Euro wrap-up

Overview

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- Bunds made gains at the short end but losses further out as the ECB's account of its December policy meeting noted the intention to push against market rate-cut expectations but the downtrend in euro area construction activity continued.
- Gilts made notable gains even as a UK housing survey offered some signs of stabilisation at the turn of the year, with a notable improvement in sales expectations.
- Friday will bring December figures for UK retail sales and German producer prices.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.671	-0.019
OBL 2.1 04/29	2.242	+0.003
DBR 2.2 02	2.335	+0.023
UKT 3½ 10/25	4.266	-0.082
UKT 4½ 06/28	3.814	-0.085
UKT 3¼ 01/33	3.917	-0.063

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

Euro area

ECB account flags policymakers' desire to push against market rate expectations

Recent days have seen several members of the ECB's Governing Council push back against market pricing, downplaying the likelihood of a rate cut over the next few months and an aggressive easing cycle thereafter. Today's account of the ECB's December monetary policy meeting similarly made clear the policymakers' discomfort of the downwards shift in rate expectations earlier that month. In particular, the account noted that market expectations had become "inconsistent with the outlook in the staff projections, with respect to both the inflation outlook and the rate path embodied in the technical assumptions… [which] incorporated only about 75bps of rate cuts for 2024". Indeed, it reported concern "that the sharp market repricing threatened to loosen financial conditions excessively, which could derail the disinflationary process." So, given also concerns about potential upside risks to the inflation outlook, it was "widely regarded as important not to accommodate market expectations in the post-meeting communication".

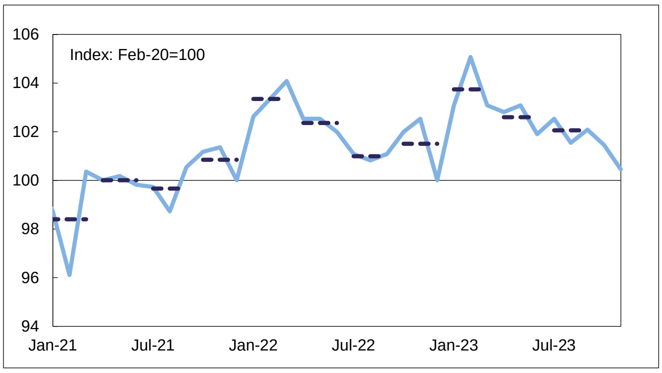
Commentary increases likelihood of a first cut in June

Nevertheless, the December meeting account also reported growing concerns that the ECB's projections for GDP might be overoptimistic, not least given fears that private consumption might remain subdued as fiscal policy support is withdrawn. It noted that the Governing Council "broadly concurred" that disinflation was probably proceeding "more strongly than had been anticipated" and that "the impact of tight financing conditions might be stronger over coming quarters". So, while the account suggests that evidence of an unexpected significant new disinflationary impulse will probably be required to justify a rate cut between now and April, it was not inconsistent with President Lagarde's comment earlier this week that a first easing of monetary policy by or in the summer looks "likely". Admittedly, the account highlighted the importance of the profile of wages over coming quarters, and reported that "members did not expect substantial hard evidence corroborating the projected moderation of wage growth to be available before the middle of the year". But, as noted by Chief Economist Lane in a newspaper interview earlier this week, the national accounts wage data for Q1, to be published at the end of April, might show a sufficient moderation in growth to justify a first rate cut in June, which is certainly now our baseline assumption.

Construction contraction continued in November with further retrenchment to come

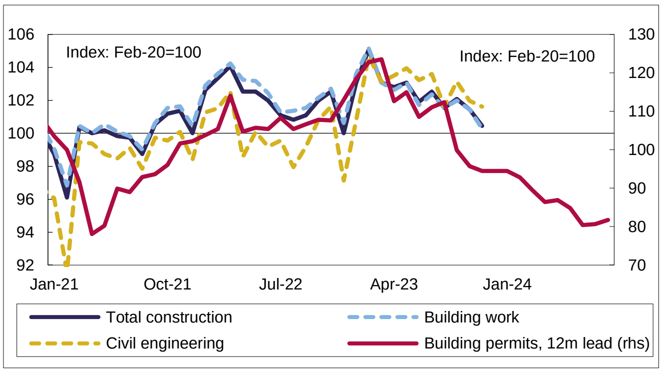
Today's construction output data highlighted the ongoing contraction in one of the most interest rate-sensitive sectors. In particular, production in construction in the euro area declined in November for the second successive month and by a chunky 1.0%M/M to be down 2.2%Y/Y, the sharpest annual fall since the first wave of Covid-19 in mid-2020. The drop in November left output in the sector at an eleven-month low and just 0.5% above the pre-pandemic level in February 2020. At

Euro area: Construction output*



*Dashed line represents quarterly average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output & permits



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

the country level, Germany and France led the way down in November, with production falling for a second successive month and by 2.9%M/M and 1.0%M/M respectively, with the Netherlands also registering a notable decline (-2.5%M/M). Compared to a year earlier, several other member states, including Finland (-6.9%Y/Y) and Austria (-4.5%Y/Y) posted significant falls, as well as Germany (-4.5%Y/Y) and France (-5.2%Y/Y). In contrast, Spain (up 1.1%M/M and 9.7%Y/Y) bucked the negative trend as probably did Italy, for which timely data are not published for confidentiality reasons. On a three-month basis, euro area construction output was down for the sixth successive month and by -0.7%3M/3M with a similar pace of decline in building work and civil engineering activity.

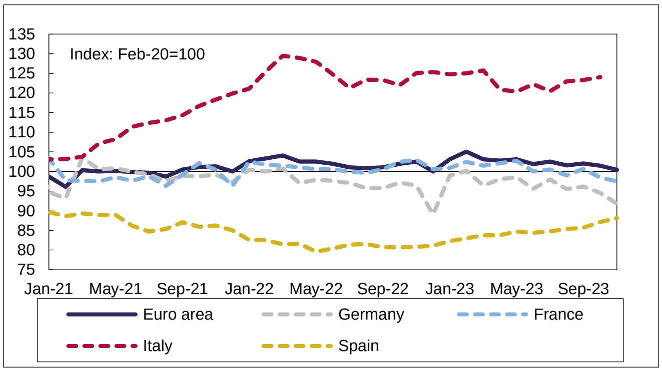
Negative construction trend to extend into 2024

Leading indicators, surveys and fundamentals all strongly suggest that the negative construction trend will continue in most member states in coming quarters. Certainly, the construction PMIs in December remained consistent with a steep pace of contraction in the euro area as a whole (43.6), Germany (37.0) and France (42.6). Like the Commission survey, the PMIs also suggested that construction new orders continue to fall sharply. The Commission survey also reported that insufficient demand was now holding back activity for more than 30% of respondent construction firms, the highest share in almost seven years. However, that survey differentiated between conditions in civil engineering, where sentiment remains supported by infrastructure projects under the NGEU programme, and building work, where fundamentals are much less favourable. Indeed, in response to the ECB's monetary tightening, the composite cost of borrowing for house purchase rose above 4.0% in November for the first time since April 2009, to be up 270bps from two years earlier. On average, house prices in the euro area in Q3 were down 2.1%Y/Y, the most since the euro area crisis in Q113, with steep declines in Germany (-10.2%Y/Y) and Finland (-7.0%Y/Y) where construction activity is particularly weak, contrasting growth of 4.5%Y/Y in Spain and 7.6%Y/Y in Portugal. Notably, while the number of building permits in the euro area edged marginally higher in September (0.5%M/M), they were still more than 25% below the peak in March 2022, with residential permits down more than one third since then.

The day ahead in the euro area

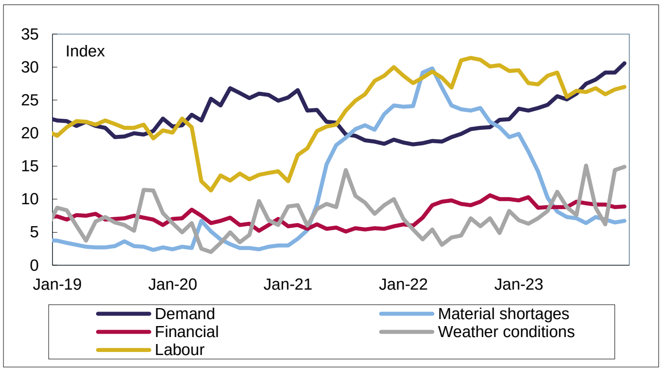
The euro area's data calendar for this week will end relatively quietly, with just the release of German industrial producer price figures for December. Prices are expected to fall for the seventh month out of the past eight to leave the headline annual PPI rate little changed from November's reading (-7.9%Y/Y).

Euro area: Construction output by country



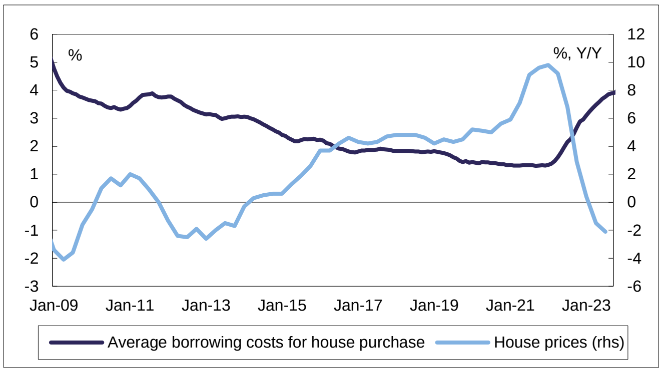
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Factors limiting construction output



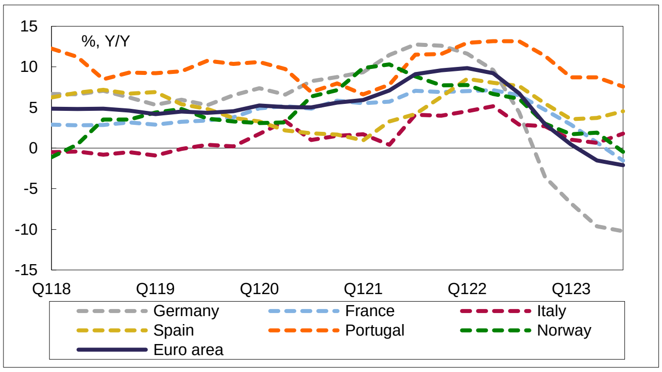
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: House prices & mortgage rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: House prices by selected member state



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK

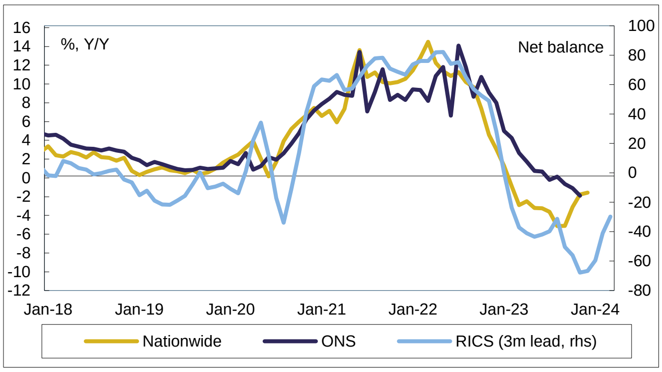
House prices continue to decline, but signs of stabilisation heading into year end

As in the euro area, the BoE's aggressive monetary tightening cycle has inevitably had a negative impact on the UK housing market. Yesterday's release of the ONS's official house price index illustrated the steady downturn. Residential property prices fell for the ninth month out of the past twelve in November to be down 2.1%Y/Y, the fifth consecutive annual drop and the steepest since mid-2011. The ONS also reported that transaction volumes (-22%Y/Y) were considerably weaker than normal, suggesting that revisions may be larger than usual over coming months. Certainly, the downwards adjustment in other house price indicators has been more striking, with the Nationwide price index having fallen more than 5% from the peak to the trough last August 2023. And the RICS residential survey saw the house price balance hit its lowest since the global financial crisis in August (-68%). But more recently, these measures suggest that the adjustment started to stabilise heading into year end. Despite edging slightly lower in December, the Nationwide house price index was more than 1% above August's trough to leave the annual drop (-1.8%Y/Y) the softest since February. And today's data showed that the RICS house price gauge rose last month to a thirteen-month high, with the net share of surveyors reporting declines up 11ppts to -30%, albeit remaining considerably below the long-run average (+15%).

Surveyors house sales expectations highest since Feb-21 as demand starts to improve

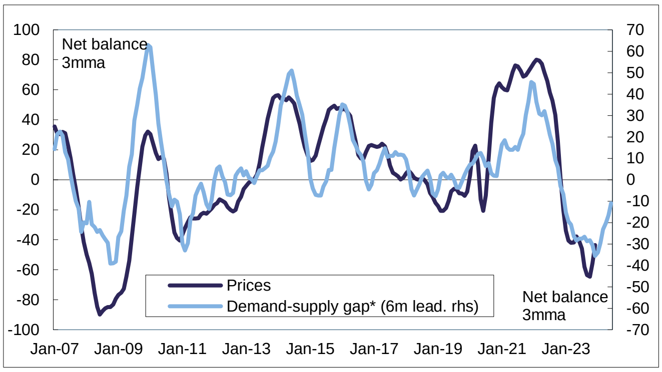
Surveyors also suggested that the recent moderation in mortgage interest rates had provided a boost to demand, with the net balance of new buyer enquiries (-4%) improving for the fourth consecutive month in December to its highest since April 2022, back in line with the pre-pandemic five-year average. As such, the downwards pull on prices from the demand-supply imbalance should start to diminish over the coming six months. And the recent adverse trend in new house building – which in November was down 20%Y/Y at its lowest level since 2016 when excluding the initial pandemic collapse – will continue to limit the pickup in supply. The RICS survey also signalled that recently agreed sales were the least negative since early 2022, while respondents were more upbeat about the near-term sales outlook, with this recovery expected to be maintained over the coming twelve months – indeed, the respective index (34%) was the highest since February 2021. Nevertheless, with mortgage lending still extremely weak, interest rates considerably higher than two years ago, and consumer confidence below average, the housing market will remain fragile for several quarters to come.

UK: Selected house price indicators



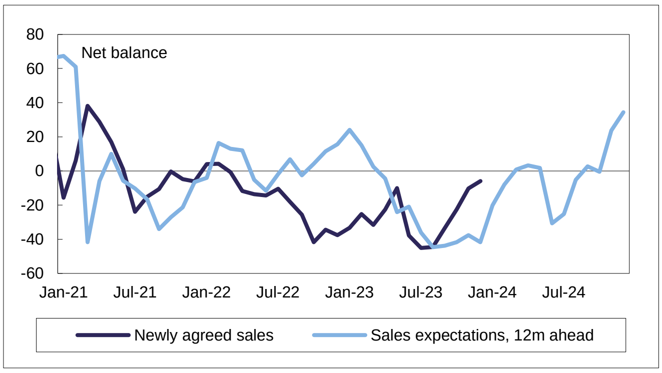
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: RICS house price balance



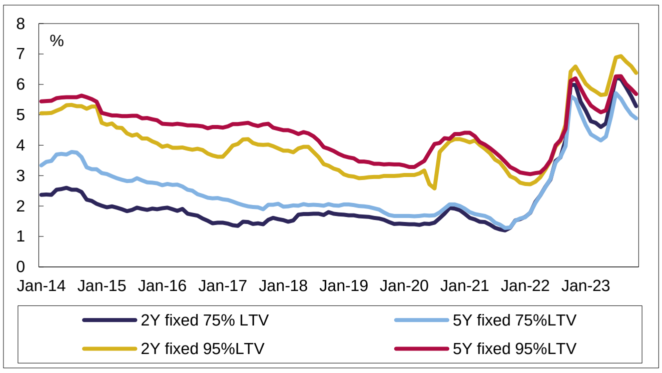
*New buyer enquiries minus new vendor instructions. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: RICS house sales



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Mortgage interest rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

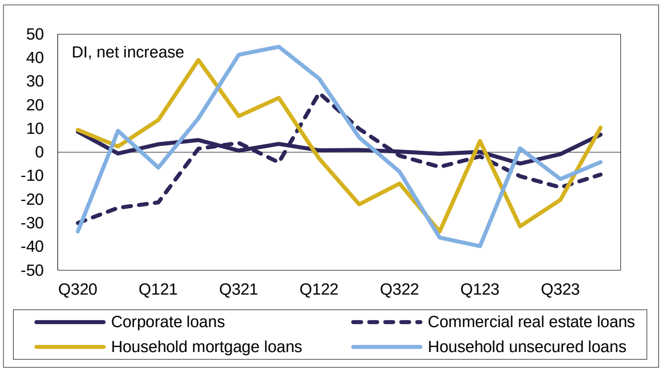
Decline in household and corporate loan demand despite improved credit availability

The BoE's credit conditions survey findings also flagged lacklustre mortgage demand, despite banks having increased the availability of credit in the three months to end-November amid an easing in wholesale funding conditions. Indeed, while the number of lenders saying that they increased mortgage loan supply rose to the highest in two years, the respective net balance for secured loan demand marked the fifth negative balance out of the past six and well below the long-run average. And while lenders expected demand to pick up in the first quarter of this year, they also expected limited further improvement in the availability of secured credit, underscoring the challenges facing the residential property market. The availability of unsecured credit also fell further in the three months to November, while demand for consumer credit declined sharply, with the respective net balance the weakest for more than a decade when excluding the initial slump in Q220, reinforcing our view that consumer spending remained subdued in Q4. Demand for corporate loans also continued to decline last quarter, with the net balance for small firms the lowest for ten quarters. But while corporate loan supply was expected to improve further at the start of 2024, lenders continued to reduce credit availability associated with commercial real estate reflecting declining prices in that sector.

The day ahead in the UK

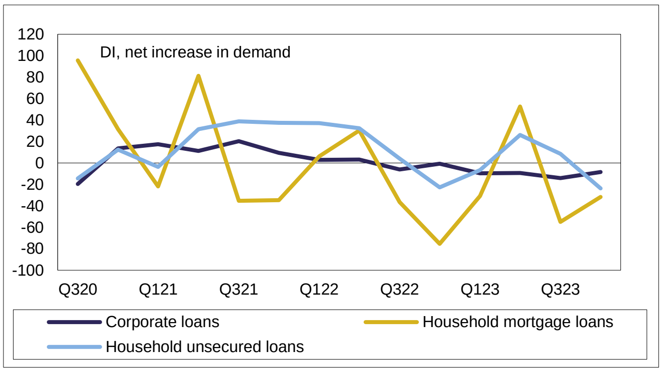
Tomorrow will bring retail sales figures for December. Surveys strongly suggest that retail spending disappointed at the end of the year. So, having risen in November (1.3%M/M) at the fastest pace since January, and while auto fuel sales were likely boosted by the drop in petrol prices, we expect total retail sales volumes to have fallen on the month, to be down in Q4 for a second successive quarter.

UK: Household & corporate credit availability



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

UK: Demand for household & corporate loans



Source: BoE credit conditions survey, Macrobond 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	EU27 new car registrations Y/Y%	Dec	**-3.3**	-	6.7	-
	Construction output M/M% (Y/Y%)	Nov	**-1.0 (-2.2)**	-	-0.9 (-0.7)	-0.6 (-)
Spain	Trade balance €bn	Nov	**-24.3**	-	-51.4	-
UK	RICS house price balance %	Dec	**-30**	-36	-43	-41

Auctions

Country	Auction
France	sold €5.6bn of 2.5% 2027 bonds at an average yield of 2.56%
	sold €4.0bn of 2.75% 2029 bonds at an average yield of 2.55%
	sold €2.40bn of 0.5% 2029 bonds at an average yield of 2.53%
	sold €596mn of 3.4% 2029 index-linked bonds at an average yield of 0.49%
	sold €463mn of 0.6% 2034 index-linked bonds at an average yield of 0.67%
	sold €561mn of 0.1% 2036 index-linked bonds at an average yield of 0.76%
	sold €378mn of 0.1% 2038 index-linked bonds at an average yield of 0.75%
Spain	sold €2.3bn o 2.5% 2027 bonds at an average yield of 2.799%
	sold €1.6bn o 1.25% 2030 bonds at an average yield of 2.954%
	sold €2.3bn o 3.9% 2039 bonds at an average yield of 3.63%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	PPI Y/Y%	Dec	-8.0	-7.9
UK	07.00	Retail sales including auto fuels M/M% (Y/Y%)	Dec	-0.5 (1.1)	1.3 (0.1)
	07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Dec	-0.6 (1.4)	1.3 (0.3)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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