Euro wrap-up

Overview

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- As hawkish Bundesbank President Weidmann announced he would step down at the end of the year, Bunds made gains as euro area inflation in September was confirmed at a 13-year high but the detail suggested that underlying pressures remain relatively limited.
- Gilts also made gains as UK inflation surprised slightly on the downside, falling to 3.1%Y/Y in September.
- Thursday will bring the flash estimate of euro area consumer confidence in October along with business surveys for the current month from France and the UK and an update on the UK's public finances.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.664	-0.027
OBL 0 10/26	-0.475	-0.030
DBR 0 08/31	-0.127	-0.019
UKT 0⅛ 01/24	0.672	-0.045
UKT 0⅜ 10/26	0.816	-0.033
UKT 0¼ 07/31	1.148	-0.016

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

Euro area

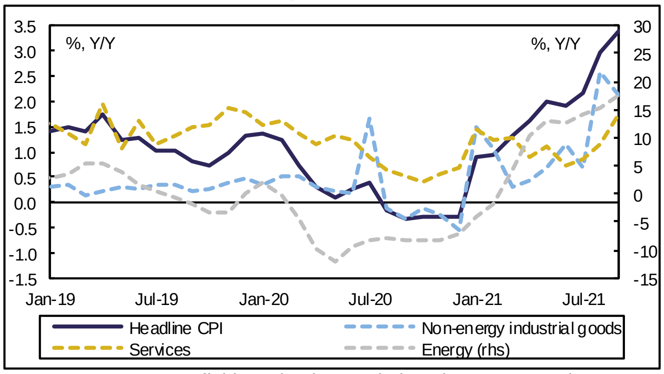
Final euro area inflation unrevised at 13-year high

The final euro area inflation figures for September offered no surprises, with the headline rate bang in line with the flash estimate that showed a rise of 0.4ppt to 3.4%Y/Y, the highest in thirteen years. The largest contributor remained energy, inflation of which accelerated 2.2ppts from August to a new euro-era high of 17.6%Y/Y, to account for roughly half of all inflation last month. This in part reflected another near-2%M/M rise in electricity prices, to leave them almost 11% higher than a year earlier, while the annual increase in prices of gas accelerated 1.8ppts to 16.9%Y/Y. But the upwards move in September's inflation largely reflected the services component, up 0.6ppt to 1.7%Y/Y, the highest since 2019. That reflected the smallest month-on-month decline in services prices in any September since 2007, with accelerated inflation of pandemic-affected items such as package holidays (up 1.4ppts to 0.5%Y/Y), restaurants and hotels (up 0.5ppt to 2.6%Y/Y) and airfares (up 4.5ppts to 14.1%Y/Y). In contrast, due to a shift back in the pattern of summer discounting, non-energy industrial goods prices rose at their softest monthly pace in any September since 2010, to leave the annual rate down 0.5ppt to 2.1%Y/Y, Overall, core inflation jumped in September, by 0.3ppt to 1.9%Y/Y, its highest in thirteen years.

Base effects and normalisation still boosting inflation

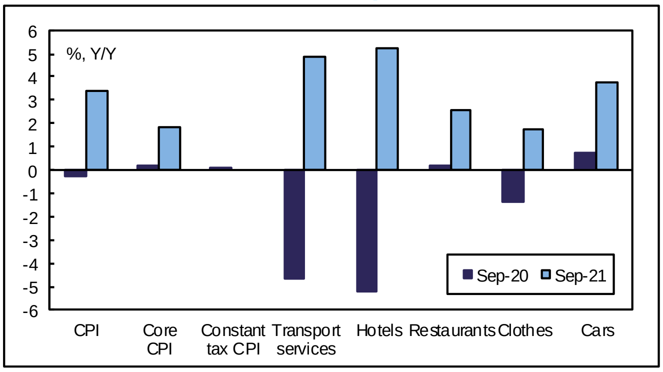
The rise in core inflation merely left the associated price index in line with the subdued pre-pandemic trend, suggesting that most of the pickup this year reflects base effects and a normalisation in prices following temporary weakness last year rather than significant new pressures. And in contrast to the increases in headline and core inflation, the euro area's trimmed mean CPI– which excludes the top and bottom 7½% price moves – was unchanged in September suggesting no intensification at the end of Q3. Admittedly, at 2.4%Y/Y, the trimmed mean remained at its joint highest for nine years but still suggests only moderate price pressures in the economy. Looking ahead, the recent spike in wholesale natural gas prices will continue to push energy inflation considerably higher over coming months, while increased pass-through from producer price inflation to consumer prices might be expected as long as demand remains relatively firm. Persisting supply constraints might also continue to exert upward pressures in certain sectors – e.g. in autos, where inflation rose 0.5ppt to a fresh series high of 3.8%Y/Y in September. But while inflation might well stay higher for longer than previously thought, we continue to expect headline inflation to peak at the end of this year, ease by mid-2022 and fall back below the 2% target by the end of next year. And with underlying price pressures still very subdued, and the risks of negative base effects from energy prices and other supply-constrained items in 2023, we continue to see headline inflation on average that year back firmly below the ECB's target and indeed a touch below the ECB's most recent projection of 1.5%.

Euro area: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: CPI selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

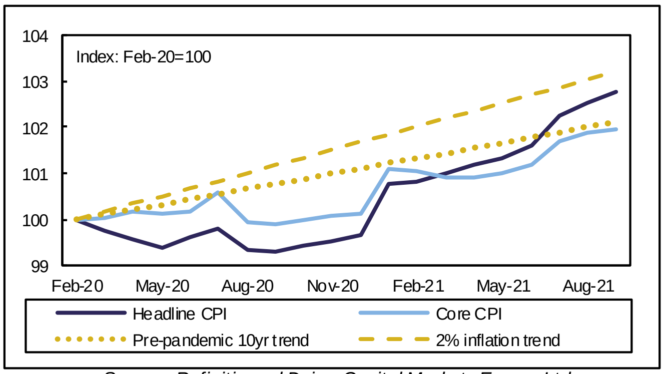
German producer price inflation up again above expectations to highest since 1974

Further price pressures in the pipeline were illustrated by today's German PPI inflation data. German producer prices again surprised significantly on the upside, rising by a series-high 2.3%M/M in September. That took the headline PPI rate up 2.2ppt to 14.2%Y/Y, the strongest annual increase since October 1974 when prices were boosted by the first OPEC oil shock. As in the early 1970s, the main contributor this time around was also energy, prices of which rose a further 8%M/M in September to push the annual rate up to a new series high of 32.6%Y/Y. However, in this category, pressures remain most acute in natural gas markets, prices of which rose 15%M/M to leave them up a record 247%Y/Y. The increase in prices of intermediate goods was more modest (0.8%M/M), nevertheless leaving them up 17.4%Y/Y, with inflation of metals and timber products, as well as plastics and fertilisers, still rapid. Further along the supply chain, inflation of capital goods rose 0.4ppt to 2.8%Y/Y, the highest since 1993, reflecting increased pass-through of upstream pressures. Likewise, inflation of consumer durables was also up a further 0.4ppt to a series high of 3.2%Y/Y as manufacturers fail to absorb fully the increased costs within their margins. However, inflation of non-durables rose to 2.2%Y/Y, merely the highest in 18 months. Nevertheless, we expect further pass-through from producer prices to consumers over the coming six-to-twelve months.

Construction output on track for Q3 contraction on supply bottlenecks

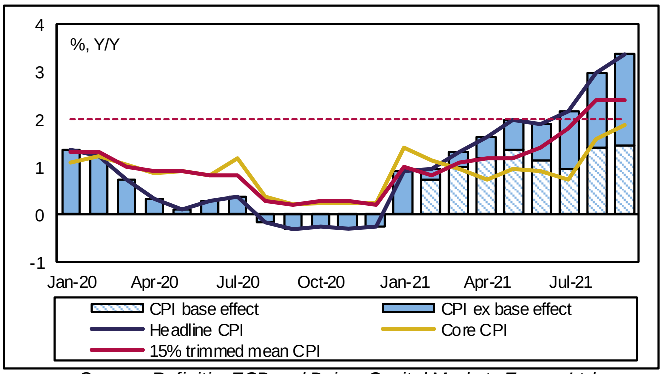
In terms of economic activity, yesterday's construction output data bore the marks of supply-side constraints that have restricted access to, and increased prices of, raw materials, intermediate items and skilled labour. Overall, euro area construction output dropped for the fourth time in five months in August and by 1.3%M/M. That left the level of production in the sector at its lowest since weather-afflicted February, more than 2.5% below March's pandemic peak and almost 3.5% below the pre-pandemic level at the start of 2020. Moreover, the average level in the first two months of Q3 was 1.1% below the Q2 average, strongly suggesting that construction activity subtracted from GDP growth in Q3. Production in the sector dropped in most member states, including Germany (-3.1%M/M), France (-1.7%M/M) and Spain (-1.5%M/M). And the fall was broad-based, with both infrastructure (-1.9%M/M) and building work (-1.3%M/M) down in August and on track for contraction in Q3. Surveys suggest that activity in the sector stabilised in September and firm growth in new orders. And while there are country differences – with firms in Italy particularly upbeat – on balance business expectations in the sector remain positive, even as supply constraints remain severe. In part, that reflects continued optimism about the outlook for residential work, for which fundamentals – including ongoing economic recovery near-record low interest rates, decent mortgage availability and an improving labour market – point to continued solid demand ahead. House prices look set for further growth over coming quarters too, having already risen in Q2 by 6.8%Y/Y, the strongest rate since Q406, with prices up more than 10%Y/Y in Germany, the Netherlands and Austria, and more than 5%Y/Y in France.

Euro area: Consumer price levels



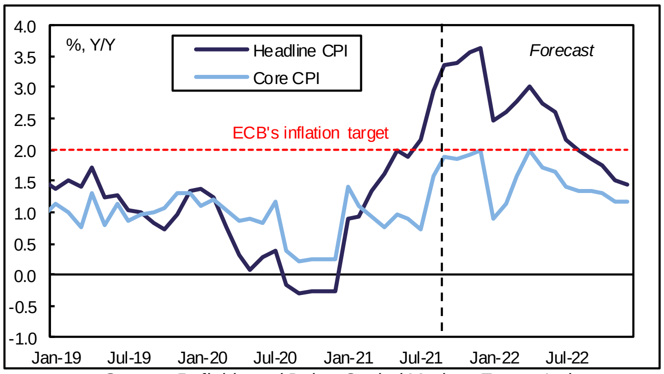
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation - selected measures



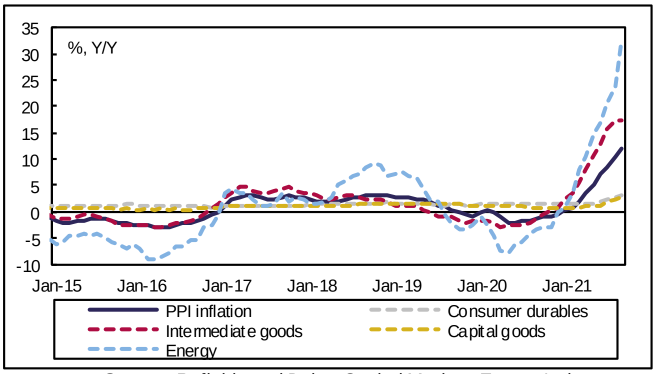
Source: Refinitiv, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Producer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

French retail sales bounce back in September

In contrast to the soft construction activity data, yesterday's Bank of France retail sales survey added to evidence of robust growth in consumer spending last quarter. In particular, according to the BoF survey, French retail sales rose a solid 2.8%M/M in September, almost fully reversing the drop (-3.2%M/M) in August, supported by a rebound in sales of food (2.3%M/M) and manufactured goods (3.0%M/M). The bounce back was broad-based, with the strongest growth in stationary (15.2%M/M) – perhaps reflecting the return to school – furniture (9.2%M/M), and hygiene products (4.8%M/M). But while sales of new autos were up around 2½%M/M for the second successive month, they were still down (-1.4%Q/Q) in Q3, with sales of other auto equipment continuing to fall in September. Overall, however, the survey measure of sales of manufactured goods rose an impressive 9.0%Q/Q last quarter, despite the increased opportunity to spend on services. Admittedly, sales of food slipped back (-0.4%Q/Q) as spending on hospitality likely increased with the relaxation of restrictions. But this still left the BoF measure of overall retail sales up more than 3%Q/Q, more than reversing the decline in Q2 and supporting the view that household consumption underpinned the acceleration in GDP growth to more than 2%Q/Q in Q3.

The day ahead in the euro area

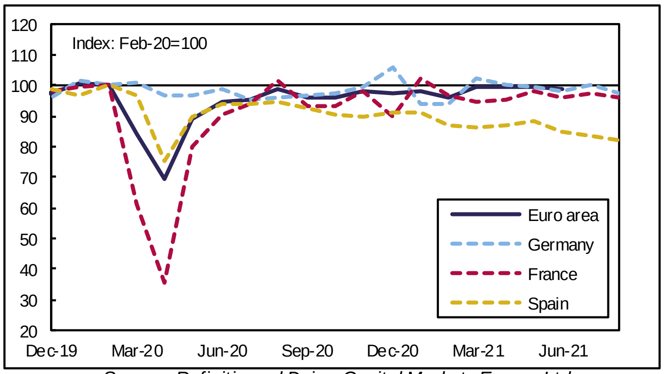
Tomorrow brings the release of the Commission's preliminary euro area consumer confidence index for October. While households are likely to have remained broadly upbeat about economic conditions at the start of Q4, they might well express some concerns about their financial situation on the back of the anticipated increase in household energy bills over the near term. At the country level, we will see the release of French business sentiment data for October, which will give insight into what to expect from Friday's flash PMIs. INSEE is expected to report another modest fall in overall manufacturing confidence to the lowest in six months not least due to energy price pressures.

UK

A temporary drop in consumer price inflation in September

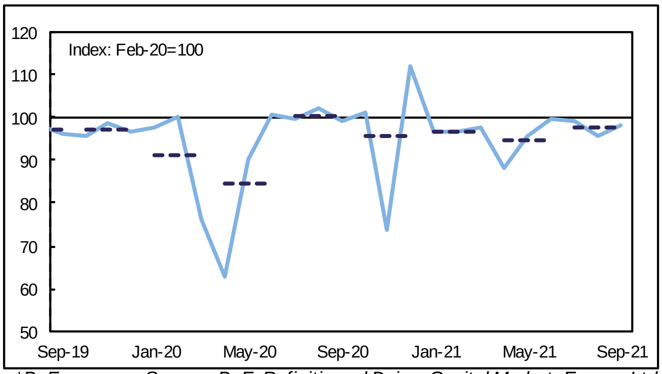
UK CPI inflation unexpectedly slowed slightly in September, moderating 0.1ppt from the prior month's nine-year high to 3.1%Y/Y. Core inflation dropped too, down 0.2ppt to 2.9%Y/Y. But these data merely represent a temporary breather in the uptrend, which will resume in October due not least to higher household energy bills, and will extend through to Q2 next year when the regulated energy price cap will be hiked again. In September, however, the declines in both headline and core measures were principally due to lower inflation of restaurants and hotels, which dropped 3.5ppts to 5.1%Y/Y reflecting base effects from the ending of the government's subsidies a year earlier – prices in the sector still rose this September but not by as much as last September. The clothing component (down to a 5-month low of just 0.6%Y/Y) also subtracted from overall

Euro area: Construction output



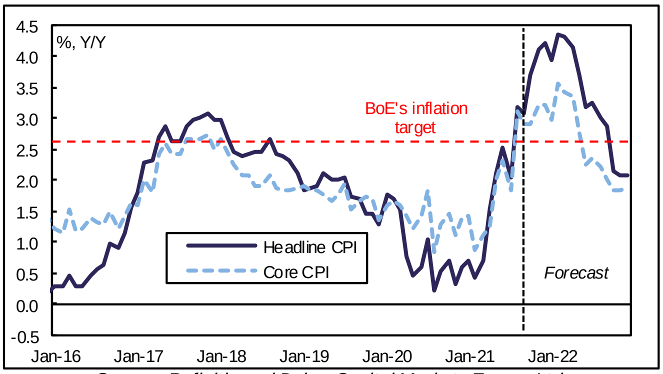
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Retail sales*



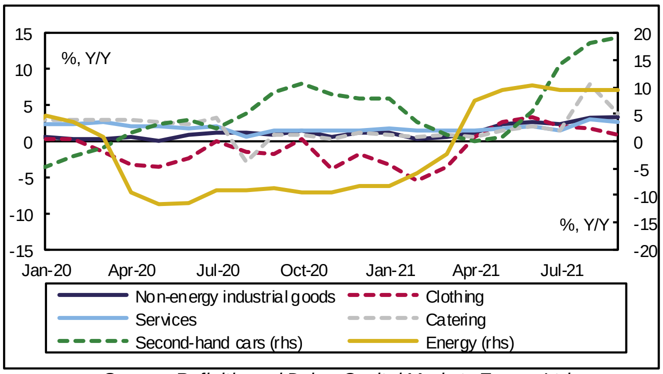
**BoF measure. Source: BoF, Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: CPI inflation - forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation – selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

inflation despite higher prices on the month. But most other components increased. In particular, transport inflation rose 0.6ppt to 8.4%Y/Y due partly to higher prices of road transport services and used cars (up almost 1ppt to be up 21.8% since April), while furniture and other household goods (up 0.8ppt to 4.5%Y/Y), and food and beverages (up 0.5ppt to 0.8%Y/Y) also made positive contributions again. In the pipeline, producer price inflation rose once again too, with the input PPI rate up 0.2ppt to 11.4%Y/Y and output PPI rate up 0.7ppt to 6.7%Y/Y. One driver here was energy prices, in particular prices of petrol and crude oil (up almost 4ppts to 24.2%Y/Y), although core producer output inflation rose a further 0.4ppt to 5.9%Y/Y, the highest since 2008 on increased prices of transport goods as well as metals, machinery and equipment. We expect further pass-through from PPI to consumer price inflation over coming months.

BoE determined to raise rates despite two-sided risks to the inflation outlook

Looking ahead, energy prices are likely to push inflation sharply higher to above 3½%Y/Y in October and above 4.0%Y/Y by year-end and into Q1 and Q2. But prices of energy and several other items recently under upwards pressure (e.g. those of used cars) will not move ever-higher at the recent pace. Indeed, base effects for many items are likely to turn negative later next year and into 2023. And in the absence of very significant pass-through of energy price pressures to other items, we expect headline inflation to fall below 2.0%Y/Y in 2023. Of course, there remain significant uncertainties. And as underlying wage growth appears now to be exceeding pre-pandemic norms amid persisting and substantive labour and skill shortages, and financial market inflation expectations are up to their highest since 2009, the upside risks to the inflation outlook now seem sufficient to prompt the BoE to withdraw stimulus. Admittedly, in his contribution to a G30 panel discussion on the weekend, BoE Governor Bailey said that he continues “to believe that higher inflation will be temporary” and stated that “monetary policy cannot solve supply-side problems”. But he also acknowledged that high inflation will last for longer than previously expected, raising “concern of embedded inflation expectations”. Most importantly, he added that the BoE had already signalled, and was signalling again, that it “will have to act…if we see a risk particularly to medium-term inflation and to medium-term inflation expectations.” And with inflation expectations at their highest levels for more than a decade, that suggests that a rate hike before the end of the year, to reverse the final 15bps cut at the start of the pandemic, is inevitable. Given the underwhelming UK growth outlook, however, the series of additional hikes throughout next year implied by current market-pricing appears overdone to us, with perhaps just one further 25bp hike in 2022 more likely.

The day ahead in the UK

Ahead of Friday’s flash PMIs, the CBI’s latest quarterly industrial trends survey tomorrow will provide an update on output, orders, employment and investment intentions in the manufacturing sector. Meanwhile, ahead of the Government’s Budget and Spending Review announcements on 27 October, Thursday will also bring the latest public finance figures for September, which are likely to suggest again that the Chancellor would have some room to relax future consolidation plans if he felt that was politically convenient.

European calendar

Today’s results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Current account €bn	Aug	**13.4**	-	21.6	**22.6**
	Final CPI (core CPI) Y/Y%	Sep	**3.4 (1.9)**	*3.4 (1.9)*	3.0 (1.6)	-
Germany	PPI Y/Y%	Sep	**2.3 (14.2)**	-	1.5 (12.0)	-
UK	CPI (core CPI) Y/Y%	Sep	**3.1 (2.9)**	*3.4 (3.0)*	3.2 (3.1)	-
	PPI input (output) prices Y/Y%	Sep	**11.4 (6.7)**	11.8 (6.8)	11.0 (5.9)	**11.2 (6.0)**
	House price index Y/Y%	Aug	**10.6**		8.0	**8.5**

Auctions

Country	Auction
Germany	sold €1.65bn of 0% 2031 bonds at an average yield of -0.16%
UK	sold £2.25bn of 0.25% 2031 bonds at an average yield of at an average yield of 1.144%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Construction output M/M% (Y/Y%)	Aug	**-1.3 (-1.6)**	-	0.1 (3.3)	**- (3.5)**
Spain	Trade balance €bn	Aug	**-3.9**	-	-1.6	**-**

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
UK	Rightmove house price index M/M% (Y/Y%)	Oct	**1.8 (6.5)**	1.8 (6.5)	0.3 (5.8)	**-**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	15.00	European Commission's preliminary consumer confidence	Oct	-5.0	-4.0
France	07.45	INSEE business confidence	Oct	110	111
	07.45	INSEE manufacturing confidence (production outlook)	Oct	105 (17)	106 (23)
UK	07.00	Public sector net borrowing, excl. banks £bn	Sep	22.6	20.0
	11.00	CBI industrial trends, total orders (selling prices)	Oct	17 (40)	22 (41)

Auctions and events

France	09.50	Auction: 0% 2025 bonds
	09.50	Auction: 1% 2025 bonds
	09.50	Auction: 0.5% 2026 bonds
	09.50	Auction: 0.1% 2032 index-linked bonds
	09.50	Auction: 0.1% 2047 index-linked bonds
	09.50	Auction: 0.1% 2026 index-linked bonds
Spain	09.30	Auction: 0% 2027 bonds
	09.30	Auction: 0.85% 2037 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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