Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses while the euro area trade deficit hit a new record high.
- Gilts made bigger losses as Liz Truss fired her Chancellor, reverted to increasing corporation tax, but still left uncertainty about the UK fiscal outlook and appeared to remain extremely lacking in market and political credibility.
- The coming week will bring new data on UK inflation, retail sales and public borrowing, and euro area inflation, consumer confidence and the region's balance of payments.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.934	+0.048
OBL 1.3 10/27	2.104	+0.045
DBR 1.7 08/32	2.340	+0.064
UKT 1 04/24	3.823	+0.133
UKT 1¼ 07/27	4.261	+0.070
UKT 4¼ 06/32	4.763	+0.226

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

Euro area

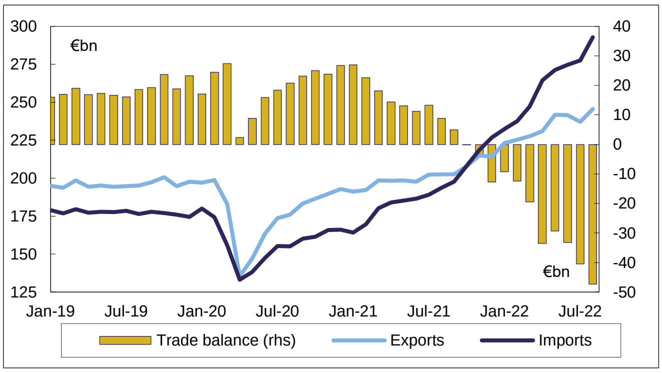
Trade deficit hits new series high on energy shock

The euro area's goods trade balance continued to deteriorate markedly in August, with the deficit on a seasonally-adjusted basis widening for a third successive month and by almost €7bn to a new series high of €47.3bn. On an unadjusted basis, the deficit also reached a record high, of more than €50bn for the first time, a marked turnaround from the surplus of almost €3bn one year earlier. Admittedly, thanks not least to a vigorous rebound in shipments to the US (up 9.1%M/M), the value of exports rose for the first month in three, and by 3.5%M/M to leave the average in the first two months of Q3 1.4% above the average in Q2. However, the value of imports rose for the nineteenth successive month, and by 5.5%M/M – the most since April – to be trending 5.6% above the Q2 average. That, of course, primarily reflects the shock to energy prices and supply. Import growth was again strongest for deliveries from Norway, up another 21%M/M to be about four times higher than a year earlier and about six times higher than the pre-Covid level, as authorities sought alternatives to the supply of Russian natural gas and also replenish inventories ahead of the winter. With natural gas prices still highly elevated, albeit down from their summer peak, the value of imports seems bound to remain high over the winter months, even if goods imports weaken due to softer demand. Surveys, however, certainly point to a weakening in export volumes ahead, with the euro area manufacturing export orders PMI dropping in September to just 42.5, the weakest since May 2020 during the first wave of Covid-19 and a level rarely lower on the survey. So, the trade deficit and current account deficit (which reached a record €19.9bn in July) will remain historically high. And while relative price shifts complicate the picture, having subtracted 0.2ppt from GDP growth in Q2, we expect net trade to continue to subtract from GDP growth into the New Year.

German inflation confirmed in double-digits, with price pressures increasingly broad-based

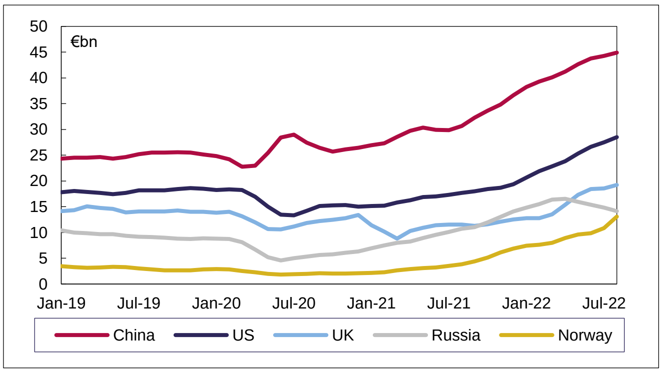
Yesterday's final German inflation data for September aligned with the flash estimates. So, the national CPI measure rose a steep 2.1ppts to 10.0%Y/Y, with the EU-harmonised HICP rate up by the same amount to 10.9%Y/Y. In part, that big jump reflected the expiry of temporary government support measures such as the fuel discount and 9-euro rail ticket, which pushed transport inflation up more than 10ppts from August to 14.0%Y/Y, still nevertheless a couple of ppts below the level in May before those measures were initially implemented. Among other details, food inflation rose more than 2ppts to 18.7%Y/Y. And energy inflation rose more than 7ppts to 43.9%Y/Y. But with non-energy industrial goods inflation also up to a series-high 6.8%Y/Y, core CPI inflation (excluding food and energy) was also significantly stronger, up 1.1ppts to a new series high of 4.6%Y/Y, pointing to increasingly broad-based pressures. Looking forward, the precise path for inflation will in part depend on the government's latest energy price support measures. While there appears likely to be an initial round of support in December, the nature of measures currently proposed are unlikely to reduce energy inflation until March, when a rebate will be deducted from bills. The modalities, however, are still unclear. And before we get there, even assuming that

Euro area: Goods trade balance



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Imports by selected trading partner



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

there will be no need for energy rationing over the winter, Germany's headline HICP inflation rate seems likely to remain firmly in double-digits.

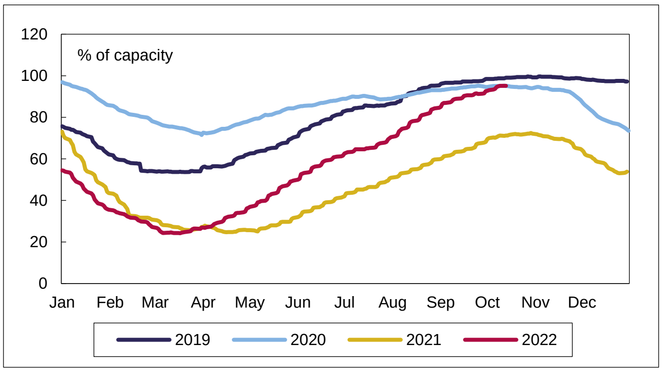
French and Spanish inflation ease due to lower energy and services prices

Today's final French inflation data for September were similarly unrevised from the flash release. But in contrast to Germany, this had shown the national CPI rate falling 0.3ppt to 5.6%Y/Y, a four-month low, with the EU-harmonised HICP rate down 0.4ppt to 6.2%Y/Y. The drop in part reflected softer energy inflation, down 4.8ppts to 17.9%Y/Y, a twelve-month low, linked to an increase in policy-related fuel discounts. But there was also a sizeable easing in services inflation (down 0.7ppt to 3.2%Y/Y), amid a steeper-than-seasonal slowdown in airfares, package holidays and accommodation costs. As such, despite a slight acceleration in non-energy industrial goods inflation, the national measure of core inflation eased slightly by 0.2ppt to 4.5%Y/Y. Meanwhile, having surprised significantly on the downside in the flash release, today's final Spanish numbers were revised even lower, with the national CPI rate down an additional 0.1ppt to 8.9%Y/Y, to be 1.6ppts lower than in August. And the revision to the HICP rate was slightly larger (-0.3ppt) to 9.0%Y/Y, raising the possibility of a downwards revision to the updated euro area figures next week, for which the headline rate was a low 10%Y/Y (9.96%Y/Y to two decimal places). The weakening in Spain in September largely reflected a 17%M/M decline in electricity prices, as well as lower public transportation prices (-9.7%M/M) likely linked to government support initiatives and tour packages (-14.7%M/M). With services and non-energy goods inflation softer, the national core CPI rate also eased, by 0.2ppt to 6.2%Y/Y.

The week ahead in the euro area

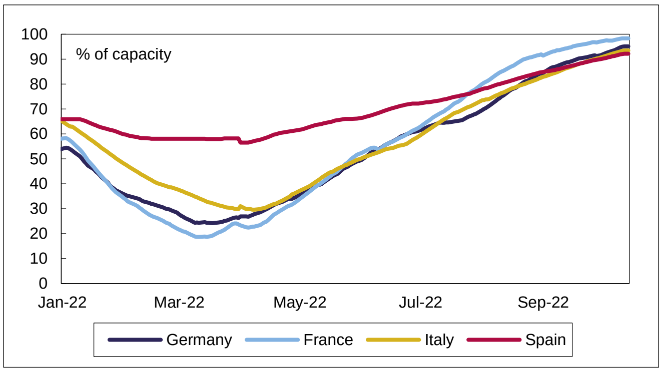
It should be a relatively quiet week ahead for top-tier euro area releases, with the final inflation figures for the region on Wednesday arguably of most interest. The flash estimate showed headline HICP inflation jumping to double-digits for the first time, up 0.9ppt to 10.0%Y/Y, with the core rate up 0.5ppt to 4.8%Y/Y. Depending on the latest Italian numbers (due Monday), there is a risk that the headline rate will be revised a touch lower to 9.9%Y/Y, nevertheless still a record high. This release will also provide more granular detail, along with the ECB's other measures of underlying inflation including the super core and trimmed mean estimates. Having surged to a series high in August, the latest German PPI inflation numbers for September (Thursday) will also be watched closely. The coming week will also bring a raft of October sentiment indicators, including the German ZEW investor survey (Tuesday), INSEE business survey (Thursday) and European Commission flash consumer confidence index (Friday). Amid record high inflation, rising borrowing costs and increasing recessionary risks, these are likely to point to a further marked deterioration in business and household conditions at the start of Q4. Euro area construction output data for August (Wednesday) are expected to suggest only moderate growth over the summer, with a rebound in Germany (1.9%M/M), partially offset by a decline in France (-1.0%M/M). In terms of ECB-speak, Chief

Germany: Natural gas storage



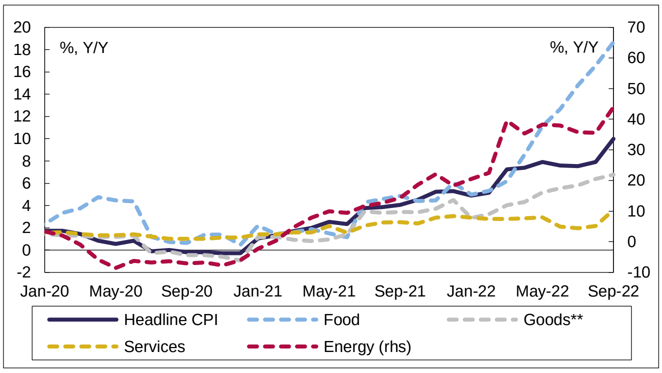
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas storage, 2022



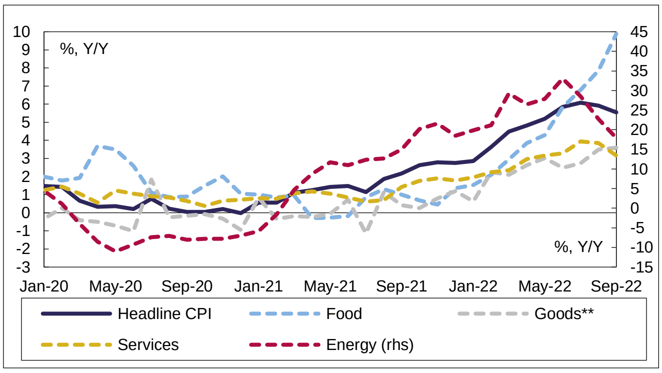
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Consumer price inflation*



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

France: Consumer price inflation*



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

Economist Lane is due to participate on Monday in a roundtable discussion on a New European Fiscal Framework, while Executive Board member Schnabel is due to speak on Tuesday.

UK

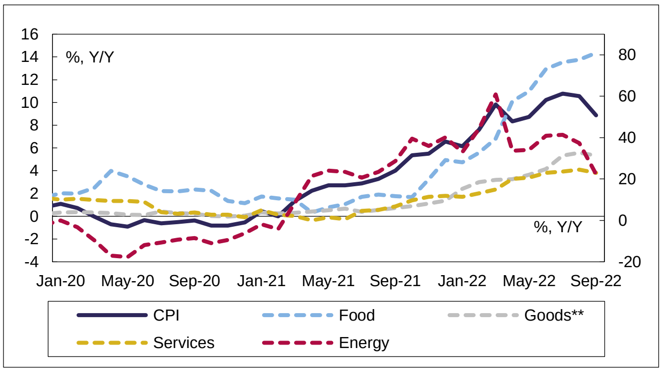
Truss kicks out Kwarteng and cancels corporation tax plans

Given his concerns of moral hazard and fiscal dominance of monetary policy, Governor Andrew Bailey had been determined to halt the BoE's gilt purchase programme after today's final operations, which took the total amount bought over the thirteen days to £19.25bn. And evidently fearful of the consequences for gilts of the BoE's imminent exit from the market, Liz Truss blinked. Today she sacked her Chancellor Kwasi Kwarteng – making his tenure as Chancellor the shortest for more than half a century – and appointed former Foreign Secretary Jeremy Hunt in his place as the government's fourth Finance Minister of 2022. In addition, having previously reversed her plan to cut the top rate of income tax, today she announced a more substantive fiscal policy U-turn. In particular, she confirmed that her previous plan to halt the legislated 6ppt increase in the rate of corporation tax to 25% – which the Treasury had estimated would have cost the taxpayer more than £12bn in the coming fiscal year and around £18.7bn by FY26/7 – would be reversed. And she stated that public spending would grow less rapidly than previously planned, albeit without clarifying whether she meant simply in real terms or nominal terms too, and without giving any indication of where any savings would be made.

Truss future as Prime Minister in grave doubt

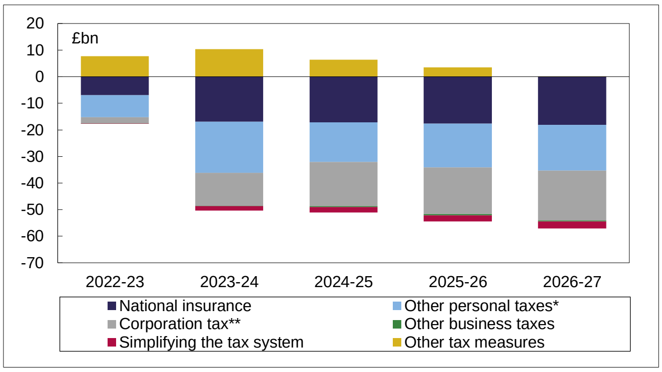
While gilts had made gains early in the day in anticipation of Kwarteng's removal, however, by the end of the day they had made significant losses. And following her press conference, Truss appeared still to be seriously lacking economic, market and political credibility. Indeed, there are very good reasons to believe that Truss has not fully drawn the sting from her crisis. Certainly, net public borrowing will remain much higher over the horizon than it would have done before she took over as PM. The remaining tax cuts will amount to more than £20bn per year in lost revenue by FY26/7, and the costs of energy price support amount to £60bn over the coming six months and likely tens of billions of pounds beyond. And debt interest payments and fiscal losses on the BoE's QE holdings are all likely to be significantly higher than they would have been, in part due to the premium on sterling assets that is likely to persist. Moreover, Truss's attempts to scapegoat Kwarteng for recent events ring horribly hollow. The crass tax policies announced by her Chancellor in the initial fiscal event on 23 September were very much the Prime Minister's own policies, advocated by her throughout her leadership election

Spain: Consumer price inflation*



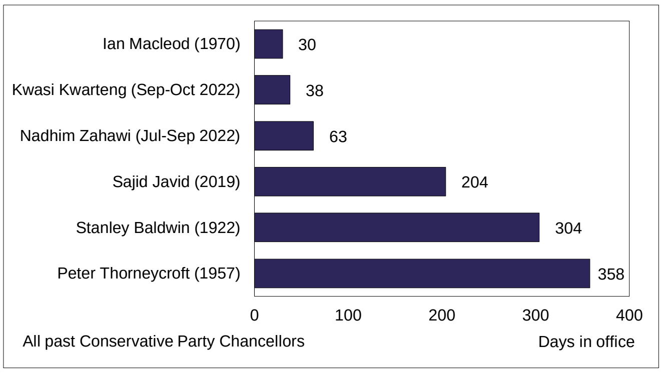
*National measure. **Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Liz Truss tax policy proposals



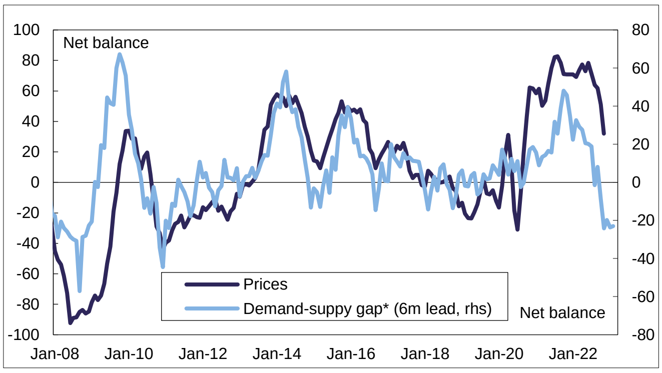
*Excludes initial proposal for cut in top rate of income tax already reversed. **Corporation tax measure reversed today. Source: HM Treasury and Daiwa Capital Markets Europe Ltd.

UK: Shortest term in office as Chancellor



Source: Daiwa Capital Markets Europe Ltd.

UK: RICS housing market indicators



*New buyer enquiries minus new seller instructions. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

campaign, in good part to give her a winning attack-line against her opponent Rishi Sunak. And while Truss will hope to gain a little political kudos from some of her MPs following her appointment of Hunt – who will now present the medium-term fiscal plan on 31 October, the date when the BoE also still hopes to start active gilts sales – it is notable that he recently argued for even bigger corporation tax cuts, which he suggested would pay for themselves from the resulting higher economic growth. Most of her MPs are highly likely to continue to believe that the election among the party membership left them with a dud leader. Reports suggest a group of senior Conservatives will in coming days openly call on her to resign. And while the party's rules will need to change to allow a challenge before next September, there must be grave doubts that she will still be Prime Minister by then. Regardless, over the near term, the BoE will continue to watch closely events in the Gilt market.

As mortgage rates jump, RICS survey flags loss of momentum in the UK housing market

Data-wise, yesterday's September RICS survey unsurprisingly suggested that the jump in mortgage rates triggered by the government's ill-considered fiscal policy is likely to hit the housing market before long. With Moneyfacts reporting that rates on 2Y fixed-rate mortgages rose this week close to 6.5% from just 4.2% at the beginning of last month, a big affordability squeeze is underway. But according to the RICS, already last month, new buyer enquiries had fallen for a fifth successive month in September. And while the headline price index remained in positive territory, in part due to a shortage of vendor instructions, this too has eased each month since April and is now the lowest since July 2020. Furthermore, near-term expectations for sales and prices have clearly turned for the worse, with price expectations in twelve months' time the weakest since April 2020. And if the deterioration in affordability for re-mortgagers, and broader economic headwinds, bring forced sellers to the market over coming weeks, house prices are certainly heading south, with double-digit percentage declines a very good bet.

The week ahead in the UK

A key UK focus in the coming week will be September's CPI inflation release on Wednesday. Despite an anticipated easing in energy inflation as petrol prices fell again, headline inflation is expected to rise back above 10%Y/Y as the components for food, other goods and services maintained a steady uptrend. Indeed, we forecast core inflation to rise a further 0.2ppt to a new series-high of 6.5%Y/Y. The latest producer price inflation figures are also due Wednesday. Meanwhile, Friday will bring retail sales data for September, which seem likely to report a further drop last month not least as most retailers shut or reduced opening times on the additional bank holiday for the Queen's funeral. But these data are also likely to illustrate the deterioration in households' purchasing power, with reduced spending on non-essentials and big ticket items. The latest GfK consumer confidence survey (Friday) seems bound to offer a gloomy outlook for near-term spending prospects too. And ahead of the Budget and fiscal forecast update on 31 October, Friday's public finance figures for September will also be closely watched. In terms of BoE-speak, Deputy Governor Cunliffe is due to appear before the Treasury Select Committee on Wednesday with the recent financial stability strains, centred on LDI funds, likely to be a key focus.

Daiwa economic forecasts

	2022			2023			2022	2023	2024
	Q2	Q3	Q4	Q1	Q2	Q3			
GDP		%, Q/Q						%, Y/Y	
Euro area	0.8	0.0	-0.2	-0.3	-0.1	0.1	3.2	-0.2	0.8
UK	0.2	-0.5	-0.3	-0.3	-0.2	-0.1	4.2	-0.9	0.3
Inflation, %, Y/Y									
Euro area									
Headline HICP	8.0	9.3	9.8	8.4	6.6	4.9	8.3	5.7	2.0
Core HICP	3.7	4.4	5.0	4.8	4.0	3.2	3.9	3.6	2.1
UK									
Headline CPI	9.2	10.0	10.9	10.4	6.9	5.9	9.1	6.7	3.5
Core CPI	6.0	6.3	6.6	6.2	5.1	4.6	6.0	5.0	3.9
Monetary policy, %									
ECB									
Refi Rate	0.00	1.25	2.50	3.00	3.00	3.00	2.50	3.00	2.25
Deposit Rate	-0.50	0.75	2.00	2.50	2.50	2.50	2.00	2.50	1.75
BoE									
Bank Rate	1.25	2.25	4.00	4.75	4.75	4.75	4.00	4.75	3.75

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		Trade balance €bn	Aug	**-47.3**	-45.0	-40.3	**-40.5**
France		Final CPI M/M% (Y/Y%)	Sep	**-0.6 (5.6)**	-0.5 (5.6)	0.5 (5.9)	-
		Final HICP M/M% (Y/Y%)	Sep	**-0.5 (6.2)**	-0.5 (6.2)	0.5 (6.6)	-
Spain		Final CPI M/M% (Y/Y%)	Sep	**-0.7 (8.9)**	-0.6 (9.0)	0.3 (10.5)	-
		Final HICP M/M% (Y/Y%)	Sep	**-0.2 (9.0)**	0.0 (9.3)	0.3 (10.5)	-

Auctions

Country		Auction
UK		BoE bought £1.321bn of long-dated gilts
		BoE bought £129.4mn of index-linked gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		Final CPI M/M% (Y/Y%)	Sep	**1.9 (10.0)**	1.9 (10.0)	0.3 (7.9)	-
		Final HICP M/M% (Y/Y%)	Sep	**2.2 (10.9)**	2.2 (10.9)	0.4 (8.8)	-
UK		RICS house price balance %	Sep	**32**	45	53	**51**

Auctions

Country		Auction
UK		BoE bought £1.56bn of long-dated gilts
		BoE bought £3.12bn of index-linked gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 18th October 2022

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 17 October 2022			
Italy		09.00	Final CPI M/M% (Y/Y%)	Sep	*0.3 (8.9)*	0.8 (8.4)
		09.00	Final HICP M/M% (Y/Y%)	Sep	*1.7 (9.5)*	0.9 (9.1)
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Oct	-	0.7 (8.7)
			Tuesday 18 October 2022			
Euro area		07.00	EU27 new car registrations Y/Y%	Sep	-	4.4
Germany		10.00	ZEW current assessment (expectations) balance	Oct	-69.0 (-66.6)	-60.5 (-61.9)
Italy		09.00	Trade balance €bn	Aug	-	-0.4
Spain		09.00	Trade balance €bn	Aug	-	-6.6
			Wednesday 19 October 2022			
Euro area		10.00	Final CPI M/M% (Y/Y%)	Sep	*1.2 (10.0)*	0.6 (9.1)
		10.00	Final core CPI Y/Y%	Sep	*4.8*	4.3
		10.00	Construction output M/M% (Y/Y%)	Aug	-	0.3 (1.5)
UK		07.00	CPI M/M% (Y/Y%)	Sep	*0.5 (10.1)*	0.5 (9.9)
		07.00	Core CPI Y/Y%	Sep	*6.5*	6.3
		07.00	PPI output prices M/M% (Y/Y%)	Sep	0.3 (15.7)	-0.1 (16.1)
		07.00	PPI input prices M/M% (Y/Y%)	Sep	-0.5 (18.5)	-1.2 (20.5)
		07.00	House price index Y/Y%	Aug	-	15.5
			Thursday 20 October 2022			
Euro area		09.00	Current account balance €bn	Aug	-	-19.9
Germany		07.00	PPI M/M% (Y/Y%)	Sep	1.0 (44.7)	7.9 (45.8)
France		07.45	INSEE business confidence indicator	Oct	101	102
		07.45	INSEE manufacturing (production outlook) indicator	Oct	101 (-8)	102 (-6)
			Friday 21 October 2022			
Euro area		10.00	Government debt/GDP ratio	2021	-	95.6
		15.00	Preliminary EC consumer confidence	Oct	-30.0	-28.8
UK		00.01	GfK consumer confidence	Oct	-52	-49
		07.00	Retail sales including autos fuel M/M% (Y/Y%)	Sep	-0.3 (-5.0)	-1.6 (-5.4)
		07.00	Retail sales excluding autos fuel M/M% (Y/Y%)	Sep	-0.4 (-4.0)	-1.6 (-5.0)
		07.00	Public sector net borrowing, excluding banks £bn	Sep	-	11.8

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions			
Country		BST	Event / Auction
			Monday 17 October 2022
Euro area		09.00	ECB Vice President De Guindos scheduled to speak
		16.00	ECB Chief Economist Lane joins a roundtable event 'A new European fiscal framework'
			Tuesday 18 October 2022
Euro area		17.00	ECB's Schnabel scheduled to speak
Germany		10.30	Auction: €4.0bn of 0% 2029 bonds
UK		10.00	Auction: £2.5bn of 1.25% 2051 bonds
			Wednesday 19 October 2022
Euro area		15.00	ECB's Centeno scheduled to speak
UK		11.30	Auction: £3.25bn of 1% 2032 bonds
		15.00	BoE's Deputy Governor Cunliffe testifies to the Treasury Select Committee
		16.00	BoE's Mann scheduled to speak
			Thursday 20 October 2022
France		09.50	Auction: 0.00% 2025 bonds
		09.50	Auction: 0.75% 2028 bonds
		09.50	Auction: 0.50% 2026 bonds
		10.50	Auction: 0.10% 2036 index-linked bonds
		10.50	Auction: 0.10% 2053 index-linked bonds
Spain		09.30	Auction: 1.95% 2026 bonds
		09.30	Auction: 0.00% 2025 bonds
		09.30	Auction: 0.80% 2029 bonds
			Friday 21 October 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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