# Euro wrap-up

## Overview

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- Bunds made losses as euro area governments looked to respond to pressures in wholesale power markets, final French and Italian inflation estimates highlighted persistent energy price pressures, and euro area industrial production jumped at the start of Q3.
- Gilts also made losses as UK inflation rose to its strongest rate since 2012, albeit largely reflecting pandemic-related base effects and other special factors.
- Wednesday will bring euro area new car registration figures for August and goods trade data for July.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0 09/23 | -0.711 | +0.004 |
| OBL 0 10/26 | -0.630 | +0.018 |
| DBR 0 08/31 | -0.311 | +0.031 |
| UKT 0⅛ 01/23 | 0.251 | +0.026 |
| UKT 0⅜ 10/26 | 0.442 | +0.026 |
| UKT 0¼ 07/31 | 0.768 | +0.032 |

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

# Euro area

### Firm rebound in industrial production at the start of Q3

Last week's data from the large member states had already made clear that the euro area manufacturing sector returned to positive growth at the start of Q3. However, today's data for the region beat expectations, with euro area industrial production (excluding construction) rising 1.5%M/M in July to move just above the pre-pandemic level in February 2020 and 1.0% above the Q2 average. Most member states, including the three largest, recorded positive growth in IP at the start of the third quarter. However, the strongest growth in the sector came from medium-sized countries: Ireland (7.8%M/M), Belgium (5.0%M/M) and Portugal (3.5%M/M).

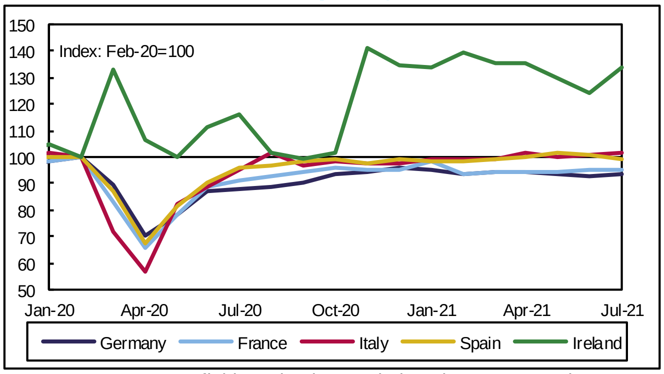
### Autos output down yet again, but capital goods production sees strong growth

While energy production fell 0.6%M/M, manufacturing output rose for the first time since April, and by a vigorous 1.8%M/M, also moving back above the pre-pandemic level and more than 1.0% above the Q2 average. Despite a pickup in the sub-sector in the larger member states, production of autos fell for the eighth successive month, albeit by just 0.2%M/M, to be still more 31% below the pandemic peak reached last November and more than 37% below the pre-pandemic level. However, production of machinery and equipment jumped 4.3%M/M, the most since January, to be back above the pre-pandemic level. Output of pharmaceuticals was also a significant contributor to growth that month, leaping 14.3%M/M to a new series high. And consumer (0.6%M/M), intermediate (0.4%M/M) and, in particular, capital goods (2.7%M/M) all rose in July. With order books in the manufacturing sector still ample, we expect industrial production to remain a contributor to GDP growth in Q3, Q4 and into the New Year. However, with domestic data pointing to a further drop in autos production in August, and supply bottlenecks still impeding production in many other sectors, we also anticipate a temporary decline in manufacturing production in August.

### Energy prices remain key driver of inflation as wholesale markets spike

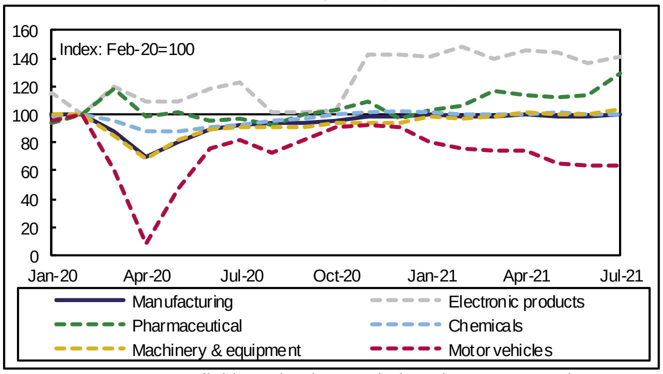
Like in Germany and Spain, today's final French inflation data for August aligned with the flash estimates, thus confirming the acceleration in the national (up 0.7ppt to 1.9%Y/Y) and EU-harmonised (up 0.9ppt to 2.4%Y/Y) measures. In Italy, the increases in the national (up just 0.1ppt to 2.0%Y/Y) and HICP (up 1.5ppt to 2.5%Y/Y) measures were both 0.1ppt less than signalled by the preliminary estimates – probably insufficient to influence the euro area figures. Among other things, the rise in the EU-harmonised measures in both countries partly reflected the timing of the summer sales, as prices of clothing and footwear – and hence of manufactured goods as a whole – rebounded in August. But the pace of increase in prices of consumer-facing services moderated, suggesting that momentum following the reopening of the sector was fading, perhaps

**Euro area: Industrial output by member state**




*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

**Euro area: Manufacturing output by selected sector**




*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

weighed additionally in France by the introduction of vaccine passes. And on the national measures, core inflation remained subdued in both France (1.5%Y/Y) and Italy (0.6%Y/Y).

Of course, energy prices remain the principal source of price pressure across the member states, e.g. accelerating 0.4ppt to 12.7%Y/Y in France and more than 1ppt to almost 20%Y/Y in Italy, still however short of the rise of 23.5%Y/Y in Spain. Admittedly, these pressures in part reflect pressures in wholesale energy markets, due not least by a shortage of gas and inadequate wind. But after Spain's government yesterday announced measures to address the pressures – suspending a power generation tax, lowering the Special Electricity Tax and capping or cutting gas and electricity bills for lower-income households, the French and Italian governments were today also reported to be looking at tax, spending and regulatory options to insulate consumers from the developments in wholesale markets. The near-term outlook for energy prices, and thus headline inflation, however, remains difficult to predict, with pressures likely to build further, particularly if the weather fails to support wind-power generation and temperatures plummet sharply when winter arrives.

## The day ahead in the euro area

A relatively quiet day for euro area economic releases tomorrow brings July trade data and August car registration figures. Having slipped back in June for the first month in five, exports are expected to have restored an upwards trend at the start of the third quarter. This notwithstanding, given persistent supply bottlenecks impacting autos production in particular and the spread of the delta variant across member states, new car registrations are expected to have remained very weak. Indeed, national figures from the four largest member states showed drops of 23%Y/Y in Germany, 15%Y/Y in France, 27%Y/Y in Italy and 29%Y/Y in Spain.

# UK

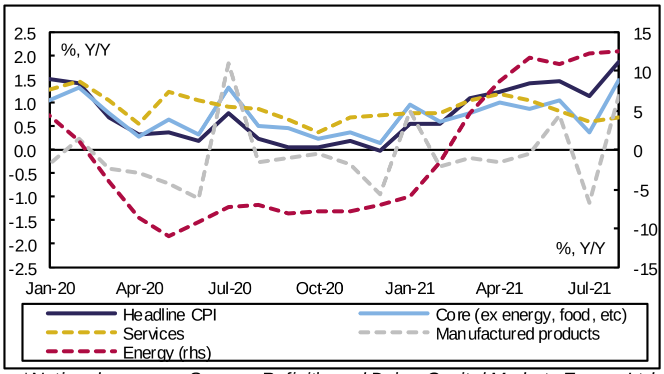
## Inflation rises more than expected to highest since 2012, principally due to base effects

Having fallen sharply in July, the UK's headline CPI inflation rate took a notable step up in August and by a larger than expected 1.2ppts to 3.2%Y/Y. While this was the largest rise since the series began in 1997 and the highest annual rate since March 2012, the jump principally reflected base effects associated with last year's hospitality subsidies and VAT cut, which will prove temporary. Indeed, also driven by increased recourse to domestic holidays due to the constraints on travelling abroad, restaurant and hotel prices were up 8.5%Y/Y in August, marking a rise of 6.5ppts from July and representing by far the strongest rate since the series began, having dropped 2.9%Y/Y a year earlier. Overall, the increase in prices of catering and accommodation services in total added more than 0.7ppt to the rise in headline inflation in August. And, as a result, services inflation leapt 1.4ppts to 3.0%Y/Y, the highest for more than four years

## Another jump in used car prices, while computer games provide a further boost

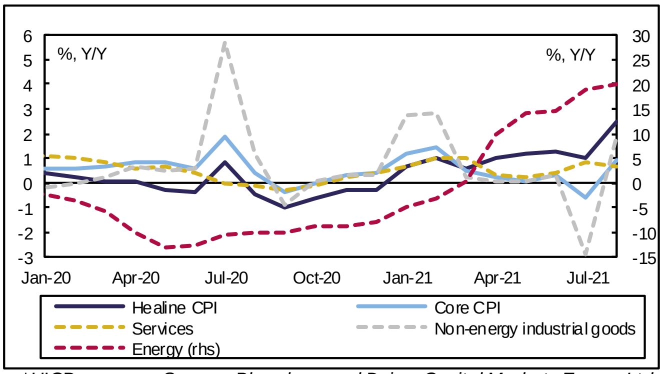
While base effects were particularly important, the monthly increase in the CPI index in August of 0.7%M/M was above the average for the month. One notable contributor was recreation and culture items, with inflation of games, toys and hobbies up 6.7ppts on the month to 3.8%Y/Y. This component, however, was pushed higher by a rise in computer game prices, which seem unlikely to represent a persistent source of inflationary pressure as they are typically highly volatile, being dependent on which games are most popular in any single month. There was also another notable contribution from the transport sector as – mimicking the recent pattern in the US – prices of second-hand cars rose a further 4.9%M/M to be up 18.3%Y/Y, the most since February 2010, reflecting increased demand amid supply bottlenecks impacting production of new autos. Overall, non-energy goods industrial prices rose 1.0%M/M, the most for the month since 2018, pushing the respective annual rate of inflation up 0.9ppt to 3.3%Y/Y, matching the series high recorded at the start of 2010. And so, core CPI inflation also surged last month, by 1.4ppts to 3.2%Y/Y, the highest since November 2011. Meanwhile, energy inflation edged up just 0.1ppt to 9.4%Y/Y but food inflation rose 0.9ppt to 0.9%Y/Y.

**France: CPI inflation***




*National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

**Italy: CPI inflation***




*HICP measure. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

## PPI suggests additional pressures in the pipeline

UK inflation also rose further at the factory gate in August, with producer output price inflation up 0.8ppt to 5.9%Y/Y, the highest since November 2011. Some of the rise was due to higher petrol price inflation, which accelerated more than 4ppts to 50.4%Y/Y. But the source of the largest contribution to the rise on the month was the “other manufactured goods” component, with wood, cork, straw and plaiting materials the principal driver. Meanwhile, despite a slight easing in crude oil inflation due to base effects, the input PPI rate also increased further, up 0.6ppt to 11.0%Y/Y, with prices of iron, steel and ferro-alloys the main source of upwards pressure, albeit with wood prices similarly adding upwards momentum. As already seen in the US, however, we would expect the increases in prices of timber and related items to fall back before long as supply responds.

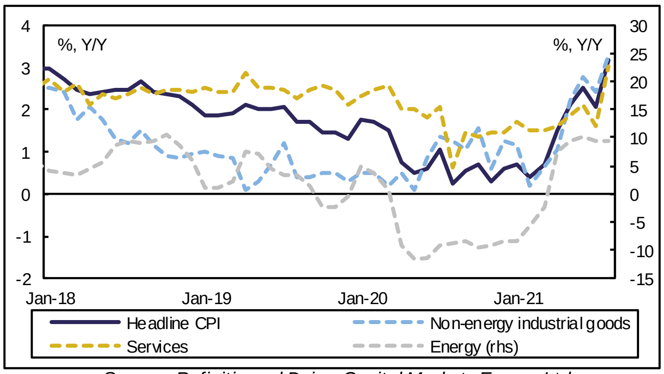
## Outlook uncertain, but inflation still likely to fall back close to target next year

Looking ahead, the price outlook in the UK remains highly uncertain. Services and manufactured goods inflation are likely to move somewhat higher over the near term due to base effects. And with the energy component set to rise again in the final quarter not least due to Ofgem’s increase of more than 12% in the regulated price cap for household energy bills from October, we expect the headline CPI rate to take a further step up before the end of the year, peaking at around 4%Y/Y. Inflation will remain elevated for much of the first half of 2022. But while household energy bills could well add additional pressure next year, base effects for petroleum prices should fade. And with still few signs of increased producer goods prices being passed on to consumers beyond the energy sector, and wage settlements still unlikely to accelerate significantly at the aggregate level, we continue to expect the headline CPI rate to fall back close to and eventually just below 2.0%Y/Y in the second half of the year. Given the risks that skill shortages pose to labour cost growth, we acknowledge that the risks to the inflation outlook are skewed somewhat to the upside. But the imminent ending of the government’s furlough scheme could well have a dampening effect. And we think that today’s market pricing of two BoE rate hikes next year is overdone.

## The day ahead in the UK

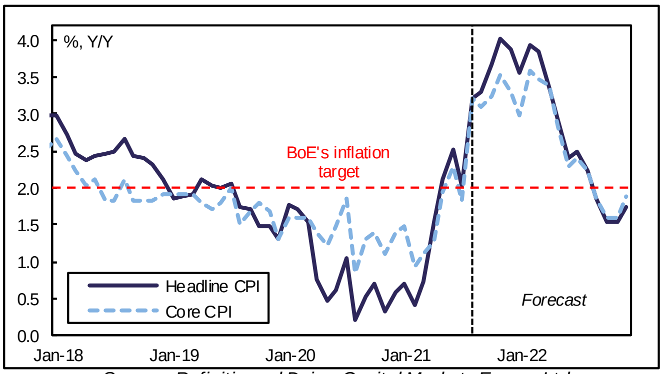
It should be an uneventful day in the UK tomorrow with no economic data due for release.

### UK: CPI inflation by key components



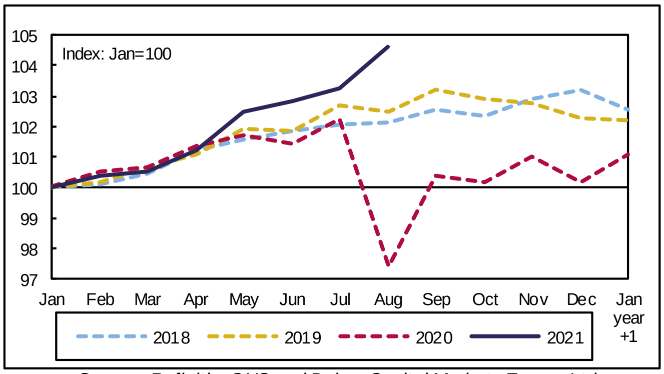

*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

### UK: Headline and core CPI inflation forecast



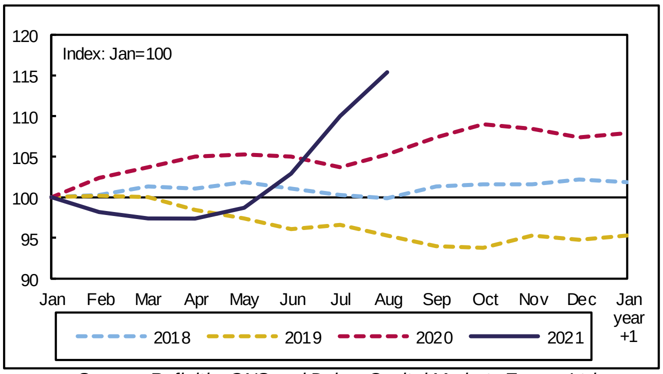

*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

### UK: Hotels and restaurant price indices




*Source: Refinitiv, ONS and Daiwa Capital Markets Europe Ltd.*

### UK: Used cars price indices




*Source: Refinitiv, ONS and Daiwa Capital Markets Europe Ltd.*

# European calendar

## Today's results

**Economic data**

| Country | | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | Revised |
|---|---|---|---|---|---|---|---|
| Euro area | | Industrial production M/M% (Y/Y%) | Jul | **1.5 (7.7)** | *1.1 (6.6)* | -0.3 (9.7) | **-0.1 (10.1)** |
| | | Labour costs Y/Y% | Q2 | **-0.1** | - | 1.5 | **1.3** |
| France | | Final CPI (EU-harmonised CPI) Y/Y% | Aug | **1.9 (2.4)** | 1.9 (2.4) | 1.2 (1.5) | - |
| Italy | | Final CPI (EU-harmonised CPI) Y/Y% | Aug | **2.0 (2.5)** | 2.1 (2.6) | 1.9 (1.0) | - |
| UK | | CPI (core CPI) Y/Y% | Aug | **3.2 (3.1)** | *3.0 (3.0)* | 2.0 (1.8) | - |
| | | PPI input prices (output prices) Y/Y% | Aug | **11.0 (5.9)** | 10.3 (5.4) | 9.9 (4.9) | **10.4 (5.1)** |
| | | House price index Y/Y% | Jul | **8.0** | 12.5 | 13.2 | **13.1** |

**Auctions**

| Country | | Auction |
|---|---|---|
| UK | | sold £2.5bn of 0.25% 2031 bonds at an average yield of 0.74% |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Tomorrow's releases

**Economic data**

| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|---|
| Euro area | | 07.00 | EU27 new car registrations | Aug | - | 10.4* |
| | | 10.00 | Trade balance €bn | Jul | 16.7 | 12.4 |
| Italy | | 09.00 | Trade balance €bn | Jul | - | 5.7 |

**Auctions and events**

| Country | | BST | Event |
|---|---|---|---|
| Euro area | | 13.00 | ECB President Lagarde scheduled to speak - 'Moving forward: The Euro and the European economy in a changing world' |
| France | | 09.50 | Auction: 0.25% 2026 bonds |
| | | 09.50 | Auction: 2.25% 2024 bonds |
| | | 09.50 | Auction: 0% 2027 bonds |
| | | 10.50 | Auction: 0.1% 2031 index-linked bonds |
| | | 10.50 | Auction: 0.1% 2026 index-linked bonds |
| | | 10.50 | Auction: 1.8% 2040 index-linked bonds |
| Spain | | 09.30 | Auction: 0% 2024 bonds |
| | | 09.30 | Auction: 0% 2026 bonds |
| | | 09.30 | Auction: 0.5% 2031 bonds |

**For June. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*