Euro wrap-up

Overview

- Bunds made further gains as euro area inflation returned to target and German retail sales data disappointed.
- Gilts outperformed while the UK construction PMIs implied a marked decline in activity in the sector in Q4.
- Thursday will bring data on German factory orders and euro area unemployment, as well as the latest Commission economic sentiment indices and the BoE DMP survey.

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Daily bond market movements

Bond	Yield	Change
BKO 2 12/27	2.082	-0.015
OBL 2.2 10/30	2.390	-0.032
DBR 2.6 08/35	2.806	-0.034
UKT 3¾ 03/27	3.660	-0.028
UKT 4⅜ 03/30	3.851	-0.062
UKT 4½ 03/35	4.408	-0.071

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

Euro area

Inflation back on target on falling energy prices & moderating core pressures

As expected, euro area inflation eased back to the ECB's 2.0%Y/Y target in December, edging down 0.1ppt to mark a four-month low. But rounding to one decimal place understated the extent of the moderation, with the decline of 18bps to 1.96%Y/Y the steepest in seven months. And the monthly change in prices was below the long-run average for each major category, underscoring the soft tone of today's data. Lower prices of auto fuel pushed the energy component down almost 1½ppts to -1.9%Y/Y. But due to higher prices of unprocessed items and a subdued December a year earlier, inflation of food, alcohol and tobacco edged up to a three-month high (2.6%Y/Y). More importantly, as the temporary upswing in vacation-related items (particularly package holidays) the prior month reversed, services inflation edged down 0.1ppt to 3.4%Y/Y. And with prices down for a second successive month, inflation of non-energy industrial goods slowed to a 15-month low of just 0.4%Y/Y. So, core inflation also edged down by 0.1ppt to 2.3%Y/Y, matching the lowest level since January 2022.

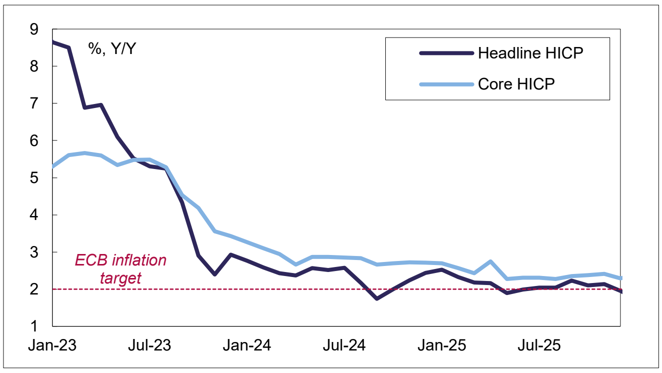
Services disinflation still very slow, but core goods & food momentum weaker

Today's figures were broadly consistent with the ECB's updated projections published last month and underscored the likelihood that inflation will move below target from January. Indeed, inflation momentum on both a three-month and six-month basis fell back below an annualised rate of 2% in December. And the impacts of tariff-related trade diversion, Chinese excess production and the strong euro exchange rate appear to be weighing on goods prices a little more than previously anticipated. Indeed, core goods inflation on a three-month basis shifted into negative territory in December for the first time since 2020. Notably too given its apparent role in shaping price expectations, food inflation momentum on the same basis fell below target for the first time in 17 months. And while the disinflation trend in services remains only gradual, it should continue over coming quarters in response to moderating labour costs.

Inflation to fall below target in Q1 & probably slightly undershoot ECB projection too

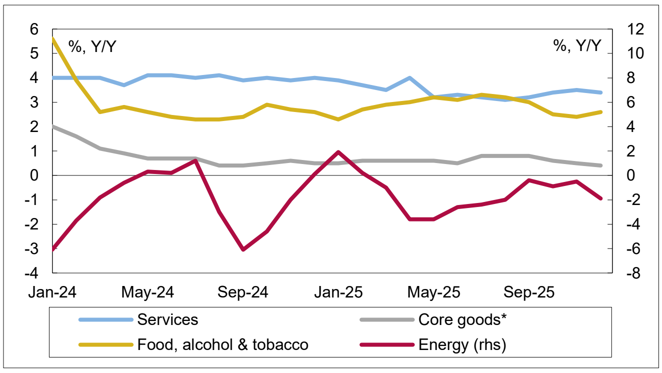
In the large member states, the inflation trends appear benign too. In Germany, cuts to electricity transmission grid fees and lower VAT on restaurants should more than offset the impact of higher national public transport prices, similarly pushing inflation below 2%Y/Y this month. With demand still tepid, inflation will remain well below target in France and Italy this year despite less favourable base effects related to regulated energy prices in the former. And despite ongoing robust expansion, softer energy and food components should allow Spanish inflation to moderate below 3%Y/Y from the New Year. Overall, we expect euro area headline inflation to average 1.7%Y/Y in Q1 and the same rate over 2026 and 2027. That would slightly undershoot the ECB's projection. But in the absence of a new negative shock to economic activity, it would not prompt a further rate cut, not least as the return of inflation to target in 2028 would still be expected.

Euro area: Headline & core HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key HICP inflation components



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

German retail sales disappoint in November but remain on track for modest growth in Q4

In terms of economic activity, at first glance today's German retail data for November disappointed, with sales declining 0.6%M/M, the most in 17 months. But given further upward revisions to the outturns for prior months – taking cumulative growth over September and October to almost 1% – retail sales were still trending some ¼% above the Q3 average. So, while December's retail sales data are notoriously volatile and often significantly revised, today's release provides cause for cautious optimism that private consumption provided modest support to German GDP growth last quarter. Within the detail, the weakness in November was led by food-store sales (-1.9%M/M), reversing a similar rise in October to be still trending some 1% above the Q3 average. And while a negative carryover from a drop over the summer left non-food sales tracking marginally below the Q3 level, they nevertheless rose for a third consecutive month in November (0.3%M/M) hinting at a tentative recovery in discretionary spending. Admittedly, the ifo survey suggested that retailers were dissatisfied by Christmas sales, with weakness in a range of categories including clothing, computers and food. But new car registrations were more positive at year-end (10%Y/Y). And while consumer confidence edged lower at the turn of the year, household willingness to spend remained close to the top of the range of the past few years, supported in part by strong wage growth.

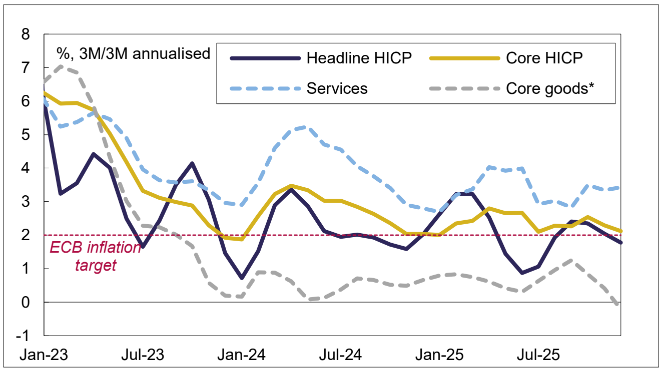
German labour market continues to stabilise as unemployment fears in France ease

Another reason to be cautiously optimistic about the outlook for German consumption relates to signs of stabilisation in the jobs market. Admittedly, the number of jobless claims edged slightly higher in December (3k). But this left the cumulative rise over the past six months at less than 10k, compared with the rise of around 75k in the previous six months and 170k in 2024. Furthermore, the Federal Employment Agency's measure of the unemployment rate moved sideways at 6.3% for a tenth month. And with the number of job vacancies up to a seven-month high in December, we expect to see employment start to gradually pick up this year. According to today's INSEE survey, French households' fears about unemployment eased in December to a 13-month low, tallying with the recent uptrend in firms' employment intentions. So, while savings intentions reached a record high last month, the share of consumers considering it a good time to purchase big-ticket items rose to the highest since August, perhaps one reason why French retail sentiment also improved markedly at the end of last year. Of course, the Spanish labour market continues to respond in a predictable way to strong economic growth. Unemployment fell in December to a whisker above 2.4mn, the lowest level in more than 17 years. Spain accounted for about two-thirds of all employment growth in the euro area in the first three quarters of 2025. And that trend is likely to continue into 2026 too.

Construction PMI up to 34-month high amid boost from housebuilders & German civil engineering

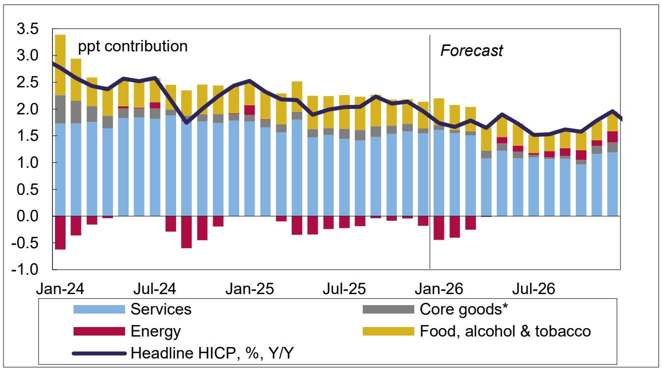
Although the final euro area manufacturing and [services PMIs](#) finished the year on a slightly less upbeat note, their trend over Q4 remained consistent with a further slight acceleration in growth momentum at the end of last year, and thereby

Euro area: Inflation momentum



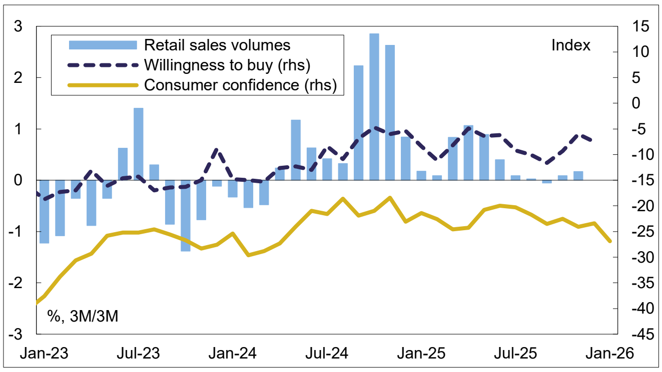
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to headline HICP inflation



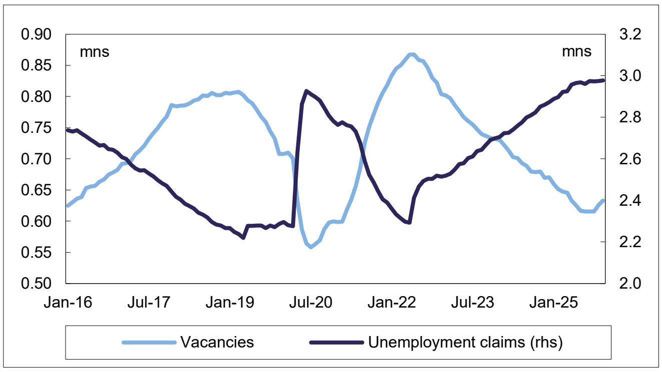
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Retail sales & consumer confidence



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Unemployment claims & job vacancies



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

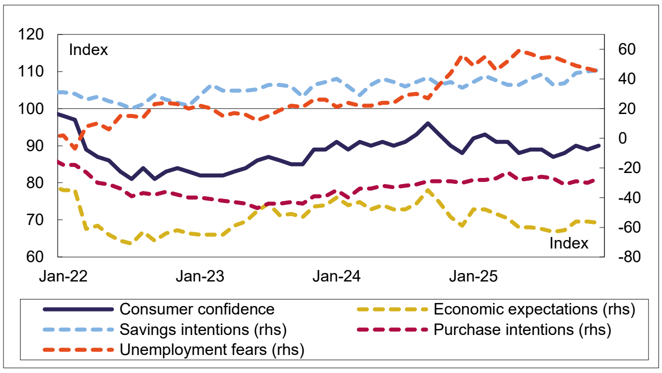
supportive of the improving growth outlook for 2026. Expectations that a boost to public infrastructure investment in Germany, though not the standalone, have been among the key drivers of that narrative, even as evidence of a pickup in construction output has so far been limited. Today's construction PMIs, however, offered greater encouragement. Indeed, the headline euro area construction activity PMI picked up a full 2pts to a 34-month high of 47.4, back above the long-run average. At the member state level, the increase was led by Germany, where the headline activity index rose a chunkier 5.1pts to exceed the 50 threshold for just the first month since the energy price spike some 45-months ago. Contrasting with the relatively muted response of other surveys, the civil engineering index rose 5.2pts to 57.5 – marking a fifth month of expansion in seven and the best since March 2011 – to suggest that fiscal loosening is starting to feed through to activity.

Regrettably, a sharp decline in the civil engineering PMI in France to a ten-month low more than offset the effects of the boost in Germany to the aggregate euro area series. So, at the sub-sectoral level, the increase in activity in the euro area principally owed to housebuilders, for which the respective PMI rose 6.6pts to 46.8. While housebuilding in Italy slipped to a 17-month low (45.0), the index jumped sharply in France (46.6) and particularly so in Germany (48.2). In the latter case, that raised the housebuilders' PMI above its long-run average for the first time in 2½ years. In some ways, that improvement seems overdue. Just as the ECB's hiking cycle inevitably weighed on house prices in many member states, the cumulative effects of policy loosening have begun to support their recovery. Indeed, German house price growth rose to 3.3%Y/Y taking the average level to its highest in almost three years. And while admittedly still subdued, building permits for residential housebuilding have started to resume an uptrend, which bodes well for a more sustained recovery in activity further ahead.

The day ahead in the euro area

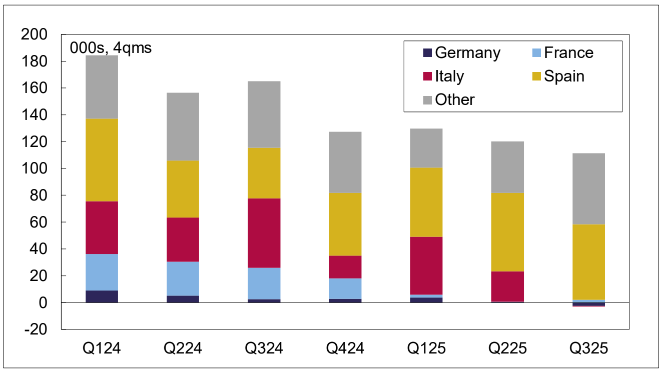
In terms of activity data, Thursday's releases focus on the factory sector. German manufacturing orders figures should remain consistent with a return to growth in Q425. But having risen 3.5% over the previous two months, we expect some payback in November, with an expected drop of about 1%M/M. France's goods trade figures, also due, should report a pickup in exports and imports. But as the improved trade balance in October reflected a particularly weak month for imports, we expect the deficit to widen on payback. In terms of surveys, the Commission's economic sentiment indicators for December will provide a cross-check on Tuesday's final PMIs. Despite the rise in French consumer confidence today, the 20-month low in German sentiment suggests that the Commission's final euro area figure will confirm a first monthly decline in four to a three-month low. Finally, tallying with the softness in core goods inflation in December, factory price inflation is likely to have slipped further into negative territory in November, beyond -1½%Y/Y, owing primarily to favourable energy base effects but with an absence of pressure in other categories. Finally, as with today's German claimant count rate, the euro area unemployment rate is expected to remain steady in November at 6.4%, just 20bps above the series low.

France: Consumer confidence indices



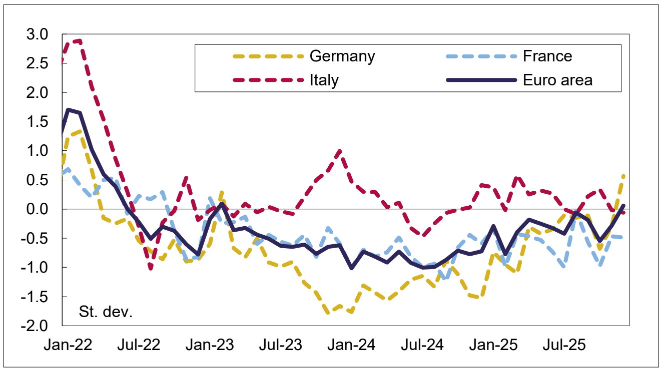
Source: INSEE, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contribution to change in employment



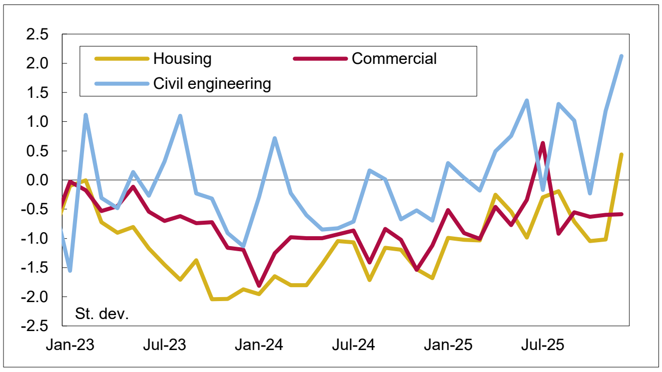
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction activity PMIs by country



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

Germany: Selected construction PMIs



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

UK

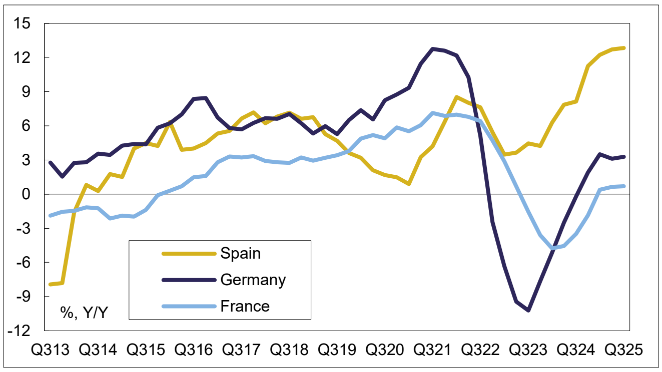
UK construction PMI slumped in Q4, but firms somewhat more upbeat about outlook in 2026

Contrasting the improvement in the equivalent euro area survey, today's UK construction PMIs disappointed as the uncertainty surrounding the government's Budget announcements seemingly continued to weigh on the sector. Indeed, while the headline activity PMI edged slightly higher in December, to 40.1, that represented the second lowest level since May 2020. And as a result, the quarterly average fell more than 4pts in Q4, strongly suggesting that the sector was a drag on GDP growth last quarter. The modest improvement in December related to civil engineering, for which the respective index rose almost 3pts to 32.9, albeit remaining firmly in contractionary territory. In contrast, the commercial and housebuilding indices fell to the lowest levels since 2019 and the Global Financial Crisis respectively outside of the initial Covid lockdown. While part of the weakness likely relates to wet weather conditions as Storm Bram hit in the first half of the month, today's survey also suggested ongoing lacklustre demand, with the new orders component (42.0) the second weakest in more than five years. This notwithstanding, constructors judged the 12-month outlook to be the most favourable for five months, with infrastructure projects, including in the utilities sector, lower interest rates and expectations of a broader recovery in economic growth to provide a boost.

The day ahead in the UK

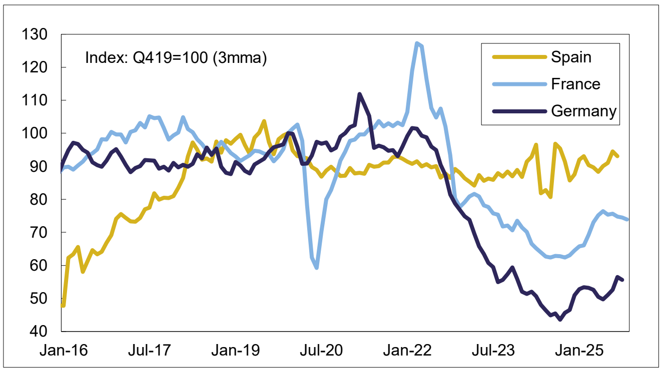
December's update to the BoE's Decision Maker Panel survey will be the economic data highlight in the UK on Thursday. As reflected by the minutes of December's monetary policy meeting, the MPC continues to place significant weight on the survey. Indeed, a majority of those who voted to hold rates explicitly cited the survey in their accompanying statements, while Deputy Governors Ramsden and Breeden (who voted to cut) expressed more caution about the still-elevated forward-looking wage indicators. While we might speculate that the downside surprise in November's CPI report could relieve some pressure on firms' inflation expectations, a downshift in expected wage growth seems less likely, not least given further significant hikes in minimum wages to come. We note too that December's final PMIs imply a risk of some stubbornness in the DMP output price expectations measures. As such, we expect only gradual softening in the surveys forward-looking indicators, supporting our view that the BoE won't look to cut rates again until Spring.

Euro member states: House price growth



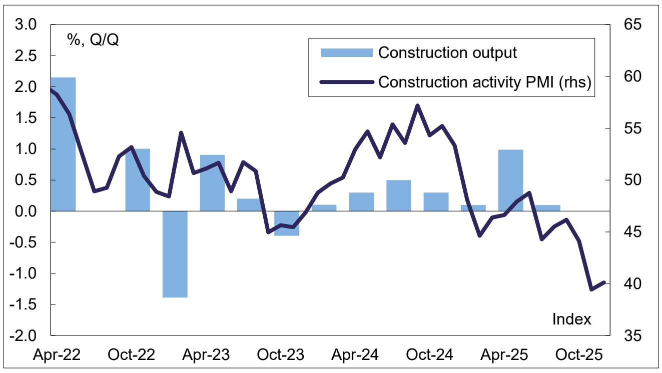
Source: National statistics agencies, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro member states: Residential building permits



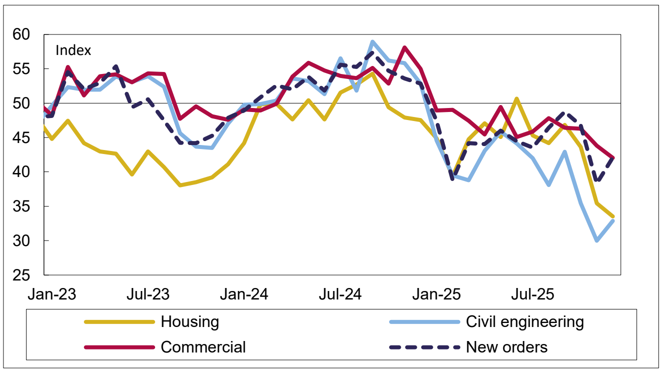
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Construction output & activity PMI



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

UK: Selected construction PMIs



Source: S&P Global, 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		Preliminary headline (core) HICP Y/Y%	Dec	**2.0 (2.3)**	*2.0 (2.4)*	2.1 (2.4)	-
		Construction PMI	Dec	**47.4**	-	45.4	-
Germany		Retail sales M/M% (Y/Y%)	Nov	**-0.6 (-1.8)**	0.2 (0.1)	-0.3 (1.3)	0.3 (2.1)
		Unemployment change 000s (claims rate %)	Dec	**6.3 (3)**	6.3 (5)	6.3 (1)	-
		Construction PMI	Dec	**50.3**	-	45.2	-
France		INSEE consumer confidence indicator	Dec	**90**	90	89	-
		Construction PMI	Dec	**43.4**	-	43.6	-
Italy		Preliminary HICP (CPI) Y/Y%	Dec	**1.2 (1.2)**	1.2 (1.2)	1.1 (1.1)	-
		Construction PMI	Dec	**47.9**	-	48.2	-
UK		Construction PMI	Dec	**40.1**	42.3	39.4	-

Auctions

Country		Auction
Germany		sold €4.542bn of 2.9% 2046 bonds at an average yield of 2.83%
UK		sold £4.25bn of 4.125% 2031 bonds at an average yield of 3.98%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	ECB consumer survey – 1Y (3Y) ahead CPI expectations Y/Y%	Nov	2.7 (2.5)	2.8 (2.5)
		10.00	Commission economic sentiment indicator	Dec	97.1	97.0
		10.00	Commission services (industrial) confidence indicator	Dec	6.0 (-9.1)	5.7 (-9.3)
		10.00	Final Commission consumer confidence indicator	Dec	*-14.6*	-14.2
		10.00	Unemployment rate %	Nov	6.4	6.4
		10.00	PPI Y/Y%	Nov	-1.7	-0.5
Germany		07.00	Factory orders M/M% (Y/Y%)	Nov	-1.0 (2.9)	1.5 (-0.7)
France		07.45	Trade balance €bn	Nov	-	-3.9
UK		09.30	DMP 3M output price (1Y CPI) expectations Y/Y%	Dec	3.6 (3.3)	3.7 (3.4)

Auctions and events

Country		GMT	Event
France		09.50	Auction: to sell up to €13.5bn of 3% 2035, 0.5% 2040, 3.6% 2042 & 3.75% 2056 bonds
Spain		09.30	Auction: to sell 2.7% 2030, 3% 2033, 3.45% 2043 bonds & 1.15% 2036 inflation-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.