Euro wrap-up

Overview

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- Bunds suffered a massive sell-off, as the ECB hiked rates by 75bps, signalled further tightening "over the next several meetings", and lifted the interest rate ceiling on government deposits.
- Gilts also sold off as Liz Truss announced a plan to freeze household energy prices for two years with costs to be borne by the public finances.
- Friday will bring the BoE's latest inflation attitudes survey and French industrial production data.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.297	+0.230
OBL 1.3 10/27	1.542	+0.180
DBR 1.7 08/32	1.703	+0.133
UKT 1 04/24	3.102	+0.052
UKT 1¼ 07/27	3.001	+0.090
UKT 4¼ 06/32	3.140	+0.109

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

Euro area

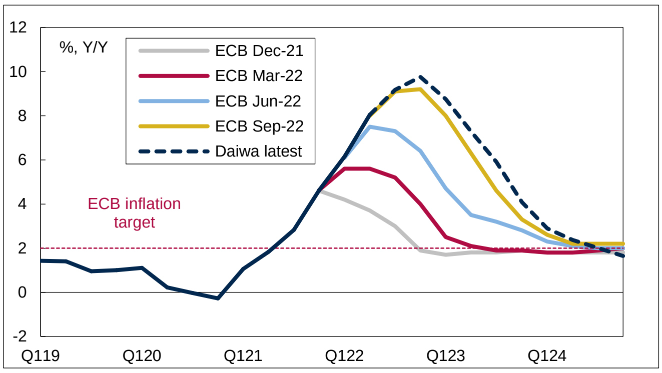
ECB hikes by 75bps, signals further tightening "over the next several meetings"

As had seemed likely following last week's further upside surprise in the euro area's flash August inflation data and evidence of broader-based price pressures, the ECB today raised its main policy interest rates by 75bps. That decision, which took the deposit rate to 0.75% and the refi rate to 1.25%, was unanimous on the Governing Council, suggesting that the differences in opinion between the hawks and doves are now more of nuance than of major substance. The ECB considered the hike to represent a "major step" to "front-load" efforts to normalise policy. But, with rates judged still to be well below any reasonable estimate of the "neutral" level, it stated that it expects to tighten steadily further "over the next several meetings. In her press conference, President Lagarde again insisted that rates were not on a preset course. Instead, policy decisions would continue to be made on a "meeting-by-meeting" basis depending on the economic data and the "evolving" inflation outlook. And while she added that the Governing Council might hike by 75bps again, such increments would not necessarily represent the "new norm" for tightening. Although she wanted to avoid providing forward guidance, Lagarde suggested that there would probably be "more than two (including this one) but probably also less than five" meetings that would bring rate hikes. She also thought that market pricing was not necessarily inappropriate in current circumstances, adding that the ECB would be prepared to push rates into restrictive territory if necessary.

ECB expects GDP to stagnate through to Q1, but acknowledges recession risks

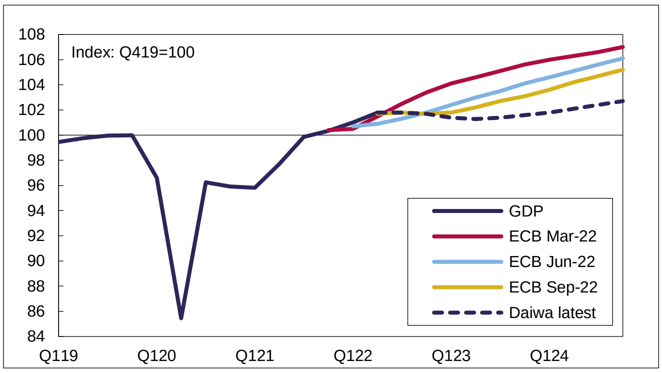
The Governing Council's readiness to push rates into restrictive territory if necessary reflects its judgement on the causes of current high inflation. While Lagarde insisted that, unlike in the US, inflation in the euro area is predominantly supply-driven, she acknowledged that demand had likely also played a role. Indeed, the Governing Council's statement suggested that further rate hikes aimed to "dampen demand" as well as "guard against the risk of a persistent upward shift in inflation expectations". However, while the level of euro area GDP in Q2 was well above the ECB's previous forecast, its new baseline projection sees the economy stagnate from now through to Q123 before steady growth resumes, so that economic output rises 3.1%Y/Y in 2022 but just 0.9%Y/Y next year. While some observers, including ourselves, might argue that recession should have featured in the baseline scenario, Lagarde acknowledged that some of the downside risks – including the suspension of euro area imports of Russian gas via Nord Stream 1 – had now crystallised since it was finalised. And a downside scenario, whereby energy rationing was eventually imposed across the euro area, would see GDP drop 0.9%Y/Y next year.

Euro area: HICP inflation forecasts



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

Euro area: GDP forecasts



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

Inflation forecast revised up to remain above-target over the horizon

In light of its mandate, it is inflation that matters for the ECB, and its baseline HICP projection was inevitably revised up across the horizon. While it was previously envisaged to peak back in Q2 at 7.5%Y/Y, the highpoint for inflation is now expected to come next quarter, at an average of 9.2%Y/Y. As growth momentum evaporates, unemployment ticks higher, supply strains ease and base effects become more favourable, inflation is expected to ease back gradually next year to 3.3%Y/Y in Q423. But it is also now expected to remain above the 2.0%Y/Y target through to the end of the projection in Q424 (2.2%Y/Y), seemingly calling for additional tightening over coming meetings. Indeed, while recession might be expected to weigh on wages and prices more heavily in due course, the ECB's downside scenario would see inflation exceed the baseline by 1.4ppts in 2023 and 0.4ppt in 2024, as energy prices and supply constraints would add to pressures, arguably calling for even more rate hikes.

ECB lifts rate ceiling for government deposits to ease collateral scarcity

Finally, to address recent signs of stress in euro area repo markets, including evidence of collateral scarcity, the Governing decided to temporarily remove the 0% interest rate ceiling for remunerating government deposits. Instead, at least until 30 April, the ceiling will be set at either the ECB's deposit rate or the euro short-term rate (€STR), whichever is lower. The decision, which aimed to prevent a sudden outflow of funds from the ECB's deposit facility that would have further pressurized demand for collateral, likely accentuated today's sell-off of euro area government bonds, as Bunds underperformed the wider market.

The day ahead in the euro area

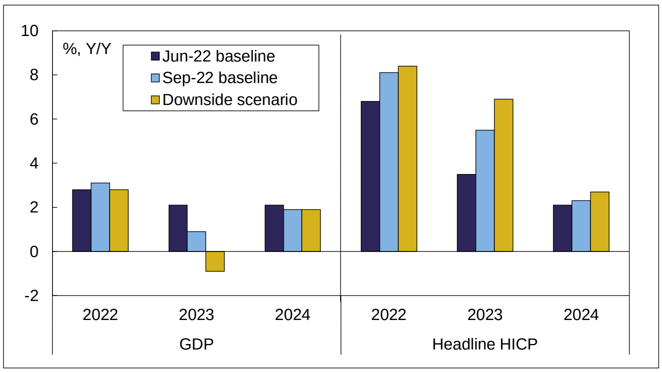
A relatively quiet end to the week for euro area economic data will bring French and Spanish industrial production data for July. Like in Germany, French IP is expected to have fallen around ½%M/M at the start of the third quarter, the first decline in three months.

UK

Truss confirms new retail energy price caps but provides no detail on costs

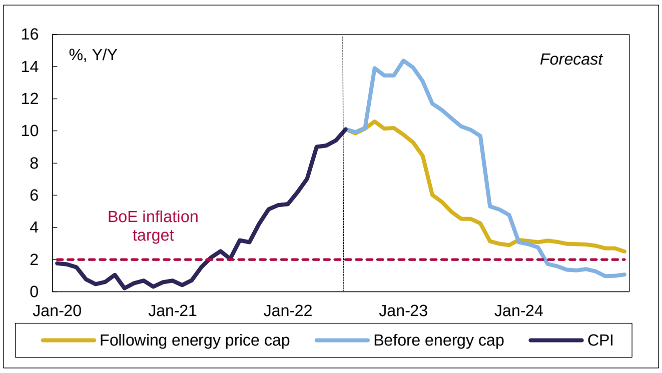
Following plenty of speculation, new PM Liz Truss today announced some of the detail of her plans to limit household energy bills. In particular, having during her leadership campaign rejected taking such action, she confirmed that the bill for a "typical" household would now be fixed at £2500 for the two years from October. That still represents an increase of 27% from the equivalent cap in the past six months, and almost double the level from a year earlier. But it is £1049 lower than had been proposed by the energy regulator Ofgem for the coming three months, with the typical bill likely to have been increased further still to £6000k or more in January and April. Moreover, the so-called "green levies" of £150 will be removed from bills, while the government will also maintain the transfers of £400 per household already envisaged, with the implication being that overall energy costs for households will be little changed. Truss also announced "similar support" for businesses for the coming six months. But she provided no substantive detail on that, nor on plans to reform the marginal-pricing system for determining prices of electricity generated by renewables and nuclear. Indeed, crucially, Truss also provided no details of the implications for public borrowing, which – despite having previously advocated small government and market-based solutions – will have to bear the costs of the initiative. Overall, estimates of an extra £150bn (or roughly 6% of GDP) on public borrowing through to FY24, with risks to the upside, seem appropriate. At the same time, the new measures should certainly reduce the depth of any recession over coming quarters. And they will also lower the near-term profile of inflation. We now forecast inflation to peak in October at just above 10½%Y/Y, almost 4ppts below the previously projected peak. But with GDP and employment likely to be firmer than otherwise would have been the case, inflation two to three years ahead is likely to be higher. And so the BoE's terminal policy interest rate for this cycle will probably also be higher.

Euro area: ECB forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation forecast



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

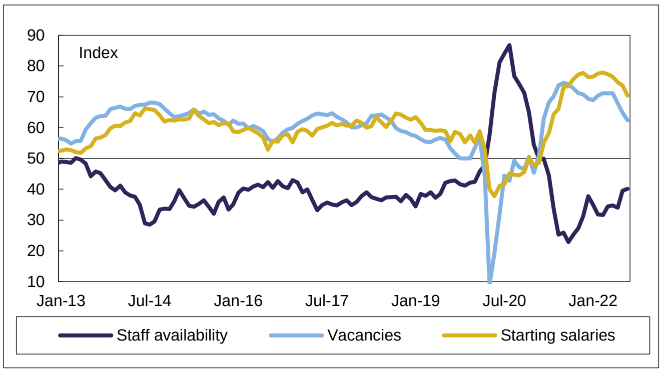
Surveys signal softening of labour and housing markets

Two surveys today provided clearer signs of a softening of conditions in key aspects of the UK economy last month as households and businesses fretted about the impact of high energy prices and increased interest rates. In the labour market, the REC report on jobs – which takes stock of activity at recruitment consultancies – signalled an easing in vacancy growth in August to an 18-month low. Growth in permanent recruitment was close to July's 17-month low while recruitment of temp staff also dropped to an 18-month low. But with candidate availability still low, starting pay reportedly remained historically elevated, albeit rising at the softest rate in 14 months. In the housing market, meanwhile, the RICS residential survey reported an easing of house price growth last month to the lowest since the lockdowns at the start of 2021 against the backdrop of the sharpest fall in new buyer enquiries since the first wave of Covid-19. With new vendor instructions and future sales expectations also lower, house prices were on balance expected to fall over the coming three months, with price growth expectations 12-months ahead minimal and the weakest since 2012, bar short-lived exceptions during the first wave of Covid-19 and immediately following the Brexit referendum. Looking ahead, while today's announcement on energy price caps might limit the extent of further softening of the labour market over coming months, the housing market will likely continue to weaken as interest rates rise.

The day ahead in the UK

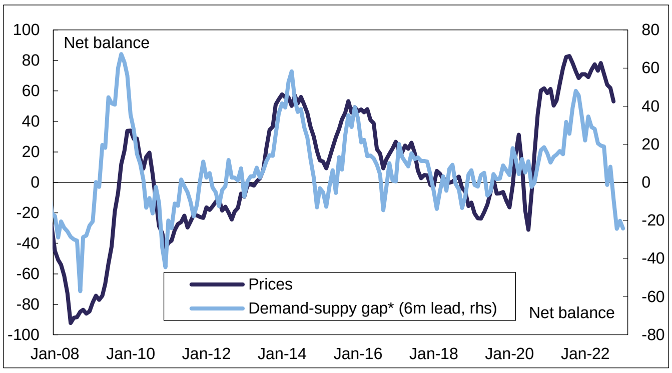
Ahead of the BoE's MPC policy announcement a week today, tomorrow's inflation attitudes survey from the Bank seems highly likely to report a further rise in expectations for the coming twelve months from the series high of 4.6% registered three months ago.

UK: REC labour market survey indicators



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: RICS residential survey indicators



**Difference between new buyer enquiries and vendor instructions.*
Source: Refinitiv, S&P Global 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		ECB refinancing rate %	Sep	**1.25**	*1.25*	0.50	**-**
		ECB deposit rate %	Sep	**0.75**	*0.75*	0.00	**-**
France		Total payrolls Q/Q%	Q2	**0.4**	0.3	0.3	**-**
		Trade balance €bn	Jul	**-14.5**	-13.0	-13.1	**-13.1**
UK		RICS house price balance %	Aug	**53**	60	63	**62**

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
France		07.45	Industrial production M/M% (Y/Y%)	Jul	-0.5 (0.4)	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

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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