

Euro wrap-up

Overview

- Bunds made further losses as wholesale energy prices again rose sharply and euro area inflation surprised to the upside in February.
- Gilts underperformed even as the UK DMO reduced its planned issuance for the next fiscal year and lowered the share of longer-dated bond sales.
- Wednesday will bring euro area unemployment and producer price inflation data for January, as well as the final European services PMIs for February.

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Daily bond market movements

Bond	Yield	Change
BKO 2.1 03/28	2.145	+0.064
OBL 2½ 04/31	2.376	+0.053
DBR 2.9 02/36	2.750	+0.040
UKT 4% 03/28	3.727	+0.094
UKT 4½ 03/31	3.956	+0.084
UKT 4¾ 10/35	4.469	+0.097

*Change from close as at 5.00pm GMT.

Source: Bloomberg

Euro area

Upside inflation surprise & spike in energy prices put ECB rate hike on the table this year

As the ECB continues to monitor the impact of the escalation in the Middle East, Chief Economist Lane in an interview with the FT was careful not to jump to conclusions, emphasising that the economic impact will depend on the breadth and duration of the conflict. Other Governing Council members have also cautioned against a rash policy response. But having been scarred by the sharp and lasting rise in inflation after the Russian invasion of Ukraine, and given the likely non-linear impact of such a marked increase in energy prices and concerns about a durable impact on inflation expectations, Lane's overall comments suggested that the ECB will likely place greater weight on the new upside risks to inflation than the downside risks to economic output. And with Brent crude up more than 15% cumulatively in euro terms and the benchmark Netherlands gas futures contract roughly two-thirds above Friday's close, market pricing for the ECB's deposit rate has swung from a roughly 50% chance of a cut this year to a non-negligible chance of a hike.

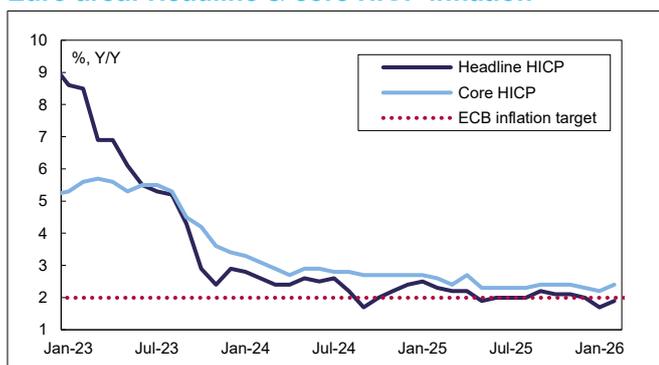
Services inflation boosted by temporary factors

Even before the outbreak of the Iran war, euro area headline inflation unexpectedly rose in February, by 0.2ppt to 1.9%Y/Y. This partly reflected a jump in French inflation due to an unfavourable energy base effect. But today's data also showed that Italian headline inflation rose 0.6ppt to 1.6%Y/Y, with the core rate (excluding energy and unprocessed food) up 0.8ppt to 2.7%Y/Y, a two-year high. This seemingly related to a (likely temporary) impulse from Italian hospitality as firms profited from the Winter Olympics. Indeed, inflation of restaurants and accommodation in Italy leapt 2.6ppts to 6.1%Y/Y, the most since October 2023. Admittedly, overall, euro area services inflation rose just 0.2ppt to 3.4%Y/Y, no stronger than the average of the past year. And while it was the highest in five months, non-energy goods inflation (0.7%Y/Y) remained relatively subdued. Nevertheless, euro area core inflation increased 0.2ppt to 2.4%Y/Y, the joint-strongest rate in ten months.

Near-term inflation outlook risks skewed significantly to the upside

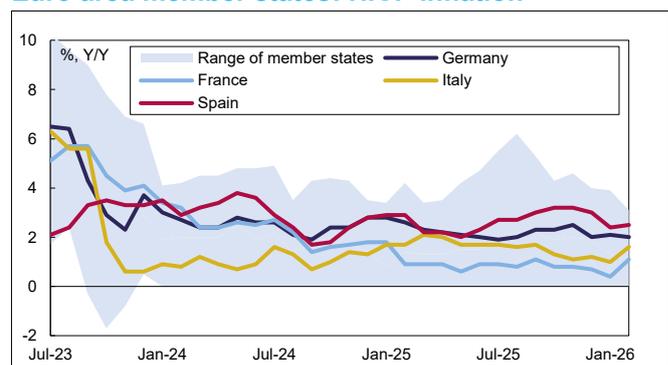
More encouragingly, the ECB's seasonally adjusted data suggested that core momentum on a three-month basis was fully consistent with the 2.0% target. And we continue to expect core inflation to ease as the Olympic effect unwinds and more favourable services base effects in April. But the energy shock – and potential second-round effects – will be the key consideration for the Governing Council at its policy-setting meeting on 19 March. Updated macroeconomic projections would normally guide the policy decision at this meeting. But the conventional cut-off period for rates and commodity prices to be used in the assumptions was mid-February. As in March 2022 after the Russian invasion, the ECB might choose to apply more timely pricing in its assumptions. Either way, at the March meeting at least, the Governing Council will likely keep policy unchanged, albeit acknowledging a substantial rise in uncertainties and a possible hint of a rate hike in due course.

Euro area: Headline & core HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

A handful of notable economic data releases are slated for the euro area on Wednesday. While recent events will take their toll on growth momentum, the final euro area composite and services PMIs for February should confirm signals from the flash estimates that private sector activity in the region picked up last month. However, the 0.6pt increase in the flash composite output PMI (51.9) was led by manufacturing, whose final PMIs on Monday reaffirmed a stronger month for the sector. In contrast, the services activity PMI (51.8) failed to benefit significantly from improvement in Germany (53.4) and France (49.6), suggesting that momentum in Southern Europe was less firm. Nevertheless, timely labour market numbers from Spain today suggested that the region's jobs engine continued to motor last month. And we expect the euro area unemployment rate to have remained around the series low of 6.2% in January. Meanwhile, at the risk of being drawn into a false sense of security, euro area PPI data will show that pipeline price pressures were negligible in January. Finally, updated estimates of Italian Q4 GDP will provide insights on the drivers of the acceleration in growth (0.3%Q/Q) flagged at year-end.

UK

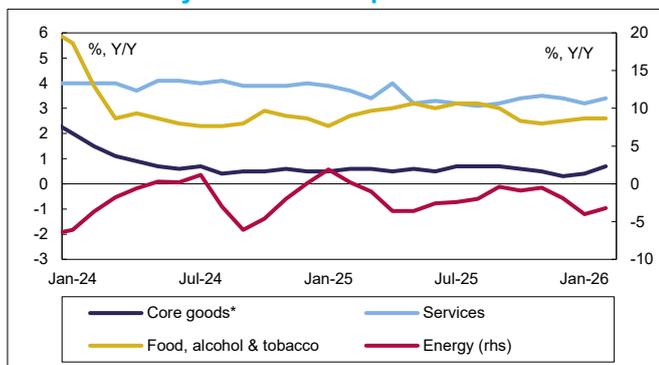
Spring Statement yields no surprises, although market moves risk leaving new projections defunct

As expected, today's Spring Statement was largely uneventful. With few new policy announcements, the Chancellor's speech amounted mostly to a stocktake on the state of the public finances, backed by updated projections from the fiscal watchdog and accompanied by the DMO's plan for gilt issuance for the coming fiscal year. As the OBR's last outlook report was published just a little over three months ago, those forecasts were little changed. In part reflecting the weakness of activity in the latter half of last year and recent data flagging additional loosening in the labour market, the OBR's forecast for full-year GDP growth in 2026 was marked down to 1.1%Y/Y, 0.3ppt below November's forecast. But with growth nudged higher in 2027 and 2028 (to 1.6%Y/Y), the medium-term profile was broadly the same. A faster deceleration in wage growth was also expected to bear down on near-term inflation, bringing the CPI rate down to 2.3%Y/Y this year and remaining at target thereafter. Of course, given that the assumptions for the forecasts were set in mid-late January, recent moves in wholesale energy prices, if sustained, would pose a massive risk to those projections. And this week's sell-off in Gilts would also have implications for the Government's fiscal projections.

Gilt issuance to fall over £50bn in FY26/7, with the DMO still favouring the short end of the curve

On the bright side, last month's Gilt rally means that the rise in yields represents a lesser threat to the OBR's assumptions than otherwise would have been the case. And, overall, the fiscal projections were more favourable. The OBR revised up its

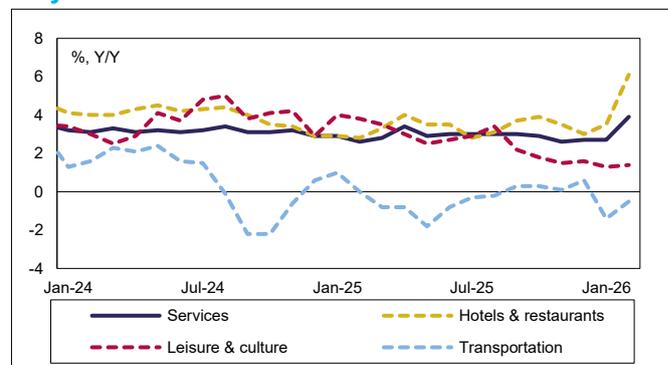
Euro area: Key inflation components



*Non-energy industrial goods.

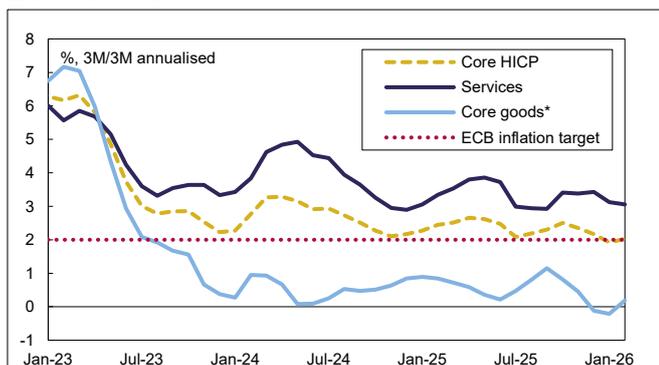
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Italy: Selected services inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

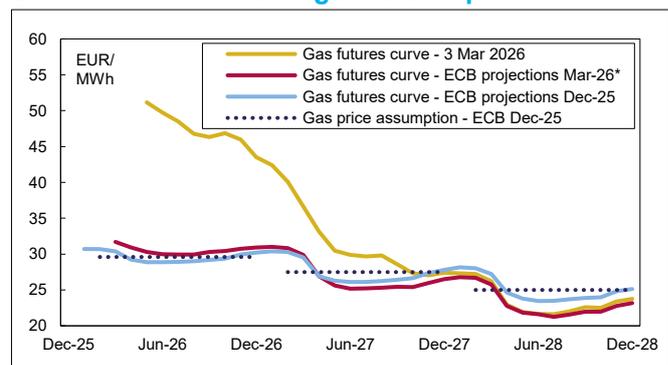
Euro area: Core inflation momentum



*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Netherlands gas futures price



*Under conventional cut-off period for ECB's commodity price assumptions.

Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

assessment of the Chancellor’s ‘headroom’ – which relates to the Government’s pledge to run a current budget surplus at the end of the Parliament – by almost £2bn, to £23.6bn. Following a record monthly surplus in the latest round of public sector finance figures, the OBR now expects public sector net borrowing (PSNB) in FY25/6 to be £5.5bn less than assumed at the November Budget, equivalent to 4.3% of GDP. Lower GDP growth means that borrowing for FY26/7 was revised marginally higher. But it was revised lower in each subsequent year, and higher tax receipts are still expected to bring PSNB down to 3.6% of GDP in FY26/7, before falling to 2.9% in FY27/8 and 1.8% in FY29/30. Following that lower borrowing forecast, public sector debt metrics were also revised down across the forecast period. And given the projected decline in borrowing, the DMO’s gross financing remit for FY26/7 was cut to a three-year low. As we had expected, that translated to a reduction in planned gilt sales for the coming fiscal year of a little over £50bn, for a total of £252.1bn. In terms of maturity, the DMO’s plan continued to reflect a skew towards greater issuance in short- and medium-term buckets amid prevailing questions about investors’ appetite for longer-term debt. As it did last year, however, the DMO also left a not-insignificant share of its planned issuance unallocated (~12%).

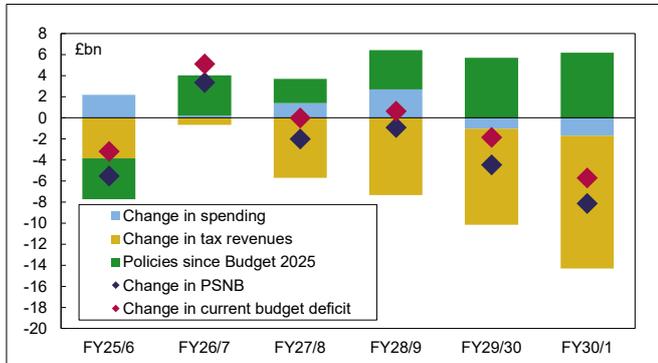
Discounting subdued shop price inflation in February but energy shock to add pressure ahead

While the escalating conflict in the Middle East and surge in wholesale energy prices pose big upside risks to the near-term inflation outlook, today’s BRC monitor suggested that underlying goods price pressures in February remained muted by soft demand and intense competition on the high street. Admittedly, the jump in January to a near-two-year high of 1.5%Y/Y had raised some concerns about a pickup in core goods price pressures. But a normalisation in retail prices in February saw shop price inflation moderate to just 1.1%Y/Y, above the average of the past two years (0.3%Y/Y) but still well below the peak of 9%Y/Y in mid-2023. Food prices were better behaved last month in line with the steady downtrend in wholesale cost inflation, which pushed the respective annual rate down 0.4ppt to 3.5%Y/Y, with ambient food inflation to the lowest for four years. Widespread discounting across health, beauty and fashion and smaller price increases in furniture and electrical products compared with a year earlier helped push non-food inflation back slightly into negative territory (-0.1%Y/Y). But the near-term price outlook is now in a state flux. While soft demand might somewhat restrain the ability of firms to maintain margins, the magnitude of the energy price shock means that suppliers and retailers might have no alternative to passing on a share of their increased costs to customers in due course. Crop damage from recent inclement weather across Europe, as well as higher energy input costs, might add a further upwards impulse to fresh food prices too.

The day ahead in the UK

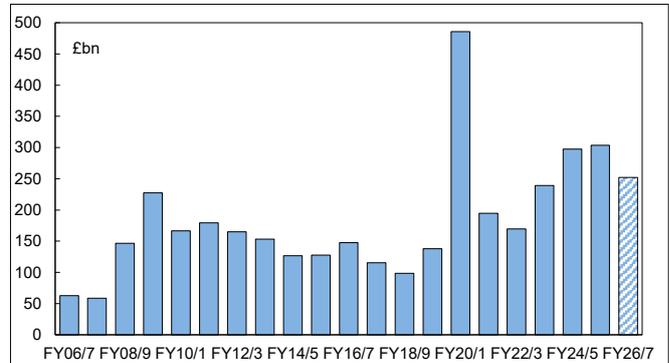
Notwithstanding the likelihood of further market gyrations on Wednesday, February’s final composite and services PMIs will be the sole focus for UK economic data. We note that Monday’s revision to the final manufacturing output PMI (52.5, down

UK: Changes to PSNB & deficit since Budget 2025



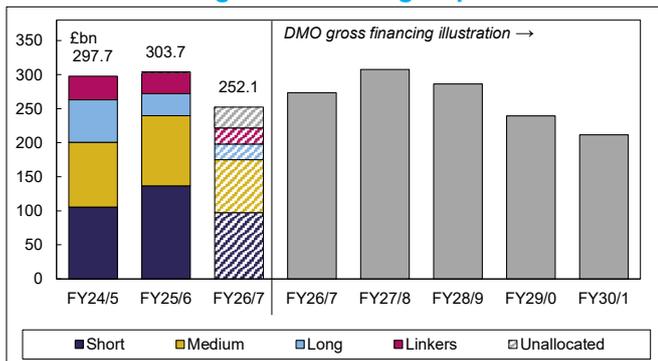
Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Gross gilt issuance*



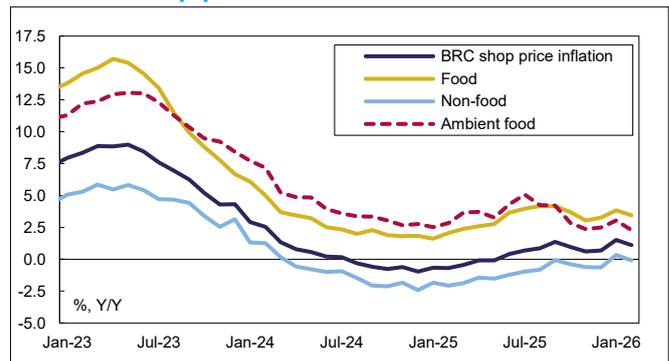
*Shaded bar shows plan for FY26/7. Source: DMO, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Gilt sales & gross financing requirement



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

UK: BRC shop price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

1.1pts from the flash release) presents a modest downside bias to the headline composite reading. But that reading still marked the fastest expansion in 17 months for that sector. And given its comparatively smaller weighting in total output, the final PMIs still look primed to signal a solid pickup in growth momentum midway through Q1. Indeed, following a notable pickup in January, the flash composite output PMI flagged the largest expansion in close to two years in February (53.9), anchored by activity in the services sector (53.9). Nevertheless, the flash PMIs also suggested that firms continued to be squeezed by rising input costs and made further cuts to headcount.

European calendar

Today's results							
Economic data							
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised	
Euro area	 Preliminary headline (core) HICP Y/Y%	Feb	1.9 (2.4)	<u>1.7 (2.2)</u>	1.7 (2.2)	-	
Italy	 Preliminary HICP (CPI) Y/Y%	Feb	1.6 (1.6)	1.1 (1.1)	1.0 (1.0)	-	
Spain	 Unemployment (net employment) change 000s	Feb	3.6 (45.2)	-	30.4 (17.3)	-	
UK	 BRC shop price index Y/Y%	Feb	1.1	1.4	1.5	-	
Auctions							
Country	Auction						
Germany	 sold €3.825bn of 2.5% 2031 bonds at an average yield of 2.43%						

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	 09.00	Final composite (services) PMI	Feb	<u>51.9 (51.8)</u>	51.3 (51.6)		
	 10.00	Unemployment rate %	Jan	<u>6.2</u>	6.2		
	 10.00	PPI Y/Y%	Jan	-2.6	-2.1		
Germany	 08.55	Final composite (services) PMI	Feb	<u>53.1 (53.4)</u>	52.1 (52.4)		
France	 08.50	Final composite (services) PMI	Feb	<u>49.9 (49.6)</u>	49.1 (48.4)		
Italy	 08.45	Composite (services) PMI	Feb	51.8 (52.5)	51.4 (52.9)		
	 10.00	GDP – final estimate Q/Q% (Y/Y%)	Q4	<u>0.3 (0.8)</u>	0.2 (0.6)		
Spain	 08.15	Composite (services) PMI	Feb	52.5 (52.8)	52.9 (53.5)		
UK	 07.45	Final composite (services) PMI	Feb	<u>53.9 (53.9)</u>	53.7 (54.0)		
Auctions and events							
Germany	 10.30	Auction: to sell up to €1bn of 2.3% 2033 green bonds					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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