# Euro wrap-up

## Overview

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- Bunds made losses at the short end of the curve as euro area inflation and German inflation expectations were confirmed at record highs.
- Longer-dated Gilts made gains as UK retail sales slumped in August, raising the risk of another contraction in GDP in Q3.
- The BoE's MPC announcements next Thursday look set to confirm a hike of 50bps in Bank Rate and the start of active Gilt sales. The UK government will flesh out the details of its energy market interventions on Friday, while the European September flash PMIs are due the same day.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0.4 09/24 | 1.520 | +0.020 |
| OBL 1.3 10/27 | 1.654 | +0.007 |
| DBR 1.7 08/32 | 1.760 | -0.002 |
| UKT 1 04/24 | 3.090 | +0.006 |
| UKT 1¼ 07/27 | 3.107 | +0.009 |
| UKT 4¼ 06/32 | 3.134 | -0.025 |

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

# Euro area

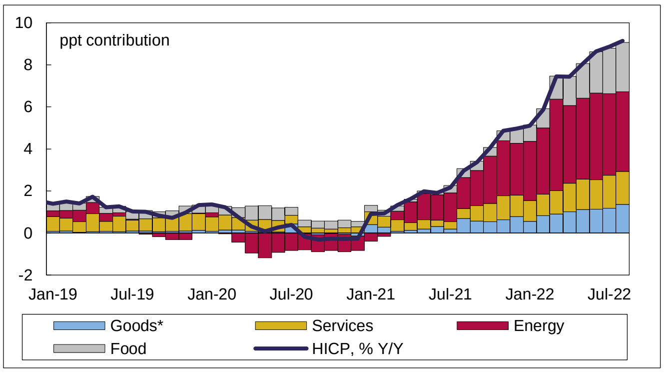
### Euro area inflation confirmed at a record high 9.1%Y/Y

There were no surprises from today's final euro area inflation data, which aligned with the flash estimates that saw the headline HICP rate rise 0.2ppt to 9.1%Y/Y, a series high. Admittedly, to two decimal places the rate was revised up by 0.06ppt to 9.14%Y/Y. This in part reflected a softer pace of easing in energy inflation (down 1ppt to 38.6%Y/Y) than initially estimated as a decline in petrol prices of 6.4%M/M (to leave the annual rate of 19.4%Y/Y some 18ppts lower than the peak in June) was in part offset by strong increases in electricity (5.4%M/M) and gas (7.9%M/M). So, energy still accounted for almost 45% of total inflation. Food prices were stronger than in the flash release too, up 1.2%M/M to be up a record 10.6%Y/Y and accounting for a further 25% of inflation, as the impact of the European drought and Ukraine war added further to cost pressures. But reflecting not least the ending of summer sales, as well as a persisting uptrend in car inflation, non-energy industrial goods prices also rose by the most in any August (0.9%M/M), boosting the annual rate by 0.6ppt to a record-high 5.1%Y/Y. And despite the drag from Germany's discounted travel pass (transport services costs were down 3.1%Y/Y), higher prices in hospitality and package holidays helped push services inflation up 0.1ppt to a new series high of 3.8%Y/Y. As a result, core prices rose more than 0.5%M/M, more than double the average in August ahead of the pandemic. And the annual rate of core inflation rose a stronger-than-initially-expected 0.3ppt to 4.3%Y/Y, suggesting a further increase in domestically-generated pressures.

### Outlook remains highly uncertain with energy prices key

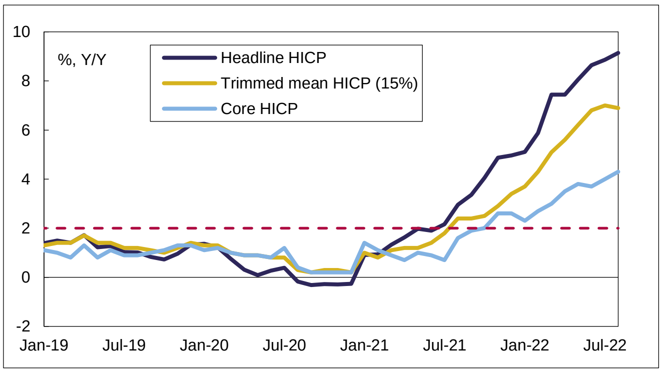
Arguably, some encouragement could be found within the detail of today's figures, with the ECB's 15% trimmed mean inflation measure easing for the first time since February 2021. However, the drop of just 0.1ppt to a still-extremely-high 6.9%Y/Y, merely 0.3ppt below the equivalent US measure, was clearly suggestive of persistent widespread inflationary pressures in the euro area. And with the German energy support initiatives having elapsed at the end of August, services inflation will take a step up in September, perhaps taking euro area core inflation up to 5%Y/Y and higher still over coming months. The end of Germany's temporary fuel duty cut will also mean higher petrol prices on average across the euro area this month. But recent developments in wholesale gas markets suggest that some pressures on electricity bills might not be quite so acute, with Netherlands TTF benchmark forward prices down roughly 40% from last month's peak, in part likely reflecting significant success of governments in meeting storage targets ahead of schedule. And looking ahead, with still limited signs of second-round effects feeding through to wages, government measures related to energy prices will remain key. While the Commission's proposals to impose a windfall tax to fund support for consumers, as well as caps on prices for non-gas-generated electricity, might struggle to gain swift agreement in the Council of Ministers, national governments continue to draw up their own interventions. In recent days, France's government committed to a new cap on electricity and

**Euro area: Consumer price inflation**




**Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

**Euro area: Consumer price inflation**




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

gas price increases of 15% next year, while Italy's government stated that firms will be able to offset a significant share of their energy bills against their tax bills. Nevertheless, the headline and core HICP inflation rates are likely to rise further over coming months – we currently foresee headline inflation peaking at around 10%Y/Y at the end of the year. And those members of the Governing Council fretting about inflation expectations will have been concerned to see today's latest survey results from the Bundesbank. Last month, German consumers' mean expectation for inflation 12 months ahead rose 0.3ppt to a new high of 7.6%, with the mean expectations for inflation five and ten years ahead both above 5.0%. So, we expect the ECB to hike rates by a further 75bps in October, with another 50bps to come in December to take the deposit rate at 2.0%.

### The week ahead in the euro area

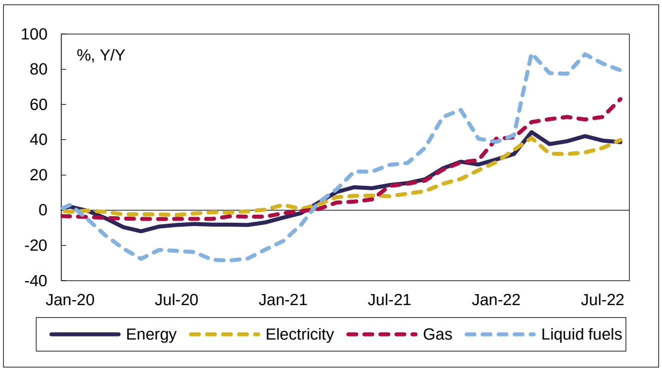
The main data focus in the euro area in the coming week will be the flash September sentiment surveys, including the Commission's consumer confidence indicator on Thursday and PMIs on Friday. Given households' diminishing purchasing power and the prospects of additional substantial interest rate hikes over the near term, expectations are for a drop in headline consumer confidence at the end of Q3, reversing the surprise uptick in August, back close to the record low in July (-27.0). Friday's flash PMIs are similarly expected to report a further deterioration in business conditions, with the euro area composite output index forecast to record the third consecutive contractionary reading in September, and to fall below the 18-month low of 48.9 logged in August. In addition to the PMIs, the latest INSEE survey (Thursday) will provide an update on the French economy. Data releases in the first half of the week kick off with euro area construction activity numbers for July on Monday. Given the solid rebound in Germany (1.4%M/M) and growth in France (0.5%M/M), we expect aggregate euro area output in the sector to have risen for the first month in five. German PPI figures for August (Tuesday) will also be watched for further upside price pressures at the factory gate.

## UK

### Retail sales fall more than expected in August raising risks of GDP contraction in Q3

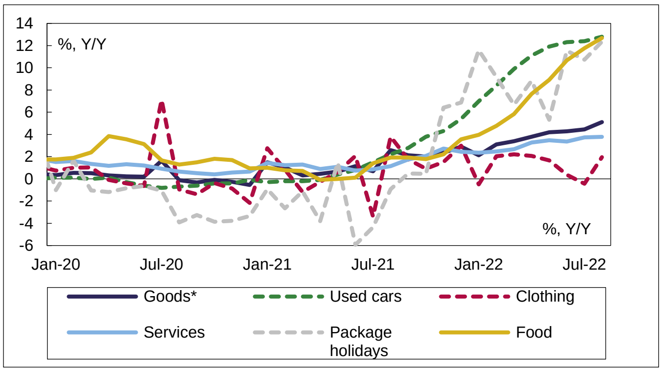
Retail sales fell further than expected in August, maintaining the clear downtrend in volumes in place since last spring as increased opportunities for spending on services coupled with the impact of high inflation and an extremely uncertain outlook to squeeze demand for goods. In real terms, retail sales dropped 1.6%M/M in August, 1.1ppt more than the median decline on the Bloomberg survey, to be down 5.4%Y/Y and 8.2% below the peak reached last April. The weakness in August left the average volume of retail sales in the first two months of Q3 some 0.8% below the Q2 average. So, given the further likely dampening effect of the period of national mourning following the Queen's death, and in particular the forthcoming extra national holiday on Monday, real sales look set to fall for a fifth successive quarter over Q3 as a whole. Given the drop in

**Euro area: HICP energy & selected subcomponents**



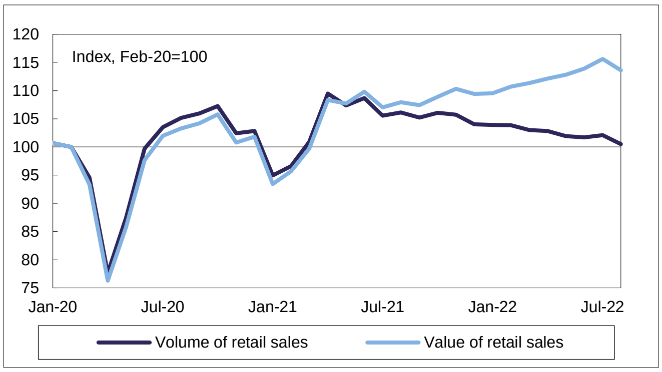

*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

**Euro area: HICP goods & services subcomponents**



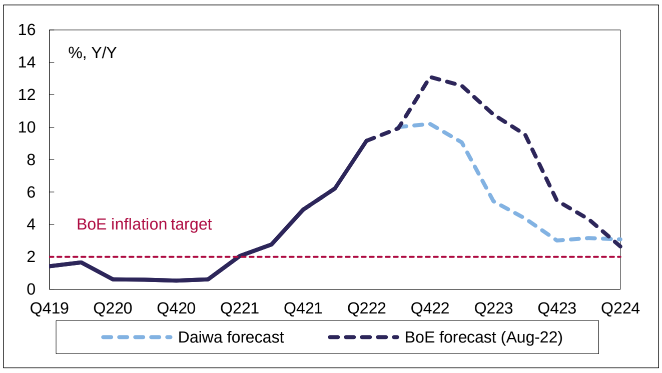

*Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

**UK: Retail sales**




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

**UK: CPI inflation forecasts**




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

consumer confidence last month to a series low and sharply falling real incomes, that should hardly come as a surprise. The government will hope that its subsequent belated announcement of measures to cap household energy bills will suffice to arrest the downtrend next quarter.

## Sales well above levels a year ago in nominal terms

With households' real disposable incomes eroded by high inflation, every major category of sales fell in real terms in August, with non-food store sales down 1.8%M/M, department stores down 2.7%M/M, clothing down 0.6%M/M and household goods down 1.1%M/M. Real sales at petrol stations dropped 1.8%M/M while sales at food stores, where price pressures have become particularly intense (the respective deflator rose 11.1%Y/Y in August), fell for a second successive month and by 0.8%M/M. In value terms, total sales dropped in August for the first time since December, by 1.7%M/M. But, given sharp price rises over the past year, the value of sales was up some 5.4%Y/Y, highlighting how shoppers are having to spend a lot more money to buy significantly less stuff.

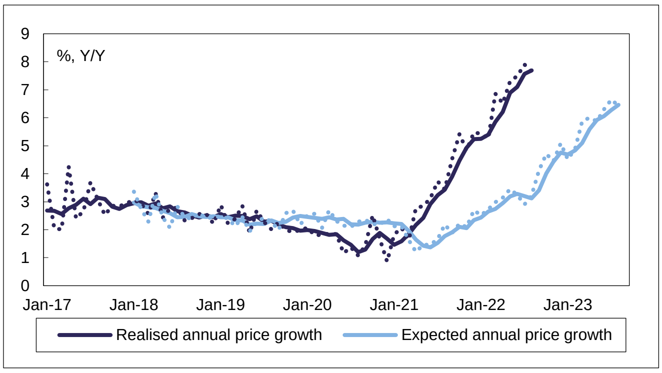
## BoE to focus on impact of household energy bill freeze on GDP and inflation outlook

After GDP rose just 0.2%M/M in July to be no higher than the Q2 average, today's retail sales report combines with recent surveys to point to a drop in overall economic output in August. And following the death of Queen Elizabeth II, and the imposition of a national holiday on Monday that looks set to be observed far more strictly than usual, GDP now looks set to decline again in September to deliver a second successive quarterly contraction and hence a technical recession. That will compare unfavourably with the BoE's August forecast of growth of 0.4%Q/Q in Q3. Moreover, while the decline in inflation in August to 9.9%Y/Y was consistent with the BoE's forecast, the near-term inflation outlook is now softer than previously feared thanks to the government's energy bill interventions. Indeed, while the BoE projected a rise in the headline CPI rate above 13%Y/Y next quarter, we now expect the peak to be close to 10½%Y/Y and inflation to fall steadily over the course of 2023. But the cap on household energy bills should also limit the contraction in GDP in Q4 and into 2023, which last month the BoE thought would cumulatively reach 2%. Indeed, the MPC might now worry that excess demand will persist over the course of the projection horizon, adding to risks that inflation will remain stubbornly above target into 2024 and beyond.

## Forthcoming fiscal policy initiatives raise risks of persistent above-target inflation

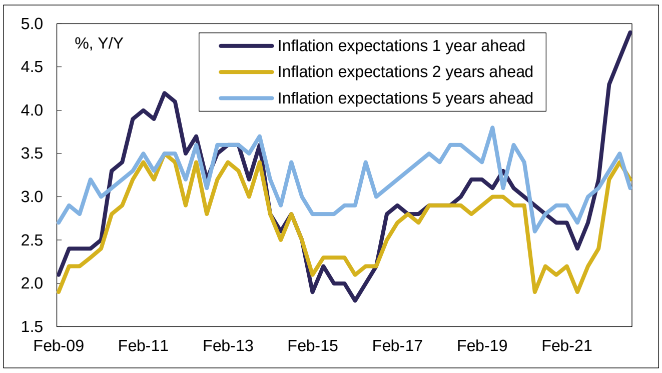
While at last month's monetary policy meeting, the MPC again judged that energy prices were the key cause of high inflation, the decision to raise Bank Rate by 50bps in part reflected concerns about increased risks of second-round effects. The MPC

### UK: Business price-setting expectations*



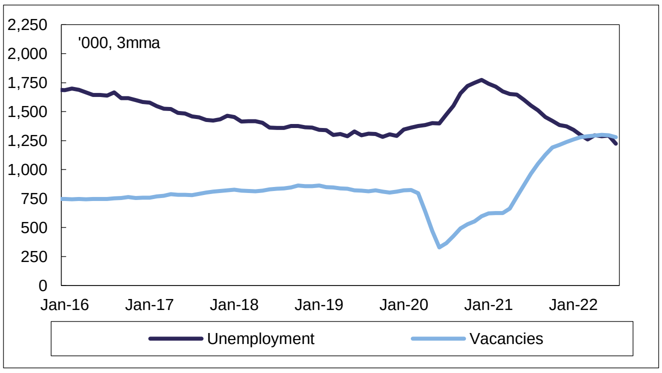

*Expected price growth relates to the coming twelve months. Dotted lines represent single-month figures. Unbroken lines represent three-month averages. Source: BoE's DMP survey and Daiwa Capital Markets Europe Ltd.*

### UK: Public inflation expectations



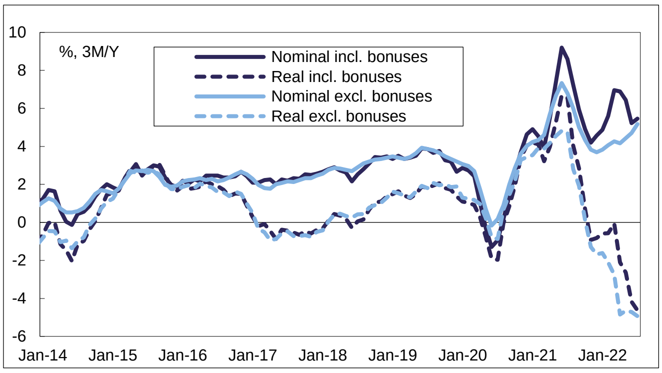

*Source: BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.*

### UK: Unemployment and vacancy levels*




*Aged 16+. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

### UK: Average weekly labour earnings*




*Real wages are deflated by CPI inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

highlighted that firms expected to increase their selling prices markedly and that wage pressures remained strong. And the BoE revised up its estimate of excess demand in the current quarter by ½ppt to ¾% of GDP. Given continued survey evidence of high business inflation expectations, persisting labour market tightness, ongoing weakness of sterling (which today fell below $1.14 to a new post-1985 low to be down another 4% in trade-weighted terms since the last MPC meeting) and increased concerns that excess demand might persist over the horizon due to the government's fiscal policy initiatives – which will likely be worth upwards of £30bn in tax cuts and extra public expenditure as well as perhaps £100bn in energy bill subsidies (depending on how wholesale prices evolve) – the MPC is bound to raise rates again at its rescheduled monetary policy meeting on Thursday.

## MPC likely to hike by 50bps on Thursday in a three-way split

The magnitude of the rate rise this month, however, is uncertain, with a three-way split likely. We expect at least one vote for a hike of 75bps, from external member Catherine Mann, and perhaps also her fellow external Jonathan Haskel. However, dovish external member Sylvana Tenreyro might prefer to raise rates by 25bps, or not at all, while the views of new member Swati Dhingra, who recently replaced hawk Michael Saunders, are unclear. Moreover, given the lack of detail on the government's fiscal policy plans, the associated inability to produce detailed updated economic projections, the likelihood of additional economic weakness this month due to the Queen's death, and yesterday's survey evidence of lower consumer price expectations two and five years ahead, we think the majority on the MPC will vote for a further hike of 50bps, taking Bank Rate to 2.25%. We would then also expect another hike of 50bps in November, and a smaller 25bps increment in December to end the year at 3.0%.

## Start to BoE Gilt sales likely to be confirmed despite likely imminent surge in new issuance

In addition to its decision on interest rates, the MPC will also likely vote on Thursday to confirm plans to smooth the path of quantitative tightening via a programme of active Gilts sales. The MPC first voted in February, when it raised Bank Rate to 0.5%, to start QT by ceasing the reinvestments of proceeds of maturing Gilts and reducing its holdings of non-financial corporate bonds. It then waited for May, when Bank Rate reached 1.0%, before considering whether to begin active Gilt sales. Last month, the MPC suggested that, together with ongoing redemptions, the BoE would reduce its stock of Gilts by around £80bn over the coming twelve months. Given the profile of maturing bonds, this would imply selling of around £10bn a quarter. Despite the marked sell-off in Gilts since that announcement, as well as the likelihood of a massive increase in government Gilt sales over coming quarters – perhaps an extra £100bn or more spread over this fiscal year and next – due to PM Truss's new fiscal policy initiatives, the BoE might be unwilling to reduce the magnitude of its planned sales in the absence of disorderly market conditions. Indeed, at the recent Treasury Committee hearing, BoE staff recalled that Bank Rate is now the marginal instrument for policy. So, if QT leads to higher Gilt yields, the MPC would simply be able to respond with a lower Bank Rate than would otherwise have been the case. The BoE will also commence the sale of corporate bonds on 27 September, one week later than originally signalled, with the delay related to the death of the Queen.

## The week ahead in the UK

Aside from the BoE's policy decisions, the coming week will see the government's new Chancellor Kwasi Kwarteng deliver a mini-budget on Friday, including more details on Prime Minister Truss's previously announced energy support proposals to cap soaring energy bills for households for the next two years and 'equivalent' support to businesses over the coming six months. In addition, the reversal of April's ill-timed hike in National Insurance Contributions, and postponement of the previously planned corporation tax hike, will likely be confirmed, with significant implications for the medium-term health of the public finances. While detail of how the government intends to finance the new fiscal proposals – presumably by higher bond issuance – will be closely watched, the lack of updated fiscal forecasts and objective scrutiny from the OBR will likely leave plenty of uncertainty about the full implications for the Gilt market. Ahead of the government's fiscal event, the coming week's public finances figures (Wednesday) will be of interest and are expected to show an increase in net public sector borrowing in August to £8.5bn, significantly lower than in August 2020 and 2021, but above equivalent borrowing in the two years ahead of the pandemic not least due to higher debt interest payments. Like in the euro area, September sentiment surveys will be published throughout the week, including most notably the flash PMIs and consumer confidence indices on Friday. With the manufacturing PMI expected to signal a steeper pace of contraction and the services PMI expected to imply stagnation, the composite output PMI is currently forecast to fall further below the key-50 expansion level to its lowest level since January 2021. The CBI's industrial trends and distributive trades indicators are also due (Tuesday and Friday respectively).

***The next edition of the Euro wrap-up will be published on 21st September 2022***

# Daiwa economic forecasts

| | | 2022 | | | | 2023 | | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | | | |
| **GDP** | | **%, Q/Q** | | | | | | **%, Y/Y** | | |
| Euro area | | 0.7 | 0.8 | 0.0 | -0.2 | -0.3 | -0.1 | 3.2 | -0.2 | 0.8 |
| UK | | 0.8 | -0.1 | -0.2 | -0.2 | -0.1 | 0.0 | 3.4 | -0.3 | 0.5 |
| **Inflation, %, Y/Y** | | | | | | | | | | |
| Euro area | | | | | | | | | | |
| Headline HICP | | 6.1 | 8.0 | 9.3 | 10.0 | 8.9 | 7.4 | 8.4 | 6.5 | 2.2 |
| Core HICP | | 2.7 | 3.7 | 4.4 | 5.2 | 5.4 | 5.2 | 4.0 | 4.7 | 2.4 |
| UK | | | | | | | | | | |
| Headline CPI | | 6.2 | 9.2 | 10.0 | 10.2 | 9.1 | 5.4 | 8.9 | 5.4 | 2.9 |
| Core CPI | | 5.1 | 6.0 | 6.3 | 6.1 | 5.0 | 3.7 | 5.9 | 3.7 | 3.2 |
| **Monetary policy, %** | | | | | | | | | | |
| ECB | | | | | | | | | | |
| Refi Rate | | 0.00 | 0.00 | 1.25 | 2.50 | 2.75 | 2.75 | 2.50 | 2.75 | 2.00 |
| Deposit Rate | | -0.50 | -0.50 | 0.75 | 2.00 | 2.25 | 2.25 | 2.00 | 2.25 | 1.50 |
| BoE | | | | | | | | | | |
| Bank Rate | | 0.75 | 1.25 | 2.25 | 3.00 | 3.50 | 3.50 | 3.00 | 3.50 | 3.00 |

*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 | EU27 new car registrations Y/Y% | Aug | **4.4** | - | -10.4 | **-** |
| | Final HICP M/M% (Y/Y%) | Aug | **0.6 (9.1)** | *0.5 (9.1)* | 0.1 (8.9) | **-** |
| | Final core HICP Y/Y% | Aug | **4.3** | *4.3* | 4.0 | **-** |
| Italy | Total trade balance €bn | Jul | **-0.4** | - | -2.2 | **-2.5** |
| | Final CPI M/M% (Y/Y%) | Aug | **0.8 (8.4)** | *0.8 (8.4)* | 0.4 (7.9) | **-** |
| | Final HICP M/M% (Y/Y%) | Aug | **0.9 (9.1)** | *0.8 (9.0)* | -1.1 (8.4) | **-** |
| UK | Retail sales including autos fuel M/M% (Y/Y%) | Aug | **-1.6 (-5.4)** | -0.5 (-3.7) | 0.3 (-3.4) | **0.4 (-3.2)** |
| | Retail sales excluding autos fuel M/M% (Y/Y%) | Aug | **-1.6 (-5.0)** | -0.7 (-3.5) | 0.4 (-3.0) | **- (-3.1)** |
| **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 19 September 2022** | | | |
| Euro area | | 10.00 | Construction output M/M% (Y/Y%) | Jul | - | -1.3 (0.1) |
| | | | **Tuesday 20 September 2022** | | | |
| Euro area | | 09.00 | ECB current account balance €bn | Jul | - | 4.2 |
| Germany | | 07.00 | PPI M/M% (Y/Y%) | Aug | 1.6 (36.4) | 5.3 (37.2) |
| | | | **Wednesday 21 September 2022** | | | |
| UK | | 07.00 | Public sector net borrowing (excluding banks) £bn | Aug | 7.5 (8.8) | 4.2 (4.9) |
| | | 11.00 | CBI industrial trends, total orders (selling prices) | Sep | -13 (52) | -7 (57) |
| | | | **Thursday 22 September 2022** | | | |
| Euro area | | 15.00 | Preliminary EC consumer confidence | Sep | -25.1 | -24.9 |
| France | | 07.45 | INSEE business confidence | Sep | 102 | 103 |
| | | 07.45 | INSEE manufacturing confidence (production outlook) | Sep | 102 (-5) | 104 (-2) |
| UK | | 12.00 | BoE Bank Rate % | Sep | *2.25* | 1.75 |
| | | | **Friday 23 September 2022** | | | |
| Euro area | | 09.00 | Preliminary manufacturing (services) PMI | Sep | 49.0 (49.2) | 49.6 (49.8) |
| | | 09.00 | Preliminary composite PMI | Sep | 48.2 | 48.9 |
| Germany | | 08.30 | Preliminary manufacturing (services) PMI | Sep | 48.3 (47.2) | 49.1 (47.7) |
| | | 08.30 | Preliminary composite PMI | Sep | 46.0 | 46.9 |
| France | | 08.15 | Preliminary manufacturing (services) PMI | Sep | 49.8 (50.5) | 50.6 (51.2) |
| | | 08.15 | Preliminary composite PMI | Sep | 49.9 | 50.4 |
| Spain | | 08.00 | Final GDP Q/Q% (Y/Y%) | Q2 | *1.1 (6.3)* | 0.2 (6.3) |
| UK | | 00.01 | GfK consumer confidence | Sep | -42 | -44 |
| | | 09.30 | Preliminary manufacturing (services) PMI | Sep | 47.8 (50.0) | 47.3 (50.9) |
| | | 09.30 | Preliminary composite PMI | Sep | 49.0 | 49.6 |
| | | 11.00 | CBI reported retail sales | Sep | - | 11 |

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

## The coming week's key events & auctions

| Country | | BST | Event / Auction |
|---|---|---|---|
| | | | **Monday 19 September 2022** |
| Euro area | | 10.00 | ECB Vice President de Guindos scheduled to speak |
| | | 10.00 | ECB's Holzmann scheduled to speak |
| | | 13.45 | ECB's Villeroy scheduled to speak |
| | | | **Tuesday 20 September 2022** |
| Euro area | | 18.00 | ECB President Lagarde scheduled to speak |
| | | | **Wednesday 21 September 2022** |
| Euro area | | 08.00 | ECB Vice President de Guindos scheduled to speak |
| Germany | | 10.30 | Auction: €4bn of 1.7% 2032 bonds |
| | | | **Thursday 22 September 2022** |
| Euro area | | 09.00 | ECB publishes Economic Bulletin |
| | | 16.00 | ECB's Schnabel scheduled to speak |
| UK | | 12.00 | BoE monetary policy announcement, summary and minutes to be published |
| | | 12.00 | BoE publishes Agents' summary of business conditions – Q322 |
| | | | **Friday 23 September 2022** |
| UK | | Tbc | UK government's fiscal announcements |

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

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs