Euro wrap-up

Overview

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- While the UK labour market remained very tight amid a further decline in participation, Gilts made gains apart from at the long end of the curve, as the BoE expanded the scope of its purchase operations to include index-linked bonds and postponed its sales of corporate bonds.
- Bunds followed Gilts higher but BTPs made losses despite some stronger-than-expected Italian IP data.
- Wednesday will bring UK GDP and trade data for August and euro area industrial production numbers for the same month.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.806	-0.057
OBL 1.3 10/27	2.049	-0.066
DBR 1.7 08/32	2.290	-0.041
UKT 1 04/24	4.102	-0.149
UKT 1¼ 07/27	4.520	-0.068
UKT 4¼ 06/32	4.775	-0.034

*Change from close as at 5.00pm BST.
Source: Bloomberg

UK

BoE starts buying index-linked gilts in face of material risks to financial stability

Having yesterday announced its willingness to increase significantly the size of its long-dated gilt purchases this week, and also unveiled a temporary expanded collateral repo facility, this morning the BoE announced additional steps to try to ease the sell-off in the UK bond market. Explicitly noting "Dysfunction in this market, and the prospect of self-reinforcing 'fire sale' dynamics", the BoE conceded that developments still "pose a material risk to UK financial stability". So, it widened the scope of the daily purchase operations to include index-linked gilts at real yields no lower than yesterday's close. Indeed, having yesterday stated that it would be ready to buy up to £10bn of gilts each day this week, today it clarified that up to half of that amount would be allocated to index linkers, with the other half allocated to conventional long-dated bonds. And illustrating again how the BoE's concerns about financial stability have the potential to impede its plans to normalise monetary policy, it also suspended its planned sales of corporate bond holdings this week. In the event, this afternoon the BoE bought almost £2.0bn of index-linked gilts and almost £1.4bn of conventional long-dated gilts.

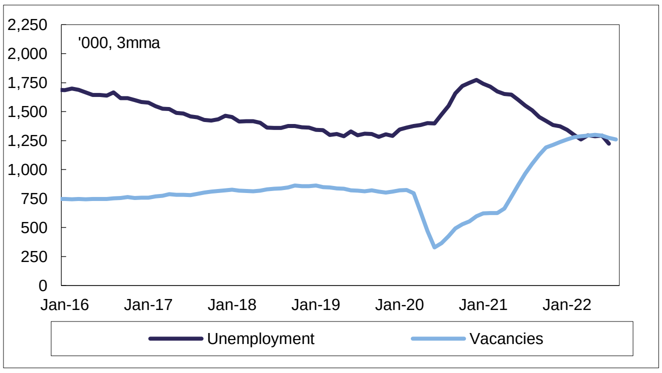
BoE likely to struggle to withdraw gilt market support according to the current timetable

While gilts closed higher on the day except at the long end of the curve, we are not convinced that the BoE's current market interventions will provide a lasting remedy to turbulence in gilts. Certainly, liquidity still appears very thin. And having decided today that dysfunction remains so severe as to require an expansion of its interventions, it is hard to believe that normal conditions will have returned by the end of the week to allow it to withdraw completely from the market from Monday on. Likewise, its plans to start active gilt sales from 31 October look extremely ambitious. Just as the sell-off was triggered by a fiscal policy announcement, so too fiscal policy will need to provide a lasting remedy. But we will not get clarity on the government's medium-term fiscal plan until 31 October – surely too late to give the BoE confidence to proceed with its sale programme. And given their track record over recent weeks, it is difficult to see why, before then, the gilt market should give the benefit of the doubt to PM Liz Truss and Chancellor Kwasi Kwarteng that their plan will pass muster.

Why should markets give government the benefit of the doubt before fiscal plan is published?

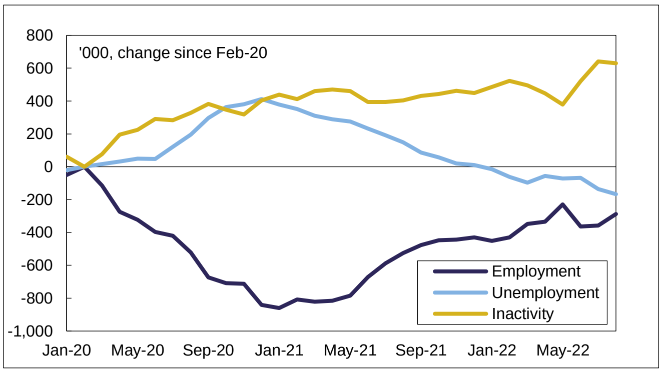
Reportedly, Truss continues to reject postponing the remainder of her planned tax cuts. And in the absence of credible new offsetting measures, not least given the sharp increase in the debt interest bill from recent events, the general government budget deficit appears on track to exceed 8½% of GDP next fiscal year. However, a consequence of the botched announcement of unfunded tax cuts on 23 September is that offsetting measures will be extremely difficult politically to implement before the next election, due by January 2025 at the latest. Certainly, the real-terms cuts to welfare benefits that

UK: Vacancy and unemployment levels*



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

UK: Unemployment, employment & inactivity



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

might originally have been envisaged could well struggle to pass the House of Commons. And while real-terms departmental budgets will be squeezed hard, and public investment plans cut (thus countering any efforts to boost potential GDP growth), the amounts to be saved are unlikely to reduce significantly the funding gap for the coming couple of years. Instead, we suspect that a large share of planned cuts to public expenditure will be postponed to the post-election period. And not given the likely significant further widening of the UK's current account deficit over the coming winter, that will leave gilts exposed.

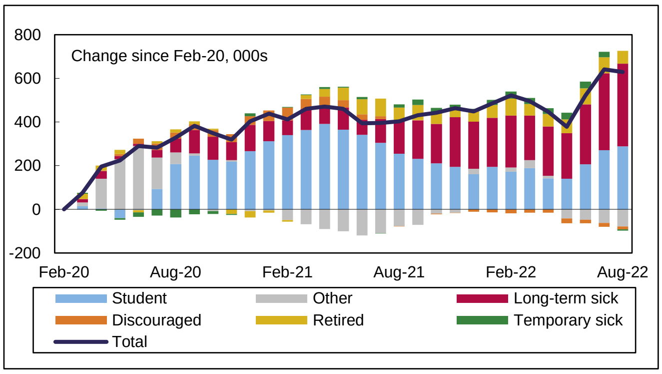
Unemployment rate at lowest since 1974 as inactivity continues to rise

Evidence that, despite recent weak growth, UK economic output continues to run above its potential level was provided by today's labour market data, which reported a further tightening over the summer. Indeed, the unemployment rate fell to a headline-grabbing 3.5% in the three months to August, marking a drop of 0.3ppt on the quarter, down 1.7ppts from the pandemic peak and the lowest rate since February 1974. This decline was hardly a cause for celebration, as it reflected another rise in inactivity. While in part that was due to an increase in the number of students, once again it also reflected a rise in the number of workers considered to suffer long-term sickness, which recorded the largest quarterly increase (169k) since the series began in 1993, to be almost 380k higher since the start of the pandemic. Meanwhile, the number of people in employment fell 109k in the three months to August, the most since February 2021, with the decline in full-time employees (-96k) the largest since 2011. As such, the employment rate (75.5%) fell 0.3ppt from the previous three-month period to be 1ppt lower than before the pandemic. Total hours worked also fell over the quarter, while the redundancy rate ticked higher. And despite the largest quarterly decline in vacancies for two years, the number of unemployed people per vacancy fell to a record low, further illustrating the tightness of the labour market.

Wage growth too high for the BoE's comfort

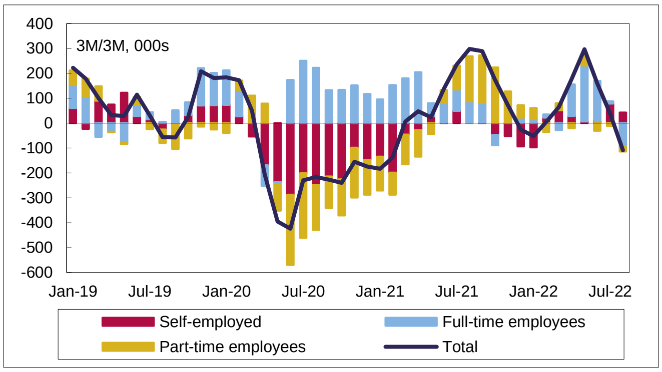
The tightness of the labour market was again also reflected in wage growth, the pace of which remains too high for the BoE's comfort. Indeed, growth in nominal wages accelerated in the three months to August, by 0.5ppt to 6.0%3M/Y, with regular wages up 5.4%3M/Y, the fastest growth for a year. Regular private sector pay jumped 6.2%3M/Y, which outside of the height of the pandemic was the strongest growth on the series. Wage growth in hospitality, retail and wholesale sub-sectors, where labour shortages are particularly acute, remained particularly strong (7.4%3M/Y) as did growth in finance and business services (5.9%3M/Y). The difference between private and public sector regular pay growth – of which the latter remained extremely subdued at 2.2%3M/Y – was also the largest on record. Of course, given high inflation, real wage growth in both the private and public sectors remained firmly in negative territory, with total pay down 2.4%3M/Y and regular earnings down 2.9%3M/Y.

UK: Economic inactivity by cause



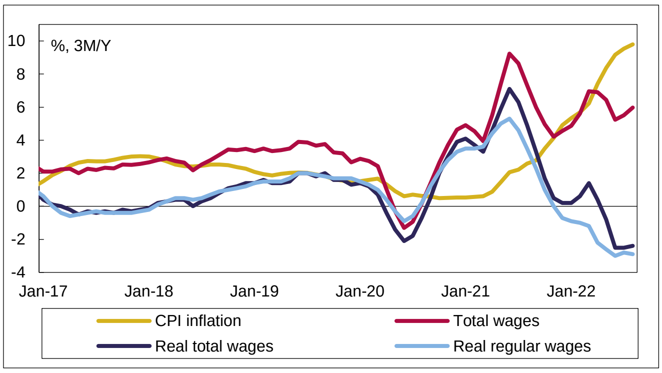
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Employment



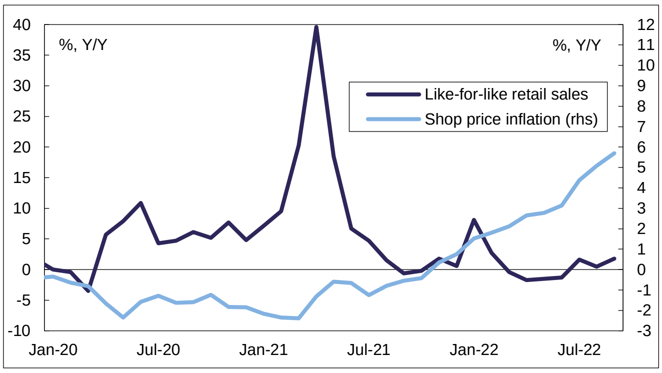
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Wages and CPI inflation



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

UK: BRC retail sales and shop price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Positive BRC retail sales survey index likely masks downtrend in UK high street spending

Despite households' diminishing purchasing power, the BRC retail sales survey, at face value at least, suggested that spending on the UK high street was firm at the end of Q3, with headline like-for-like growth up 1.3ppts to 1.8%Y/Y, the best since February. However, these nominal figures were flattered by high inflation, as well as base effects (sales in September 2021 were particularly weak). Indeed, we think they are consistent with a drop in real seasonally adjusted sales on the UK high street at the end of Q3. To some extent, that will reflect the impact of the extra national holiday for the Queen's funeral, which will have likely resulted in a significant shift to spending online. But, while the BRC noted that demand for blankets, warm clothing and energy-efficient appliances had increased ahead of the further step up in household energy bills in October, overall, total retail sales are likely to have remained weak in September and dropped over Q3 as a whole. And with consumers' purchasing power being hit by broadening price increases and rapidly rising borrowing costs, household consumption more generally seems bound to weaken even further this quarter too.

The day ahead in the UK

The data highlight tomorrow will be the monthly GDP report for August. After economic output rose by a smaller-than-expected 0.2%M/M in July, high-frequency data suggest that private sector services activity stalled in in the middle of Q3. Indeed, retail sales fell by a sizeable 1.6%M/M that month, while the service sector PMIs suggested that activity moved broadly sideways. Admittedly, with car production having picked up amid easing supply constraints, manufacturing output may well edge higher. But overall, GDP is expected to come in unchanged at 0.0%M/M in August, to leave it down 0.2%3M/3M. Meanwhile, the trade deficit is expected to deteriorate not least due to a higher price of imported natural gas. And Chief Economist Pill and (hawkish) external members Haskel and Mann are due to speaking tomorrow.

Euro area

Italian IP bounce back likely to prove temporary

Today's Italian industrial production data for August surprised on the upside, with output jumping 2.3%M/M to be up almost 3%Y/Y but nevertheless still a touch below April's pandemic high. Within the detail, manufacturing rose a stronger 2.5%M/M, a pace not exceeded since March 2021, reflecting a surge in production from the pharmaceutical (9.9%M/M) and computer and electronic subsectors (8.5%M/M). As such, output of consumer goods rose more than 2½%M/M, albeit following three months of declines. Production of intermediate goods also bucked the recent downtrend (0.8%M/M), with capital goods up a further 1.8%M/M too. But while today's figures further support our view that euro area IP rose in August (despite the drop in Germany), it left Italian output still trending so far in Q3 marginally lower than the Q2 average, with manufacturing up just 0.1% on the same basis. And if recent surveys are to be believed – the ISTAT manufacturing index fell to its lowest since February 2021, while the manufacturing output PMI (44.2) implied the steepest contraction since April 2020 – this uptick in production in the sector in August seems likely to prove temporary. Indeed, we expect Italian industrial output and GDP as a whole to decline slightly in Q3 and further still in Q4 and Q1.

The day ahead in the euro area

The data highlight in the euro area tomorrow will be the release of aggregate industrial production figures for August. Based on numbers already published by the member states, including today's increase in Italian production and surge in (typically volatile) Ireland (16.5%M/M), as well as the rebound in France (2.4%M/M), euro area IP is forecast to have risen by a little more than ½%M/M in August. But that would barely reverse July's 2.3%M/M decline, leaving industrial output on track to detract from growth in Q3. In terms of ECB-speak President Lagarde will take part in a Q&A session.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy		Industrial production M/M% (Y/Y%)	Aug	**2.3 (2.9)**	0.1 (0.5)	0.4 (-1.4)	**0.5 (-1.3)**
UK		BRC retail sales monitor, like-for-like Y/Y%	Sep	**1.8**	-	0.5	**-**
		Payrolled employees monthly change, '000s	Sep	**69**	-	71	**31**
		Unemployment claimant count rate % (change '000s)	Sep	**3.9 (25.5)**	-	3.9 (6.3)	**- (1.1)**
		Average earnings including (excluding) bonuses 3M/Y%	Aug	**6.0 (5.4)**	5.9 (5.3)	5.5 (5.2)	**-**
		ILO unemployment rate 3M%	Aug	**3.5**	3.6	3.6	**-**
		Employment change 3M/3M, '000s	Aug	**-109**	-160	40	**-**

Auctions

Country		Auction
UK		BoE bought £1.363bn of long-dated gilts
		BoE bought £1.947bn of inflation-linked gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Industrial production M/M% (Y/Y%)	Aug	0.7 (1.2)	-2.3 (-2.4)
UK		07.00	GDP M/M% (3M/3M%)	Aug	0.0 (-0.2)	0.2 (0.0)
		07.00	Industrial production M/M% (Y/Y%)	Aug	-0.1 (0.6)	-0.3 (1.1)
		07.00	Index of services M/M% (3M/3M%)	Aug	0.1 (0.1)	0.4 (-0.2)
		07.00	Construction output M/M% (Y/Y%)	Aug	0.5 (5.6)	-0.8 (4.3)
		07.00	Goods trade (excluding precious metals) balance £bn	Aug	-20.5 (-)	-19.4 (-19.5)

Auctions and events

Euro area		14.30	ECB President Lagarde scheduled to speak
		16.00	ECB's Knot scheduled to speak
Germany		10.30	Auction: €4bn of 1.7% 2032 bonds
UK		10.00	Auction: £3.5bn of 4.125% 2027 bonds
		12.35	BoE's Pill scheduled to speak
		18.00	BoE's Mann scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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