

Euro wrap-up

Overview

- Bunds made gains as German inflation declined further than expected in December, falling back to 2.0%Y/Y on the HICP measure.
- Gilts were also marginally higher as the final December UK services activity PMI was revised lower to suggest a lacklustre end to 2025.
- Wednesday will bring the flash euro area inflation estimates for December, and the latest data for German retail sales and jobless claims.

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 2 12/27	2.097	-0.025
OBL 2.2 10/30	2.424	-0.027
DBR 2.6 08/35	2.842	-0.026
UKT 3% 03/27	3.694	-0.013
UKT 4% 03/30	3.917	-0.018
UKT 4½ 03/35	4.484	-0.021

*Change from close as at 4:45pm GMT.
Source: Bloomberg

Euro area

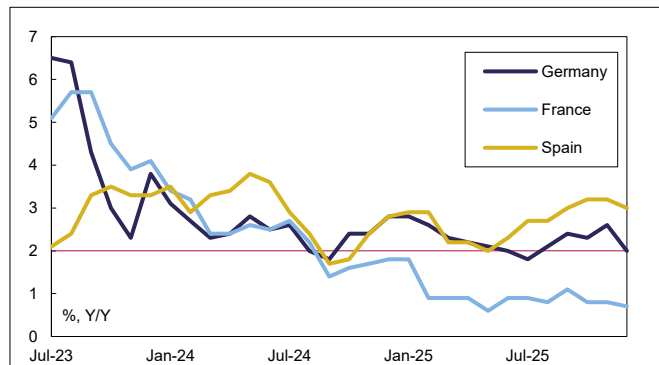
A broad-based moderation in German inflation back to 2.0% on the EU measure

As expected, the flash estimates of German and French inflation in December fell on the month, underscoring the likelihood that tomorrow's euro area figure will also be softer. Strikingly, German inflation declined further than expected, dropping on the EU-harmonised HICP rate by 0.6ppt, the most in 16 months, to a five-month low of 2.0%Y/Y. The detail published alongside the national CPI rate (which fell 0.5ppt to 1.8%Y/Y), as well as the figures from the states, suggest that the softening in inflation in December was relatively broad-based. As expected, energy led the way, with the respective CPI component down more than 1ppt to a four-month low (-1.3%Y/Y) thanks in part to lower petrol prices. In addition, food inflation maintained its downtrend, easing to an 11-month low (0.8%Y/Y), down 2ppts from May. While services inflation was steady at 3.5%Y/Y for a third successive month, our estimate of core goods inflation fell sharply to 0.7%Y/Y, the lowest since September 2024. So, the German core CPI rate fell 0.3ppt to 2.4%Y/Y, the lowest since June 2021. Moreover, the state data strongly suggest that services inflation on the EU-harmonised measure reversed the sharp rise in November (up 0.6ppt to 4.2%Y/Y), which was due to pressures in volatile vacation-related items such as package holidays and airfares. So, the German core HICP rate surely fell back too. That moderation bodes well for the coming year. Lower transmission grid fees and the abolition of the natural gas storage levy should weigh on energy inflation from January. And a cut to VAT on restaurant meals will soften somewhat the impact of the increase in the price 'Deutschlandticket' national public transport pass. So, notwithstanding the likelihood of continued volatility in holiday-related services, as for the euro area as a whole, we expect German HICP inflation to fall below 2.0%Y/Y on average in 2026.

French inflation falls further below 1% on energy price cuts

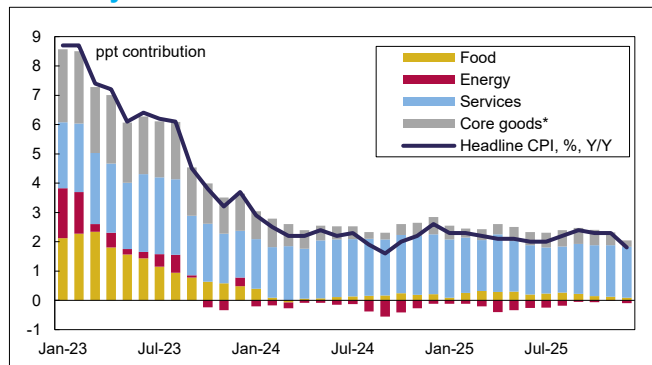
French inflation also fell in December, albeit only slightly, as the HICP rate edged down 0.1ppt to a seven-month low of just 0.7%Y/Y. The CPI measure similarly fell 0.1ppt, to 0.8%Y/Y. The detail on that national rate suggested that the softening in French inflation was due entirely to energy, as lower petrol prices pushed the component down more than 2ppts to a five-month low of -6.8%Y/Y. In contrast, French inflation of core goods (-0.4%Y/Y) and food (1.7%Y/Y) was a touch firmer, albeit still subdued. As services inflation was steady (2.2%Y/Y), French core CPI inflation appears to have inched up minimally from November's four-year low of 1.0%Y/Y. While French headline inflation will likely remain below 1%Y/Y in January, it will take a step up from February due to a base effect related to sharp cuts in regulated electricity prices a year earlier. But with underlying pressures absent, for a second successive year it should average less than 1½%Y/Y in 2026.

Euro area member states: Headline HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Contributions to CPI inflation



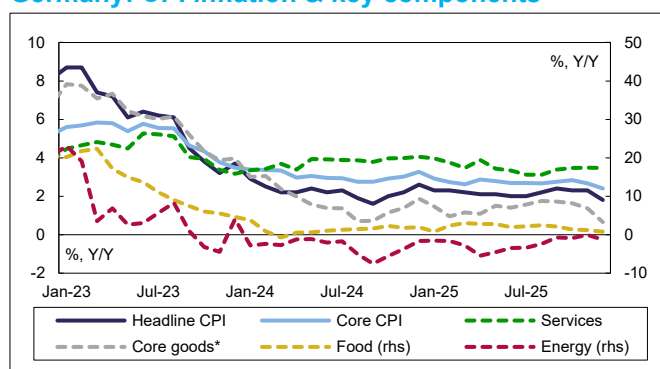
*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Final PMIs point to strengthening Spanish growth but softening in Italy towards year-end

There were no major surprises in the final December euro area PMIs. Due to the deterioration in the manufacturing survey, the composite output PMI was revised lower from the flash release, by 0.3pt to 51.5, a three-month low down more than 1pt from November. Admittedly, this followed six consecutive gains to leave the Q4 average (52.3) at the highest quarterly level for 2½ years and consistent with GDP growth of 0.3%Q/Q. Despite weakening into year-end, the survey continued to point to ongoing growth in services, for which the activity PMI (52.4) was broadly in line with the long-run average. Growth in that sector continues to be led by Spain, for which the respective index jumped 1.5pts to a 12-month high (57.1). Spanish services strength partially offset weakening elsewhere, particularly in Italy where the index dropped 3.5pts to 51.5. If today's survey is to be believed, ongoing expansion in German services (52.7) contrasted renewed stagnation in France (50.1). But we wouldn't read too much into the French PMIs, which often underestimate the vigour of economic activity. And other French national surveys point to another quarter of solid GDP growth in Q4. Conversely, the German composite PMI in Q4 (52.5) was the highest for 2½ years, while the ifo survey signalled limited improvement last quarter. Elsewhere, the Italian composite PMI implied that economic growth petered out at the end of 2025. But despite a weakening in manufacturing, the Spanish composite PMI ticked up ½pt in December to 55.6, the second highest reading this year. And the new business components point to ongoing Spanish outperformance into 2026 too, led by services.

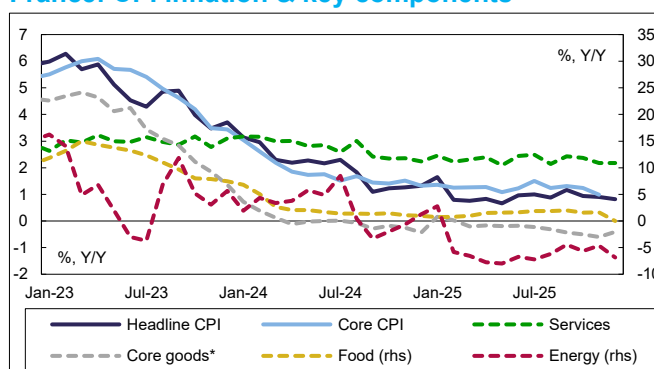
Germany: CPI inflation & key components



*Non-energy industrial goods.

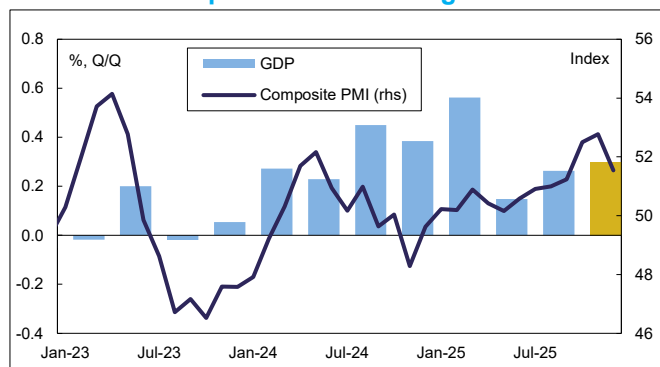
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: CPI inflation & key components



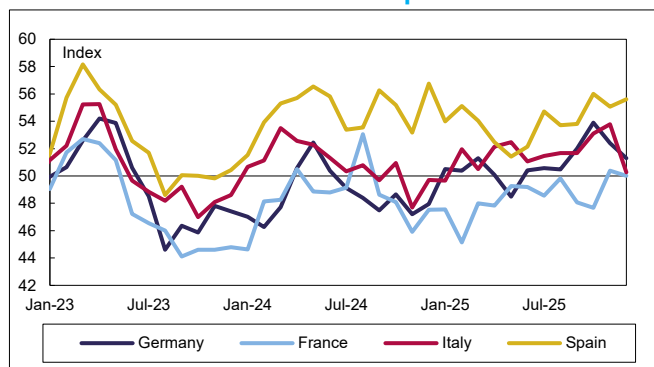
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMI & GDP growth*



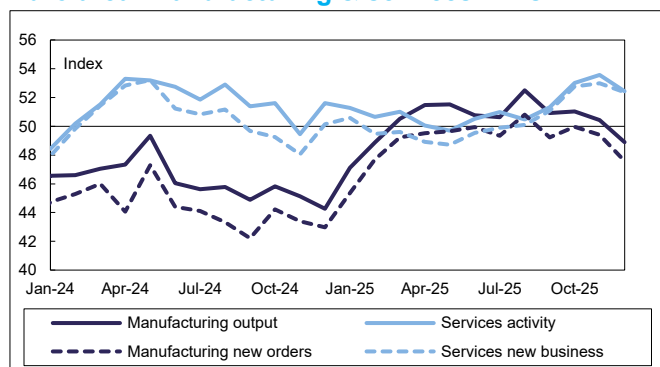
*Gold bar represents Daiwa forecast for Q4. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite PMIs



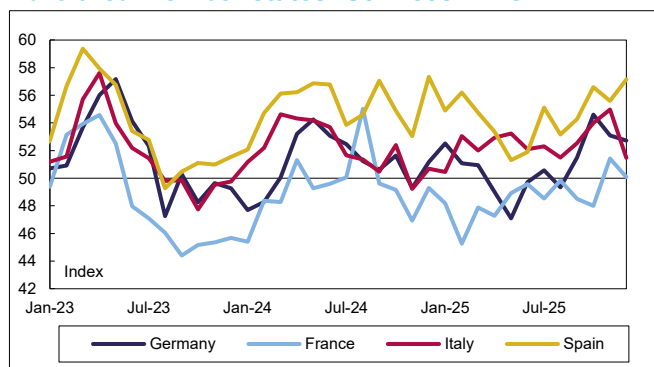
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing & services PMIs



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

Euro area member states: Services PMIs



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

The day ahead in the euro area

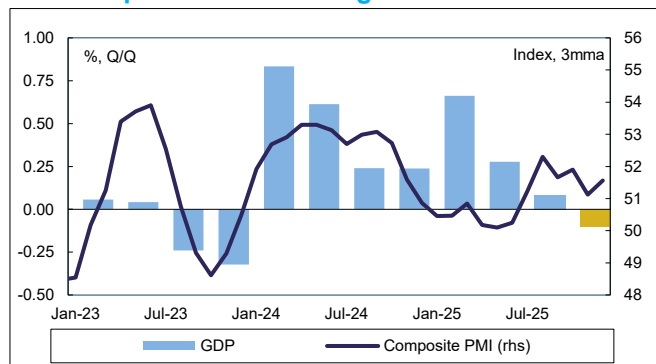
Consistent with today's weaker data from Germany and France, we expect Wednesday's preliminary inflation estimates for the euro area as a whole to confirm an easing of price pressures towards year-end. In line with the Bloomberg survey consensus, we expect headline inflation to edge down by 0.1ppt to 2.0%Y/Y in December, the lowest since August and bang in line with the ECB's inflation target. The drop will owe primarily to a more pronounced drag from energy and in particular lower petrol prices. Core inflation, by contrast, probably moved sideways at 2.4%Y/Y, even as pressure in volatile services categories eased in Germany last month. Nevertheless, given the downside surprise in today's German figures, we see a non-negligible risk that both headline and core euro area rates will slightly undershoot our forecasts. Besides the inflation data, Wednesday will also bring a handful of consequential releases from the member states, including German retail sales data for November. Given the positive revisions to that series over the prior two months (marked up by 0.2ppt and 0.4ppt respectively), it seems likely that these figures will point towards a return to positive German retail sales and private consumption growth in Q4. Consistent with today's employment PMIs, jobless claims in Germany in December are likely to have been broadly stable too. The euro area construction PMIs will provide an update on activity in that sector while France's December INSEE consumer confidence survey results are also due.

UK

Final services PMI point to lacklustre end to 2025, but a potential pickup at the start of 2026

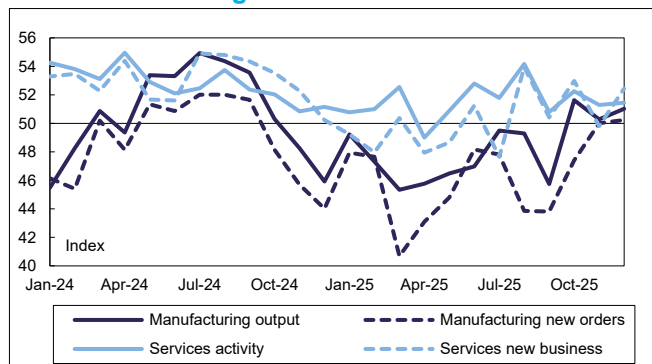
As we expected, the final UK services PMIs brought a more sizeable downwards revision than in the euro area, with the activity index cut from the flash release by 0.7pt to 51.4. This left it little changed from November, but slightly lower than the average in the second half of the year and well below the long-run average (54.2), suggesting lacklustre growth in the sector over the festive period. Given also a weaker outturn in the manufacturing sector, the downwards revision to the composite output PMI (51.4) similarly represented little improvement from November. So, over the fourth quarter, the composite index (51.6) was a touch below the Q3 outturn, and a level that before the pandemic would have been consistent with a very modest contraction, in line with our forecast for GDP growth in Q4 (-0.1%Q/Q). Against this backdrop, the employment component unsurprisingly signalled further cuts to headcount across both the manufacturing and services subsectors. But today's survey results were not all doom and gloom. The services new business index (52.4) pointed to a pickup in demand, supported in part by an improvement in export sales to the US, which reportedly pushed backlogs in the sector to the highest since April 2023. New factory orders also reportedly stabilised at the end of last year as the decline in overseas sales was the softest for 17 months. So, notwithstanding ongoing downside risks from domestic politics and geopolitics, UK firms overall judged the outlook for output over the coming twelve months to be the most favourable since October 2024.

UK: Composite PMI & GDP growth*



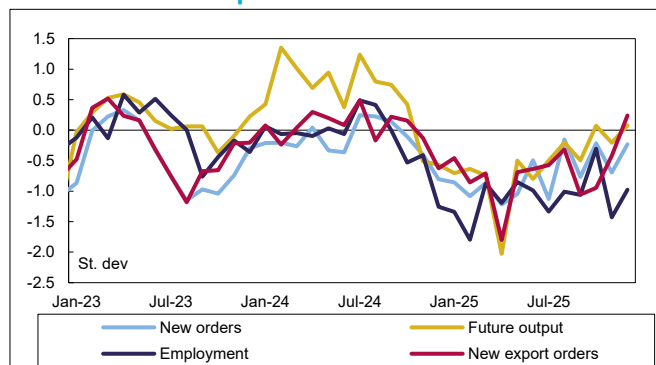
*Gold bar represents Daiwa forecast for Q4. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing & services PMIs



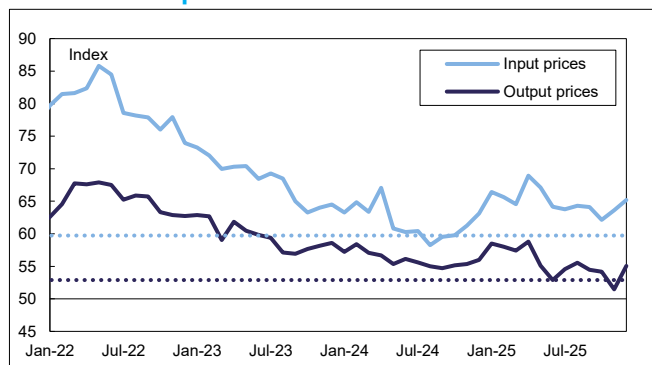
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected composite PMIs



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

UK: Services price PMIs*



*Dotted lines represent long-run average. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

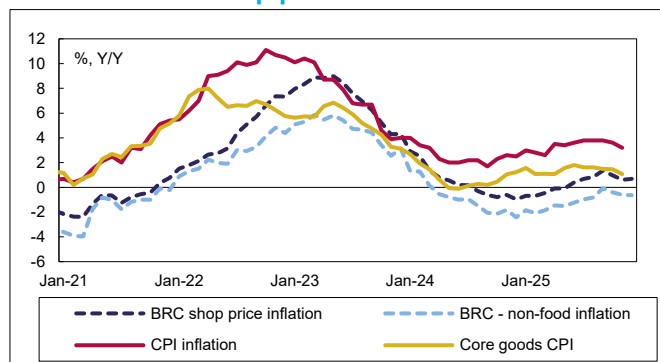
Service price PMIs jump in December, but shop price inflation remains subdued on BRC measure

In terms of inflation, today's UK PMIs were at face value less encouraging. Due to rising wages and higher fuel costs, services firms suggested that cost burdens in December were the highest since May. And despite subdued demand, output prices in the sector were reportedly increased last month by the most since August and by more than the flash release implied. But having in November signalled the softest inflation since 2020, the average composite output price index in Q4 (53.2) was still the lowest for five years and in line with the long-run average. Moreover, pricing powers in the factory sector clearly remain limited. Indeed, today's BRC shop price monitor suggested that prices on the High Street rose only very slightly in December (0.1%M/M) after falling in October and November. Further discounting of certain goods – such as toys, books and electrical items – was offset by a moderate rise in fresh food prices. But while the BRC's measure of food price inflation increased 0.3ppt to 3.3%Y/Y, it remained almost 1ppt below the peak this summer and ½ppt below the average of the past six months. Moreover, with non-food price inflation remaining in negative territory (-0.6%Y/Y) for a 21st successive month, the BRC's measure of shop price inflation remained very weak, up just 0.1ppt to 0.7%Y/Y.

The day ahead in the UK

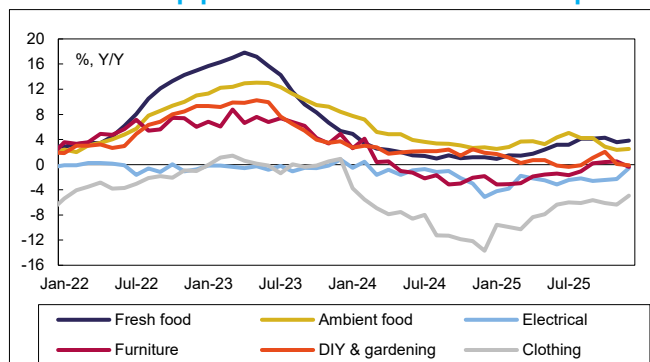
December's construction PMIs will provide the sole UK economic data release of note tomorrow. And, as it has implied throughout last year, that seems bound to signal an ongoing contraction in activity for the sector. That said, to the extent that November's exceptional weakness is likely to have been exaggerated by pre-Budget caution and much wetter weather, we do expect the implied pace of contraction to be more modest. But, at 39.4 (down 4.7pts on the month), November's construction PMI implied the steepest drop in output in the sector with the exception of the pandemic and GFC aftermath in 2009, with the civil engineering subsector (30.0) in particular reporting its worst month on record outside of the first Covid lockdown.

UK: CPI & BRC shop price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: BRC shop price inflation – selected components













Source: Macrobond and Daiwa Capital Markets Europe Ltd.


European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Final composite (services) PMI	Dec	51.5 (52.4)	<u>51.9 (52.6)</u>	52.8 (53.6)	-
Germany	 Preliminary HICP (CPI) Y/Y%	Dec	2.0 (1.8)	2.2 (2.1)	2.6 (2.3)	-
	 Final composite (services) PMI	Dec	51.3 (52.7)	<u>51.5 (52.6)</u>	52.4 (53.1)	-
France	 Preliminary HICP (CPI) Y/Y%	Dec	0.7 (0.8)	0.7 (0.9)	0.8 (0.9)	-
	 Final composite (services) PMI	Dec	50.0 (50.1)	<u>50.1 (50.2)</u>	52.4 (53.1)	-
Italy	 Composite (services) PMI	Dec	50.3 (51.5)	53.0 (54.1)	53.8 (55.0)	-
Spain	 Composite (services) PMI	Dec	55.6 (57.1)	54.3 (54.8)	55.1 (55.6)	-
UK	 Final composite (services) PMI	Dec	51.4 (51.4)	<u>52.1 (52.1)</u>	51.2 (51.3)	-
	 BRC shop price index Y/Y%	Dec	0.7	0.6	0.6	-
	 New car registrations Y/Y%	Dec	3.9	-	-1.6	-











Auctions

Country	Auction
Germany	 sold €4.547bn of 2% 2027 bonds at an average yield of 2.11%



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	 08.30	Construction PMI	Dec	-	45.4
	 10.00	Preliminary headline (core) HICP Y/Y%	Dec	<u>2.0 (2.4)</u>	2.1 (2.4)
Germany	 07.00	Retail sales M/M% (Y/Y%)	Nov	0.2 (0.1)	0.1 (1.8)
	 08.30	Construction PMI	Dec	-	45.2
	 08.55	Unemployment change 000s (claims rate %)	Dec	6.3 (5)	6.3 (1)
France	 07.45	INSEE consumer confidence indicator	Dec	90	89
	 08.30	Construction PMI	Dec	-	43.6
Italy	 08.30	Construction PMI	Dec	-	48.2
	 10.00	Preliminary HICP (CPI) Y/Y%	Dec	1.2 (1.2)	1.1 (1.1)
UK	 09.30	Construction PMI	Dec	42.3	39.4

Auctions and events

Germany	 10.30	Auction: to sell up to €6bn of 2036 bonds
UK	 10.00	Auction: to sell £4.25bn of 4.125% 2031 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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