Daiwa Capital Markets

Euro wrap-up

Overview

Emily Nicol
+44 20 7597 8331

Edward Maling
+44 20 7597 8030

- While euro area inflation in February remained well contained, Bunds made sizeable losses as the impact of rising wholesale energy prices in March was evident on weekly petrol and heating oil inflation data.
- Gilts similarly followed USTs lower on a quiet day for UK economic news.
- The ECB and BoE will leave rates unchanged on Thursday, but the former might make clear a new hawkish bias.

Daily bond market movements

Bond	Yield	Change
BKO 2.1 03/28	2.438	+0.063
OBL 2½ 04/31	2.610	+0.049
DBR 2.9 02/36	2.937	+0.035
UKT 4⅜ 03/28	4.095	+0.057
UKT 4⅛ 03/31	4.266	+0.048
UKT 4¾ 10/35	4.737	+0.047

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

Euro area

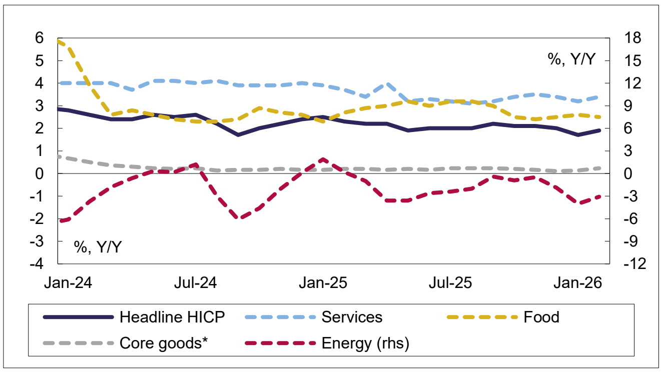
Euro area inflation uptick in February was related to temporary factors

As the ECB's monetary policy meeting got underway, today's euro area inflation estimates for February were bound to have less bearing on the Governing Council's discussions than normal given the war in the Middle East. However, ahead of the new global energy price shock, inflationary pressures appeared reassuringly well contained. Indeed, today's final figures confirmed that headline inflation – up 0.2ppt to 1.9%Y/Y – was no more than the ECB's 2.0% target for a third successive month. Moreover, the increase last month principally reflected temporary factors. An uptick in services inflation (3.4%Y/Y) related in part to Italy's Winter Olympics, which pushed euro area accommodation prices up almost 5%M/M and the respective annual rate up to 5.7%Y/Y, the highest since June 2024. Unfavourable base effects boosted inflation of airfares to an 11-month high. And together these two components added 0.35ppt and 0.12ppt to services and headline inflation respectively. The increase in core goods inflation (0.7%Y/Y, a five-month high) was largely due to a different sampling period this year to last, which among other things pushed clothing inflation to a 15-month high. And the smaller drag from energy inflation (-3.1%Y/Y) related in part to base effects around electricity pricing in France and Spain and a rise in auto fuel prices from January. In contrast, food inflation (2.1%Y/Y) eased slightly.

But energy shock will push inflation back above 3%Y/Y to prompt hiking bias at the ECB

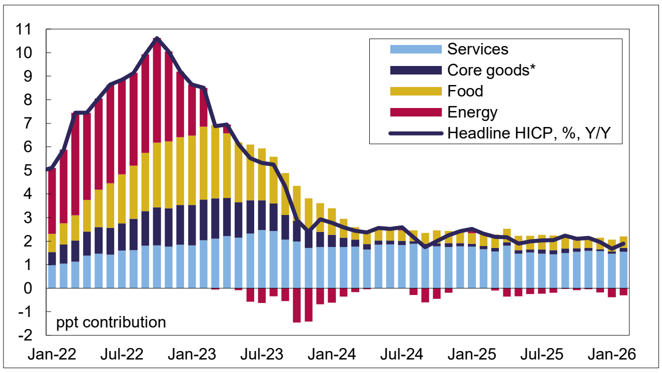
Of course, the near-term inflation outlook has been dramatically transformed. With Brent crude oil prices above $100bbl, average petrol prices in the euro area rose 3.3%W/W in the week to 16 March, taking the cumulative rise so far this month above 12%. Heating oil prices have so far risen 35% in March, with an especially steep rise in Spain (50%). So, with wholesale gas prices sharply higher too, energy inflation could jump as much as 10ppts in March. While member state governments are likely to respond – e.g. Italy's government today proposed new caps on petrol and diesel prices and EU-wide interventions are likely to be discussed by May – it will likely reach high single-digits or more in Q2. Due to the less inflationary initial macroeconomic conditions and the more limited gas market shock, second-round effects on inflation are likely to remain more moderate than in 2022. But higher energy and fertiliser prices mean food inflation will accelerate over coming months. And while softer demand could restrain non-energy industrial goods price pressures, services inflation seems bound to shift higher through the second half of this year and into 2027 as firms pass on increased costs to customers and workers demand greater wage compensation for yet another inflation shock. The conflict and disruption to the Strait of Hormuz obviously remains in a state of flux as do the various government energy policy interventions. But we currently expect headline inflation to take a substantial step up in March, by more than ½ppt, before rising above 3%Y/Y in Q2 and Q3. As such, while the Governing Council seems bound to leave policy unchanged tomorrow as it awaits more information on the likely impact of the new energy shock, we also expect the policymakers to signal a new hiking bias.

Euro area: HICP inflation & key components



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

Euro area: Contributions to HICP inflation



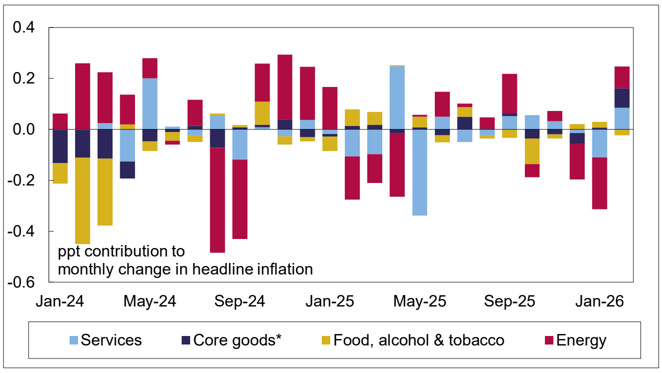
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

In addition to leaving the Deposit Rate unchanged at 2.0%, the Governing Council will surely maintain that future decisions will be data dependent and taken on a meeting-by-meeting basis. But scarred by the impact of Russia's invasion of Ukraine, services inflation still sticky and labour market slack at historically low levels, we expect policymakers to want to show their determination to guard against the current energy price shock transmitting into a sustained bout of inflation. As such, President Lagarde might suggest that all policy meetings from as early as April could be live for a possible hike. Certainly, swap markets are currently pricing the first of two rate hikes this year in the summer. In our view, that seems appropriate. And unless events in the Middle East – and commodity prices – normalise by early June, we would expect a first 25bps hike that month.

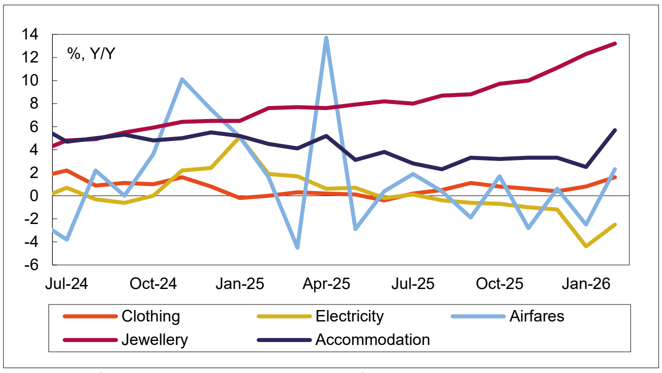
Normally, the ECB's updated macroeconomic projections would give strong clues to the near-term path of monetary policy. And a new set will be published tomorrow. While the usual cut-off for conditioning assumptions came before the outbreak of hostilities, ECB Executive Board member Schabel suggested that they would "at least partly already reflect recent developments". Unfortunately, these projections or any associated scenario analyses will unlikely fully reflect the new and ever-changing landscape. But if the ECB assumes that wholesale oil and gas prices follow a path similar to that embedded currently in forward markets, it could well have to revise up its projection for inflation in 2026 by almost 1ppt from 1.9%Y/Y previously. Base effects could help push headline inflation back closer to 2%Y/Y in 2027, but second-round effects across food and services inflation categories raise risks of greater persistence through much of next year. For output, recent economic data already suggest that the ECB's baseline projection for GDP growth in Q1 (0.3%Q/Q) is tough to achieve. And higher energy prices will dent real incomes, while heightened uncertainty will increase precautionary saving and encourage businesses to delay investments. As such, although fiscal policy will offer support, the ECB will need to revise down its baseline projection for GDP too, from a currently unrealistic quarterly pace of 0.4%Q/Q. Still, with the policymakers giving precedence to containing upside inflation risks as opposed to balancing the trade-off between prices and growth, we do not expect the downward revision to the growth outlook to materially impact the ECB rate outlook.

Euro area: Contributions to change in inflation



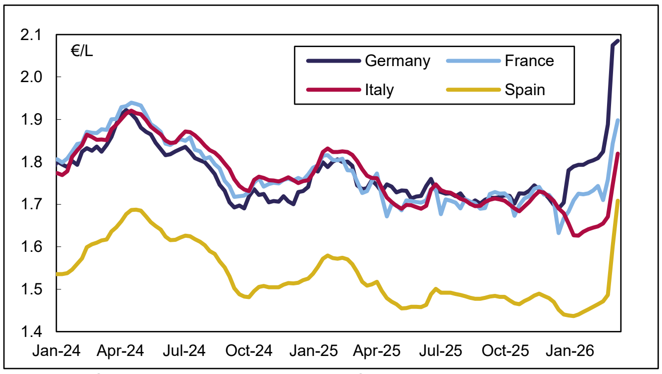
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected inflation components



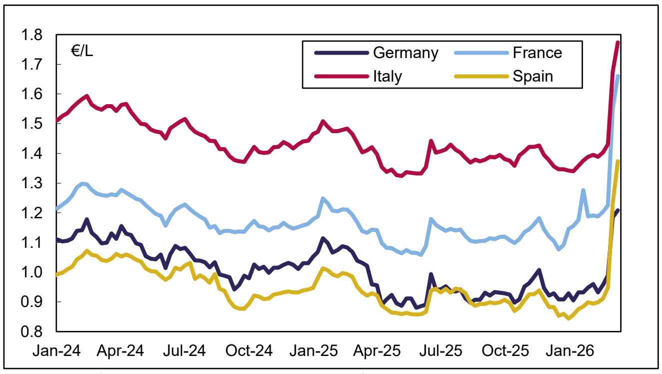
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Weekly petrol prices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Weekly heating oil prices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

Monetary policy will also dominate the narrative in the UK on Thursday. As discussed in Friday's Euro wrap-up – given the MPC's more dovish tilt in the aftermath of February's decision and forecast update, as well as the softer inflation and labour market data – the BoE had initially been expected to resume easing at March's MPC meeting. But events in the Middle East and their associated energy shock have seemingly taken near-term BoE rate cuts off the table. As such the MPC will leave Bank Rate steady, at 3.75%, for a second consecutive meeting. To the extent that policy remains somewhat restrictive, however, the BoE might maintain an easing bias, but only in the event that the conflict in the Middle East is diffused soon. And conscious of the effects from the energy shock on already subdued demand, a couple of dovish members (Dhingra and Taylor) might yet retain their support for rate cuts this week. But others are likely already to be concerned about inflation persistence, and particularly cognizant that petrol and diesel prices were already up 6½%M/M and 12¼%M/M respectively at the start of this week. Based on current energy forward prices, we expect headline inflation to peak firmly above 3%Y/Y in the autumn and only fall below 3%Y/Y in a year's time. Subsequent indexation of certain services prices and higher employee compensation raise further risks of second-round effects, which could keep inflation above target through end-2027. Of course, the medium-term outlook will depend on the persistence of the shock, and we expect policymakers will maintain that risks remain two-sided. But, at the very least, the MPC's previous guidance that "Bank Rate is likely to be reduced further" seems highly likely to be dropped from this month's policy statement.

Before the BoE's announcement, January's labour market report will be foremost amongst the economic data on Thursday. Admittedly, however, we expect little change to the headline figures this time around. Consistent with signals of still gradual loosening in the jobs market, February payrolls will probably continue to flag a modest reduction in PAYE employment. But having already overshot the BoE's projection in December, we see the unemployment rate merely moving sideways at 5.2%3M (with risks to the upside). We also expect the BoE's preferred wages series – private sector regular pay – to be broadly unchanged at around 3½%3M/Y. But a blend of lackluster labour demand and the fading base effects of higher public sector settlements last year should weigh on broader wage growth measures.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final headline (core) HICP Y/Y%	Feb	**1.9 (2.4)**	*1.9 (2.4)*	1.7 (2.2)	-
		Final job vacancy rate %	Q4	**2.2**	*2.2*	2.2	2.1

Auctions

Country		Auction
Germany		sold €757mn of 2.5% 2046 bonds at an average yield of 3.36%
		sold €1.148bn of 2.9% 2056 bonds at an average yield of 3.45%

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 labour costs Y/Y%	Q4	*3.3*	3.4
		10.00	Construction output M/M% (Y/Y%)	Jan	-	0.9 (-0.9)
		13.15	ECB Deposit (Refinancing) Rate %	Mar	*2.00 (2.15)*	2.00 (2.15)
UK		07.00	Average wages (excluding bonuses) 3M/Y%	Jan	3.9 (4.0)	4.2 (4.2)
		07.00	Private sector regular wages 3M/Y%	Jan	3.5	3.4
		07.00	Unemployment rate 3M%	Jan	5.2	5.2
		07.00	Employment 3M/3M change 000s	Jan	-12	52
		07.00	Payrolled employees M/M change 000s	Feb	-10	-11
		07.00	Claimant count rate % (change 000s)	Feb	-	4.4 (28.6)
		12.00	BoE Bank Rate %	Mar	*3.75*	3.75

Auctions and events

Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds post-Governing Council meeting press conference
		14.45	ECB to publish macroeconomic projections
France		09.50	Auction: to sell up to €15.5bn of 2.4% 2029, 2.5% 2030, 2.7% 2031& 3.5% 2033 bonds
		10.50	Auction: to sell up to €1.5bn of 3.4% 2029, 0.1% 2031, 0.1% 2036 & 0.1% 2053 inflation-linked bonds
Spain		09.30	Auction: to sell 2.6% 2031, 2.55% 2032 & 3.3% 2036 bonds
UK		12.00	BoE monetary policy announcement, statement and minutes to be published
		12.00	BoE to publish quarterly Agents' summary of business conditions (Q126)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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