Euro wrap-up

Overview

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- Bunds followed USTs higher, despite an upwards surprise to euro area producer price inflation on the back of a substantial rise in energy prices.
- Ahead of the announcement on Monday of the next Conservative Party leader and UK Prime Minister, Gilts made further losses as markets remained concerned about the likely future path for macroeconomic policy.
- Focus in the coming week will be on Thursday's ECB policy announcement and forecast update, with interest rates expected to be hiked by 75bps.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.068	-0.085
OBL 1.3 10/27	1.298	-0.059
DBR 1.7 08/32	1.514	-0.041
UKT 1 04/24	3.132	+0.006
UKT 1¼ 07/27	2.843	+0.025
UKT 4¼ 06/32	2.911	+0.034

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

Euro area

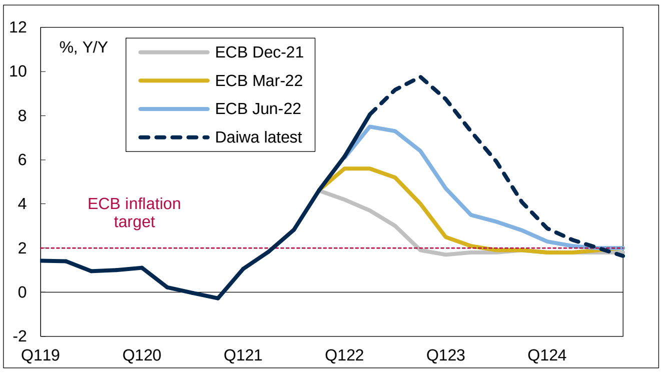
Producer price pressures suggest peak in consumer price inflation is still to come

The ECB's monetary policy decision on Thursday will only to some extent be guided by its updated inflation projections. But the forecasts will nevertheless make ugly reading, with another big upwards revision to the expected path of prices illustrating the case for another big rate hike. Indeed, after the flash headline HICP estimate for August rose to 9.1%Y/Y, the average rate in the first two months of Q3 was 9.0%Y/Y, 1.7ppts above the ECB's baseline forecast for the quarter published in June. Not least as Germany's public transport and fuel duty discounts elapsed at the end of last month, inflation is likely to rise again in September. And while there is plenty of uncertainty, a further rise in the HICP rate looks likely over the fourth quarter as firms try to pass increased costs onto consumers. Indeed, today's PPI data showed that producer prices rose a further 4.0%M/M in July – with energy prices up 9.0%M/M and persistent pressures also evident in capital and consumer goods components – to be up a series high 37.9%Y/Y. While they have since fallen back from their peak late last month – in response perhaps to higher natural gas storage levels and/or reports that EU ministers will next Friday discuss possible reforms to the so-called marginal pricing mechanism in electricity markets – wholesale power prices point to additional pressures on household and business electricity bills in many member states over the near term. So, although petrol prices are down from recent peaks, the energy component of HICP inflation will remain above 30%Y/Y over coming months too. And with inflation of food, non-energy industrial goods and services all likely to rise further, we currently expect inflation to exceed 9½%Y/Y in the coming quarter, with a double-digit rate feasible, well above the ECB's June projection for the quarter of just 6.4%Y/Y.

Inflation should peak in the New Year, but ECB hawks wary of medium-term price expectations

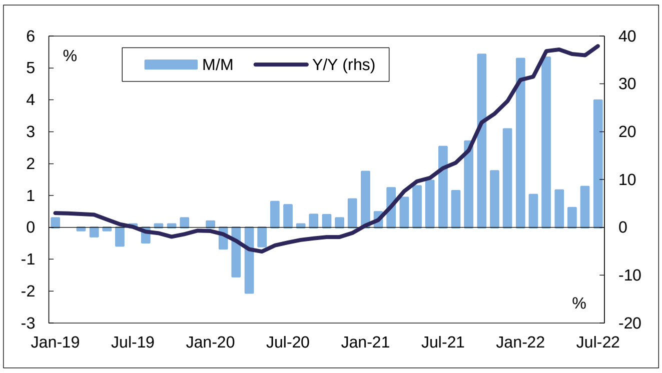
Looking further ahead, however, several factors point to a slowing of inflation in the New Year in the absence of a new shock to energy prices. Base effects from past price shifts should provide some downwards pressure, as should a further easing of supply bottlenecks and slowing economic demand. Indeed, mild recession should now form part of the ECB's baseline GDP projection. And as unemployment will be expected to pick up, wage growth should remain contained and inconsistent with second-round effects. So, we expect the ECB's baseline forecast to show inflation declining from Q123 on. However, core inflation surprised on the upside in August to rise to a new high of 4.3%Y/Y. While the Commission survey suggested that consumers and firms in all major sectors had last month moderated their inflation expectations for the coming year, the ECB's consumer survey for July today reported an upwards revision in expectations for inflation three years ahead, by 0.2ppt to a new high of 3.0%Y/Y. In addition, the ECB's most recent survey of professional forecasters also revised up the median expectation for inflation in the longer term (2027) to a new high and above-target 2.2%Y/Y. And financial market measures of inflation expectations, such as the 5Y5Y rate, are also still above 2.0%Y/Y. So, the ECB's projections of headline inflation in

Euro area: Consumer price inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Producer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

both 2023 and 2024 will be revised up, respectively from 3.5%Y/Y and 2.1%Y/Y. And core inflation will also again be projected to be above the 2.0%Y/Y target on average in 2024.

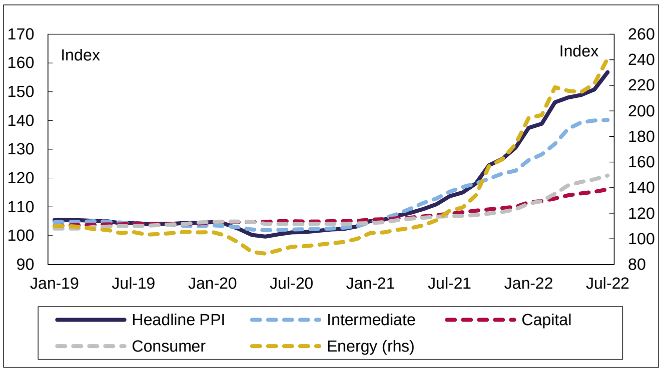
With real rates still far from neutral, ECB likely to hike by 75bps

While headline and core inflation will on average be projected to exceed the ECB's target in 2024, both measures will be expected to be close to 2.0%Y/Y by the end of that year. That might call for no bigger rate hike this month than July's 50bps increment. As suggested earlier this week by Chief Economist Philip Lane, the doves on the Governing Council – who include Executive Board member Fabio Panetta as well as many of the Southern European national bank governors – will also argue that the significant upwards shift in the yield curve in anticipation of future rate hikes already represents a non-negligible tightening of financial conditions. And in advocating merely a 'steady' pace of tightening, they will also highlight uncertainty about the outlook, and the possible need for a 'mid-course' correction of policy if circumstances suddenly change. However, as at recent monetary policy meetings, the hawks on the Governing Council – led by Executive Board member Isabel Schnabel – are likely to maintain a majority this month (see chart below). For them, the ongoing uncertainty with respect to the economic outlook, coupled with repeated significant failures by the ECB to predict the full extent of the rise in inflation over the past year, mean that the risks to the central bank's credibility continue to rise. So, greater weight should now be placed on inflation outturns and expectations than projections. And with nominal interest rates on bank loans and deposits rising only very gradually, and real short-term rates still extremely negative and hence still far from a neutral (let alone restrictive) stance, they will likely win the argument for a hike of 75bps this month, taking the deposit rate to 0.75% and the refi rate to 1.25%. With another hike of at least 50bps then likely for October, and a neutral stance likely to be achieved by year-end, the Governing Council might also this month request advice from the ECB's committees – to be discussed at a future policy meeting – on an appropriate strategy for reducing the stock of bonds purchased under the regular APP programme (i.e. quantitative tightening) for if and when it eventually decides to push policy into restrictive territory.

The week ahead in the euro area

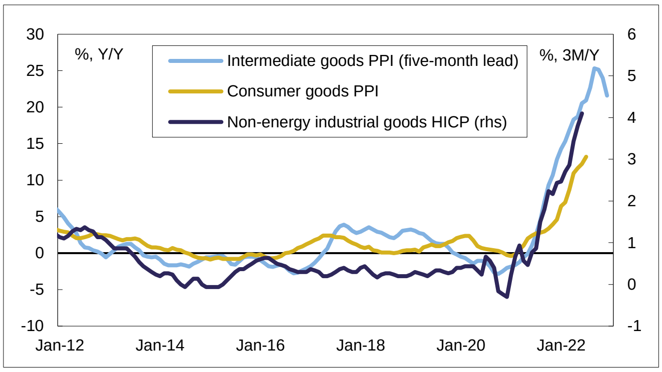
The coming week's economic data calendar kicks off on Monday with euro area retail sales for July. National spending figures from some of the larger member states published in the past week were somewhat mixed, with German retail sales posting a solid increase in July, while other member states, such as France, Spain and Ireland revealed a dip in spending on goods at the start of Q3. On balance, euro area retail sales should be expected to post modest growth of about ½%M/M in July, insufficient to reverse the drop of 1.2%M/M in June. Monday also brings the latest Sentix investor confidence survey for September, as well as the final services and composite PMIs for August, which will be followed by the construction PMIs on Tuesday. With yesterday's final manufacturing PMIs confirming that the output index remained contractionary at 46.5, and

Euro area: Producer price levels



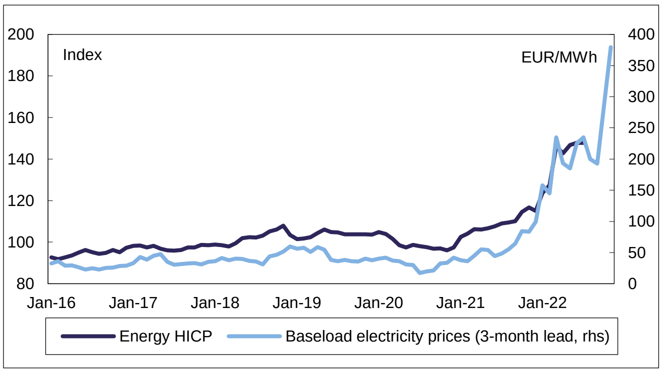
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer and producer price inflation



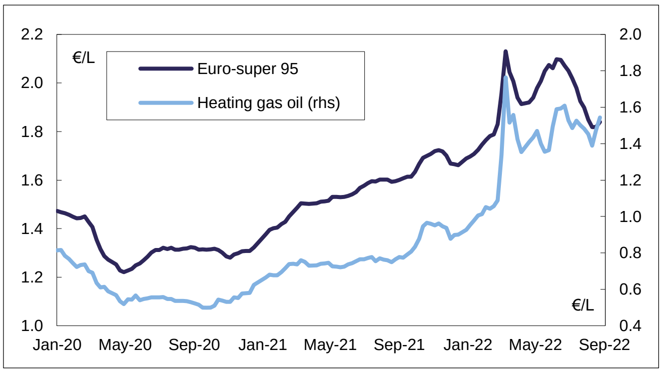
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Energy HICP and electricity prices*



**Baseload electricity one month forward prices. Source: Refinitiv, Bloomberg and Daiwa Capital Markets Europe Ltd.*

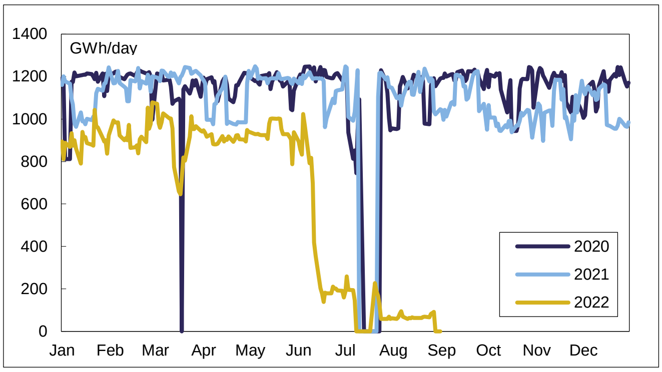
Euro area: Petrol and heating fuel prices



Source: European Commission and Daiwa Capital Markets Europe Ltd.

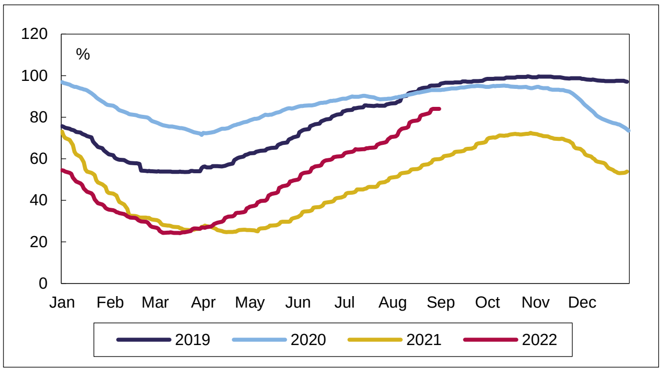
the flash composite PMI having fallen to an eighteen-month low of 49.2, these surveys will likely add to evidence that the euro area economy is heading for recession. In the meantime, however, final Q2 euro area GDP figures (Wednesday) should confirm growth of 0.6%Q/Q, driven by a rebound in consumer spending on services as pandemic restrictions were eased. At the member state level, the flow of July data will include German factory orders (Tuesday), German IP and Italian retail sales (Wednesday), and French goods trade and industrial production (Thursday and Friday respectively).

Germany: Russia gas inflows via Nord Stream 1



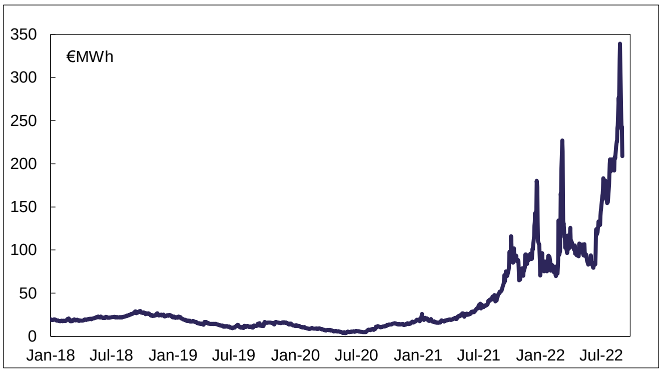
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Natural gas storage



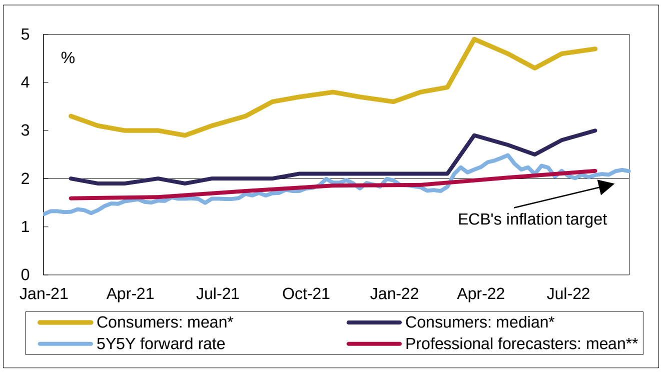
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Netherlands: Natural gas forward prices



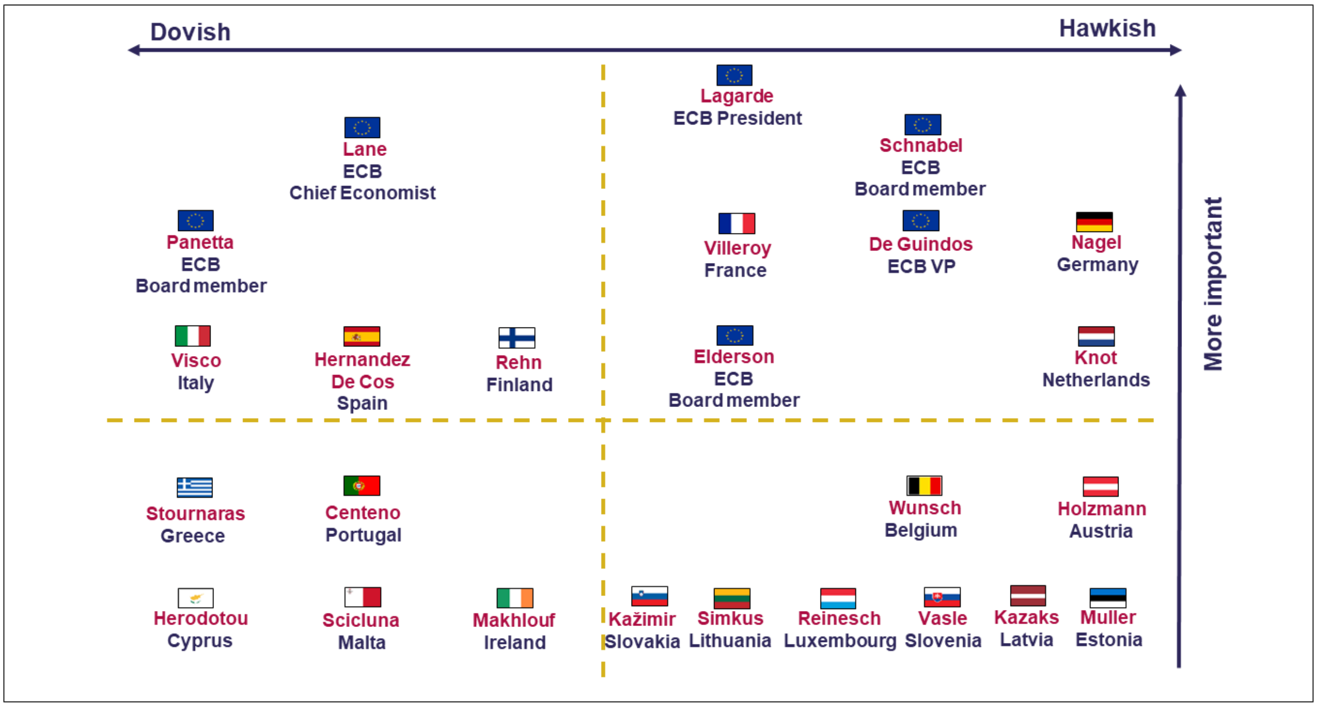
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation expectations



**3 years ahead. **5 years ahead. Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.*

ECB: The balance of power



Source: Daiwa Capital Markets Europe Ltd.

UK

Truss set to become fourth Tory Prime Minister in six years, facing unprecedented shock

The main event in the UK in the coming week will be Monday's announcement by the Conservative Party of the identity of its new leader, who will also become Boris Johnson's successor as Prime Minister. All opinion polls suggest that the opportunistic Foreign Secretary Liz Truss, who has run a campaign presenting herself as a libertarian, will comfortably beat her opponent, the former Chancellor and more orthodox Rishi Sunak. Truss will lead an increasingly unpopular party that has contributed to, rather than helped to alleviate, the UK's economic woes during its past twelve years in government. Indeed, the fourth Conservative Prime Minister in the six years since the Brexit referendum will take office facing huge challenges, not least the biggest cost-of-living crisis for generations. With household energy bills set to rise by about 80% in October, and further still in January and probably April too, real disposable incomes are on track to suffer their sharpest two-year decline in a century. Additionally, a large share of small and medium-sized businesses face increases several times over in their energy bills. So, significant increases in public expenditure, on top of those already pledged to cushion the impact on consumers, are likely to be required to avoid an economic and social crisis over the winter.

Policy priorities raise questions about fiscal responsibility

Truss's plans for addressing the immediate cost-of-living crisis posed by increased energy bills remain extremely unclear, not least as she was initially oblivious as the challenges built up steadily over recent months and is unlikely to have a clear idea what to do. But she has let known her longer-term policy commitments, which being largely focused on tax cuts will do little to support the poorest households or struggling business. Such policies include a reversal of the recent increase in National Insurance Contributions, a family tax break, the abolition of so-called green levies on energy bills and reversal of plans to increase the main corporation tax rate. Added to an aim to increase defence spending to 2½% of GDP, these pledges would likely lead to significant increases in public borrowing over the medium term, even before accounting for any (likely temporary) new measures to address the energy crisis, or the adverse impact of high inflation and likely economic recession is accounted for. So, Truss might be expected to tear up the government's current fiscal rules, which aim to deliver a decline in public debt as a share of GDP and a current budget surplus by the end of the current parliament (scheduled for January 2025 at the latest).

Uncertainties regarding BoE and Brexit further fuel market concerns about Truss

Beyond fiscal policy, markets have no shortage of cause for concern about what Truss's government might bring. With respect to monetary policy, her calls for the BoE's mandate to be reviewed, perhaps seeking constraints on its ability to look through (possibly temporary) spikes in inflation, and/or making reference to monetary aggregates or even nominal GDP, raise questions about institutional credibility and independence. Her determination to maintain confrontation with the EU over the post-Brexit trade arrangements – particularly by pressing ahead with her Northern Ireland Protocol Bill that threatens overriding the current rules, and also considering activation of the emergency Article 16 provision – risks a slide into a damaging trade war, further harming the UK's export performance, deterring business investment and generating additional macroeconomic instability. Indeed, Truss's cabinet appointments will grant senior positions to many of the hard-Brexit-advocating populists and ideologues who over recent years have prioritized debatable notions of sovereignty above economic wellbeing and diplomacy. And Truss's own apparent lack of firm principles, which have seen her flip-flop on policy issues throughout her career, give no reason to expect the government to address the UK's main economic challenges in anything but a haphazard fashion. Judging by the recent sell-off in Gilts and sterling weakness, many investors appear to have made up their mind already.

The week ahead in the UK

On the UK data front, Monday sees the release of the final services and composite PMIs for August, while the construction PMIs will be published on Tuesday. The flash UK composite PMI slowed in line with expectations, falling 1.2pts to an eighteen-month low of 50.9, a full 10pts lower than March's peak to be trending so far in the third quarter 3½pts below the Q2 average. Admittedly, the services activity PMI held up relatively well in August, down just 0.1pt to a still-expansionary 52.5, albeit still the softest reading since February 2021. And yesterday's final manufacturing PMI nudged higher the output index by 0.3pt, although that left it at a highly contractionary 42.7, the lowest since the first wave of Covid-19. The BRC retail sales monitor for August will be published on Tuesday, followed by the RICS house price balance for the same month on Thursday. The latest KPMG/REC report on jobs (also Thursday) will provide insights into the tightness of the labour market, while the Bank of England's latest inflation attitudes survey (Friday) seems highly likely to report a further rise in expectations for the coming twelve months from the series high of 4.6% registered three months ago. We will also hear from hawkish MPC member Catherine Mann (Monday), who is due to talk about the persistence of inflation and monetary policy strategy. And most notably perhaps, Governor Bailey, Chief Economist Pill and external MPC members Mann and Tenreyro (the latter being the only member to vote for a 25bps hike in August) will appear before the Treasury Select Committee on Wednesday to answer questions on the BoE's latest Monetary Policy Report.

Daiwa Capital Markets

Daiwa economic forecasts

	2022				2023				
	Q1	Q2	Q3	Q4	Q1	Q2	2022	2023	2024
GDP	%, Q/Q						%, Y/Y		
Euro area	0.5	0.6	0.0	-0.1	-0.3	-0.1	2.9	-0.2	0.8
UK	0.8	-0.1	-0.1	-0.4	-0.1	-0.2	3.3	-0.6	0.4
Inflation, %, Y/Y									
Euro area									
Headline HICP	6.1	8.0	9.2	9.8	8.8	7.3	8.3	6.5	2.2
Core HICP	2.7	3.7	4.4	5.0	5.2	5.0	3.9	4.5	2.4
UK									
Headline CPI	6.2	9.2	10.1	13.6	13.1	9.5	9.8	8.4	2.0
Core CPI	5.1	6.0	6.2	6.1	5.1	3.9	5.8	3.7	2.0
Monetary policy, %									
ECB									
Refi Rate	0.00	0.00	1.25	2.00	2.00	2.00	2.00	2.00	1.75
Deposit Rate	-0.50	-0.50	0.75	1.50	1.75	1.75	1.50	1.75	1.50
BoE									
Bank Rate	0.75	1.25	2.25	3.25	3.50	3.50	3.50	3.50	2.50

Source: Bloomberg, ECB, BoE 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	PPI M/M% (Y/Y%)	Jul	**4.0 (37.9)**	2.6 (35.9)	1.1 (35.8)	**1.3 (36.0)**
Germany	Trade balance €bn	Jul	**5.4**	4.6	6.3	**6.2**
Spain	Unemployment change '000s	Aug	**40.4**	-	3.2	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ Daiwa forecast/actual	Previous
			Monday 05 September 2022			
Euro area		09.00	Final services (composite) PMI	Aug	50.2 (49.2)	51.2 (49.9)
		09.30	Sentix investor confidence	Sep	-26.5	-25.2
		10.00	Retail sales M/M% (Y/Y%)	Jul	0.4 (-0.8)	-1.2 (-3.7)
Germany		08.55	Final services (composite) PMI	Aug	48.2 (47.6)	49.7 (48.1)
France		08.50	Final services (composite) PMI	Aug	51.0 (49.8)	53.2 (51.7)
Italy		08.45	Services (composite) PMI	Aug	48.8 (48.0)	48.4 (47.7)
Spain		08.15	Services (composite) PMI	Aug	52.4 (52.5)	53.8 (52.7)
UK		09.00	New car registrations Y/Y%	Aug	-	-9.0
		09.30	Final services (composite) PMI	Aug	52.5 (50.9)	52.6 (52.1)
			Tuesday 06 September 2022			
Euro area		08.30	Construction PMI	Aug	-	45.7
Germany		07.00	Factory orders M/M% (Y/Y%)	Jul	-0.5 (-13.5)	-0.4 (-9.0)
		08.30	Construction PMI	Aug	-	43.7
France		08.30	Construction PMI	Aug	-	48.6
Italy		08.30	Construction PMI	Aug	-	46.2
UK		00.01	BRC retail sales like-for-like Y/Y%	Aug	-	1.6
		09.30	Construction PMI	Aug	-	48.9
			Wednesday 07 September 2022			
Euro area		10.00	Final GDP Q/Q% (Y/Y%)	Q2	0.6 (3.9)	0.5 (5.4)
		10.00	Final employment Q/Q% (Y/Y%)	Q2	0.3 (2.4)	0.6 (2.9)
Germany		07.00	Industrial production M/M% (Y/Y%)	Jul	-0.5 (-2.0)	0.4 (-0.5)
Italy		09.00	Retail sales M/M% (Y/Y%)	Jul	-	-1.1 (1.4)
			Thursday 08 September 2022			
Euro area		13.15	ECB refinancing rate %	Sep	1.25	0.50
		13.15	ECB deposit rate %	Sep	0.75	0.00
France		06.30	Total payrolls Q/Q%	Q2	0.3	0.3
		07.45	Trade balance €bn	Jul	-13.0	-13.1
UK		00.01	RICS house price balance %	Aug	61	63
			Friday 09 September 2022			
France		07.45	Industrial production M/M% (Y/Y%)	Jul	-0.5 (-0.1)	1.4 (1.4)
Spain		08.00	Industrial production M/M% (Y/y%)	Jul	-	1.1 (7.0)
UK		09.30	BoE inflation expectations, next 12 months	Aug	-	4.6

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 05 September 2022
UK		16.30	BoE's Mann scheduled to speak on 'inflation persistence and monetary policy strategy'
			Tuesday 06 September 2022
Germany		10.30	Auction: €400mn of 0.1% 2046 index-linked bonds
UK		10.00	Auction: £3.50bn of 0.25% 2025 bonds
			Wednesday 07 September 2022
Germany		10.30	Auction: €1.5bn of 1.00% 2038 bonds
UK		10.00	BoE Governor Bailey and MPC members Pill, Mann and Tenreyro testify to Parliament's Treasury Select Committee
		10.00	Auction: £2.75bn of 1% 2032 bonds
			Thursday 08 September 2022
Euro area		13.45	ECB President Lagarde's post-meeting press conference
UK		00.01	KPMG/REC report on jobs
			Friday 09 September 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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