.6)	-0.1 (-2.7)
	House price index Y/Y%	Nov	**-2.1**	-	-1.2	-1.3

Auctions	
Country	Auction
Germany	sold €747mn of 0% 2052 bonds at an average yield of 2.42%
	sold €862mn of 1.8% 2053 bonds at an average yield of 2.45%
UK	sold £3.75bn of 4.625% 2034 bonds at an average yield of 3.973%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	07.00	EU27 new car registrations Y/Y%	Dec	-	6.7
	10.00	Construction output M/M% (Y/Y%)	Nov	-	-0.9 (-0.7)
Spain	09.00	Trade balance €bn	Nov	-	-51.4
UK	00.01	RICS house price balance %	Dec	-36	-43

Auctions and events		
Euro area	12.30	ECB publishes account of December meeting
France	09.50	Auction: 2.5% 2027 bonds
	09.50	Auction: 2.75% 2029 bonds
	09.50	Auction: 0.5% 2029 bonds
	10.50	Auction: 3.4% 2029 index-linked bonds
	10.50	Auction: 0.6% 2034 index-linked bonds
	10.50	Auction: 0.1% 2036 index-linked bonds
	10.50	Auction: 0.1% 2038 index-linked bonds
Spain	09.30	Auction: 2.5% 2027 bonds
	09.30	Auction: 1.25% 2030 bonds
	09.30	Auction: 3.9% 2039 bonds
UK	09.30	BoE to publish Credit Conditions Survey for Q4

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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