Daiwa Capital Markets

Euro wrap-up

Overview

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- Gilts rallied hard as new UK Chancellor Hunt cancelled most of PM Truss's planned tax cuts and also his intention to reduce the generosity of the government's support for household energy bills from April on.
- Bunds followed Gilts higher while European natural gas prices fell to the lowest since mid-June on expectations of new EU policy interventions in the market.
- Tuesday will bring the ZEW investor survey for October while Wednesday will bring updates on inflation from the UK and euro area.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.931	-0.004
OBL 1.3 10/27	2.071	-0.033
DBR 1.7 08/32	2.263	-0.077
UKT 1 04/24	3.487	-0.336
UKT 1¼ 07/27	3.894	-0.367
UKT 4¼ 06/32	3.963	-0.351

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

UK

Hunt trashes most of Truss's tax-cut plans

Friday afternoon's press conference by hapless Prime Minister Liz Truss failed to assuage market concerns about the direction of UK fiscal policy, prompting a reversal of the gilt rally seen earlier that day. So, to repair the damage, today brought the announcement by her new Chancellor Jeremy Hunt of a further set of fiscal U-turns, which had been hastily compiled, seemingly in panic mode, over the weekend. Certainly, on Friday, markets had been underwhelmed by Truss's decision merely to re-instate the plans to raise corporation tax by 6ppts to 25% from April, to reduce net borrowing compared to her original plan by £12.4bn (about ½% of 2019 GDP) in the coming fiscal year and almost £19bn by FY26/7. So, to start with, today Hunt announced a reversal of most of the other tax measures in the Truss-Kwarteng mini-budget that had not yet been legislated. Most notably, the government will no longer cut the basic rate of income tax in April, instead deciding to keep it at 20% indefinitely, saving more than £5bn from the next fiscal year on compared to Truss's original plan. And added to the U-turns already announced by Truss, the updated tax plans will now reduce net borrowing compared to the mini-budget by almost £5bn this fiscal year, £20.1bn in FY23/4 and more than £32bn (1¼% of GDP) by FY26/7.

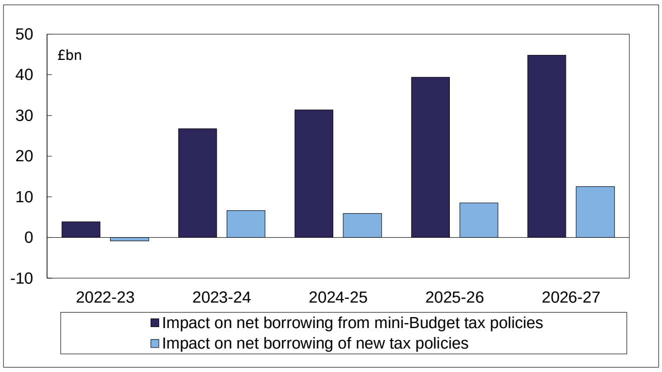
Government's energy bill support for households to be rationalised from April

The tax measures that were retained from the mini-budget – including the cancellation of the National Insurance increase legislated by the Johnson government and cuts to stamp duty to support the housing market – will still increase net borrowing by more than £6½bn in FY23/4, rising to about £12½bn by FY26/7. And given the extra costs of debt interest, losses on the BoE's QE-related gilt holdings that will accrue to the government due to higher gilt yields, and large-scale expenditure commitments, Hunt therefore also saw the need today to announce an initial plan to cut public spending relative to Truss's original intentions from FY23/4 on. Most notably, he announced that the government's plan to cap energy bills for households would only remain in its current form for the coming six months – at the cost of £31bn this fiscal year – rather than be maintained for two years. The design of the support for households from April onwards, like the government's support for businesses (which will cost £29bn this fiscal year), will instead now be determined on the basis of a Treasury review to reduce the cost in terms of public borrowing "while ensuring enough support for those in need" – implying a significant role for means-testing.

Additional austerity likely to come from FY23/4 on

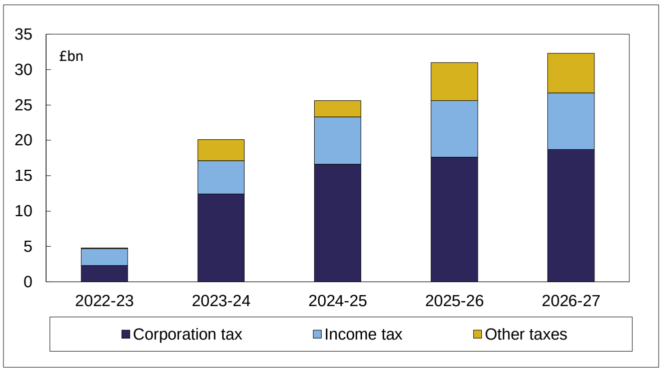
Beyond the government's energy bill support measures, Hunt also stated that government departments will be asked to "find efficiencies within their budgets", hinting at new fiscal austerity to come. More measures, including costings, will be

UK: Impact on net borrowing of fiscal plans



Source: HM Treasury and Daiwa Capital Markets Europe Ltd.

UK: Savings from government tax-policy U-turns



Source: HM Treasury and Daiwa Capital Markets Europe Ltd.

announced on 31 October, on the basis of the updated OBR forecasts, which should at least be based on assumptions of lower gilt yields than would have been the case before today's announcement. Of course, the amendments to the energy bill support policy will mean that inflation will be higher than previously expected from April onwards. However, as the new fiscal stance will also be more restrictive than anticipated from that point on, we maintain our forecast that Bank Rate will peak below 5% in the course of next year. As market-implied pricing for the terminal rate has also been tempered significantly from the levels close to 6% before the government entered damage-limitation mode, that might provide some better news for Truss. However, as the vast majority of measures in the mini-budget have now been trashed less than four weeks after being presented to parliament, it still seems difficult to believe that the humiliated Prime Minister will still be in Number 10 when the new fiscal policy is implemented from April on. Of course, given the Conservative Party's current dire poll ratings, most of its MPs will also wish to avoid triggering an early general election. But while she might well still be in office, Truss is now in no way in power.

The coming two days in the UK

In terms of UK economic data, most focus this week will be on Wednesday's inflation numbers for September. Despite an anticipated easing in energy inflation as petrol prices fell again, the headline CPI rate is expected to rise back above 10%Y/Y as the components for food, other goods and services likely 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 that day, while the ONS house price index for August is likely to show the annual increase moderating sharply following the base-effect surge in July. In addition, BoE Deputy Governor Jon Cunliffe and Executive Director for Markets Andrew Hauser are due to appear before the Treasury Select Committee on Wednesday to testify on the Bank's recent gilt market intervention, with its plans for sales of gilts and corporate bonds also likely to be discussed.

Euro area

The coming two days in the euro area

After a relatively quiet few days for euro area economic releases, Wednesday will bring final aggregate inflation estimates for September. Today's equivalent numbers from Italy saw the headline HICP rate revised down by 0.1ppt to 9.4%Y/Y, due principally to a slightly softer pace of increase in food prices (admittedly still up 1ppt on the month to 10.2%Y/Y). Taken together with the downwards revision to Spain's HICP inflation, we now think there is a strong likelihood that headline euro area HICP rate will be nudged slightly lower from the flash estimate, by 0.1ppt to 9.9%Y/Y, albeit still up 0.8ppt from August and a series high. Meanwhile, the core inflation rate is likely to be unrevised at a record-high 4.8%Y/Y, 0.5ppt higher than August. Wednesday will also bring the latest euro area construction output data for August, which 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 addition, tomorrow's German ZEW investor survey is likely to echo the downbeat tones of the euro area Sentix indices and signal rising recession risks. Policy-wise, ahead of the EU leaders' summit later this week, the European Commission is expected to unveil a package of proposals to limit spikes in wholesale gas prices. With respect to ECB-speak, key hawk Isabel Schnabel is scheduled to speak tomorrow.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	🇮🇹	Final CPI M/M% (Y/Y%)	Sep	**0.3 (8.9)**	*0.3 (8.9)*	0.8 (8.4)	-
	🇮🇹	Final HICP M/M% (Y/Y%)	Sep	**1.6 (9.4)**	*1.7 (9.5)*	0.9 (9.1)	-
UK	🇬🇧	Rightmove house price index M/M% (Y/Y%)	Oct	**0.9 (7.8)**	-	0.7 (8.7)	-
Auctions							
Country		Auction					
- Nothing to report -							

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 19th October 2022

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Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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

Auctions and events

Country	BST	Event
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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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

Auctions and events

Country	BST	Event
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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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