Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest losses despite a continued uptrend in new coronavirus cases in the euro area and the likelihood of increased restrictions on activity to come.
- Gilts made significant losses, particularly at the long end of the curve, as comments from EU chief negotiator Barnier raised expectations of an imminent restart to formal intensive negotiations on an FTA.
- Thursday will bring new consumer confidence indicators from the euro area and Germany, and the results of business surveys from France and the UK.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.786	+0.003
OBL 0 10/25	-0.797	+0.008
DBR 0 08/30	-0.598	+0.010
UKT 1¾ 09/22	-0.064	+0.012
UKT 0⅝ 06/25	-0.060	+0.027
UKT 4¾ 12/30	0.234	+0.050

*Change from close as at 4:15pm BST.
Source: Bloomberg

UK

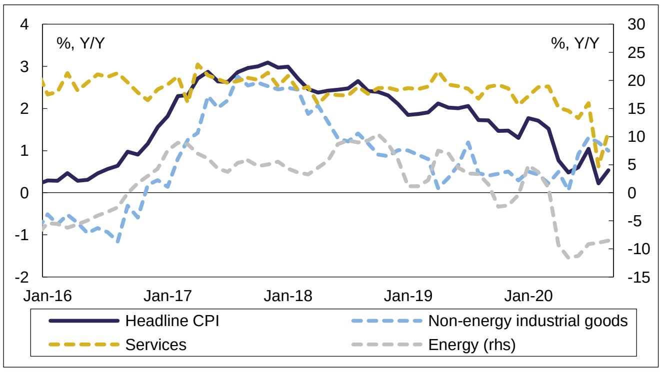
UK inflation ticked temporarily higher in September

There were no major surprises from today's UK CPI figures, which showed that headline inflation ticked higher in September as the temporary negative impact of the Government's Eat Out to Help Out scheme – which the ONS estimated accounted for around 0.4ppt of the decline in headline inflation in August – fell out of the calculation. Indeed, having dropped to its lowest level since 2015 in August (0.2%Y/Y), the headline CPI rate rose 0.3ppt to 0.5%Y/Y. This left inflation at 0.6%Y/Y in Q3, unchanged from Q2 but 0.4ppt higher than the rate assumed by the BoE in its August Monetary Policy Report. Within the detail, the increase was more than fully accounted for by higher contributions from transport (boosted by a much smaller drag from airfares) as well as catering services, up 4.8ppts to 4.0%Y/Y and 3.7ppts to 0.9%Y/Y respectively – although the latter remained well below July's rate as some restaurants continued to offer discounts equivalent to those provided under the Government's scheme. So, despite ongoing weakness in other subsectors – e.g. a much steeper pace of decline in accommodation services costs (down 4.4ppts to -6.2%Y/Y) as the summer staycation boom came to an end – overall services inflation jumped 0.8ppt to 1.4%Y/Y, admittedly still the second-softest reading on the series. Meanwhile, non-energy industrial goods inflation edged lower for the second successive month, principally due to falls in prices of furniture and computer games (the latter component of which is particularly volatile and possibly impacted by delayed game releases due to Covid-19). Overall, core inflation rose 0.4ppt to 1.3%Y/Y.

While the Brexit talks will have a big impact, underlying inflation should remain subdued

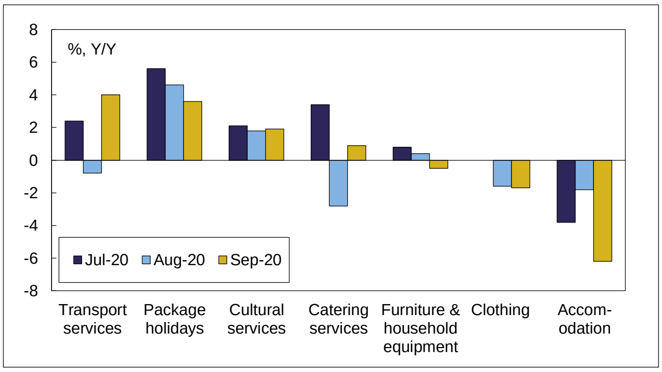
The escalation of the pandemic and associated re-imposition of stricter restrictions on activity – which this week have been extended across Wales and the north of England – might seem likely to keep core inflation well contained over the near term. But in 2021 much will depend on the outcome of the UK's current negotiations with the EU. If the UK fails to agree a new free trade agreement with the EU, inflation will likely be pushed considerably higher than 2%Y/Y next year not least due to its impact on sterling as well as the imposition of tariffs on more than half of items imported from the EU, before likely falling back due to weaker demand. On the other hand, if – as on balance we expect – an FTA is agreed, the avoidance of such tariffs and a likely appreciation of sterling will help to ensure that underlying inflation remains relatively subdued. Admittedly, the drag from energy prices will likely ease further, and the end of the hospitality VAT cut at the end of March might conspire to push inflation briefly to 2.0%Y/Y or above. However, given also the large amount of spare global capacity, inflation of non-energy industrial goods would likely remain weak. And with unemployment set to increase sharply and wage growth to remain subdued, services inflation would likely to fall back again in 2022 ensuring that headline inflation falls back below target too.

UK: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected CPI sub-components



Source: ONS and Daiwa Capital Markets Europe Ltd.

Extra QE in November before a move to negative rates in 2021?

So, with the recent pace of recovery seemingly slightly softer than had been previously anticipated by the BoE and the risks to the economic outlook skewed to the downside due to the pandemic, there appears to remain a strong case for additional monetary stimulus to be agreed at next month's policy meeting, when the MPC will have updated economic forecasts. External member Vlieghe yesterday was the latest in a string of BoE policymakers to acknowledge that economic activity remains close to 10% below its level at the end of 2019 with significant implications for inflation. And while he also judged that there was only a low risk that negative rates might end up being counterproductive, he also emphasised that the groundwork for a move to such a policy had not yet concluded. He thus made clear that, for now, additional asset purchases were likely to be the preferred policy tool. So, we maintain our expectation that a further increase in the Bank's asset purchase target by £100bn to £845bn will be announced on 5 November. And although there remain sceptics on the MPC, such as Deputy Governor Ramsden, and momentum could become significantly more positive if and when a successful vaccine becomes available, there is also a good chance that the BoE will eventually cut rates to zero or lower in the course of next year.

UK public borrowing above consensus in September…

In terms of the UK's public finances, the September UK government borrowing figures came in a little above expectations, with an inevitable record for the month, but still suggested that the fiscal deficit was on track to undershoot somewhat the OBR's most recent forecast in FY20/21 as a whole. In particular, public sector net borrowing (excluding public sector banks) came in at £36.1bn, up £28.4bn from a year earlier and the third-highest deficit for any month. Nevertheless, cumulative net borrowing in the first six months of FY20/21 still reached £208.5bn, almost £175bn more than in the same period last year. And public sector net debt (excluding public sector banks) rose by £259.2bn in the first six months of FY20/21 to £2.06trn, estimated at about 103.5% of GDP, the highest such ratio in 60 years.

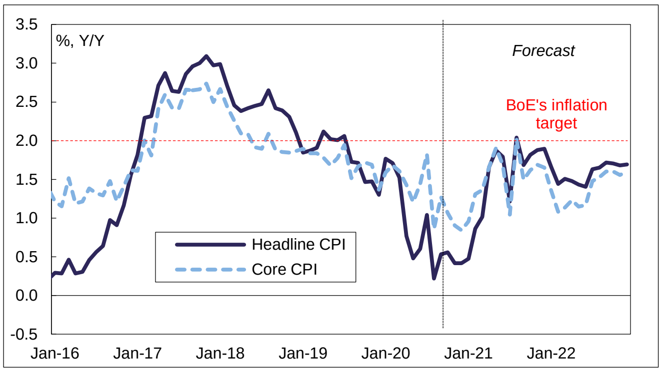
…but still trending below OBR forecast

Cumulative borrowing in the first six months of FY20/21, however, was some £54bn less than predicted by the OBR in its most recent projections published in June, which had predicted total borrowing of £372.1bn over FY20/21 as a whole. The lower-than-expected path of borrowing largely appears to reflect a higher profile for GDP than assumed by the OBR, supporting tax revenues. However, the revival in the pandemic is bound to have an impact going forward – and today saw Boris Johnson announce new restrictions in Sheffield after yesterday's confirmation of tighter rules for Greater Manchester. And additional fiscal support measures, including the new Job Support Scheme and extension of the VAT cut for the hospitality sector to end-March, which weren't reflected in the original arithmetic, could well see the OBR's forecast reached by the end of the fiscal year.

Fiscal policy to become less supportive going forward

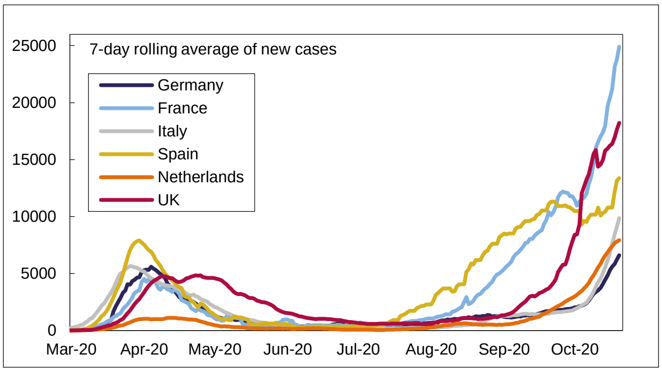
Overall, however, with the new Job Support Scheme less generous than its predecessors, and discretionary spending – such as on the NHS – also set to be tighter, the overall fiscal stance looks set to be less than supportive than following the immediate shock from Covid-19. Indeed, about two-thirds (£18.1bn) of the increase in borrowing in September from a year earlier was due to increased central government spending, not least reflecting the £5.9bn cost of the government's original Job Retention Scheme and income support for the self-employed. Meanwhile, central government tax receipts were down £6.0bn from a year earlier reflecting steep falls in Value Added Tax (VAT), partly due to the temporary cut for the hospitality sector, as well as lower Business Rates and Corporation Tax receipts. Looking at the first six months of the fiscal year, the picture was broadly similar, with government receipts down 11.6%Y/Y but spending up 34.0%Y/Y. Given the major ongoing shock to the public finances from Covid-19, the government pulled its plans for tax changes in a Budget announcement this

UK: Headline and core inflation forecast*



*Forecast assumes that an FTA is reached to avoid the imposition of new tariffs on imports from the EU at the start of 2021. Source: Refinitv and Daiwa Capital Markets Europe Ltd.

New daily coronavirus cases



Source: ECDC and Daiwa Capital Markets Europe Ltd.

autumn. And the FT has reported that it could also now drop plans for its comprehensive spending review to set new departmental spending plans for the coming three years. However, once the pandemic is out of the way, public expenditure seems bound to be tight, while tax increases will be firmly on the table, as the government will seek to regain control of borrowing.

The day ahead in the UK

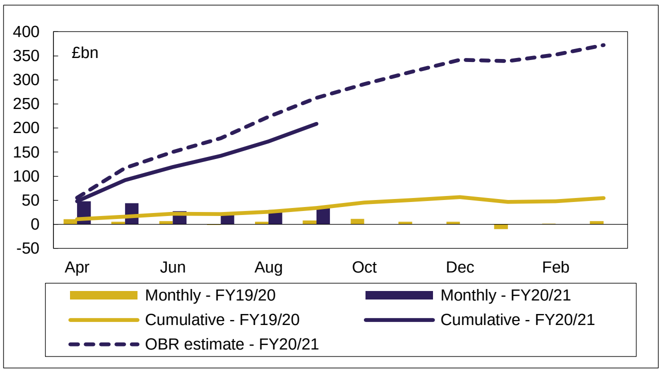
Thursday will likely see further progress towards a resumption of formal intensified negotiations on an EU-UK FTA, perhaps with 15 November set as a firm deadline to conclude an agreement. That will reflect UK satisfaction at today's statement by EU chief negotiator Barnier to the European Parliament, whereby he asserted that the EU recognised that the deal should be "mutually beneficial…in respect of the autonomy and sovereignty of both sides…reflecting a balanced compromise". He also acknowledged that the UK was willing "to move forward and shift" its position on the Level Playing Field. (Market optimism at Barnier's comments today gave a boost to sterling and saw Gilts make significant losses, particularly at the long end of the curve.) Meanwhile, data-wise, tomorrow will bring the CBI's latest industrial trends survey for October, which will provide an update on manufacturing conditions at the start of Q3. This survey will be accompanied by its more detailed quarterly indicators, including for business optimism about the year ahead, employment and investment intentions. Given persistent uncertainty related to the negotiations with the EU and the pandemic, we expect manufacturers to remain downbeat about the near-term outlook. Finally, BoE Governor Bailey and Chief Economist Haldane are due to speak at online events.

Euro area

The day ahead in the euro area

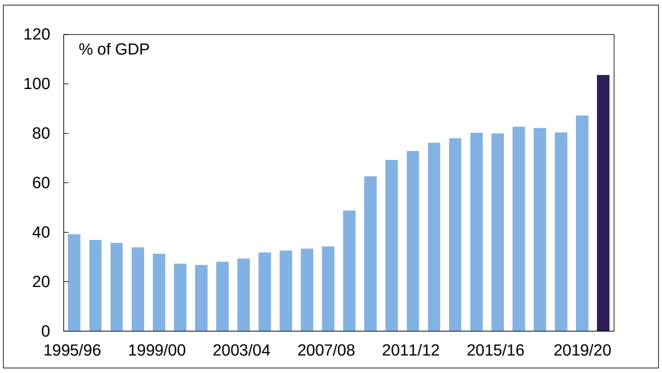
After a quiet first half of the week and ahead of Friday's flash PMIs, tomorrow will bring the Commission's preliminary euro area consumer confidence indicator for October, alongside Germany's GfK consumer and INSEE business sentiment surveys. Given the spread of the second pandemic wave across member states we expect all these surveys to imply a deterioration in sentiment this month. Indeed, the number of new daily cases in France has averaged a whopping 25k over the past seven days, while it tripled in Italy to above 15k today and also hit new record highs in Germany (of more than 7½k) and the Netherlands (almost 8k) over recent days. And new restrictions on activity – including possibly a tougher approach in Italy and the extension of the French curfews to other regions – might also be announced tomorrow.

UK: Public sector net borrowing



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt*



**Data for fiscal years, except dark blue bar represents September 2020.*
Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	CPI (core CPI) Y/Y%	Sep	**0.5 (1.3)**	*0.4 (1.1)*	0.2 (0.9)	**-**
	PPI input prices (output prices) Y/Y%	Sep	**-3.7 (-0.9)**	-5.7 (-)	-5.8 (-0.9)	**-5.6 (-)**
	Public sector net borrowing £bn	Sep	**36.1**	33.6	35.9	**30.1**
	House price index Y/Y%	Aug	**2.5**	-	2.3	**2.1**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Construction output M/M% (Y/Y%)	Aug	**2.6 (-0.9)**	-	0.2 (-3.8)	**0.3 (-3.4)**
UK	Rightmove house price index M/M% (Y/Y%)	Oct	**1.1 (5.5)**	-	0.2 (5.0)	**-**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tuesday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	ECB current account balance €bn	Aug	**19.9**	-	16.6	**17.0**
Germany	PPI Y/Y%	Sep	**-1.0**	-1.3	-1.2	**-**

Auctions

Country	Auction
Germany	sold €3.4bn of 0% 2022 bonds at an average yield of -0.80%
UK	sold £600mn of 1.25% 2032 index-linked bonds at an average yield of -2.976%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		15.00	Preliminary consumer confidence	Oct	-15.0	-13.9
Germany		07.00	GfK consumer confidence	Nov	-3.0	-1.6
France		07.45	INSEE business confidence	Oct	91	92
		07.45	INSEE manufacturing confidence (production outlook)	Oct	96 (-)	96 (-2)
UK		11.00	CBI industrial trends, total orders (business optimism)	Oct	-	-48 (-1)
Auctions and events						
EMU		08.00	ECB's Panetta scheduled to speak			
UK		09.30	BoE's Chief Economist Haldane scheduled to speak			
		10.00	Auction: £2.25bn of 0.625% 2035 bonds			
		10.20	BoE Governor Bailey scheduled to speak			
		11.30	Auction: £1.75bn of 0.625% 2050 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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