Euro wrap-up

Overview

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- Ahead of the FOMC decision, shorter-dated Bunds followed USTs lower, while a BoF retail survey suggested that sales declined for the third consecutive month.
- Gilts largely also made losses, while UK public sector net borrowing continued to rise as debt interest payments reached a record high for August.
- Tomorrow the BoE's MPC will hike Bank Rate by at least 50bps and confirm the start of active Gilt sales. The Commission's flash consumer confidence indicator is also due.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.726	+0.040
OBL 1.3 10/27	1.822	+0.007
DBR 1.7 08/32	1.883	-0.036
UKT 1 04/24	3.387	+0.062
UKT 1¼ 07/27	3.373	+0.068
UKT 4¼ 06/32	3.311	+0.021

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

Euro area

French retail sales on track to be a drag on GDP in Q3

On a relatively quiet day for euro area economic data, today's Bank of France retail sales survey pointed to a likely notable drop in spending on goods over the third quarter. The survey measure of sales volumes dropped only 0.3%M/M in August. However, that marked the third successive decline. And due to a big step lower in June, French retail sales were down 3.1%3M/3M. Despite stabilising in August, the volume of sales of manufactured items was down a steep 5.3%3M/3M but sales of food were broadly stable despite significant price pressures. While INSEE's consumer survey points to a modest improvement in households' intentions to make major purchases, overall spending on goods looks set to have dropped in Q3. However, spending on services likely continued to grow, not least due to the rebound in tourism activity. As a result, the Bank of France forecasts GDP growth of 0.3%Q/Q this quarter; we are a touch more downbeat than that at 0.1%Q/Q.

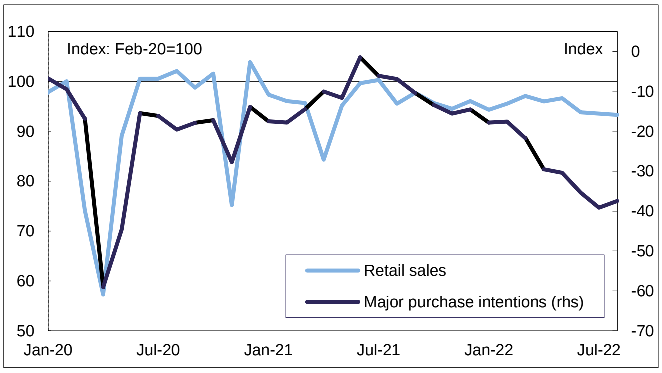
Meloni on track to become Italian PM

Looking ahead, the next big political event in the euro area will be Sunday's Italian general election. But, for some time, the outcome has seemed to be in little doubt. Final opinion polls conducted before the pre-election blackout period reinforced expectations that the right-wing alliance – of Georgia Meloni's Brothers of Italy (FdI), Matteo Salvini's Lega and Silvio Berlusconi's Forza Italia (FI) – will win a landslide victory, securing almost 50% of the vote, thus securing most first-past-the-post seats and comfortably gaining a sizeable majority in the new (reduced-size) parliament. In part, that will reflect the failure of the many parties on the left and centre to work together to provide a viable alternative alliance. Indeed, while the centre-left Democratic Party (PD) will likely increase its share of the vote from 2018, the populist left Five Star Movement – which came top last election with almost one third of the vote – could see its share decline by as much as 20ppts. And the smaller centrist and left parties will scrap to maintain a presence in parliament. In contrast, the right-wing alliance managed to put apart their differences sufficiently to unite around a loose manifesto of policies as well as an agreement that the leader of the party with the most votes should become the next Prime Minister. And with FdI having roughly tripled support over the past three years to be polling around 25%, while Lega has slumped more than 20ppts over the same period and FI remains relatively weak, the far-right nationalist Meloni – who always opposed Draghi's Government of National Unity – looks set to be invited by President Mattarella to lead the next Italian government, which could well be in office by the end of October.

Italian markets should maintain composure for the time being

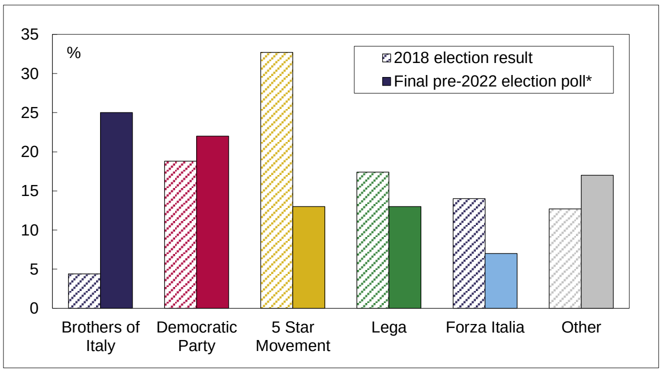
Importantly, to make itself more electable, the FdI stated that it now intends to retain membership of the EU and euro, and also has no desire to alter the fundamentals of Italy's foreign and defence policies. The alliance also claims to maintain a

France: BoF retail sales & purchase intentions



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

Italy: Political party voting intentions



**Aggregated Poll of Polls. Source: Politico and Daiwa Capital Markets Europe Ltd.*

commitment to the main elements of Draghi's reform programme and 2023 budget plans, as well as the EU budgetary rules, and hence sustain Italian eligibility for Next Generation EU grants and loans. And so, as the ECB used the flexibility allowed within its PEPP reinvestment policy to increase net purchases of BTPs earlier in the summer and also has its new Transmission Protection Instrument (TPI) to use as backup if needed, Italian sovereign spreads relative to Bunds have remained relatively stable throughout the recent bond sell-off. There is good reason to believe that will remain the case once the result of the election is confirmed, particularly if the coalition leaders appoint a market-friendly Finance Minister to give the impression of policy continuity from the incumbent Daniele Franco. Nevertheless, significant policy differences exist within the right-wing alliance, ranging from issues related to Russia and Ukraine, specific tax rates, new measures to ease the cost of living, and the importance (or otherwise) of fiscal prudence. And in light of the extremely challenging economic outlook, it is possible that damaging fault-lines on budgetary issues could emerge and widen very early in the term of the new government. At the same time, it also remains to be seen whether FI will be able to win sufficient seats to be able to have much influence in the next coalition – if not, a government dominated by FdI and Lega would risk the evolution of a more nationalist Eurosceptic policy than has up to now been promised. Finally, a two-thirds majority for the right in the parliament, which would open the door to constitutional revision without need for a popular referendum, would undeniably provide a cause for concern.

The day ahead in the euro area

The euro area data highlight tomorrow will be the release of the European Commission's flash September consumer confidence indicator. Given households' diminishing purchasing power and the prospect 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 series low in July (-27.0). Indeed, while the Netherlands government intends to cap gas and electricity bills from January and will also extend its fuel tax cut to the middle of next year, the Dutch consumer confidence indicator released today fell 5pts to a fresh record low of -59, with households more concerned about their financial situation. Thursday will also bring INSEE's French business confidence survey for this month, in which the headline indicator is also expected to fall further – to a seventeen-month low of 102 – albeit remaining firmly above the post-pandemic low of 47.5 in April 2020.

UK

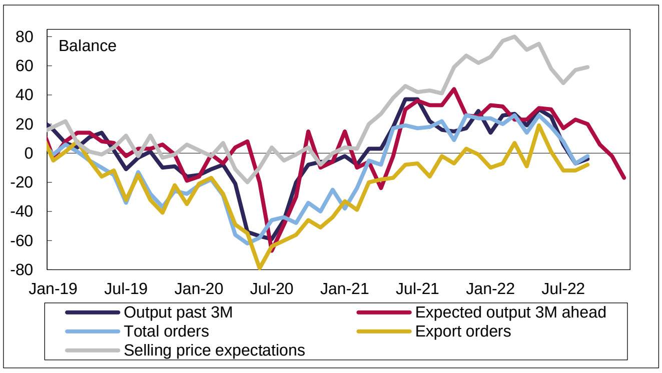
UK public borrowing rises as debt interest payments reached a record high for August

Ahead of Friday's mini-budget statement, today's UK public finance figures suggested that borrowing exceeded expectations in August but that cumulative borrowing so far this fiscal year remained broadly in line with OBR expectations. In particular, net public sector borrowing increased £11.8bn in August, lower than in August 2020 (£24.3bn) and 2021 (£14.4bn), but above equivalent borrowing in the ten years ahead of the pandemic and almost double the amount forecast by the OBR in March. Within the detail, central government receipts were £5.6bn higher than in August 2021 at £69.6bn, due to higher VAT, PAYE and National Insurance Contributions – the latter in part due to the increase that is about to be reversed. But government spending was little changed from a year ago despite the decline of more than £3bn in pandemic-related subsidy payments, with debt interest payments (£8.2bn) recording the highest August figure since monthly records began in April 1997. Indeed, so far this financial year, interest payments have totaled £49.1bn, some £9bn more than the OBR forecast in March. And with RPI inflation having shifted even higher over recent months to 12.3%Y/Y in July and August, interest payable on index-linked gilts looks bound to remain historically elevated.

Substantial fiscal loosening on the way, but how it will be financed remains unclear

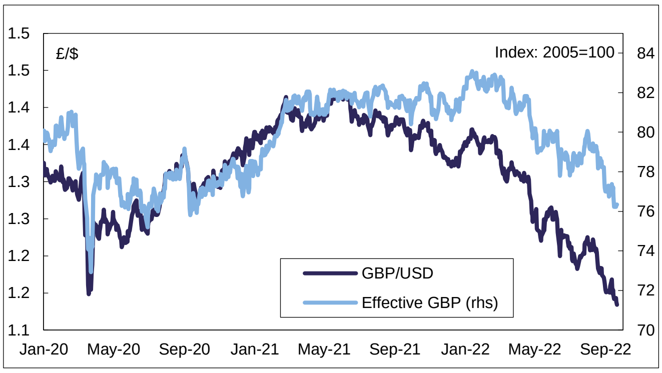
Given downwards revisions to public sector net borrowing in the first four months of the financial year (totalling £8.6bn), cumulative borrowing (£58.2) was broadly in line with the OBR's forecast (which envisages full-year borrowing at a little more than £99bn) and £21.4bn lower than the equivalent period in 2021. Admittedly, it remains more than £30bn higher than over

UK: CBI industrial survey indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Sterling exchange rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

the same period in 2019 ahead of the pandemic. And Friday's mini-budget is set to bring a significant fiscal loosening, confirming among other things the reversal of April's hike in National Insurance Contributions, abandonment of the planned increase in the main corporation tax rate previously scheduled for April next year and reportedly a possible cut to housing stamp duty too. As well as the planned freeze in the typical household energy bill at £2,500, the government today also confirmed that it will cap wholesale energy bills for businesses for six months from 1 October, with electricity prices to be capped at £211MWh and gas at £75MWh, less than half the anticipated level of wholesale prices this winter, on contracts signed since 1 April. The detail of how the government intends to finance the new energy market proposals, however, remains unclear. Loans to energy suppliers to facilitate these caps would boost debt but might not score as public borrowing. And the lack of updated fiscal forecasts and objective scrutiny from the OBR to come this week will also likely leave plenty of uncertainty about the full implications for the Gilt market.

CBI survey points to a marked weakening in manufacturing conditions

Ahead of the flash PMIs at the end of the week, today's CBI industrial trends survey suggested that manufacturing conditions remained challenging at the end of the third quarter. Admittedly, contrasting with the sharp contraction implied by recent PMIs, the survey suggested that output declined only slightly in the three months to September. But this largely reflected strong growth in the autos sector, which had previously been more acutely impacted by supply constraints. Moreover, the survey's output indicator (-4) was 29pts lower than in June. While total order books were assessed to be broadly normal, the relevant survey gauge posted the second successive negative reading and was roughly 20pts lower than in June. Overseas demand also reportedly remained weak. And with manufacturers considering stocks to be more than adequate and by the greatest extent since February 2021, they expected a much steeper pace of decline in production over the coming three months – indeed, the respective survey index slumped to -17 in September some 37pts lower than three months ago. Despite subdued demand, and ahead of today's government announcement of how it will limit energy bills, manufacturers had continued to expect a rapid increase in average selling prices over the final quarter of the year.

The day ahead in the UK

All eyes in the UK tomorrow will be on the delayed BoE monetary policy announcement at lunchtime, which is bound to see rates rise again. The magnitude of tightening this month, however, is uncertain, with a good chance of a three-way split. We expect at least one vote for a hike of 75bps, from external member Catherine Mann – who has been concerned about firms' elevated price expectations and the need to be mindful of additional inflation risks from sterling weakness. Her fellow external member Jonathan Haskel, who has flagged concerns about the risks from labour market tightness, might join her. And the 100bps hike announced yesterday by the Swedish Riksbank might also suggest that some of the Bank's internal members will be inclined to vote for a hike of 75bps this week. However, as she is concerned that the full pass-through from recent rate hikes, e.g. to most borrowers on fixed-rate mortgages, has yet to be felt, dovish external member Sylvana Tenreyro might prefer to raise rates by just 25bps. In addition, the views of new member Swati Dhingra, who recently replaced hawk Michael Saunders, are unclear. But given the lack of full clarity 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 recent 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 – the same as in August – 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 3.00%. In addition to its decision on interest rates, the MPC will also likely confirm plans to smooth the path of quantitative tightening via a programme of active Gilts sales.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	🇬🇧	Public sector net borrowing (excluding banks) £bn	Aug	**11.1 (11.8)**	8.1 (8.0)	4.2 (4.9)	**2.1 (2.9)**
	🇬🇧	CBI industrial trends, total orders (selling prices)	Sep	**-2 (59)**	-13 (52)	-7 (57)	-

Auctions

Country		Auction
Germany	🇩🇪	sold €3.59bn of 1.7% 2032 bonds at an average yield of 1.87%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		15.00	Preliminary EC preliminary consumer confidence	Sep	-25.5	-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
Auctions and events						
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			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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