Euro wrap-up

Overview

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- Bunds made modest gains as the sharp drop in euro area inflation in August was confirmed and the region's construction and car registration data were predictably subdued.
- Gilts made gains as the BoE left policy unchanged but maintained preparations for a shift to negative rates should that become appropriate.
- Friday will bring new data for UK retail sales and the euro area balance of payments.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.710	-0.010
OBL 0 10/25	-0.698	-0.012
DBR 0 08/30	-0.494	-0.007
UKT 1¾ 09/22	-0.083	-0.003
UKT 0⅝ 06/25	-0.119	-0.048
UKT 4¾ 12/30	0.185	-0.023

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

Euro area

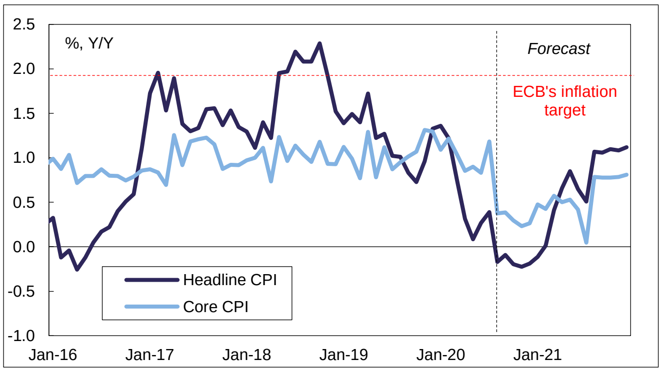
Euro area inflation confirmed in negative territory

There were no major surprises from today's final August inflation release. Indeed, it confirmed that the annual rate of CPI plunged 0.6ppt to -0.2%Y/Y, the first negative reading since May 2016. Admittedly, that partly reflected the timing of the start of the summer sales and Germany's VAT cut – for example, the annual increase in clothing prices fell sharply last month, by 8.1ppts to -1.0%Y/Y. As such, non-energy goods inflation declined 1.8ppts to -0.1%Y/Y. While the decline in accommodation prices moderated slightly (up 0.8ppt to -2.5%Y/Y), costs of package holidays fell further (-3.9%Y/Y). Partly as a result, services inflation was confirmed at 0.7%Y/Y, down 0.2ppt from July. And core inflation fell to a record-low 0.4%Y/Y (and to two decimal places revised slightly lower from the flash estimate to 0.37%Y/Y). While some of this weakness will relate to temporary factors, underlying disinflationary pressures will remain at the fore, not least given sizeable labour market slack and recent strengthening of the euro. So, we continue to expect headline inflation to remain in negative territory through to the end of the year, before taking a modest step up at the start of 2021 as the German VAT holiday ends and energy inflation likely returns to positive territory from Q2. But with substantive domestically generated price pressures unlikely for the foreseeable future, we remain downbeat about the outlook, forecasting full-year headline inflation of just 0.7%Y/Y in 2021 and 1.1%Y/Y in 2022, with core inflation to remain below 1% in both years.

Euro area construction levelled off in July

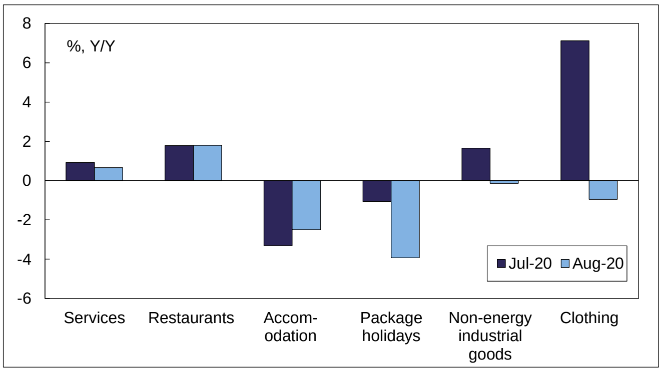
While the initial recovery in the euro area's construction sector was robust, today's figures suggested some levelling off at the start of Q3. In particular, total construction output rose just 0.2%M/M in July, as building construction was unchanged while civil engineering work rose 1.1%M/M. So, while roughly 80% of the post-pandemic slump had been recovered that month, output was still almost 6% below the peak at the start of the year and 3.8% lower than a year earlier. The country breakdown suggested mixed performances in July. Having been hit particularly severely during lockdown, French construction output continued to grow at a robust pace (5.0%M/M), nevertheless leaving it still 5% below February's level. In contrast, German construction output – which initially fared much better than other member states – fell 4.3%M/M in July, to leave it 6½% lower than the pre-pandemic peak, while Spanish output was down a further 1%M/M and more than 8% lower than February's level. Moreover, the recent PMIs and Commission confidence indicators suggest limited improvement in conditions through the remainder of the third quarter as well. Of course, given the recent profile, output from the sector will still provide a sizeable boost to GDP growth in Q3, with July's reading 12% higher than the Q2 average.

Euro area: Headline and core inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Selected inflation components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area car registrations still highly subdued

Today's car registration figures also predictably confirmed disappointingly subdued demand in August, falling 17.2%Y/Y, the eighth consecutive year-on-year drop and a steeper pace of contraction than the 4.3%Y/Y decline in July. As had been previously published, the weakness across member states was widespread – i.e. Germany -20.0%Y/Y, France -19.8%Y/Y and Spain -10.1%Y/Y – although Italy outperformed with registrations broadly flat compared with a year earlier. But this followed marked weakness earlier in the year, with Italian registrations in the first eight months of 2020 down 38.9%YTD/Y, exceeded only by Spain (-40.6%YTD/Y), while year to-date registrations in France and Germany were down 32.0% and 28.8% respectively. So, overall, demand for euro area cars in the first eight months of the year was down by one third compared to a year earlier to 5.2mn units, the weakest year-to-date reading for August since the series began in 1989.

The day ahead in the euro area

A quiet end to the week for euro area economic releases will bring just the ECB's balance of payments figures for July, German PPI numbers for August and Italian industrial orders and sales data for July. Meanwhile, ECB Vice President de Guindos and Executive Board member Schnabel are scheduled to speak publicly at separate online events.

UK

BoE leaves current policy settings and future guidance unchanged

There were no major surprises from today's BoE policy announcements, with Bank Rate left at 0.1% and the asset purchase target left at £745bn. As last month, the decision was unanimous among the nine MPC members. The guidance on future policy in the post-meeting statement was also left completely unrevised from August. In particular, the MPC stands ready to "adjust" (i.e. ease) monetary policy to meet its remit; will "keep under review the range of actions that could be taken"; and "does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably".

MPC notes that economic data have been a little stronger than it expected last month

In terms of economic conditions, the MPC acknowledged that GDP and inflation had recently been running above the path projected in the August Monetary Policy report. But it also emphasised that the labour market outlook is very uncertain. The MPC also noted downside risks from the recent revival in the pandemic in the UK. And it recognised the significance to the economic outlook – and by inference also the outlook for monetary policy – of whether or not the UK ends the Brexit transition period at the end of the year with an FTA.

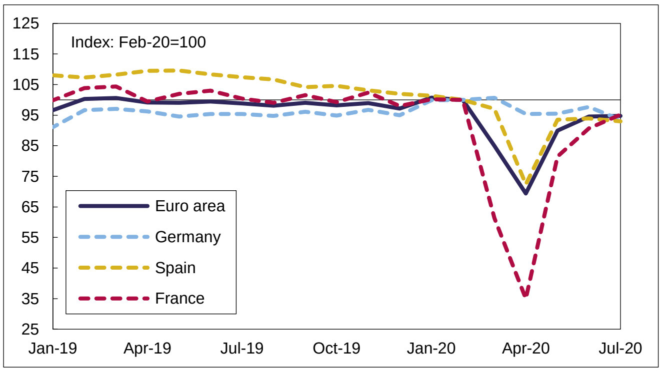
We still expect an increase in asset purchase target in November

Given the capricious behaviour of the UK Government, there has to be a strong probability that the future trading relationship with the EU will still not have been resolved by the time of the November MPC. But if the BoE maintains its assumption that a deal will eventually be reached, its updated forecasts would seem highly unlikely to justify any dramatic further easing of policy. However, by the same token, it will also not want to reduce the current level of monetary accommodation. So, with its net asset purchases currently set to finish before year-end, we still expect the MPC in November to vote to extend its net bond-buying into 2021, with a further increase of £100bn in the asset purchase target to £845bn.

BoE contingency planning for negative rates for if the outlook sours

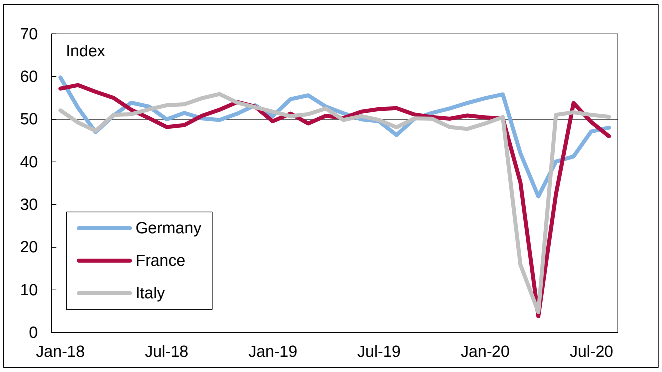
Of course, negative rates are among the range of policy actions that are being kept under review at the BoE. Indeed, today's post-meeting minutes recalled that the MPC had already discussed them last month, and noted that it had subsequently been briefed on "plans to explore how a negative Bank Rate could be implemented effectively, should the outlook for inflation

Euro area: Construction output by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs by member state



Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

and output warrant it at some point." In addition, they announced that the BoE and PRA will work on the operational considerations next quarter. This move attracted some attention in the markets, pushing Gilt yields and (for a while at least) sterling lower. However, it was fully consistent with previous commentary from BoE Governor Bailey that negative rates might at some time be appropriate, but that preparations would be required before they could be implemented smoothly. So, today's news should not have been interpreted as a signal that a move to negative rates is imminent. Instead, it simply made it clear that the MPC is contingency planning for if and when the outlook deteriorates significantly – e.g. in the event that the government fails to deliver an FTA with the EU by year-end, or if the UK suffers a far more significant second pandemic wave and national lockdown.

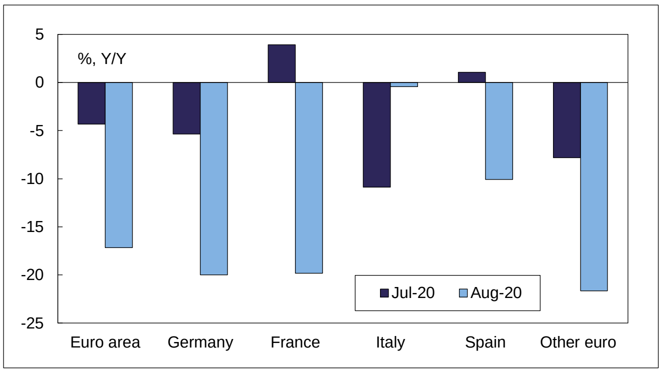
Amendments to UK internal market bill unlikely fully to satisfy the EU but deal still possible

Admittedly, downside risks related to the UK's future trading relationship with the EU appear to have increased over the past couple of weeks. And that remains the case even though Boris Johnson and certain key Conservative Party backbenchers reached a deal yesterday to revise the Government's controversial internal market bill. By appeasing many Tory MP rebels, the revisions would likely ensure safe passage for the Bill through the House of Commons, although the House of Lords might well still seek to disrupt progress. Moreover, as the amendments to the Bill would merely establish a Parliamentary mechanism that could give a green light to future Government action inconsistent with the Withdrawal Agreement, the EU seems unlikely to be satisfied and a formal legal challenge might yet be forthcoming next month. But yesterday's comments from Joe Biden and Nancy Pelosi warning the UK Government that there will be no UK-US trade agreement on their watch if the Good Friday Agreement – underpinned via the Northern Ireland Protocol of the Withdrawal Agreement – is not respected, could nevertheless prove a more effective stick than any legal moves from Brussels to force Boris Johnson to back down. And this afternoon European Commission President Von Der Leyen stated that she was still 'convinced' that a deal on an FTA could be reached, helping to neutralize the impact of the BoE's talk of negative rates on sterling.

The day ahead in the UK

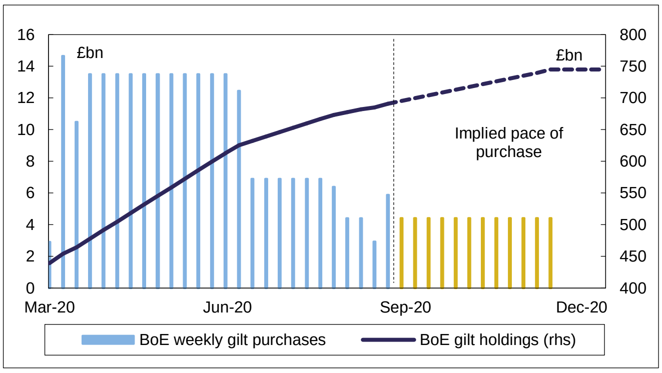
The week's UK data calendar ends with the release tomorrow of retail sales data for August, which will reveal whether the Government's "Eat out to help out scheme" gave support to spending on the high street. Recent surveys from the CBI and BRC have given different impressions in that respect. Expectations are for a further increase (0.8%M/M), which would leave sales more than 3½% higher than the pre-pandemic level.

Euro area: Car registrations by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: BoE weekly gilt purchases



Source: BoE and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		EU-27 new car registrations	Aug	**-18.9**	-	-5.7	**-**
		Construction output M/M% (Y/Y%)	Jul	**0.2 (-3.8)**	-	4.0 (-5.9)	**5.1 (-4.8)**
		Final CPI (core CPI) Y/Y%	Aug	**-0.2 (0.4)**	-0.2 (0.4)	0.4 (1.2)	**-**
Italy		Total trade balance €bn	Jul	**9.7**	-	6.2	**-**
UK		BoE Bank Rate %	Sep	**0.10**	*0.10*	0.10	**-**
		BoE gilt and corporate bond purchase target £bn	Sep	**745**	*745*	745	**-**

Auctions

Country		Auction
France		sold €2.7bn of 0% 2023 bonds at an average yield of -0.64%
		sold €3.8bn of 0.5% 2026 bonds at an average yield of -0.53%
		sold €2.0bn of 0.75% 2028 bonds at an average yield of -0.4%
		sold €624mn of 0.1% 2026 index-linked bonds at an average yield of -1.12%
		sold €448mn of 0.7% 2030 index-linked bonds at an average yield of -1.14%
		sold €177mn of 0.1% 2047 index-linked bonds at an average yield of -0.91%
Spain		sold €675mn of 0% 2023 bonds at an average yield of -0.449%
		sold €935mn of 0.8% 2027 bonds at an average yield of -0.04%
		sold €1.1bn of 4.7% 2041 bonds at an average yield of 0.813%
		sold €1.5bn of 1% 2050 bonds at an average yield of 1.091%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Current account balance €bn	Jul	-	20.7
Germany		07.00	PPI Y/Y%	Aug	-1.4	-1.7
France		07.45	Final wages Q/Q%	Q1	0.9	0.2
Italy		09.00	Industrial orders M/M% (Y/Y%)	Jul	-	23.4 (-11.8)
		09.00	Industrial sales M/M% (Y/Y%)	Jul	-	13.4 (-16.4)
UK		07.00	Retail sales including fuel M/M% (Y/Y%)	Aug	0.8 (2.7)	3.6 (1.4)
		07.00	Retail sales excluding fuel M/M% (Y/Y%)	Aug	0.4 (4.2)	2.0 (3.1)

Auctions and events

Country		BST	Auction / Event
EMU		10.15	ECB's de Guindos scheduled to speak
		15.00	ECB's Schnabel scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.