Euro wrap-up

Overview

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- Bunds made losses even as the flash euro area PMIs pointed to a steeper pace of economic contraction at the end of Q3.
- Gilts got smashed and sterling weakened sharply as the UK government announced a larger-than-expected package of tax cuts, magnifying concerns about the lack of credibility of its economic policy.
- The coming week will bring the flash estimates of euro area inflation in September along with updates on the euro area labour market and UK current account deficit.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.884	+0.078
OBL 1.3 10/27	2.014	+0.086
DBR 1.7 08/32	2.026	+0.068
UKT 1 04/24	3.854	+0.408
UKT 1¼ 07/27	4.032	+0.492
UKT 4¼ 06/32	3.807	+0.320

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

Euro area

Gloomy euro area flash PMIs imply a steeper pace of contraction at end-Q3

After yesterday's preliminary consumer confidence index from the Commission registered a drop to a series low, the flash PMIs similarly pointed to a deterioration in business conditions at the end of Q3 as the impact of the rising cost of living and uncertainty about the economic outlook took its toll. The euro area composite output index fell for the fifth successive month in September, by 0.7pt to 48.2, the lowest since January 2021. And outside of the Covid-19 lockdown periods, the PMI was the weakest since the euro crisis in 2013. Moreover, this marked the third consecutive sub-50 reading, to leave the average for the third quarter (49.0) more than 5pts lower than in Q2 and consistent with contraction. Despite signs of a further easing in supply bottlenecks, the downturn remained most marked in manufacturing as the output PMI (46.2) fell to a level that was last weaker at the start of the pandemic, reflecting not least a further substantive drop in new orders. But the services sector was not immune to the gloom either, with the activity PMI recording the second successive contractionary reading (48.9) amid weakening in tourism, recreation, real estate and insurance as the post-pandemic summer bounce faded. Over the third quarter as a whole, the manufacturing and services activity PMIs were respectively more than 4pts and 5½pts lower. With businesses also still facing rising costs – the composite input price PMI rose 4.2pts to 76.5 – and increasing concerns about the energy market, as well as softer global growth, firms' expectations for output over the coming year slumped sharply, with the relevant index at its lowest since May 2020, and November 2012 before the pandemic.

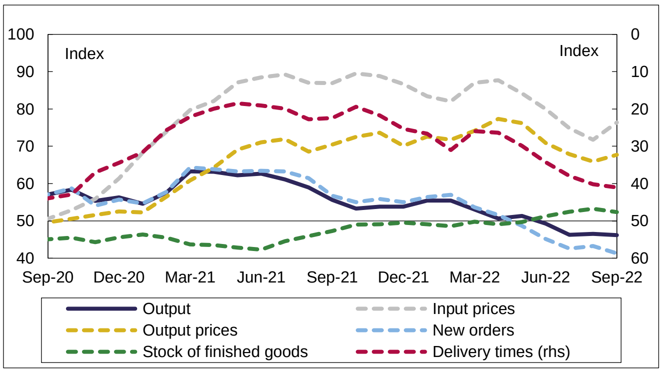
German PMIs give off clear recession vibes

The respective German indices gave off clear recession vibes, as the composite PMI dropped a little further than expected, by 1pt to 45.9, the lowest since the first wave of Covid-19. While the manufacturing output index was a touch firmer in September at 47.0, it was still consistent with ongoing retrenchment as heavy industry continues to cut its reliance on Russian gas. And the services survey was much weaker than expected, with the activity index down more than 2pts to just 45.4, a 28-month low. Over Q3 as a whole, the picture was not at all pretty. In German manufacturing, the output index was down 3.6pts from Q2 while the new orders index was down a whopping 6pts. And in services, the activity index was down more than 7pts from Q2 with the new orders component also down more than 5pts on the quarter.

French PMIs point to a (temporary) rebound in services

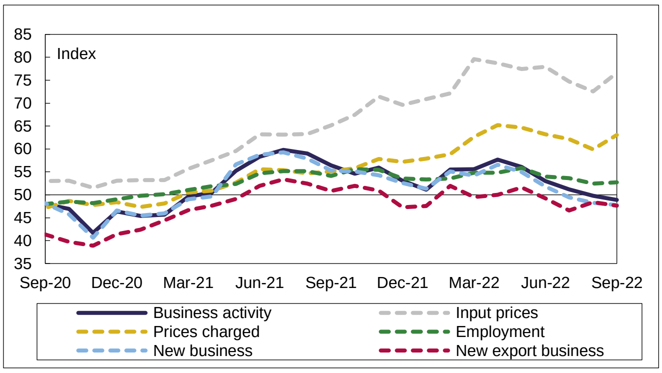
However, contrasting with the modest downwards trend in yesterday's INSEE survey, there was a welcome upside surprise to the French flash PMIs, reflecting a rebound in the services sector where the headline activity index jumped 1.8pts to 53.0, albeit merely a two-month high. Nevertheless, given a further marked decline in the manufacturing output index, which fell

Euro area: Manufacturing PMIs



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

Euro area: Services PMIs



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

more than 3pts to 43.4, a 28-month low, the improvement in the composite PMI was more modest, up 0.8pt to 51.2 and therefore still consistent with slowing economic momentum over the third quarter as a whole. Indeed, the average composite PMI in Q3 was a sizable 4.6pts lower than in Q2. And we caution that the French PMIs are often revised significantly from their flash estimates.

The week ahead in the euro area

The coming week will be a busy one for top-tier euro area data releases, with the calendar including the Commission's business and consumer confidence surveys (Thursday), flash HICP inflation estimates for September and labour market data (Friday). Of most interest will be Friday's preliminary euro area inflation figures, which will likely report that the headline HICP rate jumped in September, from August's record high of 9.1%Y/Y, in part due to the expiration of the German discounted travel pass and fuel duty cut – our forecast is for an increase of 0.7ppt to 9.8%Y/Y. While this will also partly reflect higher food inflation, we expect core inflation to rise to as much as 5.0%Y/Y, from 4.3%Y/Y previously. The equivalent member state numbers from Germany and Spain are due Thursday, with those from France and Italy coming the following day. With the flash PMIs today having signalled a pickup in inflationary pressures, the price expectations measures in Thursday's Commission survey will be watched closely. Overall, we expect the EC sentiment indices to echo the deterioration in the flash PMIs and also confirm the record low in consumer confidence. We will also get a number of national sentiment indices over the coming week, including the German ifo business climate index for September on Monday, which seems likely to point to increasing risks of recession. Meanwhile, the latest labour market data should remain a source of comfort, with the euro area unemployment rate expected to have moved sideways at a record-low 6.6% in August. Other data due in the coming week include euro area money supply numbers for August on Tuesday.

It will also be a busy week for ECB-speak, with a number of Executive Board members in action, including on Monday, President Lagarde's quarterly economic update before the European Parliament's Economic and Monetary Committee. On Thursday, Chief Economist Lane is due to speak on inflation at a Fed-sponsored conference, while key hawk Schnabel is due to speak on Friday.

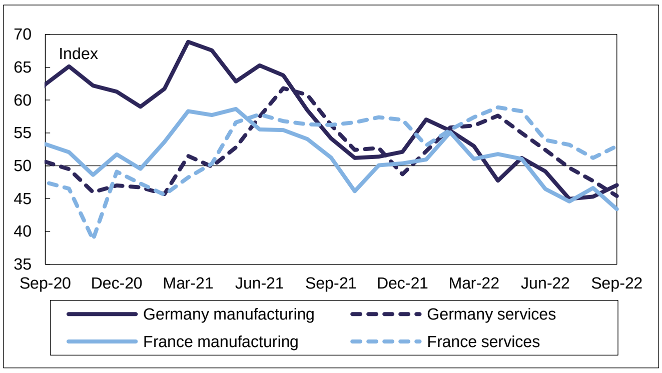
Finally, focus at the start of the week will also be on the outcome of Sunday's Italian general election, which looks set to deliver a large parliamentary majority for the right-wing coalition. Georgia Meloni, the leader of the nationalist Brothers of Italy, looks destined to be Mario Draghi's successor as Italian Prime Minister.

UK

Gilts and sterling smashed as tax cuts magnify concerns about lack of policy credibility

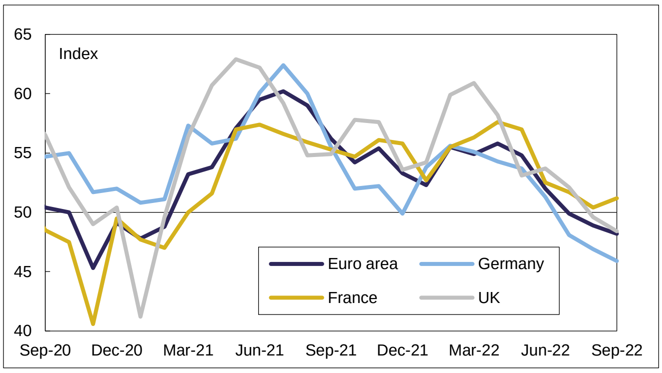
The decline in sterling and gilts accelerated today – e.g. with 5Y yields rising by a record daily amount while markets priced-in the strong possibility of a hike of 100bps at the MPC's next policy meeting in November – as the government's fiscal

Germany & France: Manufacturing & services PMIs*



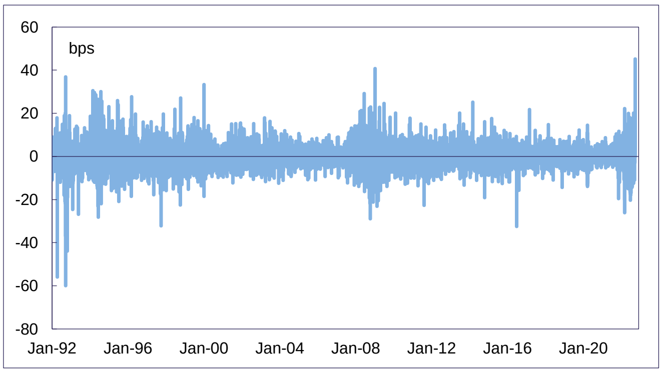
Output indices. Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Composite PMIs*



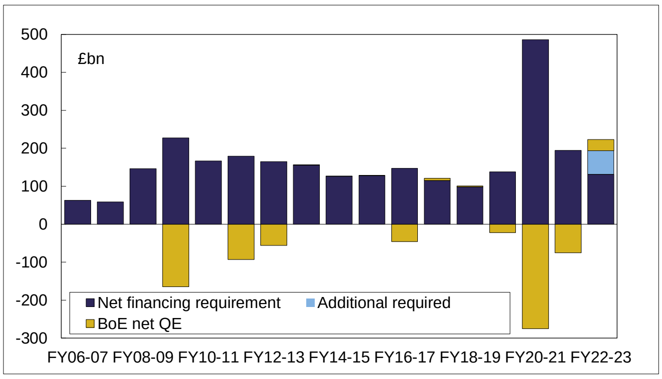
Output indices. Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Daily change in 5Y Gilt yield



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Government net financing requirement



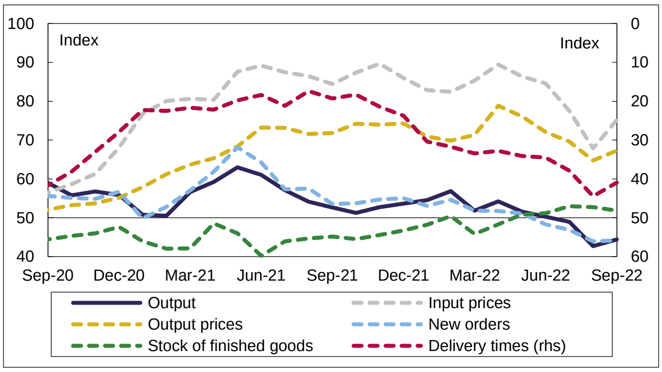
Source: DMO, BoE, ONS and Daiwa Capital Markets Europe Ltd.

easing plans significantly exceeded expectations, magnifying concerns about the lack of credibility of its economic policy. Among other things, the package of tax cuts represented the biggest in fifty years and a permanent fiscal loosening of £45bn (about 1¾% of GDP), at least £10bn more than had been anticipated. Many of the measures had long been trailed in advance, including the reversal of April's National Insurance increase and cancellation of plans to increase the Corporation Tax rate from 19% to 25% in April. As had been rumoured, the stamp duty threshold on property purchases for first-time buyers was also lifted sharply. However, surprises today included a decision to reform personal income tax in April, when the basic rate will be cut by 1ppt to 19% and the 45% top rate will be abolished. On top of the cost of the tax cuts, the Chancellor estimated that the government's energy bill subsidies would cost £60bn over the coming six months, with additional costs to come for the eighteen months thereafter. And as a result, he revised up sharply the DMO's Net Financing Requirement (NFR) for the current fiscal year, by £72.4bn to £234.1bn. Additional gilt sales of £62.4bn will take the planned total to £193.9bn, above expectations, while additional net sales of bills for debt management purposes of £10.0bn will take the planned increase this fiscal year to £40.2bn.

Policies incompatible with fiscal rules and pose economic and financial stability risks

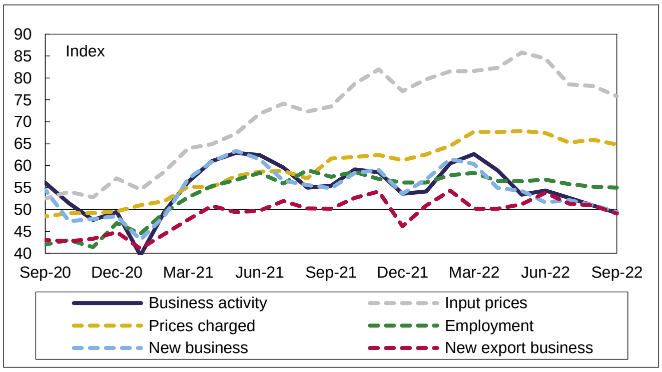
While the support for energy bills should be limited to two years, the permanency of the tax cuts and the failure so far to offset them with any expenditure savings means that, in contradiction with the government's legislated fiscal rules, net public borrowing will likely remain above £100bn per year over the medium term and public debt is set to rise as a share of GDP over the coming three years. Admittedly, a new medium-term fiscal plan and new fiscal rules were promised to be prepared in due course. At the same time, with most of the benefits to be felt by higher earners and business – indeed, according to the IFS, only the richest 10% of households will pay less tax over coming years – the package represented a marked U-turn of the policies of Boris Johnson, and smacked of a return to trickle-down economics. The government hopes that the measures will boost potential GDP growth to 2½%Y/Y, double the average rate of the past fifteen years, to increase the sustainability of the public finances. But there is no evidence to support such hopes. The government has made no meaningful attempt to lift the real obstacles to UK economic growth, which include the drop in labour supply since the pandemic, the new barriers to trade with the EU, inadequate infrastructure and other disincentives to business investment, which remains firmly below its level before the Brexit referendum. So, just as the largest previous set of tax cuts in 1972 ended in tears, exacerbating macroeconomic imbalances and high inflation, so too today's announcement poses significant risks to stability. With the BoE already judging excess demand in the economy to have reached ¾% of GDP this quarter despite recent economic weakness, the boost to demand from today's announcement will be met by higher BoE interest rates than previously expected. A hike in Bank Rate of 100bps in November now looks a good bet, as does a terminal rate above 5.0%. And, at a time when the BoE is set to reduce its stock of Gilt holdings by £80bn over the coming twelve months, and the measures exacerbating the UK's twin fiscal and current account deficits – the latter of which could feasibly reach

UK: Manufacturing PMIs



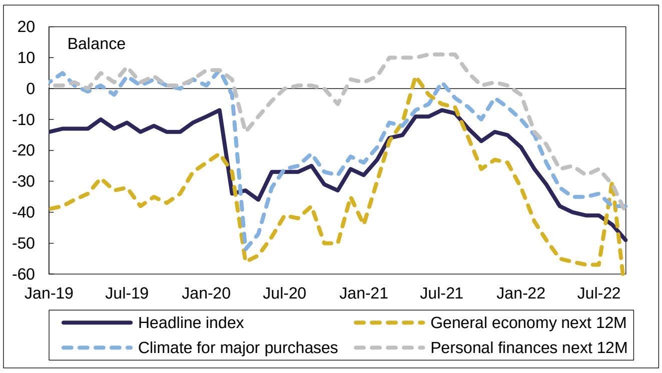
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs



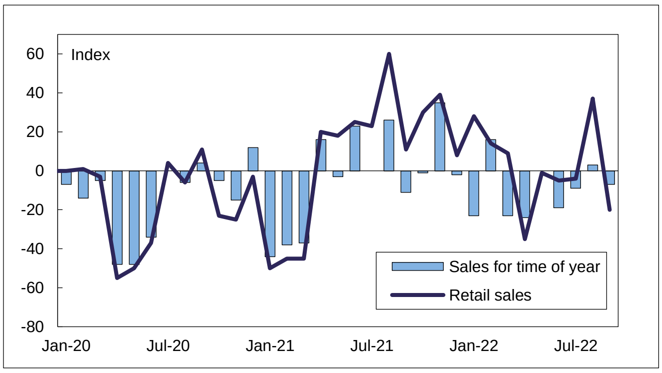
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: GfK consumer confidence



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI retail sales indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

10% of GDP before long – concerns about a lack of policy credibility are likely to weigh further on sterling and Gilts, and could well require very aggressive action from the BoE before long.

Flash PMIs and CBI survey add to evidence of drop in GDP in Q3

Of course, the government will cite the recent weakness of economic activity as justification for taking risks with fiscal policy. And after the BoE yesterday acknowledged that GDP is likely to decline slightly for the second successive quarter in Q3, today's flash September PMIs and CBI distributive trades survey results provided further evidence to support that judgement. In particular, the flash composite output PMI dropped for a third successive month and by 1.2pts to 48.4, the lowest since the lockdowns of January 2021. That left the quarterly average at 50.0, which is arguably consistent with steady economic activity. But that was 5pts lower than the average in Q2 when GDP dropped 0.1%Q/Q, and was the lowest quarterly average since Q121 when GDP dropped 1.2%Q/Q. The deterioration was led by the services sector, for which the activity index dropped 1.7pts to a 20-month low of 49.2. In contrast, the manufacturing output PMI ticked higher, by the same magnitude. But at 44.4, that level remained highly contractionary and was still the second-lowest since the first wave of Covid-19, reportedly weighed by a weakening in new orders, particularly from abroad, as well as ongoing supply-side restraints. Meanwhile, following a bounce on the respective measure (but not in the official sales data) in August, the CBI distributive trades survey suggested that retail sales fell in September at the sharpest annual pace since April. Moreover, the drop in sales volumes of 20%Y/Y this month was expected to be followed by a decline of 13%Y/Y in October. Orders placed with suppliers fell too (-16%Y/Y), while wholesalers also reported a drop in sales (-21%Y/Y). And motor trade sales reportedly fell at the sharpest pace since the first wave of Covid-19 (-65%Y/Y), and were expected to shrink at an even faster pace in October.

Consumer confidence plunges to series low

The sluggishness of retail sales at end-Q3 would tally with today's GfK's sentiment survey, which suggested that UK consumers have never been so downbeat. While the government's plans to cap household energy bills were well-known by households over most of the survey period, the headline confidence indicator fell a further 5pts in September to -49, the lowest since the series began in 1974. GfK also noted that the death of the Queen also had no perceptible impact on sentiment. Within the detail, the weakness was unsurprisingly broad-based. Faced with near-double-digit inflation, the sharply rising cost of borrowing, and declining real incomes, households were notably more downbeat about their expected financial situation over the coming twelve months – indeed, the relevant survey gauge fell a further 9pts to a record-low of -40, some 12pts lower than at the end of Q2 and 51pts lower than the peak last August. And not least given ongoing concerns surrounding the war in Ukraine and the slowing global economy, expectations about the general economic outlook also deteriorated markedly – the survey component slumped 38pts (more than reversing August's surprise 27pt increase) to -68, similarly a series low. Admittedly, households considered the climate for making major purchases to be no materially worse over the month, although that survey index was still historically weak at -38, to be 3pts lower over the third quarter as a whole, a whopping 37pts lower than the long-run average. Not least reflecting the further 50bps hike in Bank Rate yesterday, and the prospects of additional rate hikes to come over coming months, as well as the continued expected uptrend in prices of a wide range of items, consumption certainly seems set to remain extremely subdued despite the government's new tax cuts.

The week ahead in the UK

Looking to the week ahead, Friday's current account data for Q2 will be of interest. The current account deficit deteriorated to a record 8.3% of GDP in Q1. While the worsening of the deficit was largely caused by the soaring price of energy imports following Russia's invasion of Ukraine, continued balance of payments weakness will add to concerns about the government's ability to finance its tax cuts and energy bill support, leaving sterling and Gilts vulnerable to further marked correction. Alongside these data, final Q2 GDP figures are expected to confirm a contraction of 0.1%Q/Q, likely marking the beginning of a recession in the UK. Ahead of these data, we will get the BoE's latest bank lending numbers (Thursday), which are expected to confirm that demand for consumer credit remained firm in August as household budgets continue to be squeezed by high inflation. Indeed, the BRC's shop price index (Wednesday) seems bound to flag elevated price pressures on the High Street, not least due to higher global food prices, with the headline rate likely to have risen further from August's series high of 5.1%Y/Y. Other data due in the coming week include the Nationwide house price index for September and Lloyds business barometer for the same month on Friday.

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 26 September 2022			
Germany		09.00	ifo business climate index	Sep	87.0	88.5
		09.00	ifo current assessment (expectations) balance	Sep	96.0 (79.0)	97.5 (80.3)
Spain		08.00	PPI M/M% (Y/Y%)	Aug	-	0.0 (40.4)
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Sep	-	-1.3 (8.2)
			Tuesday 27 September 2022			
Euro area		09.00	M3 money supply Y/Y%	Aug	5.4	5.5
			Wednesday 28 September 2022			
Germany		07.00	GfK consumer confidence index	Oct	-38.5	-36.5
France		07.45	INSEE consumer confidence index	Sep	80	82
Italy		09.00	ISTAT business (manufacturing) sentiment indicator	Sep	- (102.1)	109.4 (104.3)
		09.00	ISTAT consumer confidence index	Sep	95.0	98.3
UK		00.01	BRC shop price index Y/Y%	Sep	-	5.1
		-	Nationwide house price index* M/M% (Y/Y%)	Sep	-	0.8 (10.0)
			Thursday 29 September 2022			
Euro area		10.00	EC economic sentiment indicator	Sep	95.0	97.6
		10.00	EC industrial (services) confidence	Sep	-0.6 (7.3)	1.2 (8.7)
		10.00	EC final consumer confidence	Sep	-28.8	-24.9
Germany		13.00	Preliminary CPI M/M% (Y/Y%)	Sep	1.6 (9.6)	0.3 (7.9)
		13.00	Preliminary HICP M/M% (Y/Y%)	Sep	1.5 (10.1)	0.4 (8.8)
Italy		09.00	PPI M/M% (Y/Y%)	Aug	-	6.5 (45.9)
Spain		08.00	Preliminary CPI M/M% (Y/Y%)	Sep	-	0.3 (10.5)
		08.00	Preliminary HICP M/M% (Y/Y%)	Sep	0.6 (10.0)	0.3 (10.5)
UK		09.30	Net consumer credit £bn (Y/Y%)	Aug	1.4 (-)	1.4 (6.9)
		09.30	Net mortgage lending £bn (approvals '000s)	Aug	4.9 (62.5)	5.1 (63.8)
			Friday 30 September 2022			
Euro area		10.00	Preliminary HICP M/M% (Y/Y%)	Aug	*1.0 (9.8))*	0.6 (9.1)
		10.00	Preliminary core HICP Y/Y%	Aug	*5.0*	4.3
		10.00	Unemployment rate %	Aug	6.6	6.6
Germany		08.55	Unemployment change '000s (rate %)	Sep	20.0 (5.5)	28.0 (5.5)
France		07.45	Preliminary CPI M/M% (Y/Y%)	Sep	-0.2 (6.0)	0.5 (5.9)
		07.45	Preliminary HICP M/M% (Y/Y%)	Sep	-0.1 (6.6)	0.5 (6.6)
		07.45	PPI M/M% (Y/Y%)	Aug	-	1.6 (27.2)
		07.45	Consumer spending M/M% (Y/Y%)	Aug	-0.1 (-3.7)	-0.8 (-4.3)
Italy		10.00	Preliminary CPI M/M% (Y/Y%)	Sep	-0.3 (8.1)	0.8 (8.4)
		10.00	Preliminary HICP M/M% (Y/Y%)	Sep	1.7 (9.5)	0.9 (9.1)
Spain		08.00	Retail sales Y/Y%	Aug	-	-0.5
UK		00.01	Lloyds business barometer	Sep	-	16
		07.00	Final GDP Q/Q% (Y/Y%)	Q2	-0.1 (2.9)	0.8 (8.7)
		07.00	Current account £bn	Q2	-43.8	-51.7

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

The coming week's key events & auctions

Country		BST	Event / Auction
Monday 26 September 2022			
Euro area		14.00	ECB President Lagarde scheduled to speak before European Parliament Economic and Monetary Committee
Tuesday 27 September 2022			
Euro area		14.15	ECB Vice President de Guindos scheduled to speak
Germany		10.30	Auction: €3bn of 0% 2027 bonds
Italy		10.00	Auction: €2.5bn of 1.75% 2024 bonds
		10.00	Auction: €1.25bn of 0.10% 2033 index-linked bonds
UK		10.00	Auction: £1.2bn of 0.125% 2031 index-linked bonds
		14.35	BoE Chief Economist Pill to speak at a conference
Wednesday 28 September 2022			
Euro area		08.15	ECB President Lagarde scheduled to speak
Thursday 29 September 2022			
Euro area		08.00	ECB's Panetta scheduled to speak
		18.00	ECB Chief Economist Lane scheduled to speak
Italy		10.00	Auction: 5Y and 10Y bonds
UK		12.30	BoE Deputy Governor Ramsden takes part in a panel discussion on central banking
Friday 30 September 2022			
Euro area		16.30	ECB's Schnabel scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary manufacturing (services) PMI	Sep	**48.5 (48.9)**	48.8 (49.1)	49.6 (47.7)	-
		Preliminary composite PMI	Sep	**48.2**	48.2	48.9	-
Germany		Preliminary manufacturing (services) PMI	Sep	**48.3 (45.4)**	48.3 (47.2)	49.1 (47.7)	-
		Preliminary composite PMI	Sep	**45.9**	46.1	46.9	-
France		Preliminary manufacturing (services) PMI	Sep	**47.8 (53.0)**	49.8 (50.5)	50.6 (51.2)	-
		Preliminary composite PMI	Sep	**51.2**	49.9	50.4	-
Spain		Final GDP Q/Q% (Y/Y%)	Q2	**1.5 (6.8)**	*1.1 (6.3)*	-0.2 (6.7)	-
UK		GfK consumer confidence	Sep	**-49**	-42	-44	-
		Preliminary manufacturing (services) PMI	Sep	**48.5 (49.2)**	47.5 (50.0)	47.3 (50.9)	-
		Preliminary composite PMI	Sep	**48.4**	49.0	49.6	-
		CBI distributive trades survey, reported retail sales %	Sep	**-20**	-	37	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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https://www.uk.daiwacm.com/ficc-research/recent-blogs