# Euro wrap-up

## Overview

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- Euro area gowies made widespread and substantial losses, despite Lagarde's attempt to push back on market pricing of future ECB rate hikes.
- Gilts also made notable losses at the shorter end of the curve, despite some weak UK car production numbers.
- A busy end to the week brings the flash estimates of euro area Q3 GDP and October inflation. UK bank lending figures for September are also due.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0 09/23 | -0.641 | +0.014 |
| OBL 0 10/26 | -0.458 | +0.015 |
| DBR 0 08/31 | -0.152 | +0.029 |
| UKT 0⅛ 01/24 | 0.613 | +0.073 |
| UKT 0⅜ 10/26 | 0.739 | +0.054 |
| UKT 0¼ 07/31 | 0.989 | +0.010 |

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

# Euro area

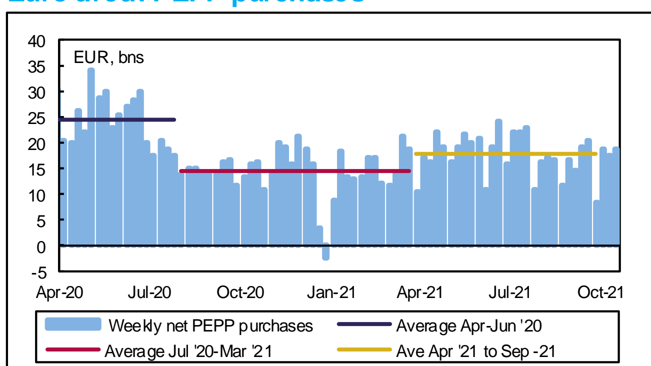
### Lagarde tries (but fails) to push back on market pricing of ECB rate hikes

In terms of current policy, today's ECB announcements provided no surprise whatsoever with all key parameters – in terms of interest rates, asset purchases and forward guidance – left unchanged. However, Christine Lagarde's post-meeting press conference was not without interest, as the ECB President was repeatedly forced to push back on market pricing of a first rate hike as soon as the end of 2022. Admittedly, Lagarde acknowledged that supply bottlenecks were set to persist well into 2022, and so inflation would now remain higher for longer than the ECB had envisaged even just last month. However, she insisted that all of the key current drivers of higher inflation – mismatches between supply and demand, higher energy prices, and base effects such as that associated with German tax changes – would fade over the course of the coming year and might even go into reverse. So, she reiterated that the ECB expected inflation to fall back over the course of 2022 and remain below the 2% target over the medium term. With the ECB's guidance stating that inflation would need to be expected to remain at 2% or above well before the end of the projection horizon and into the medium term to merit a rate hike, Lagarde insisted that the preconditions for such tightening simply were not likely to be met in the timeframe expected by the markets "nor any time soon thereafter". So, she posited that either the markets did not understand the ECB's forward guidance or saw the inflation outlook differently to the ECB. With several central banks having recently shifted their messaging from dovish to hawkish, and euro rates markets continuing to sell off while Lagarde was speaking, the markets might well differ from the ECB's position on both counts. However, we share the ECB's view that inflation is more likely than not to be back below 2% in 2023, suggesting that rate lift-off remains unlikely before 2024.

### PEPP likely to end in March 2022 after slower pace of purchase in Q1

Beyond inflation and rates, the ECB's communication today was relatively upbeat. Among other things, the Governing Council assessed that the economy continued to grow strongly and that the risks to the outlook remained "broadly balanced". So, despite some moderation of momentum, the ECB still expects output to exceed its pre-pandemic level by the end of the year. The Governing Council also judged that the "grip of the pandemic on the economy has visibly weakened", supporting consumer and business spending. And in light of that diminished economic impact from the pandemic, Lagarde today made her clearest signal yet that the PEPP programme is likely to end in 2022. While that should already have been investors' baseline assumption, her comments might have contributed to today's underperformance of BTPs in particular. While it might be justifiable given recent declines in real yields, the ECB's reiteration that financial conditions remained favourable despite higher nominal yields, suggesting no immediate need to accelerate purchases, might also have played a role. In terms of the ECB's other tools, however, Lagarde suggested that the Governing Council would seek to avoid a cliff edge at the end of the TLTRO-3 programme, the final operation of which will be conducted next month. Expect news on that policy instrument, but

**Euro area: PEPP purchases**




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

**Euro area: 5Y5Y inflation forward swap rate**

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

more importantly also the pace of net asset purchases in Q122 and the nature of post-PEPP purchases from Q222 onwards, when the next Governing Council policy meeting concludes on 16 December. We continue to expect a further slowing in the pace of net purchases in the first quarter of next year, and beyond, but also increased flexibility to be given to the regular asset purchase programme once the PEPP is retired in March.

## Energy pushes German and Spanish inflation to euro-era highs

In her press conference, Lagarde stated that the ECB's discussions had been dominated by a consideration of the inflation outlook. And ahead of tomorrow's flash euro area CPI estimates, today's German and Spanish inflation reports confirmed the continuation of the recent marked upwards trend. Indeed, slightly ahead of expectations, Germany's harmonised HICP rate rose 0.5ppt in October to a euro-era high of 4.6%Y/Y with the headline national rate up 0.4ppt to 4.5%Y/Y, the highest since August 1993. However, energy inflation, which rose more than 4ppts to a series high of 18.6%Y/Y, was again the main driver. Among the other major items, inflation of services and food was weaker, and inflation of non-energy durable goods appears to have been little changed. The equivalent Spanish inflation estimates were much more striking. On the EU-harmonised HICP measure, inflation jumped 1.5ppts to a euro-era high of 5.5%Y/Y, some 0.9ppt above the Bloomberg consensus. Spain's statistical agency provided little detail, but again made it clear that the increase was driven by electricity prices and to a lesser extent by fuels and oil prices for personal vehicles and gas, whose impact was exaggerated by base effects. Indeed, on the national measure, while the headline rate also leapt to 5.5%Y/Y (the highest since September 1992), the rise in core inflation was much more muted, up 0.4ppt to 1.4%Y/Y, marking the largest difference between the headline and core rates since the series began in 1986. We note that the impact of energy prices on inflation in most other member states is likely to be much smaller than in Spain.

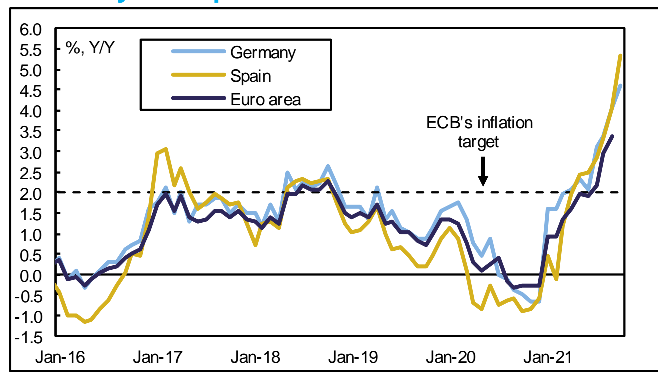
## Despite rising prices, economic sentiment improves at the start of Q4

Against this backdrop of high and rising inflation, the European Commission's sentiment survey today reported a further substantial rise in consumers' inflation expectations in October to their highest since November 1992. And amid persisting supply chain disruption, labour shortages and rising energy costs, the survey continued to flag extremely elevated price pressures on firms too, with selling price expectations continuing on a steep upwards trend and reaching all-time highs across the major sectors. In spite of this, and contrasting with the further loss of momentum implied in last week's flash PMIs, today's survey saw its headline Economic Sentiment Indicator (ESI) unexpectedly rise at the start of the fourth quarter, by 0.8pt to 118.6, just shy of July's record high. Improvements in the French, Italian and Spanish ESIs – the latter to a fresh series high – were partly offset by a drop in the German index, admittedly from a record high in September. At the sectoral level, the rebound reflected improved optimism among services firms. Manufacturers also suggested some stabilisation at the start of the fourth quarter, but the index remains boosted by rising order books rather than a rebound in production. Indeed, the scarcity of stock levels was assessed to be close to a record, with a separate quarterly survey suggesting that shortages of material and equipment limiting production in the sector had risen to a record. While construction confidence rose to its highest level since January 2019 as order books remained elevated, the share of managers citing shortages of labour and materials similarly reached new record-high levels. And while the headline index suggested greater optimism among retailers, this indicator was arithmetically flattered by the record low stock levels. Indeed, amid a decline in consumer confidence, retailers reported a further deterioration in expected business over the near term.

## Lending to businesses picks up in September, but consumer credit remains subdued

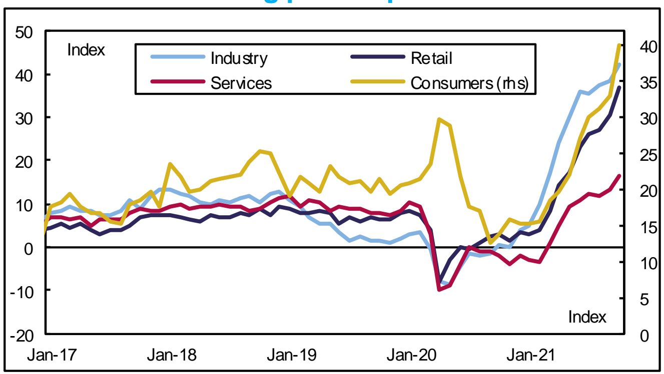
The latest ECB monetary data were consistent with near-term economic expansion, reporting a ninth successive increase in the flow of longer-dated loans to non-financial corporations (NFCs). That tallied with the message from this week's ECB's bank lending survey that suggested a pickup in firms' financing needs for fixed investment. While the magnitude of increase in such net new lending (€8.7bn) in September was smaller than the average seen in the first half of the year (€21.9bn), this still left the stock up 6.9%Y/Y. And with the net flow of shorter-dated loans to firms (€7.8bn) positive for the first time since

### Germany and Spain: Headline CPI inflation*




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

### Euro area: EC selling price expectations




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

March, the flow of total lending to NFCs (adjusted for loan sales and securitisation) increased to €18.7bn, the most since March and almost double the average pace in the year before the pandemic. As such, the annual growth rate in the stock of loans to NFCs jumped 0.6ppt to 2.1%Y/Y, a five-month high. Bank lending to households remained solid in September, with the net flow marginally firmer at €21bn, to leave the annual growth rate down just 0.1ppt at 4.1%Y/Y. But despite a reported tightening of credit standards in the third quarter, the rise in September was again underpinned by lending for house purchases, which was up a further €21bn in September, to leave the annual rate in the stock of such loans at 5.5%Y/Y. In contrast, despite increased opportunities to spend, household demand for consumer credit remained subdued last month, to leave the annual growth of such loans up just 0.4%Y/Y.

### The day ahead in the euro area

A busy end to the week for top-tier euro area data sees the release of the flash estimates of Q3 GDP and October inflation. We expect to see another quarter of solid GDP growth in the euro area of 1.8%Q/Q in Q3 (following growth of 2.2%Q/Q in Q2), thanks to a strong contribution from services as Covid restrictions were relaxed. At the country level, we expect growth to have accelerated in France and Spain (from 1.1%Q/Q in Q2), be a little stronger in Germany (from 1.6%Q/Q in Q2) and have moderated in Italy (from 2.7%Q/Q previously). Data out today showed that GDP in Belgium – a bellwether for the euro area economy – rose a firm 1.8%Q/Q in Q3, up 0.1ppt from Q2.

In terms of inflation, tallying with today's releases from Germany and Spain, we expect the euro area's headline measure of inflation to have taken a step up from September's thirteen-year high of 3.4%Y/Y, driven by a further jump in energy inflation following the surge in wholesale gas prices. In contrast, the core measure is likely to have moved sideways at 1.9%Y/Y this month.

## UK

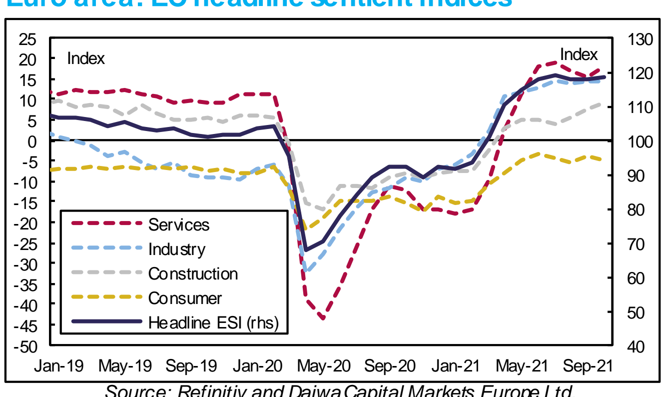
### Budget gives a moderate boost to future spending amid rising tax burden

Ahead of the coming week's BoE monetary policy decisions, focus in the UK this week was on yesterday's Government Budget and Spending Review announcements for insight into the fiscal stance over coming years. Against the backdrop of an improved economic backdrop, the Chancellor decided to provide a modest boost to public spending over the forecast horizon by an average £30bn a year. Almost half of that extra spending had already been announced when the Government unveiled additional resources for health and social care last month. The remainder will seek to reverse cuts to which the Government was previously supposedly committed. Among its spending U-turns, a modest reversal of the Government's recent cut to Universal Credit benefit payments for some people in work was perhaps most notable. Much of this extra spending will be frontloaded, with the policy decisions boosting departmental spending by £25bn next year, before tapering to a little more than £10bn from 2024/25. Of course, the extra spending pales into comparison with the pandemic-related splurge last year. And given the expected recovery in economic activity and employment, public spending is projected by the independent Office for Budgetary Responsibility (OBR) to fall from 53.1% of GDP in FY20/21 to 45.1% this fiscal year and 42.1% next fiscal year, before levelling out at around 41.6% by 2024/25, 1.8ppts above the pre-pandemic level and the highest share of GDP on a sustained basis (i.e. outside of recessions) since the 1970s.

### Fiscal backdrop improved by faster economic recovery and significantly higher tax receipts

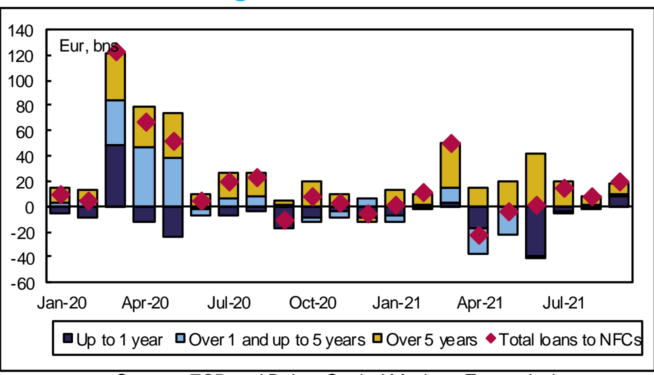
The opportunity to boost public spending partly reflects the significantly improved economic backdrop which – even without taking into account the ONS's most recent upwards revisions to GDP – saw the OBR revise up its GDP growth forecast by a hefty 2.5ppts to 6.5%Y/Y in 2021, with the pre-Covid level of GDP now expected to be reached at the turn of the year, several months earlier than assumed back in March. The OBR also revised down its expectations for the unemployment rate, which it now estimated to rise modestly to just 5¼% this quarter, 1¼ppt lower than estimated in March. And overall, while it left unchanged its estimate of the long-run hit to GDP from Brexit (4%), the OBR scaled down its estimate of longer-

#### Euro area: EC headline sentient indices




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

#### Euro area: Lending to NFCs




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

term scarring on the economy from the pandemic by 1ppt to 2%, which is nevertheless still 1ppt higher than that assumed by the BoE. The Chancellor was keen to focus on the Budget's supportive measures, including a predictable extension of the fuel duty freeze and reduced business rates for certain sectors hardest hit by the pandemic, as well as the improved universal credit payments for working claimants. But, overall, the measures in this Budget and Spending Review, combined with those announced last month – in particular the health and social care levy – and in the March Budget, equates to an increase in net taxes by about £16.7bn a year within five years. Indeed, taxes will rise this year by the most since 1993. And as a share of GDP taxes are projected to rise from 33.5% of GDP before the pandemic to 36.2% of GDP – the highest since the 1950s – at the end of the forecast horizon.

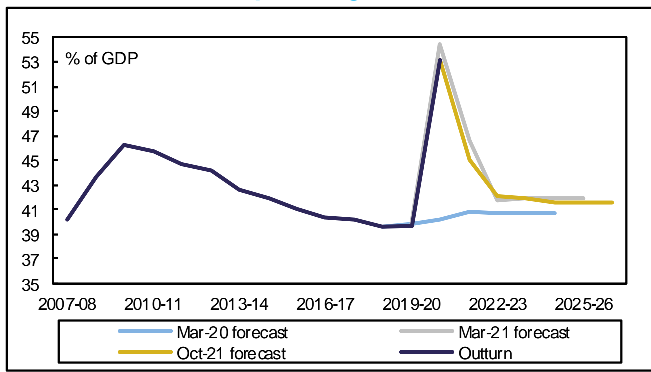
## Fiscal tightening to be less severe than previously forecast

Of course, the rebound in economic activity and increase in net taxes should allow the government to reduce its borrowing requirements substantially over coming years. Indeed, net public sector borrowing in FY20/21 was already £35bn less than the OBR forecast in March, with expected borrowing for the current fiscal year also revised down by £51bn to be almost half (£183bn) the historically high level of borrowing (£320bn) in FY20/21. That led the DMO to cut sharply its Gilt issuance plan for FY21/22 by a whopping £57.8bn to £194.8bn, prompting a marked drop in yields. And with borrowing forecast to be more than halved again next year and fall in each subsequent year of the forecast projection, on current plans public sector borrowing in FY25/26 is now projected by the OBR to be the lowest for 25 years. As such, public sector debt is now forecast to peak just below 100% of GDP this year before falling to 88% of GDP in 2026/27. And overall, the fiscal stance is still set to tighten over coming years: cyclically adjusted public sector net borrowing is projected to fall from above 15% of GDP in FY20/21 to 8.3% of GDP this fiscal year, 3.9% of GDP in FY22/23, and by roughly 1ppt again in each of FY23/24 and FY24/25. But yesterday's announcements suggest a somewhat less severe tightening profile over the near term than had been previously projected – the OBR suggests that the latest fiscal policy measures contributed to a fiscal loosening compared with the March plans of 0.8% of GDP in FY22/23 and by diminishing amounts thereafter, to 0.2% of GDP in FY26/27. On balance, therefore, yesterday's announcements provide further support to those at the BoE in favour of near-term monetary tightening.

## Car production the weakest in any September since 1982, retail sales remain subdued

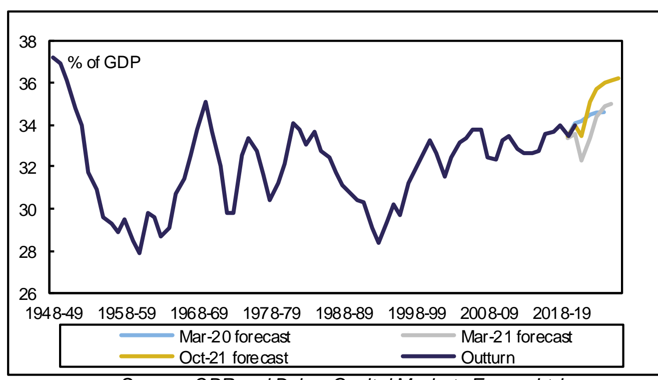
Nevertheless, the latest economic data releases suggest that risks to the near-term growth outlook remain skewed to the downside, not least due to persisting supply-chain challenges. Certainly, the September SMMT car production figures were again disappointing with just 67k units leaving factory gates. While that represented a pickup in output from previous months it was still the worst September since 1982. So, output was still down 41.5%Y/Y despite the pandemic-induced low base a

### UK: Public sector spending



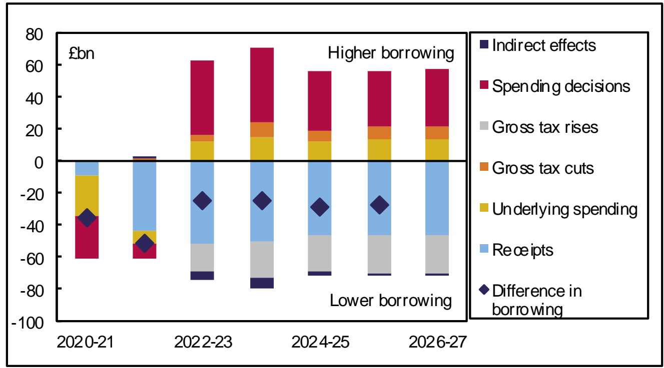

Source: *OBR and Daiwa Capital Markets Europe Ltd.*

### UK: Tax-to-GDP ratio



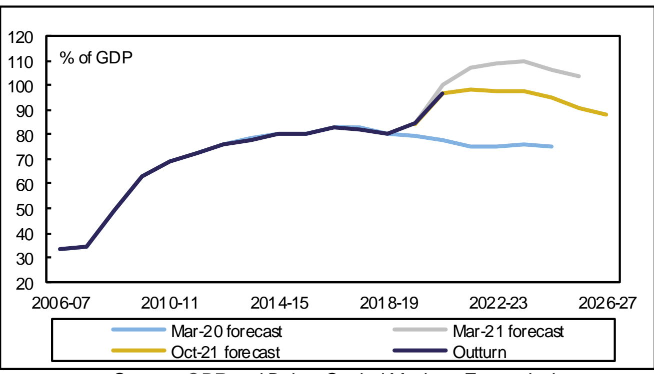

Source: *OBR and Daiwa Capital Markets Europe Ltd.*

### UK: Changes in PSNB since March 21 forecast




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

### UK: Public sector net debt



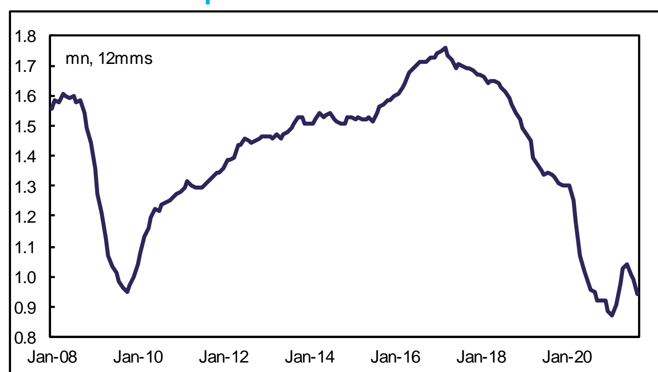

Source: *OBR and Daiwa Capital Markets Europe Ltd.*

year earlier – indeed, production was down by more than half compared with the average output in the decade leading up to the pandemic. The global semiconductor shortage remains the key factor behind the weak auto production trend, with a separate SMMT survey today suggesting that more than 80% of auto manufacturers have been negatively impacted due to reduced orders, cost increases and logistical disruptions. And more than half do not expect supply constraints to improve until Q322, with one third having reduced operating hours to cope with these persistent challenges. The latest CBI distributive trades survey suggested that retailers continued to face ongoing disruption too, with stock levels falling to the lowest on the series. And while the headline retail sales indicator surprised on the upside in October – rising 19pts to +30 – sales were merely in line with the average for the year. Moreover, with yesterday's BRC survey suggesting that retailers expect prices to rise in the run up to Christmas, consumer spending seems likely to remain subdued over the months ahead too.

## The day ahead in the UK

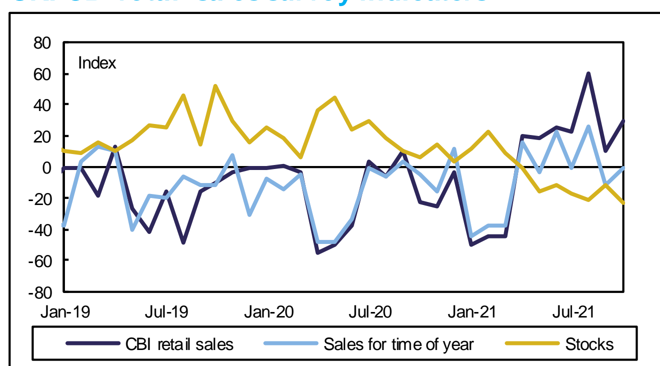
A relatively quiet day for UK economic news will bring just the BoE's latest lending figures. These are expected to report another month of solid mortgage lending at the government's Stamp Duty holiday concluded at the end of the month. But the number of mortgage approvals is likely to have moderated signalling a slowdown in housing market activity, while demand for consumer credit is likely to have remained subdued against the backdrop of heightened concerns about the near-term economic outlook.

### UK: SMMT car production




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

### UK: CBI retail sales survey indicators




*Source: Refinitiv 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 | | European Commission's economic sentiment index | Oct | **118.6** | 116.6 | 117.8 | - |
| | | European Commission's final consumer confidence | Oct | **-4.8** | -4.8 | -4.0 | - |
| | | European Commission's industrial (services) confidence | Oct | **14.2 (18.2)** | 13.0 (14.6) | 14.1 (15.1) | **- (15.2)** |
| | | ECB refinancing rate % | Oct | **0.00** | *0.00* | 0.00 | - |
| | | ECB marginal lending facility rate % | Oct | **0.25** | *0.25* | 0.25 | - |
| | | ECB deposit rate % | Oct | **-0.50** | *-0.50* | -0.50 | - |
| Germany | | Unemployment rate % (change '000s) | Oct | **5.4 (-39.0)** | 5.4 (-20.0) | 5.5 (-30.0) | **- (-31.0)** |
| | | Preliminary CPI (EU-harmonised CPI) Y/Y% | Oct | **4.5 (4.6)** | 4.4 (4.5) | 4.1 (4.1) | - |
| Italy | | ISTAT consumer (manufacturing) confidence index | Oct | **118.4 (114.9)** | 118.5 (112.3) | 119.6 (113.0) | **- (113.2)** |
| | | ISTAT economic sentiment indicator | Oct | **115.0** | - | 113.8 | **113.7** |
| | | Hourly wages Y/Y% | Sep | **0.7** | - | 0.6 | - |
| | | PPI Y/Y% | Sep | **15.6** | - | 13.8 | - |
| Spain | | Preliminary CPI (EU-harmonised CPI) Y/Y% | Oct | **5.5 (5.5)** | 4.4 (4.6) | 4.0 (4.0) | - |
| UK | | SMMT car production Y/Y% | Sep | **-47.1** | - | -27.0 | - |

**Auctions**

| Country | | Auction |
|---|---|---|
| Italy | | sold €2.00bn of 0% 2026 bonds at an average yield of 0.28% |
| | | sold €1.25bn of 2029 floating-rate bonds at an average yield of -0.01% |
| | | sold €3.75bn of 2032 0.95% 2032 bonds at an average yield of 1.05% |

*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 | | M3 money supply Y/Y% | Sep | **7.4** | 7.5 | 7.9 | - |
| Germany | | GfK consumer confidence | Nov | **0.9** | -0.5 | 0.3 | **0.4** |
| France | | INSEE consumer confidence | Oct | **99** | 101 | 102 | **101** |
| | | PPI Y/Y% | Sep | **11.6** | - | 10.0 | - |
| | | Jobseekers, mn | Q3 | **3.3** | - | 3.5 | |
| UK | | BRC shop price index Y/Y% | Oct | **-0.4** | - | -0.5 | - |

**Auctions**

| Country | | Auction |
|---|---|---|
| Germany | | sold €1.51bn of 0% 2036 bonds at an average yield of 0.02% |

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

## Tuesday's results

**Economic data**

| Country | | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | Revised |
|---|---|---|---|---|---|---|---|
| Spain | | PPI Y/Y% | Sep | **23.6** | - | 18.0 | **17.9** |
| UK | | CBI distributive trades survey, reported sales | Oct | **30** | 13 | 11 | **-** |

**Auctions**

| Country | | Auction |
|---|---|---|
| Germany | | sold €2.36bn of 0% 2028 bonds at an average yield of -0.31% |
| Italy | | sold €2.25bn of 0% 2024 bonds at an average yield of -0.23% |
| | | sold €750mn of 0.15% 2051 index-linked bonds at an average yield of -0.16% |
| UK | | sold £2.75bn of 0.375% 2026 bonds at an average yield of 0.789% |

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

## Tomorrow's releases

**Economic data**

| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|---|
| Euro area | | 10.00 | Preliminary CPI (core CPI) Y/Y% | Oct | *3.6 (1.9)* | 3.4 (1.9) |
| | | 10.00 | Preliminary GDP Q/Q% (Y/Y%) | Q3 | *1.8 (3.3)* | 2.2 (14.3) |
| Germany | | 09.00 | Preliminary GDP Q/Q% (Y/Y%) | Q3 | *1.5 (1.8)* | 1.6 (9.4) |
| France | | 06.30 | Consumer spending M/M% (Y/Y%) | Sep | 0.4 (-1.7) | 1.0 (-5.4) |
| | | 06.30 | Preliminary GDP Q/Q% (Y/Y%) | Q3 | *2.0 (2.1)* | 1.1 (18.7) |
| | | 07.45 | Preliminary CPI (EU-harmonised CPI) Y/Y% | Oct | 2.5 (3.2) | 2.2 (2.7) |
| Italy | | 09.00 | Preliminary GDP Q/Q% (Y/Y%) | Q3 | *1.5 (2.6)* | 2.7 (17.3) |
| | | 10.00 | Preliminary CPI (EU-harmonised CPI) Y/Y% | Oct | 2.9 (3.2) | 2.5 (2.9) |
| Spain | | 08.00 | Preliminary GDP Q/Q% (Y/Y%) | Q3 | *2.0 (2.7)* | 1.1 (17.5) |
| | | 08.00 | Retail sales Y/Y% | Sep | 0.0 | -0.9 |
| UK | | 09.30 | Net consumer credit £bn (Y/Y%) | Sep | 0.5 (-) | 0.4 (-2.4) |
| | | 09.30 | Net mortgage lending £bn (approvals 000s) | Sep | 5.7 (72.0) | 5.3 (74.5) |
| | | 09.30 | M4 money supply Y/Y% | Sep | - | 7.0 |

**Auctions and events**

- Nothing to report -

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

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