Euro wrap-up

Overview

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- As German retail sales data beat expectations, Bunds made losses despite further notable declines in French and Italian inflation and signals from Lagarde of possible future amendments to the ECB's policy strategy.
- Gilts made steeper losses as BoE Chief Economist Haldane suggested that pessimism regarding the UK economy had been overdone.
- Thursday will bring new data on euro area unemployment and car registrations in certain member states, as well as the final manufacturing PMIs for September.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.711	+0.006
OBL 0 10/25	-0.718	+0.013
DBR 0 08/30	-0.529	+0.019
UKT 1¾ 09/22	-0.029	+0.024
UKT 0⅝ 06/25	-0.063	+0.022
UKT 4¾ 12/30	0.219	+0.036

*Change from close as at 4:00pm BST.
Source: Bloomberg

Euro area

Inflation falls further in several member states in September

After yesterday's flash German CPI figures surprised on the downside, today's equivalent data from France, Italy and Portugal did likewise, guaranteeing a notable drop in euro area inflation when the respective figures are released on Friday. In particular, the French EU-harmonised measure of inflation fell 0.2ppt in September to 0.0%Y/Y, the lowest since April 2016. And the declines on the equivalent measures in Italy (down 0.4ppt to a series low of -0.9%Y/Y) and Portugal (down 0.5ppt to -0.7%Y/Y) were even steeper. While the limited detail published in each country suggested that a sharper drop in energy prices played a role, services inflation weakened in France and Italy with inflation of non-energy industrial goods also weaker in Italy as some retailers extended their summer sales. Indeed, the flash estimate of core inflation on the EU measure in Italy – the only country to publish such a figure – fell 0.7ppt to -0.3%Y/Y, similarly a series low. Given today's figures, we now expect euro area headline inflation to fall at least 0.2ppt to -0.4%Y/Y, with the core rate likely also to drop to a series low of 0.2%Y/Y or below.

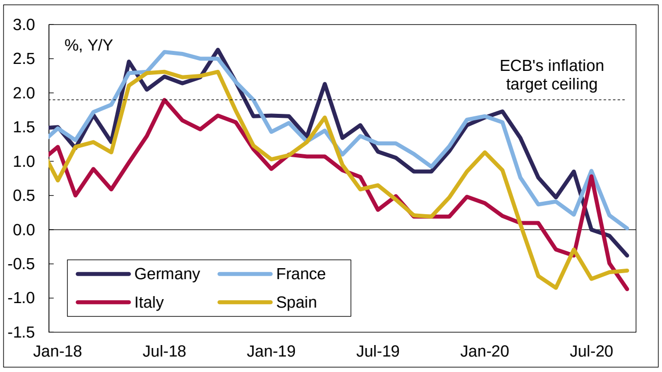
Lagarde gives clues as to what to expect from the ECB's strategic monetary policy review

In her speech to today's ECB watchers' conference, Christine Lagarde refrained from commenting on the recent weak inflation data and outlook, or indeed the case for near-term monetary easing. Instead, she focused on issues to be addressed in the ECB's strategic review of monetary policy. Notably, just as the Fed's recent strategic policy review agreed the need for a new framework – average inflation targeting – to ensure that inflation expectations in the US did not become de-anchored from target, Lagarde acknowledged the case for new approaches at the ECB to address the euro area's persistent sub-target inflation. And she gave some clues as to what to expect when the ECB's strategic review concludes.

Lagarde flags case for overshooting inflation target, ongoing unconventional measures

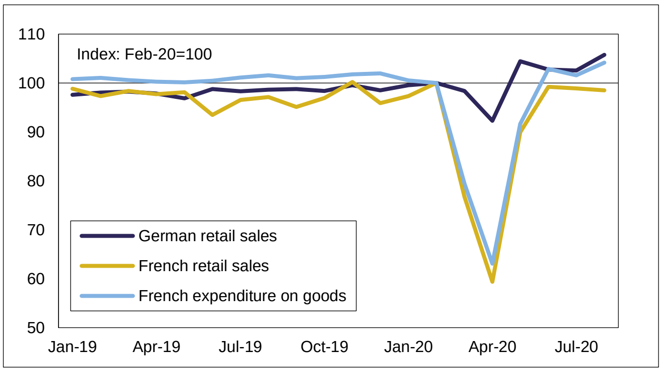
Among other things, Lagarde made clear that the ECB's target of "below but close to 2%" should be replaced by a goal that is unambiguously symmetric. She noted that an emphasis on underlying inflation measures, which better predicted inflation over the medium term, was more appropriate than a focus on headline inflation. Lagarde also saw merits from committing, like the Fed, to make up for periods when inflation has been persistently below target with a period of overshooting. And given the structural forces that have weakened the link between the real economy and inflation, and pushed the so-called "natural" interest rate – which would be consistent with inflation at target and output at potential – to historically low levels, she recognised that the ECB might not be able to wind down fully its unconventional policies. So, the tiered system for remunerating excess reserves, coupled with incentives to boost lending via the ECB's long-term liquidity provision, would

Euro area: Headline inflation by member state*



*EU-harmonised measure. Source: Refinitiv and Daiwa Capital Market Europe Ltd.

Germany and France: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

likely remain to soften the impact of a persistent negative deposit rate. And asset purchases to support the transmission of monetary policy to the real economy – and thus cap spreads on periphery government bonds – would also need to be sustained.

German retail sales roared ahead in August

Beyond inflation, recent evidence on the strength of economic activity has been mixed. While high-frequency data hinted at a loss of momentum in Germany's recovery over the past couple of months, today's retail sales figures offered a welcome upwards surprise, perhaps boosted by a delayed reaction to the 3ppt VAT cut at the start of July. Indeed, having edged lower in June and July, sales (in real terms) rose a stronger-than-expected 3.1%M/M in August, to leave them 3.7% higher than a year ago and an impressive 5.8% higher than the pre-pandemic level in February. As a result, on average in the first two months of Q3, total sales were up more than 4% compared with the Q2 average. Within the detail, in nominal terms, sales of food and pharmaceutical goods led the rebound last month (up 5.6%M/M and 6.8%M/M), while sales of IT goods (-8.3%M/M) and clothing (-0.4%M/M) were weak. Indeed, when adjusting for price effects, turnover in clothing and footwear was still down more than 10%Y/Y, to be down more than 25%YTD/Y. In contrast, sales of furniture and household appliances were up by more than 8%Y/Y, to leave then 2½%YTD/Y higher. Meanwhile, the shift to increased online shopping brought about by the pandemic remained intact, with internet and mail order sales up 23%Y/Y, compared with growth of just 1.2%Y/Y in stores. Separately, there was better news today from the labour market too, with German jobless claims falling for the third consecutive month in September (-8k). And so, while the claimant count rate remains almost 1½ppt higher than the pre-pandemic level, it edged slightly lower in September to 6.3%. Of course, this still left the number of people unemployed up by more than 600k compared with a year earlier. And these figures will remain limited by the Government's 'kurzarbeit' short-time working scheme. But the Federal Employment Agency suggested that the number of people registered for such support continued to decline in September.

French consumer spending stronger too

Earlier this month we had already received the release of the Bank of France's retail sales figures, which, in marked contrast, suggested that French sales fell for the second successive month in August (-0.4%M/M). But today's INSEE data on household expenditure on goods were more upbeat, suggesting that spending rose 2.6%M/M in August, driven by a near-17½%M/M increase in spending on clothing prompted by the delayed start to the summer sales. So, the level of spending was more than 4% higher than the pre-pandemic level in August, and so far in Q3 almost 20% higher than the Q2 average. Of course, given that France has seen one of the more significant resurgences of Covid-19 cases in the region over the past month, we would expect some payback in September, with the impact on services expenditure bound to be larger.

The day ahead in the euro area

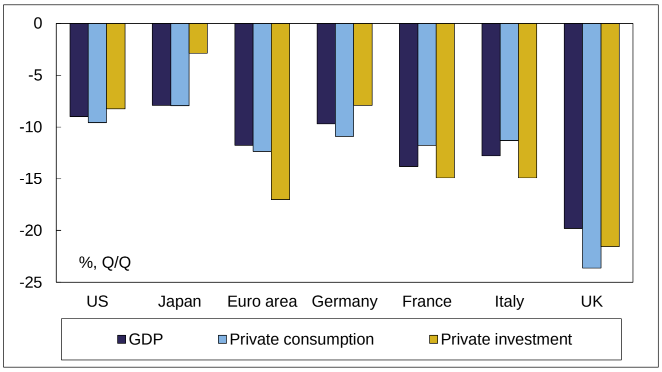
Tomorrow will bring the final September manufacturing PMIs from the euro area and member states. These are likely to confirm the uptick seen in the flash estimate, which saw the headline euro area PMI rise 2pts to 53.7, a more-than two-year high, seemingly driven by a rebound in the German sector. Tomorrow's release will also include PMI outturns from Italy and Spain for the first time. Thursday will also bring the latest euro area labour market figures – expected to show the unemployment rate ticking above 8% for the first time in more than two years – while September new car registration numbers from France, Italy and Spain are also due. Elsewhere, ECB Chief Economist Lane will again be in action at an online conference in the afternoon.

UK

BoE Chief Economist upbeat about economic outlook

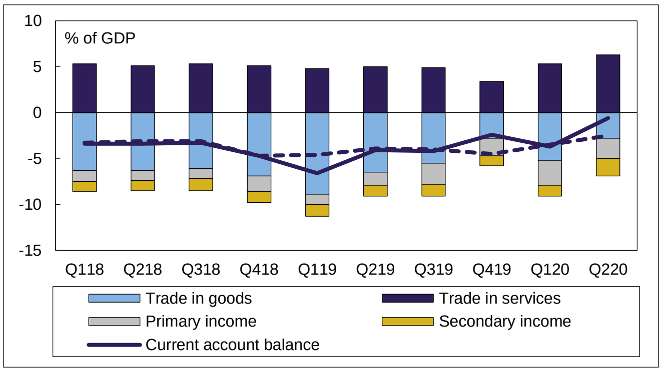
Like the ECB, the past week has seen various BoE policymakers discuss potential future monetary policy options, with somewhat mixed messages. Certainly, external MPC member Tenreyro over the weekend implied that she was in favour of

Q220 GDP growth in major economies



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Current account balance*



**Dashed line is current account excluding non-monetary gold and other precious metals. Source: ONS and Daiwa Capital Markets Europe Ltd.*

negative rates, offering a positive assessment of the potential benefits. But BoE Governor Bailey yesterday reiterated that the Bank had not yet reached a judgement, with research work still ongoing. This followed more clear-cut comments from Deputy Governor Ramsden suggesting that he was not currently in favour of negative rates and that evidence implied that 0.1% was at present the effective lower bound for Bank Rate. And today saw BoE Chief Economist Haldane weigh in on the debate, emphasising that technical work that would eventually allow a move to negative rates will likely take a number of months and so no imminent rate cut is on the cards. In any case, Haldane offered a relatively upbeat assessment of the current economic backdrop, noting that “good economic news (of which there has been plenty) [was] being discounted too readily, and fearfulness about the future being accentuated.” He also noted that the recent recovery implied that GDP was on track to be between 3-4% below the pre-pandemic level at the end of Q3. And so, having previously voted against the most recent round of additional asset purchases, Haldane might well see the current policy stance as most appropriate for the foreseeable future. We are less upbeat about the near-term outlook, with risks – not least related to new Covid-19 containment measures, rising unemployment and lack of progress on an FTA agreement with the EU – skewed significantly to the downside. As such, while we currently don’t expect Bank Rate to be cut into negative territory, we maintain our forecast of an extra £100bn of QE to be announced in November.

Q2 drop in UK GDP revised slightly as current account deficit temporarily narrows

The extent of the drop in UK GDP in Q2 was revised down slightly today, to a nevertheless still-huge 19.8%Q/Q, compared to the initially estimated plunge of 20.4%Q/Q, and the worst performance of any major economy. That left GDP down 21.5%Y/Y, compared to the previous estimate of -21.7%Y/Y – similarly a record pace of decline. Among the details, the drop in private consumption was bigger than previously thought, down 23.6%Q/Q, but gross fixed investment was a touch firmer than originally estimated, falling 21.6%Q/Q. Of course, these data are history, and more interesting will be the August GDP figures due on 9 October – supported by the Government’s Eat Out to Help Out scheme, further significant growth of more than 5%M/M seems highly likely for that month. But that will still likely leave the level of GDP down more than 5% from February’s pre-lockdown level. Meanwhile, with imports having dropped to the lowest level since Q310, and at a faster rate than exports (down to the lowest level since Q216), today’s data revealed a significant narrowing in the UK’s current account deficit in Q2 to £2.8bn or 0.6% of GDP, the smallest since Q211. Excluding non-monetary gold and other precious metals, however, the improvement was not so marked, down £7.5bn to £12.1bn, or 2.5% of GDP. Given the recovery in imports over recent months, we fully expect the current account deficit to widen once again in Q3.

The day ahead in the UK

A quieter day for UK economic news tomorrow brings just the final manufacturing PMI for September. In contrast to the euro area, the flash headline manufacturing index fell back this month (down 0.9pt to 54.3), with the output component down a steeper 1.7pts, albeit to a still elevated level of 59.3, the second-strongest reading in six years. And while the government has subsequently announced stricter containment measures affecting customer-facing services, this seems unlikely to have had a material impact on conditions in the manufacturing sector.

European calendar

Today’s results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Retail sales M/M% (Y/Y%)	Aug	**3.1 (3.7)**	0.4 (4.5)	-0.9 (4.2)	**-0.2 (5.0)**
	Unemployment rate % (change ‘000s)	Sep	**6.3 (-8.0)**	6.4 (-7.0)	6.4 (-9.0)	-
France	Preliminary CPI (EU-harmonised CPI) Y/Y%	Sep	**0.1 (0.0)**	0.2 (0.3)	0.2 (0.2)	-
	Consumer spending M/M% (Y/Y%)	Aug	**2.3 (2.4)**	-0.2 (0.5)	0.5 (0.6)	**-0.9 (0.3)**
Italy	Preliminary CPI (EU-harmonised CPI) Y/Y%	Sep	**-0.5 (-0.9)**	-0.4 (-0.4)	-0.5 (-0.5)	-
UK	Lloyds business barometer	Sep	**-11**	-	-14	-
	BRC shop price index Y/Y%	Sep	**-1.6**	-1.4	-1.6	-
	Final GDP Q/Q% (Y/Y%)	Q2	**-19.8 (-21.5)**	-20.4 (-21.7)	-2.2 (-1.7)	-
	Current account balance £bn	Q2	**-2.8**	-0.8	-21.1	**-20.8**
	Nationwide house price index M/M% (Y/Y%)	Sep	**0.9 (5.0)**	0.5 (4.5)	2.0 (3.7)	-

Auctions

Country	Auction
Germany	sold €3.3bn of 0% 2025 bonds at an average yield of -0.73%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09.00	Final manufacturing PMI	Sep	53.7	51.7
	10.00	Unemployment rate %	Aug	8.1	7.9
	10.00	PPI Y/Y%	Aug	-2.7	-3.3
Germany	08.55	Final manufacturing PMI	Sep	56.6	52.2
France	08.50	Final manufacturing PMI	Sep	50.9	49.8
	-	New car registrations* Y/Y%	Sep	-	-19.8
Italy	08.45	Manufacturing PMI	Sep	53.5	53.1
	09.00	Unemployment rate %	Aug	10.2	9.7
	17.00	New car registrations Y/Y%	Sep	-	-0.4
Spain	08.15	Manufacturing PMI	Sep	50.5	49.9
	-	New car registrations* Y/Y%	Sep	-	-10.1
UK	09.30	Final manufacturing PMI	Sep	54.3	55.2

Auctions and events

Country	BST	Auction / Event
EMU	16:45	ECB's Chief Economist Lane scheduled to speak at online international macro conference
France	09.50	Auction: 0% 2030 bonds
	09.50	Auction: 1.25% 2034 bonds
	09.50	Auction: 0.5% 2040 bonds
	09.50	Auction: 0.75% 2052 bonds
Spain	09.45	Auction: 0% 2025 bonds
	09.45	Auction: 1.25% 2030 bonds
	09.45	Auction: 0.7% 2033 index-linked bonds
	09.45	Auction: 3.45% 2066 bonds
UK	09.30	BoE publishes its Monthly Decision Maker panel data
	10.00	Auction: £3.25bn of 0.125% 2023 bonds
	11.30	Auction: £2bn of 1.25% 2041 bonds

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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