Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made gains as euro area inflation reached double digits for the first time on broad-based price pressures.
- Gilts also made gains as sterling appreciated despite persisting fiscal uncertainties, while revisions to UK GDP left output still below the pre-pandemic level in Q2.
- The coming week will bring the ECB's account from its 8 September monetary policy meeting, the UK Conservative party conference, euro area PPI inflation and retail sales data and final PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.734	-0.032
OBL 1.3 10/27	1.955	-0.061
DBR 1.7 08/32	2.102	-0.073
UKT 1 04/24	4.167	-0.103
UKT 1¼ 07/27	4.360	-0.084
UKT 4¼ 06/32	4.076	-0.053

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

Euro area

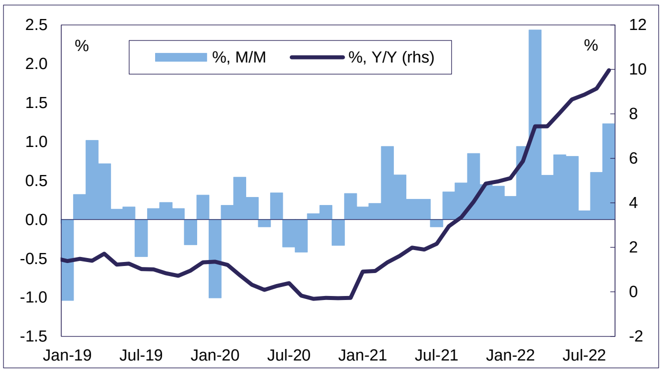
Euro area inflation reaches double digits for the first time on broad-based pressure

Today's flash euro area inflation numbers will do nothing to alleviate the concerns of the hawks on the Governing Council, merely adding to the sense of urgency for continued front-loading of policy normalistation next month. According to today's estimates, consumer prices rose a much stronger 1.2%M/M in September, exceeding the average increase for that month previously by almost 1ppt, the most in any month since March, and leaving the average monthly increase so far this year (0.9%) well above the norm (0.2%M/M). This left the annual HICP rate up a whopping 0.9ppt to 10.0%Y/Y, the first double-digit reading on the series, and taking the quarterly average (9.3%Y/Y) 0.2ppt higher than that projected by the ECB earlier this month. Within the detail, despite the easing in petrol prices, energy provided a sizeable upwards impulse this month (3.0%M/M), to leave the annual rate back above 40%Y/Y, albeit still 3½ppts below March's peak. Food inflation maintained its upwards trend too, rising 1.2ppts to a record-high 11.8%Y/Y. And price pressures among other items intensified, with non-energy industrial goods inflation up a further 0.5ppt to 5.6%Y/Y, a new euro-era high. Reflecting not least the impact of the conclusion of Germany's discounted travel pass over the summer, services inflation also rose 0.5ppt to 4.3%Y/Y. As such, core HICP inflation rose from 4.3%Y/Y to 4.8%Y/Y, similarly a fresh series high and providing further support to those advocating another hike of (at least) 75bps at its 27 October meeting. Of course, as noted by Chief Economist Lane yesterday, the next policy-setting meeting is still four weeks off. And as illustrated by the UK over the past week a lot can happen in that period.

EU energy measures agree measures to help ease energy inflation while also reducing demand

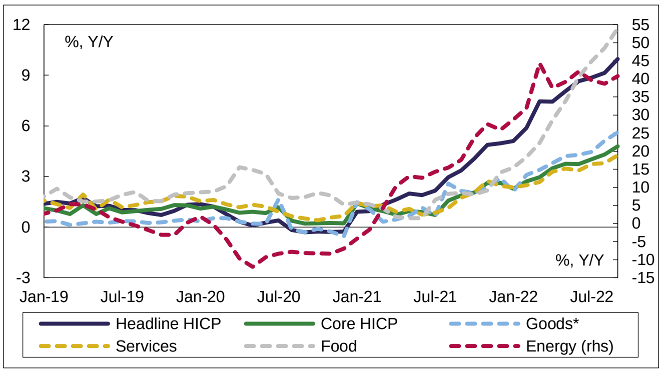
Looking ahead, energy prices – which still account for roughly 40% of headline inflation – will remain a key driver of inflation. And the outlook for that component will at least in part be determined by government policy. In France, increases in electricity and gas prices will be capped through to the end of 2023, while Germany's government yesterday reaffirmed plans to cap gas prices as part of wider energy relief package. In addition, EU energy ministers today agreed to various new measures, broadly in line with Commission proposals, including a 10% voluntary target to reduce electricity consumption during peak hours between December and March; a revenue cap for electricity generating firms that use renewables, nuclear, lignite and other non-natural gas based technologies and had made windfall profits from recent high prices; a solidarity levy on the fossil-fuel sector; and a price cap for retail energy prices faced by SMEs. So, coupled with base effects related to past price increases, and assuming no new rebound in oil prices, energy inflation should ease back from now on. And while core inflation might well have a little further to rise over the near term as pipeline cost pressures continue to be passed on to consumers, with the still-limited signs of second-round effects illustrated in subdued wage growth, we expect this component also to peak around the end of the year.

Euro area: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation



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

Euro area unemployment down for a 16th month, but German claimant count continues to rise

While surveys – including yesterday's Commission ESI and last week's flash PMIs – point to a marked deterioration in sentiment, they also suggest that firms are wary of cutting back on staffing in what is still a tight labour market. Indeed, today's figures for August reported the sixteenth consecutive monthly decline in the number of jobless people, by 30k, to 10.97mn, some 1.4mn lower than a year ago and almost 3.0mn below the peak in September 2020. Admittedly, the drop was the smallest in that sequence, to leave the unemployment rate unchanged at a record-low 6.6%. Among the larger member states, France and Italy saw the biggest falls in joblessness, to leave the respective rates down 0.1ppt a piece at 7.3% and 7.8%. However, these tourist hotspots are likely to turn for the worse once the holiday season ends. Certainly, we saw a further rise in the Dutch unemployment rate last month, which rose for a fourth month to 3.8% with the number of jobless workers up to the highest since last October. And while attributed in large part to the inclusion of Ukrainian refugees, the number of German jobless claims rose for the fourth consecutive month (14k) to a thirteen-month high in September. That, however, merely left the claimant count rate unchanged at 5.5%.

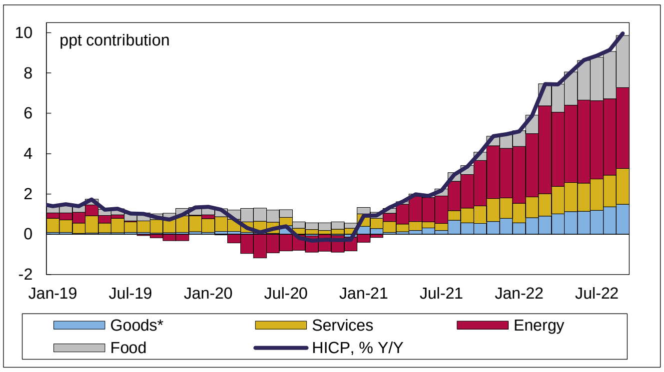
French consumer spending maintains a downwards trend

The impact of higher prices, weak consumer confidence and pent-up demand for services was evident in today's French goods consumption numbers. In particular, while unchanged in August, total expenditure on goods had still only increased in one month since the end of last year. And so, such spending was down 3.8%Y/Y and trending so far in Q3 more than 1.0% below the Q3 average. Admittedly, there was an increase in spending in August on durable goods (1.3%M/M), which INSEE attributed to a pickup in purchases of new cars, as well as a rebound in sales of clothing (2.4%M/M). But spending on food (-1.0%M/M) and energy (-0.4%M/M) continued to decline.

The week ahead in the euro area

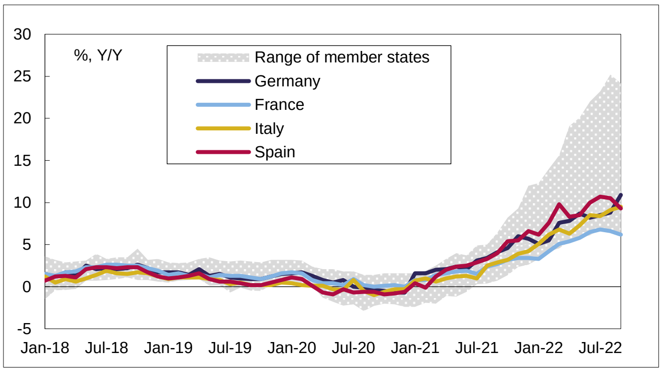
Looking to the week ahead, the most noteworthy release will be the publication on Thursday of the ECB account from its 8 September monetary policy meeting, where the Governing Council raised interest rates by 75bps and signalled further tightening over the next several meetings. The account will be watched for the debate between the hawks and doves, any further discussion on the likely pace of hikes going forward, as well as any debate about QT and a possible reverse-tiering system to reduce interest payments on banks' excess reserves. In terms of economic data, following today's flash CPI estimates, euro area producer price figures on Tuesday will provide an update on inflationary pressures at the factory gate in August. Given the surge in the German PPI rate to a new series high due to the energy shock, and higher PPI rates in France (29.5%Y/Y) and Italy (50.5%Y/Y), we expect the headline euro area producer inflation rate to jump to a new record

Euro area: Contributions to HICP inflation



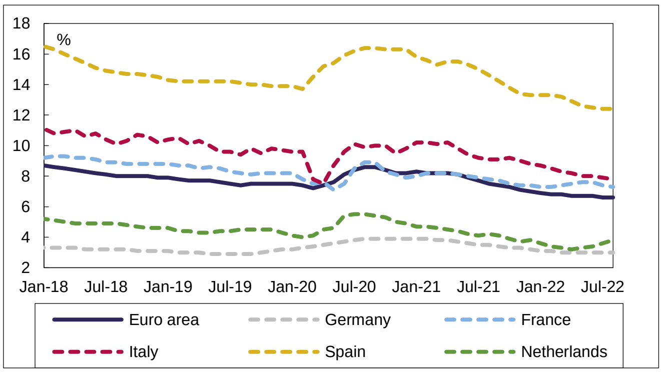
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation by member state



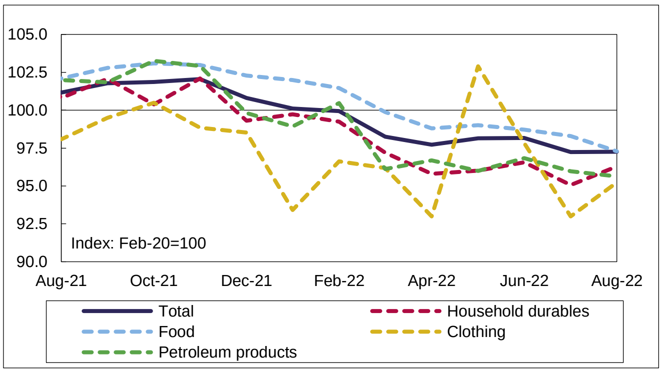
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Consumer spending on goods



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

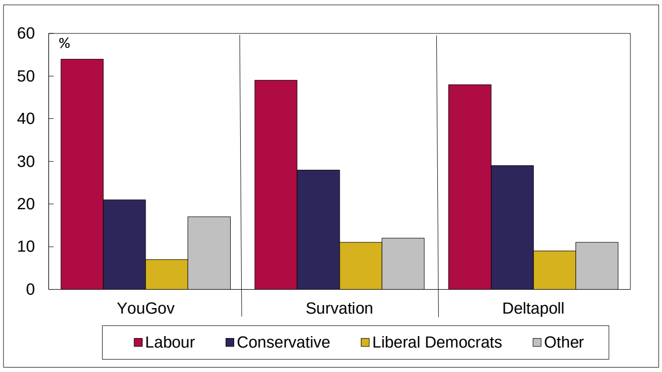
from July's reading of 37.9%Y/Y to well above 40%Y/Y, although we might well see a further easing in the core PPI rate. Friday's ECB survey of consumer expectations will be watched too, while the final PMIs will provide further insight into firms' price pressures this month, as well as more general economic conditions, with the final surveys for manufacturing due on Monday, services on Wednesday and construction on Thursday. The flash PMI estimates implied a steeper pace of contraction, with the manufacturing output index (46.2) last lower in May 2020, and the services activity index (48.9) at its weakest since February 2021. In addition, Thursday's release of euro area retail sales figures will offer an update on the sector in the middle of the summer, with spending on non-essential goods likely to have been hampered by rising prices and increased spending on services. Among the country releases, Germany's goods trade (Wednesday), factory orders (Thursday) and industrial production numbers (Friday), all for August, will provide an update on the likely extent to which the manufacturing sector will be a drag on GDP growth in the third quarter, reflecting not least ongoing supply constraints and slowing global demand. German autos production data for September are also due on Wednesday, while French and Spanish IP figures for August will be published on Wednesday and Thursday respectively.

UK

Sterling firmer for now, but question marks over lack of fiscal credibility to persist

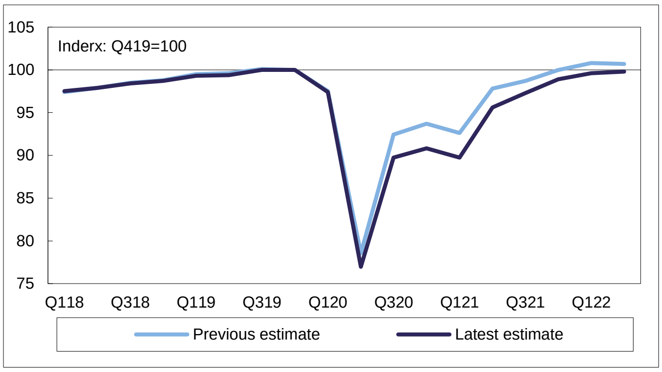
Having rebounded late yesterday, cable remained at its highest levels since the ill-conceived fiscal event a week ago. However, there was no further game-changing catalyst over the past 24 hours for the shift in mood to suggest it will be sustained on a lasting basis. Admittedly, the BoE's presence in the market for long-dated Gilts, which will continue for a further fortnight, continues to draw a line in the sand in the bond market, with its further £1.2bn of purchases today taking the total so far to just above £3.6bn, well below the £15bn maximum indicated for the first three days of operations. But other factors that might be cited look somewhat more questionable. Yesterday's talk of a commitment to new public spending cuts, including real-terms reductions of welfare benefits and cuts to public investment and R&D, are likely to be inimical to the government's aim to boost potential GDP growth. And not least in light of yesterday's devastating opinion polls, which suggested risks of wipe-out for the Conservative party if the next election was held immediately, such measures would seem politically extremely difficult to implement. Of course, those opinion polls might also have increased market participants' expectations that Truss will either seek or be forced by her MPs to U-turn on her most egregious tax-cut proposals. However, at the coming week's Conservative Party conference, she is unlikely to want to lose face. And as she will be preaching to converted, more bombast seems more likely than humility. Moreover, the outcome of her meeting today with the OBR fiscal watchdog, which reaffirmed her determination not to present any detailed medium-term fiscal plan until 23 November, suggested no desire to tone down her proposals or seek independent validation for their merits just yet.

UK: Latest political party opinion polls



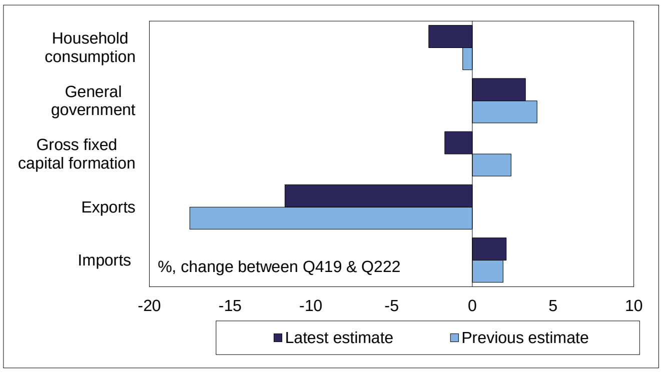
Source: YouGov, Survation, Deltapoll and Daiwa Capital Markets Europe Ltd.

UK: Real GDP levels



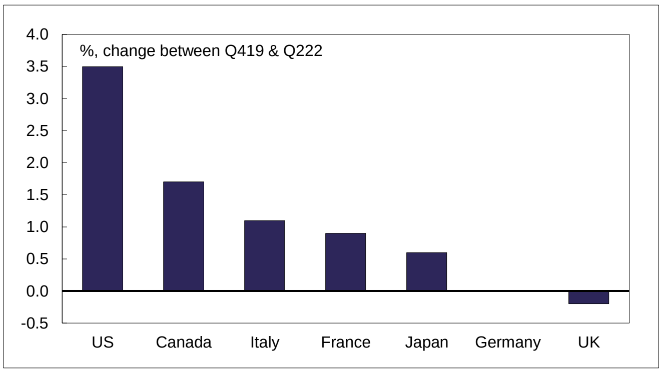
Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Revisions to selected GDP components



Source: ONS and Daiwa Capital Markets Europe Ltd.

G7: GDP comparisons, Q419 vs Q222



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

GDP expanded in Q2, but was smaller than previously thought and below pre-pandemic level

Contrary to earlier indications, the UK economy is not yet in recession, but recent economic performance looks extremely underwhelming nonetheless. Today's updated national accounts data showed that GDP grew 0.2%Q/Q in Q2 rather than contracted 0.1%Q/Q as had previously been estimated. Private consumption in Q2 edged up 0.1%Q/Q rather than contracted. And government spending (-1.5%Q/Q) was also not as weak as thought beforehand. But fixed investment was weaker than previously estimated, falling 1.4%Q/Q rather than rising 0.6%Q/Q. In addition, GDP growth in Q1 was revised down to 0.7%Q/Q. And given notable revisions to the data for 2020, when GDP contracted by an extreme 11.0%Y/Y and not 9.3%Y/Y, the level of GDP in Q222 was judged still to be 0.2% below that in Q419 ahead of the pandemic. Most expenditure components, bar net trade, are also now estimated to have been weaker than previously thought relative to the pre-Covid benchmark. And strikingly, the UK is now the only G7 country yet to have recovered its pre-pandemic level of economic output by Q2.

UK external current account improved in Q2 but deficit still large and set to widen again in H2

The UK remains highly dependent on the kindness of strangers to fund itself but not quite as much as in Q1, with net borrowing from the rest of the world declining 1.7ppts in Q2 but still historically high at 5.6% of GDP. In nominal terms, the current account deficit in Q1 was revised down almost £8bn to £43.9bn – still a modern record – and narrowed to (an admittedly still substantive) £33.8bn in Q2. Excluding precious metals which are typically highly volatile and distort the picture, the underlying deficit narrowed a little further in Q2, to £32.5bn and 5.3% of GDP from (a downwardly revised) £37.0bn and 6.1% of GDP in Q1, which is no longer the record on the series. The improvement in Q2 was caused principally by an increase in direct investment earnings from abroad, as the goods trade deficit (9.9% of GDP) and services surplus (5.8% of GDP) were little changed from Q1. Given subsequent movements in the wholesale markets for natural gas, however, the goods trade and current account deficits look set to widen once again in the second half of the year and thus leave UK asset prices vulnerable to renewed correction.

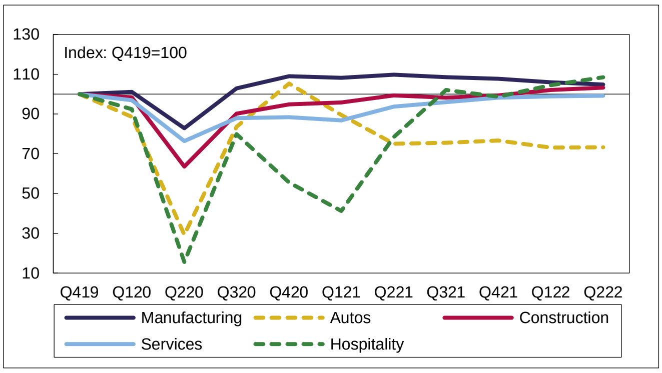
House prices flat in September after mortgage approvals surge in August

According to the Nationwide index, UK house prices were unchanged on a seasonally adjusted basis in September, representing the first month in fourteen in which they failed to rise. As a result, the annual rate of house price inflation on this measure moderated 0.5ppt to 9.5%Y/Y, the softest since April last year. That still, however, left them more than 26% above the level at the end of 2019 ahead of the pandemic. 10 of the UK's 13 regions registered a moderation of annual house price growth in Q3, with London still with the lowest pace of increase, albeit picking up to 6.7%Y/Y. Today's bank lending data from the BoE showed a marked pickup in mortgage approvals in August, of more than 10k, to a seven-month high of 74.3k, more than 13% above the average in the two years ahead of the onset of the pandemic.

Higher rates risk significant housing market adjustments ahead

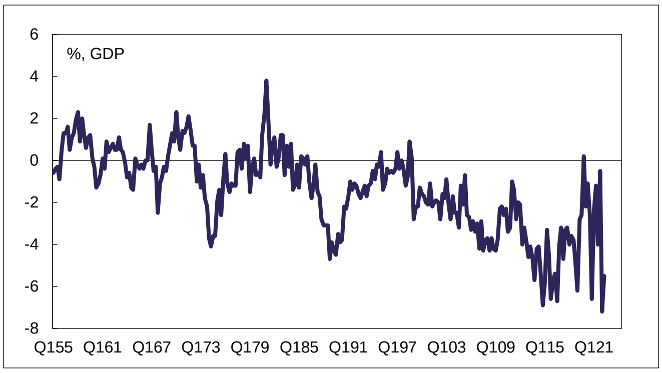
While that rise in mortgage approvals might appear to suggest decent momentum in the market, that pickup is likely to reflect attempts by house-buyers to beat the rise in mortgage rates, which was already underway ahead of the recent market turbulence. Indeed, the effective rate of interest on new mortgages rose more than 20bps last month to 2.55%, up almost 100bps from the end of last year. Effective rates on 2Y and 5Y fixes – the most common form of mortgages – also rose above 2.5%, with those with a loan-to-value ratio of 75% rising above 3.6%. Given the response of the markets to the government's fiscal event a week ago, and the likely accelerated path of Bank Rate, which we now expect to peak at 5.0% or more in the first half of next year, those rates are set to leap sharply from this month on, likely also eventually exceeding 5.0% for those with an LTV ratio of 75%. Indeed, roughly half of all available mortgage products were reportedly withdrawn from the market over the past week, and others are now being offered at significantly higher rates. UK Finance estimates that some 1.8mn mortgage-holders will have to refinance over the coming year as their fixed-rate periods come to an end, with many set to see their interest rates doubling or more. Moreover, the higher rates of interest on new mortgages will

UK: GVA by selected sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Current account balance



Source: ONS and Daiwa Capital Markets Europe Ltd.

significantly constrain the purchasing power of borrowers, despite the government's doubling of the stamp duty land tax threshold to £250k. The overall effect will likely be to push house prices lower – possibly significantly so given the affordability strains long evident in the market – while also further constraining household real disposable incomes and overall private consumption too.

The week ahead in the UK

Another relatively quiet week for UK economic data kicks off with September's final manufacturing PMIs on Monday, which will be followed by the equivalent services and construction surveys on Wednesday and Thursday respectively. Despite edging slightly higher on the month, the flash manufacturing output index (44.4) still implied a marked pace of decline at the end of Q3, while the services activity index (down 1.7pts to 49.2) fell into contractionary territory for the first time since February 2021. The construction PMI is also likely to be consistent with declining activity in September. In addition, the latest REC/KPMG Report on Jobs (Friday) will be worth watching for a further drop in labour demand amid weakening economic conditions, while the latest new car registrations figures for September are due (Wednesday).

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary HICP M/M% (Y/Y%)	Sep	**1.2 (10.0)**	*1.0 (9.8)*	0.6 (9.1)	-
	Preliminary core HICP Y/Y%	Sep	**4.8**	*5.0*	4.3	-
	Unemployment rate %	Aug	**6.6**	6.6	6.6	-
Germany	Unemployment change '000s (rate %)	Sep	**14.0 (5.5)**	20.0 (5.5)	28.0 (5.5)	**26.0 (-)**
France	Preliminary CPI M/M% (Y/Y%)	Sep	**-0.5 (5.6)**	-0.2 (6.0)	0.5 (5.9)	-
	Preliminary HICP M/M% (Y/Y%)	Sep	**-0.5 (6.2)**	-0.1 (6.6)	0.5 (6.6)	-
	PPI M/M% (Y/Y%)	Aug	**2.7 (29.5)**	-	1.6 (27.2)	**1.9 (27.6)**
	Consumer spending M/M% (Y/Y%)	Aug	**0.0 (-3.8)**	-0.1 (-3.7)	-0.8 (-4.3)	**-0.9 (-4.6)**
Italy	Preliminary CPI M/M% (Y/Y%)	Sep	**0.3 (8.9)**	0.0 (8.6)	0.8 (8.4)	-
	Preliminary HICP M/M% (Y/Y%)	Sep	**1.7 (9.5)**	1.7 (9.5)	0.9 (9.1)	**0.9 (-)**
Spain	Retail sales Y/Y%	Aug	**0.0**	-	-0.5	-
UK	Lloyds business barometer	Sep	**16**	-	16	-
	Final GDP Q/Q% (Y/Y%)	Q2	**0.2 (4.4)**	-0.1 (2.9)	0.8 (8.7)	-
	Current account balance £bn	Q2	**-33.8**	-43.6	-51.7	**-43.9**
	Nationwide house price index M/M% (Y/Y%)	Sep	**0.0 (9.5)**	0.3 (9.9)	0.8 (10.0)	**0.7 (-)**
	Net consumer credit £bn (Y/Y%)	Aug	**1.1 (7.0)**	1.4 (7.4)	1.4 (6.9)	**1.5 (7.0)**
	Mortgage lending £bn (approvals 000s)	Aug	**6.1 (74.3)**	4.9 (62.0)	5.1 (63.8)	**- (63.7)**

Auctions

Country	Auction
UK	BoE bought £1.19bn in special long-term gilt tender

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's data calendar

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			The coming week's key data releases			
			Monday 3 October 2022			
Euro area		09.00	Final manufacturing PMI	Sep	48.5	49.6
Germany		08.55	Final manufacturing PMI	Sep	48.3	49.1
France		08.50	Final manufacturing PMI	Sep	47.8	50.6
		-	New car registrations* Y/Y%	Sep	-	3.8
Italy		08.45	Manufacturing PMI	Sep	47.5	48.0
		17.00	New car registrations Y/Y%	Sep	-	9.9
Spain		08.15	Manufacturing PMI	Sep	49.4	49.9
		-	New car registrations* Y/Y%	Sep	-	9.1
UK		09.30	Final manufacturing PMI	Sep	48.5	47.3
			Tuesday 4 October 2022			
Euro area		10.00	PPI M/M% (Y/Y%)	Aug	4.9 (43.2)	4.0 (37.9)
Spain		08.00	Unemployment change '000s	Sep	-	40.4
			Wednesday 5 October 2022			
Euro area		09.00	Final services (composite) PMI	Sep	48.9 (48.2)	49.8 (48.9)
Germany		07.00	Trade balance €bn	Aug	4.0	5.4
		08.55	Final services (composite) PMI	Sep	45.4 (45.9)	47.7 (46.9)
France		07.45	Industrial production M/M% (Y/Y%)	Aug	-0.1 (-1.5)	-1.6 (-1.2)
		07.45	Manufacturing production M/M% (Y/Y%)	Aug	-	-1.6 (0.2)
		08.50	Final services (composite) PMI	Sep	53.0 (51.2)	51.2 (50.4)
Italy		08.45	Services (composite) PMI	Sep	49.3 (48.3)	50.5 (49.6)
Spain		08.15	Services (composite) PMI	Sep	50.3 (49.9)	50.6 (50.5)
UK		09.00	New car registrations Y/Y%	Sep	-	1.2
		09.30	Final services (composite) PMI	Sep	49.2 (48.4)	50.9 (49.6)
			Thursday 6 October 2022			
Euro area		08.30	Construction PMI	Sep	-	44.2
		10.00	Retail sales M/M% (Y/Y%)	Aug	-0.4 (-1.7)	0.3 (-0.9)
Germany		07.00	Factory orders M/M% (Y/Y%)	Aug	-0.7 (-5.3)	-1.1 (-13.6)
		08.30	Construction PMI	Sep	-	42.6
France		08.30	Construction PMI	Sep	-	48.2
Italy		08.30	Construction PMI	Sep	-	41.2
Spain		08.00	Industrial production M/M% (Y/Y%)	Aug	-0.5 (4.1)	-1.1 (5.3)
UK		09.30	Construction PMI	Sep	48.0	49.2
			Friday 7 October 2022			
Germany		07.00	Retail sales M/M% (Y/Y%)	Aug	-1.0 (-5.0)	1.9 (-5.1)
		07.00	Industrial production M/M% (Y/Y%)	Aug	-0.5 (2.4)	-0.3 (-1.1)
France		07.45	Trade balance €bn	Aug	-	-14.5
Italy		09.00	Retail sales M/M% (Y/Y%)	Aug	-	1.3 (4.2)

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

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 3 October 2022
			- Nothing scheduled -
			Tuesday 4 October 2022
Euro area		15.00	ECB President Lagarde due to speak at an event organised by Central Bank of Cyprus
Germany		10.30	Auction: €400mn of 2033 index-linked bonds
UK		10.00	Auction: 0.5% 2061 bonds
			Wednesday 5 October 2022
Euro area		10.00	Non-monetary policy Governing Council meeting
Germany		10.30	Auction: €1.5bn of 1.0% 2038 bonds
UK		10.00	Auction:1.0% 2032 bonds
			Thursday 6 October 2022
Euro area		12.30	ECB publishes account of September Governing Council meeting
France		09.50	Auction: 2.00% 2032 bonds
		09.50	Auction: 0.75% 2053 bonds
		09.50	Auction: 1.75% 2066 bonds
Spain		09.30	Auction: bonds of mixed maturities
UK		09.30	BoE publishes Decision Maker Panel data
			Friday 7 October 2022
Euro area		08.00	ECB publishes consumer expectations survey results
UK		00.01	KPMG/REC report on jobs
		11.25	BoE Deputy Governor Ramsden scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.