Euro wrap-up

Overview

- Bunds made modest gains as the euro area flash December PMIs surprised to the downside, albeit remaining consistent with an acceleration in GDP growth in Q4.
- While UK unemployment jumped in October and private regular pay growth slowed, Gilts made losses after the flash PMIs exceeded expectations.
- Wednesday will bring November inflation data from the euro area and UK, as well as the December German ifo business survey.

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Daily bond market movements

Bond	Yield	Change
BKO 2 12/27	2.130	-0.017
OBL 2.2 10/30	2.450	-0.018
DBR 2.6 08/35	2.843	-0.008
UKT 3¾ 03/27	3.753	+0.015
UKT 4⅜ 03/30	3.958	+0.014
UKT 4½ 03/35	4.517	+0.023

*Change from close as at 5.00pm GMT.
Source: Bloomberg

Euro area

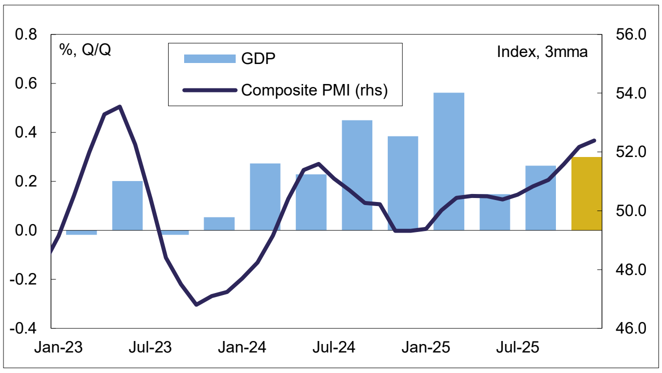
Flash PMIs consistent with acceleration in Q4 GDP growth despite downside surprise in December

At the conclusion of the Governing Council meeting on Thursday, Christine Lagarde should strike a cautiously optimistic tone in her press conference. The ECB will expect inflation to return close to target in 2028 and it will also judge that euro area economic activity remains resilient. Certainly, we don't expect the Governing Council to be overly concerned by the deterioration in today's flash December PMIs, which nevertheless remained consistent with expansion in Q4. Indeed, while the headline euro area composite PMI fell 0.9pt to a three-month low (51.9), this left the quarterly average up almost 1½pts from Q3 and at a level that in the past was consistent with GDP growth of 0.3%Q/Q. Despite weakening into year-end, the survey continued to point to ongoing growth in the services sector, for which the activity PMI (52.6) was bang in line with the long-run average. In contrast, the manufacturing output index dropped to a ten-month low (49.7), suggesting a slight contraction over the fourth quarter too. The reported further decline in factory orders might suggest that sustained recovery in manufacturing remains some way off. But firms in the sector were the most upbeat about the production outlook for the coming 12 months since early 2022. That improvement in sentiment was led by a bounce in Germany, where public spending should provide a boost to defence- and infrastructure-related sub-sectors. Admittedly, today's survey flagged ongoing weakness in German manufacturing in December. But the German composite PMI (51.5) pointed to a return to positive GDP growth in Q4 despite softening to a four-month low this month. Elsewhere, while the respective manufacturing index improved, the French composite PMI (50.1) was merely consistent with stagnation. And so, notwithstanding some softening this month, today's survey suggested that economic momentum remains strongest in the rest of the euro area – presumably still led by Spain – where the quarterly composite PMI (54.1) was the firmest in 2½ years.

Jobs growth remains subdued, while output price pressures well contained

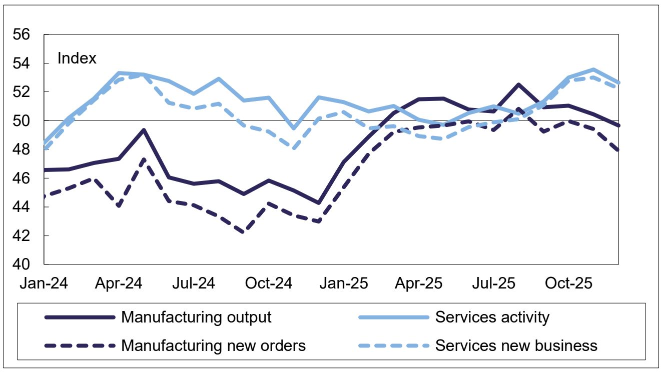
Despite the steady improvement in economic momentum, today's survey suggested negligible firming of the labour market, with the composite employment PMI in December (50.6) little better than the average of the past six months. Perhaps unsurprisingly, it reported an ongoing decline in headcount in the factory sector – led by Germany – with sluggish jobs growth in services too. This notwithstanding, today's price PMIs suggested that input price pressures rose further in December to a nine-month high, reportedly led by a pickup in costs in the factory sector. But today's survey also suggested that manufacturers continued to struggle to pass these on in the face of weak demand. And having eased to a 4½-year low in November, services price pressures reportedly remained well contained this month, leaving the composite output PMI (52.2) bang in line with the average of the past six months. Overall, therefore, with growth momentum still turning for the better but the labour market subdued and output price pressures well behaved, today's survey results suggested no need for the ECB to change rates in either direction this week.

Euro area: GDP growth* & composite output PMI



*Gold bar is Daiwa forecast for Q425.
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing & services PMIs

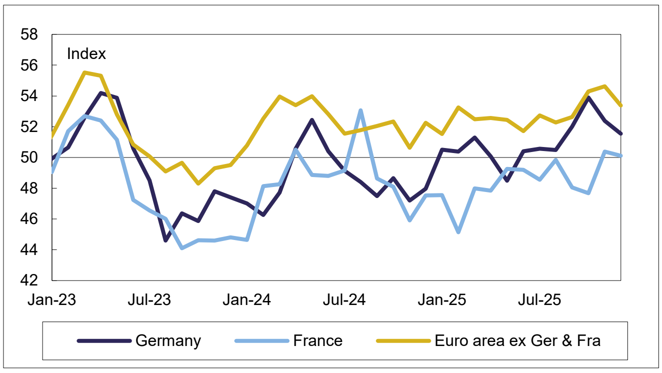


Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Exports predictably fall back in October, but blow to GDP softened by weak imports

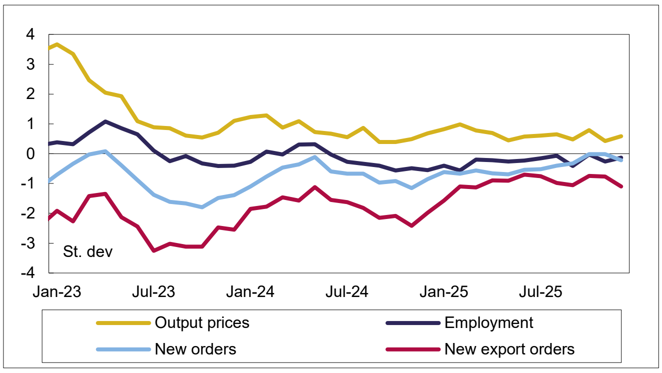
While increased public spending on infrastructure and defence will provide greater support for the manufacturing sector over coming quarters, external headwinds – chiefly those from US tariffs, weakening Chinese demand and increased Chinese competitiveness vis-à-vis European areas of specialisation such as autos – will persist. And data on factory orders and survey indicators such as the manufacturing new export orders PMI into year-end tally with our expectation of ongoing softness in external demand. Indeed, today's goods trade data reported that export values fell sharply at the start of Q4 (-4.5%M/M) to fully reverse the previous month's rise. But as September's boost had been almost wholly attributable to exceptionally large shipments of Irish chemicals to the US, that reversal was unsurprising. However, with weakness apparent in equipment, machinery & transport goods too (-17.4%Y/Y), it will be of greater concern that October saw the value of US-bound exports shrink to the lowest level since Q122 (-15.9%Y/Y), whilst volumes fell to their lowest since April 2017. With German shipments also down steeply in October, euro area export volumes to China were the weakest since September 2009, and more than one-third down from the level in 2019. So, total export values in October were left trending some 2% below the average level in Q3. But with imports down slightly more than 3% on the same basis, courtesy of a 3.3%M/M drop, we at least maintain hopes that net trade will make a positive contribution to GDP growth in the current quarter, albeit not for the most encouraging of reasons.

Euro area member states: Composite output PMIs



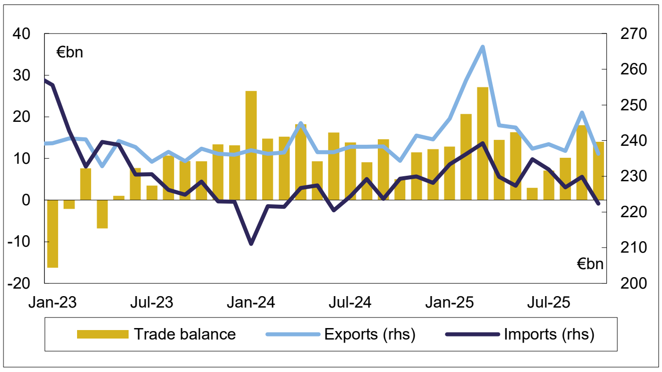
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected composite PMIs



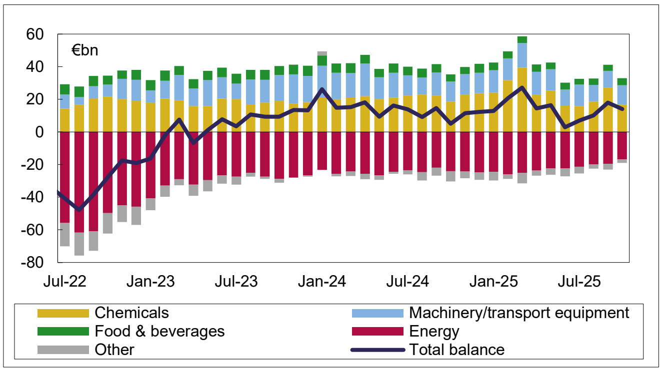
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade balance, exports & imports



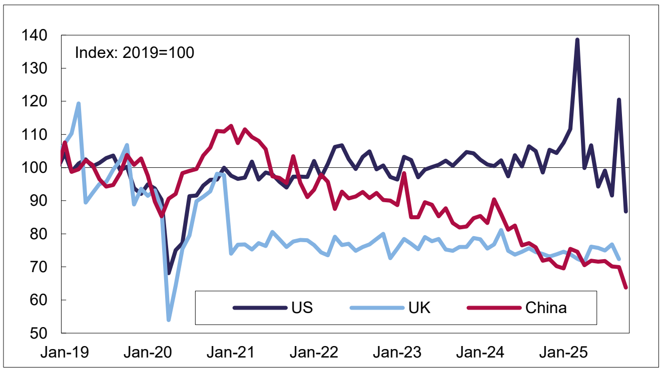
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade balance by product



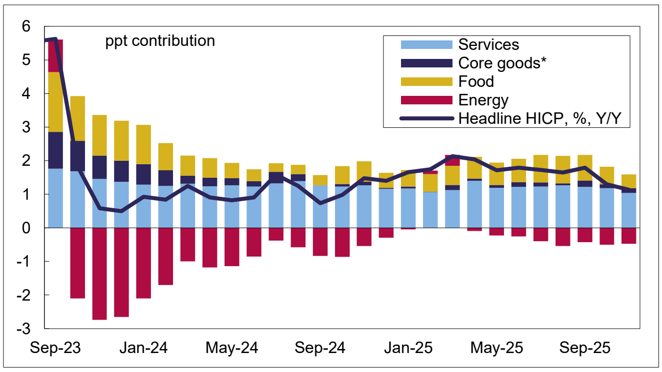
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Export volumes by country



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Italy: Contributions to HICP inflation



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

The day ahead in the euro area

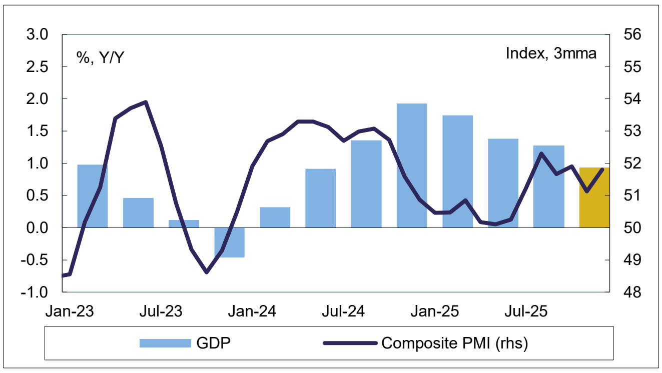
While the final estimate of Italian inflation in November on the national CPI measure was today revised a touch lower, the HICP rate was unchanged from its flash release at a 13-month low of 1.1%Y/Y, 0.2ppt softer than in October. The detail attributed most of that decline to softer food inflation, as well as sharper decline in the often-volatile airfares component. Given the unchanged Italian HICP rate, Wednesday's final inflation print for the euro area should similarly confirm its flash release, which saw headline inflation round up 0.1ppt to 2.2%Y/Y. Given the steadiness of the aggregate core rate (2.4%Y/Y), we expect the granular detail to attribute the rise in headline inflation to marginally higher fuel price inflation. Perhaps more significant in the context of the inflation outlook, Wednesday will also bring final labour cost indicators for Q3, which will include a sectoral breakdown. Indeed, their flash release suggested that whole-economy labour costs rose 3.5%Y/Y in Q3, marking a slight deceleration from Q2 (3.6%Y/Y) but still somewhat elevated. Wednesday's other headline release will be Germany's ifo survey for December. The ifo indices have generally been less bullish about the prospects for, and extent of, a return to German GDP growth in Q4 than the respective PMI series. Nevertheless, the survey will provide a second opinion with respect to any loss of momentum this month.

UK

Flash PMIs suggest that activity firmed a touch in December as Budget uncertainty lifted

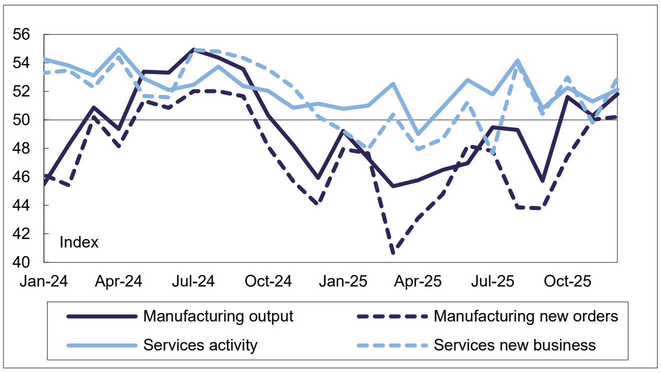
After data last week showed that GDP fell at the start of Q4 and so has now grown in only one month since March, today's flash December PMIs suggested that activity at the end of the quarter turned slightly for the better, and above expectations, but remained relatively subdued. The headline composite activity PMI rose 0.9pt to 52.1 to suggest that the lifting of Budget-related uncertainty at the end of last month provided some relief to businesses. But that left it still slightly below the figure for October and the quarterly average (51.8) at a level that in the past would be consistent with little better than a sideways move in GDP in Q4. Reassuringly perhaps, the PMIs pointed to modest improvement in both major sectors in December. The services activity index rose 0.8pt to 52.1, just below the average of the prior six months, with new business also firmer following a dip the prior month. In addition, the manufacturing output index rose 1½pts to 51.8, the best in 15 months, with new orders reportedly flat for a second successive month. If the survey is to be believed, work backlogs in aggregate stopped falling for the first time in more than 2½ years. Disappointingly, with input costs rising the most since May, the flash PMIs suggested that output prices were hiked this month by the most since August, having in November registered the softest rise since 2020.

UK: GDP growth* & composite output PMI



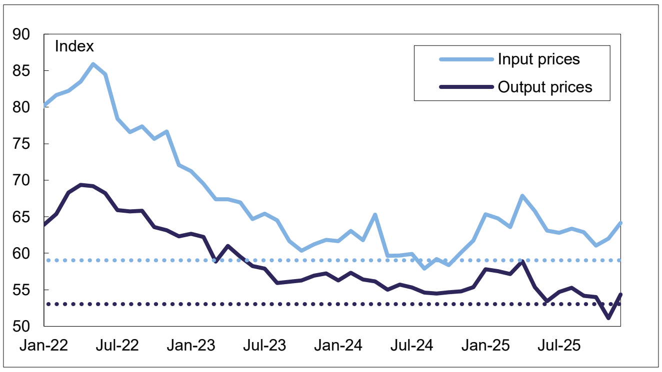
*Gold bar is Daiwa forecast for Q425. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing & services PMIs



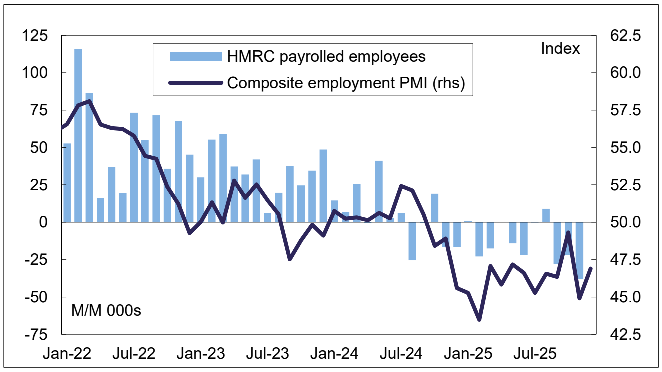
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Composite price PMIs*



*Dotted lines are pre-pandemic long-run averages. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Employees & employment PMI



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

Improved PMIs shouldn't prevent a rate cut this week not least as employment signal remains weak

The suggestions in the flash PMIs of a slight improvement in economic momentum and firmer cost and price pressures seems highly unlikely to prevent BoE Governor Bailey from pivoting to ensure a majority on the MPC in favour of a rate cut at this week's monetary policy meeting. After all, the flash December results are often revised significantly and might be considered a less reliable guide than normal to broader economic activity. Moreover, the survey suggested that firms, and particularly in services, remain keen to keep cutting headcount to control costs. Indeed, the composite employment PMI (46.9) remained below 50 for a 15th successive month and was still close to the average reading over that adverse period to suggest that the labour market continues to soften. And more importantly, today's ONS official jobs and wages data suggested that labour slack continued to increase into Q4.

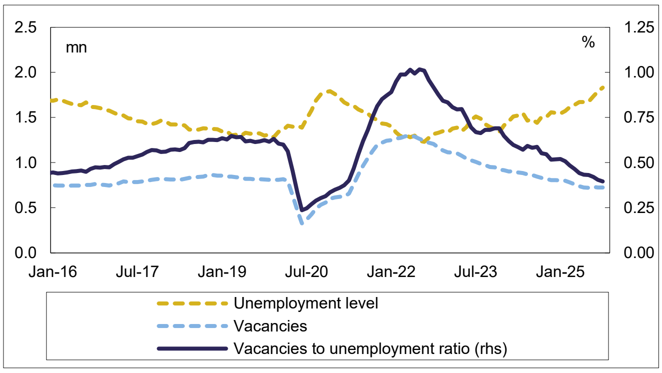
Highest unemployment rate since early 2022, most labour slack since 2015 excluding the pandemic

Certainly, likely due to a mix of cyclical and structural factors, the signals on labour demand from the ONS's official data remain weak. HMRC's provisional estimate of payrolled employees – the timeliest guide to employment – fell in November for a third successive month and the eighth time in the past ten months and by 38k, the most in five years, to be down 0.6%Y/Y. Although it ticked up on a single-month basis, the LFS measure of total employment fell 16k3M/3M in October due to falls in the number of full-time employees (-49k) and self-employed workers (-58k). That pushed the employment rate down a further 0.1ppt to 74.9%, 0.4ppt below the level in the three months to June and an 11-month low. With inactivity also down on a three-month basis and more than 230k below the level a year earlier, the unemployment rate rose 0.4ppt from the prior three-month period to 5.1%, 1.0ppt above the 2024 trough 15 months earlier and 1.0ppt above the BoE's projection for end-2025 in the November 2024 Monetary Policy Report. And with the number of vacancies broadly flat, the ratio of vacancies to unemployed dropped to 0.40, well below the long-run average. That suggested the largest amount of labour slack since April 2021 and – excluding the pandemic period – since mid-2015.

Moderating private pay growth suggests that inflation persistence risks continue to diminish

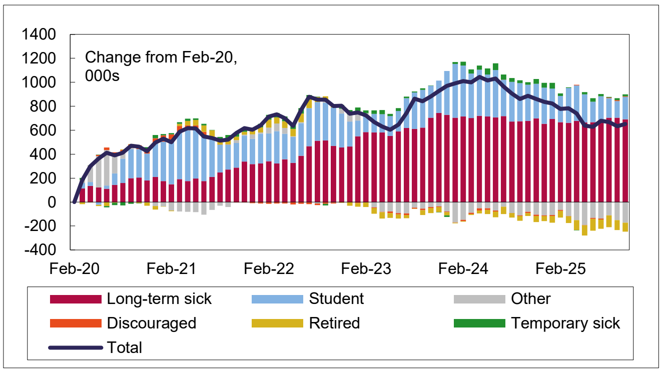
Given uncertainty as to whether the softening in labour demand reflects cyclical factors such as weak demand or structural factors such as minimum wage hikes, this year's hike in employer National Insurance Contributions (NICs) and increased rigidities (e.g. due to Brexit), the pay data arguably remain the best indirect gauge of slack. And despite upside surprises in the headline figures, the detail of today's wage data were also consistent with continued loosening of the labour market and an easing of underlying price pressures. Average weekly earnings growth remained elevated, slowing in October by only 0.2ppt from an upwardly figure in the prior month to 4.7%3M/Y. But that was skewed higher by a base effect in the public sector (7.7%3M/Y) related to the earlier-than-usual timing of pay settlements this year. In the private sector, total pay slowed

UK: Vacancies to unemployment ratio



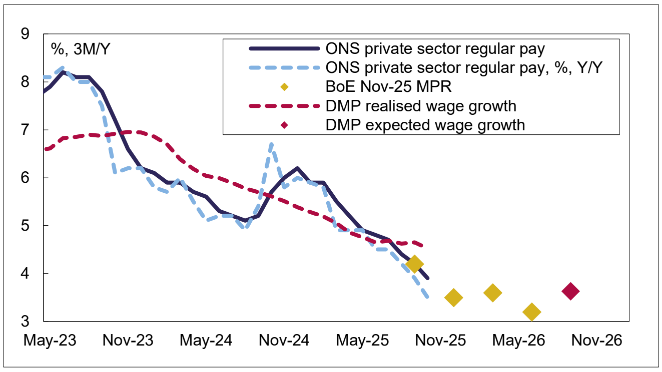
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Inactivity by reason



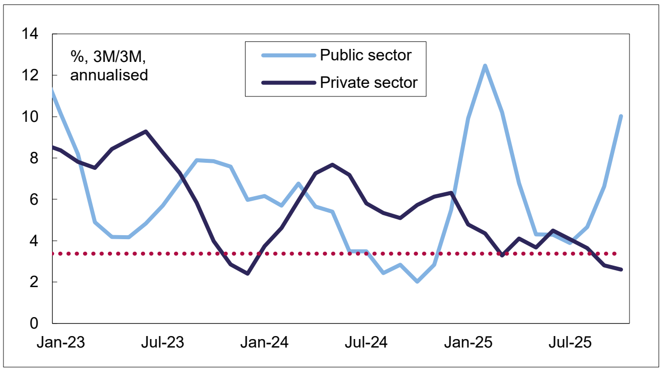
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Measures of wage growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Private & public regular pay growth*



**Red dotted line is 20-year average.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

0.7ppt from three months earlier to 4.0%3M/Y. And stripping out bonuses, private sector regular pay – arguably the BoE's preferred measure, slowed to 3.9%3M/Y, with the single-month figure down 0.4ppt from September to 3.5%Y/Y, the lowest since October 2020 and also below the 2019 average. That suggests that private regular pay is firmly on track to match and undershoot the BoE's projection for year-end (3.5%3M/Y). And given evidence of persisting slack and subdued economic activity, further moderation in private regular pay growth closer to 3.0%Y/Y by mid-2026 looks likely. In our view, risks of an eventual persistent undershoot of the inflation target appear to be rising.

The day ahead in the UK

November's CPI inflation report will mark the highlight of Wednesday's UK economic calendar and the final top-tier data release before Thursday's MPC announcement. It will also represent the second inflation print since the MPC held rates unchanged in November, at which time inflation was prevailing at its Q3 peak of 3.8%Y/Y. But headline inflation predictably stepped down in October to 3.6%Y/Y. And despite upside risks, we expect November's print to be slightly softer too. Indeed, in line with the consensus, but a touch firmer than the BoE, we expect headline inflation to edge down to 3.5%Y/Y. That partly reflects our expectation of another slight uptick in energy inflation, this time owing to a rise in petrol prices. But favourable base effects relating to last year's extra tobacco duty increases, as well as some additional softness in food, should provide some offset. Otherwise, we expect services and core goods inflation to hold relatively steady, leaving the core rate at 3.4%Y/Y for the time being before moderating throughout the first half of 2026. Besides the inflation report, December's CBI industrials survey will provide a cross-check on the tentative improvement in manufacturing sentiment and output flagged by the flash PMIs.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary services (manufacturing) PMI	Dec	**52.6 (49.2)**	53.3 (49.9)	53.6 (49.6)	-
	Preliminary composite PMI	Dec	**51.9**	52.7	52.8	-
	Trade balance €bn	Oct	**14.0**	-	18.7	18.0
	Final job vacancy rate %	Q3	**2.2**	*2.2*	2.3	-
Germany	Preliminary services (manufacturing) PMI	Dec	**52.6 (47.7)**	53.0 (48.6)	53.1 (48.2)	-
	Preliminary composite PMI	Dec	**51.5**	52.4	52.4	-
	ZEW current situation (expectations) balance	Dec	**-81.0 (45.8)**	-80.0 (39.0)	-78.7 (38.5)	-
France	Preliminary services (manufacturing) PMI	Dec	**50.2 (50.6)**	51.2 (48.1)	51.4 (47.8)	-
	Preliminary composite PMI	Dec	**50.1**	50.4	50.4	-
Italy	Final HICP (CPI) Y/Y%	Nov	**1.1 (1.1)**	*1.1 (1.2)*	1.3 (1.2)	-
UK	Average wages (excluding bonuses) 3M/Y%	Oct	**4.7 (4.6)**	4.4 (4.5)	4.8 (4.6)	4.9 (4.7)
	Private sector regular wages 3M/Y%	Oct	**3.9**	3.8	4.2	-
	Unemployment rate 3M%	Oct	**5.1**	5.1	5.0	-
	Employment 3M/3M change 000s	Oct	**-16**	-75	-22	-
	Payrolled employees M/M change 000s	Nov	**-38**	-20	-32	-22
	Claimant count rate % (change 000s)	Nov	**4.4 (20.1)**	-	4.4 (29.0)	4.3 (-3.9)
	Preliminary services (manufacturing) PMI	Dec	**52.1 (51.2)**	51.6 (50.4)	51.3 (50.2)	-
	Preliminary composite PMI	Dec	**52.1**	51.6	51.2	-

Auctions

Country	Auction
UK	sold £4.25mn of 4.125% 2031 bonds at an average yield of 4.093%

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 headline (core) HICP Y/Y%	Nov	*2.1 (2.4)*	2.1 (2.4)
		10.00	Final labour costs Y/Y%	Q3	*3.5*	3.6
Germany		09.00	ifo business climate indicator	Dec	88.2	88.1
		09.00	ifo current assessment (expectations) indicator	Dec	85.8 (90.5)	85.6 (90.6)
UK		07.00	Headline (core) CPI Y/Y%	Nov	*3.5 (3.4)*	3.6 (3.4)
		07.00	PPI – output (input) prices Y/Y%	Nov	3.2 (0.6)	3.6 (0.5)
		09.30	House price index Y/Y%	Oct	-	2.6
		11.00	CBI industrial trends survey – total orders (selling prices) balance %	Dec	-35 (9)	-37 (7)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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