Euro wrap-up

Overview

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- Despite a slight downside revision to euro area inflation in September, Bunds followed USTs lower.
- While UK inflation rose back into double-digits, Gilts made gains.
- Thursday will bring new data on German producer prices and the euro area's balance of payments.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	2.053	+0.123
OBL 1.3 10/27	2.192	+0.121
DBR 1.7 08/32	2.359	+0.083
UKT 1 04/24	3.388	-0.095
UKT 1¼ 07/27	3.824	-0.025
UKT 4¼ 06/32	3.861	-0.074

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

Euro area

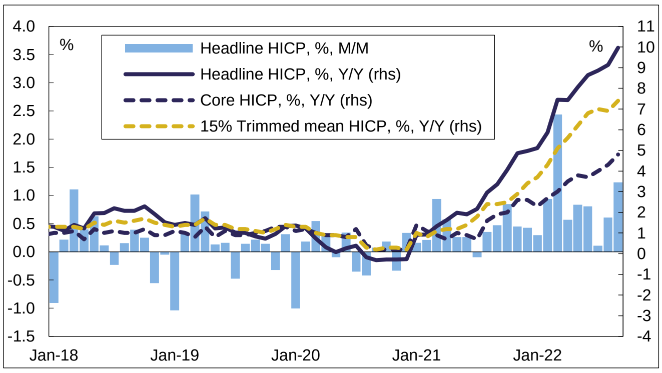
Headline inflation revised down, but record highs in a range of components will concern the ECB

As we expected, the final estimate of euro area consumer price inflation in September brought a slight downwards revision from the flash release, of 0.1ppt, to the headline HICP rate. However, that left it up 0.8ppt from August and at a series high of 9.9%Y/Y. It also left the Q3 average at 9.3%Y/Y, overshooting by 0.2ppt the ECB's baseline forecast published last month. The revision reflected a modest downwards adjustment to the estimate of energy inflation, which nevertheless still rose 2.1ppts to 40.7%Y/Y, the third highest reading on the series, as the gas component jumped almost 10ppts to a new high above 72%Y/Y. Food inflation was also confirmed at a series high, up more than 1ppt to 11.8%Y/Y. However, the increasingly broad-based nature of price pressures in today's data will have been of greatest concern at the ECB. Inflation of non-energy industrial goods rose 0.4ppt to a series high of 5.5%Y/Y, in part reflecting increases of more than 1ppt in the components for clothing (3.4%Y/Y) and household appliances (7.1%Y/Y), while motor car inflation remained at its own record rate (8.7%Y/Y). Moreover, in part due to the ending of the German discounted rail ticket, increased inflation of transport services (up more than 6ppts to 7.3%Y/Y) combined with a new high in hospitality (8.5%Y/Y) to push services inflation up 0.5ppt to a record 4.3%Y/Y. So, core inflation rose 0.5ppt to a new high of 4.8%Y/Y. And trimmed mean measures of underlying inflation rose further too, with the 30% and 15% rates also up 0.5ppt to 6.8%Y/Y and 7.4%Y/Y respectively. Certainly, if there had still been any doubts, today's data reinforced the likelihood that the Governing Council will increase rates by a further 75bps at next week's monetary policy meeting.

A hugely uncertain inflation outlook, but some reasons for cautious optimism

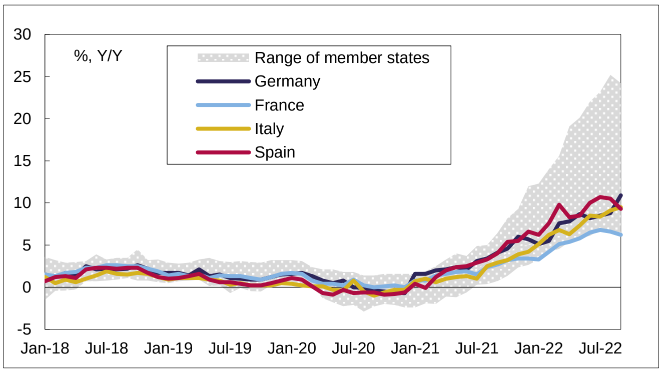
Looking ahead, inflation remains extremely difficult to forecast with any precision. Much will continue to depend on energy prices, which will be affected by the details of evolving policy measures to cap prices in wholesale and/or retail markets. Encouragingly, stockpiling of natural gas has advanced ahead of scheduled, with mild autumn weather also helping to reduce wholesale gas prices to four-month lows this week. At their two-day summit starting tomorrow, EU leaders will discuss new Commission proposals for joint gas purchases, as well as the development of a new gas trading benchmark for LNG prices and a temporary "price correction mechanism", with agreements at the regional level possible in the Council of Ministers next month. So, also in light of base effects, in the absence of new shocks, the energy component should be on a firm downwards trend over coming quarters. Among core items, some comfort might be taken from a range of survey indicators and hard data that suggest that supply-chain strains have diminished over recent months. And with global demand softening too, prices of many commodities, intermediate inputs and freight transport have all moderated. Recent pressures in certain consumer-facing services might also reflect temporary factors related to post-pandemic normalisation, and be expected to ease as economic activity weakens.

Euro area: HICP inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation in member states



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Notwithstanding risks of big new shocks, headline and core inflation should be near their peaks

So, while the weak euro will likely provide a little further impetus to prices of imported goods, and there remain risks of new big shocks from the Russian war and/or harsh winter weather over coming months, headline and core inflation are most likely to be near their respective peaks. And both rates should decline steadily from the springtime on. Indeed, while inflation will likely remain above-target throughout 2023, with the economy likely to be firmly in recession over coming quarters, and still little hard evidence of second-round effects via wages or price expectations, there remains a good chance that inflation will fall below (and perhaps a long way below) 2% in 2024. Nevertheless, given repeated large-scale upside surprises to inflation over several consecutive quarters, many members of the ECB Governing Council will continue to downplay the role to be played by projections in guiding monetary policy. And as real short-term interest rates remain so hugely negative, they will continue to argue that further steps are required to take the ECB's policy stance into neutral territory.

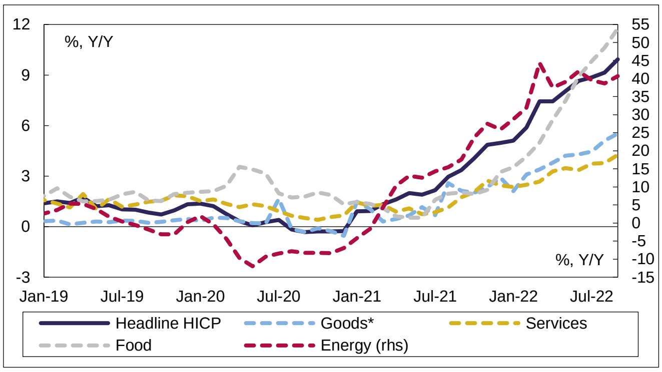
Euro area construction slips back over the summer

Today's euro area construction output figures for August came in on the soft side, suggesting a further loss of momentum in the sector over the summer. In particular, activity fell 0.6%M/M, more than reversing the moderate growth seen in July (0.3%M/M), with building work down 0.4%M/M and civil engineering down for the third consecutive month (-1.4%M/M). The weakness was broad-based among the member states, with sizeable monthly drops in Germany (-2.1%M/M), France (-1.0%M/M) and the Netherlands (-3.7%M/M) following growth in July. A modest drop in Spanish output (-0.3%M/M) left it almost 20% below the pre-pandemic level in February 2020. And while Italy's data are published with a lag, today's release confirmed another large contraction in July (-3.0%M/M) leaving it almost 7% lower than April's peak and trending so far in Q3 some 4½% below the Q2 average. Overall, euro area construction activity in the first two months of Q3 was averaging some 0.7% lower than in Q2. And with surveys suggesting that conditions deteriorated further towards the end of the quarter, not least reflecting a weakening in demand amid a slowing economic recovery and higher borrowing costs, construction looks set to be a drag on euro area GDP growth in Q3 for the second successive quarter.

The day ahead in the euro area

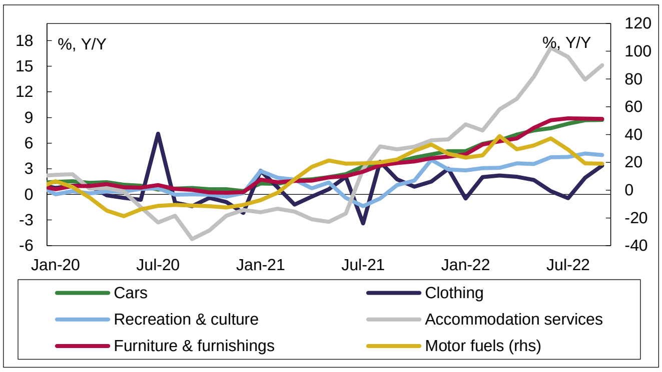
Looking ahead, tomorrow brings the release of the ECB's balance of payments data for August. In July, the euro area's current account deficit widened to a new record of €20bn, up from €4bn the previous month, as high energy prices resulted in a surge in the value of imports. National data, as well as natural gas price shifts, point to a further widening in the deficit in August. Tomorrow will also bring the release of German PPI inflation numbers for September. Having risen to a series high of 45.5%Y/Y in August due to gas price pressures, PPI inflation is expected to moved broadly sideways last month. We will also

Euro area: HICP inflation – key components



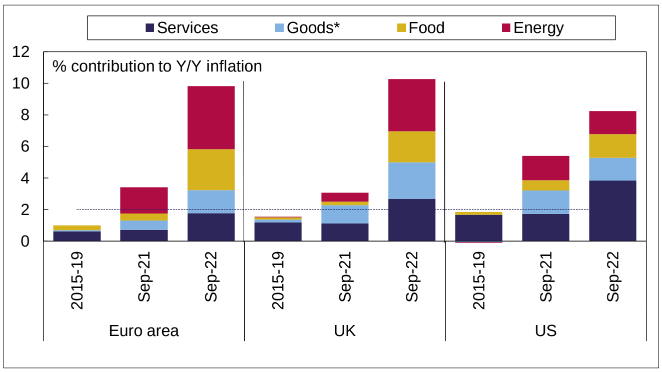
*Non-energy goods inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation – selected components



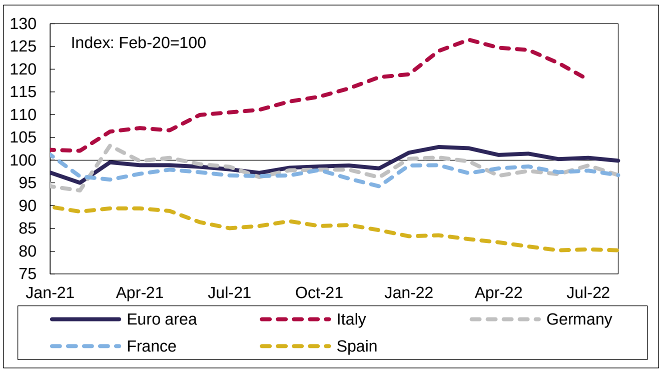
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Major economies: Contributions to inflation



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

Euro area: Construction output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

get the French INSEE business survey for October, which will most likely point to a deterioration in business conditions at the start of Q4.

UK

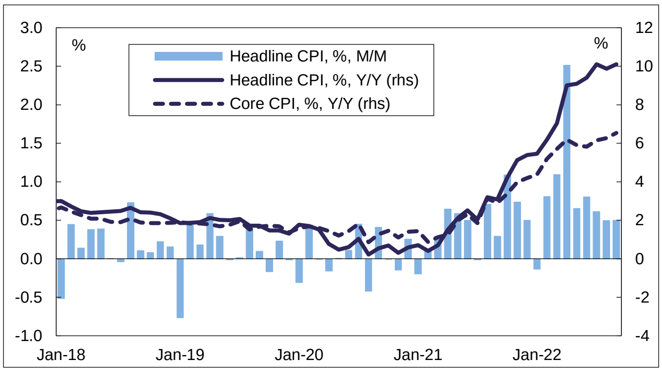
UK inflation back in double-digits amid the highest food inflation since 1980

In line with our forecast, UK inflation rebounded in September, reversing the 0.2ppt drop in August to be back in double-digits at 10.1%Y/Y, matching July's near-40-year high. The principal cause of the rise last month was food, prices of which rose for the twelfth consecutive month and by 0.9%M/M to push the respective annual rate up 1.4ppt to 14.8%Y/Y, up almost 14ppts from a year earlier and the highest since 1980. In contrast, a further drop in the motor fuels component saw transport inflation ease 1.4ppts to 10.6%Y/Y, the lowest since last October. So, energy inflation temporarily edged below 50%Y/Y for the first time since March. But prices of other goods including clothing (8.8%Y/Y), household appliances (10.6%Y/Y), and new cars (6.9%Y/Y) continued to trend higher, to leave non-energy industrial goods inflation up 0.4ppt to 7.0%Y/Y. Meanwhile, higher prices of accommodation services, due in part to differing seasonal patterns between this year and last, pushed services inflation up a further 0.2ppt to a new high of 6.1%Y/Y. So, core inflation rose 0.2ppt to a new series high of 6.5%Y/Y. And the NIESR 10% trimmed mean measure rose 0.5ppt to a new high of 8.3%Y/Y.

Inflation to rise again in November due to higher household energy bills

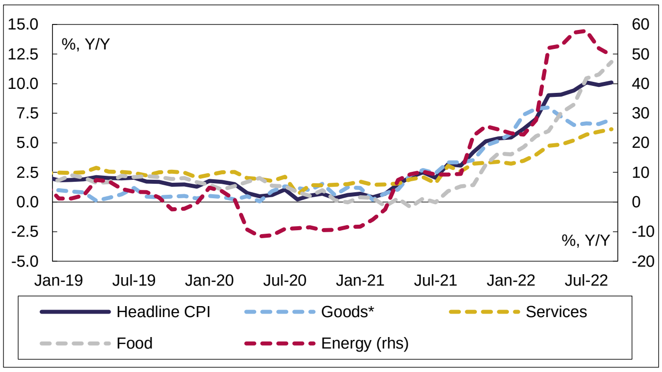
Looking ahead, inflation will jump further in October principally due to the 27% increase in household energy bills. Indeed, we forecast the headline CPI rate to rise close to 11%Y/Y this month, with energy accounting for roughly one quarter of total inflation. Food inflation will also likely continue to trend higher. But with producer goods inflation having seemingly peaked – the input PPI measure fell for the third consecutive month in September to 20.0%Y/Y, with the output price measure down ½ppt to 15.9%Y/Y – and global demand set to ease further, consumer non-energy industrial goods inflation might soon start to subside. This will, however, be countered by still prominent price pressures in services, with today's producer price figures reporting a further notable rise over the past quarter, by 1.2ppt to 6.6%Y/Y, a new series high. While this in part reflects high transportation costs, information and communication and hospitality costs provided significant positive contribution to services PPI in Q3 too. And annual indexed adjustments to prices of several services (e.g. mobile phone charges and social housing rents) will in due course add upside pressure on CPI in the New Year. So, we expect headline inflation to remain in double-digits for the time being, with core inflation likely to rise further in Q4 too.

UK: CPI inflation



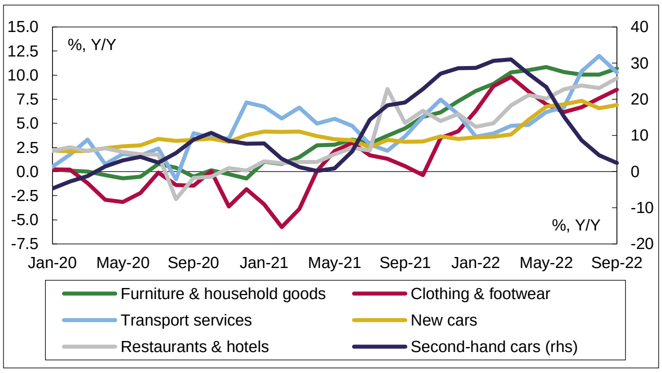
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation – key components



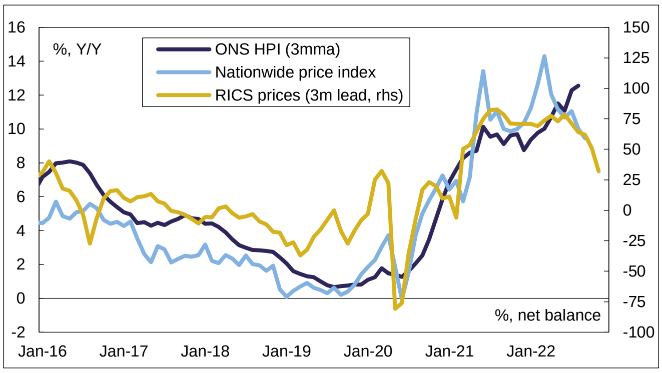
**Non-energy goods inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: CPI inflation – selected components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Outlook remains highly uncertain not least due to government's energy price guarantee review

The outlook further ahead remains highly uncertain, not least due to the government's belated, but still vague, decision to cut public expenditure, including by limiting the generosity of its energy price guarantee policy from April onwards and cutting departmental budgets in real terms. Depending on the extent of the reduction in energy bill support from April, inflation could well peak above 11%Y/Y and remain above 7%Y/Y by the end of next year. But the overall tightening of fiscal policy will deepen the recession that now looks inevitable in the wake of the sharp tightening of financial conditions induced by the original mini-Budget. And an eventual easing of energy and food pressures could yet enable headline inflation to fall back below the BoE's 2% target by end-2024. However, the current loosening of fiscal policy – via lower National Insurance Contributions and stamp duty – against the backdrop of non-negligible domestically-generated pressures from the tight labour market – might be judged to risk persistence of above-target inflation. Indeed, we currently expect core inflation to remain well above target by end-2024. As such, while there is vast fiscal policy-related uncertainty regarding the outlook, we continue to expect the MPC to tighten monetary policy significantly further. We currently still expect a hike of 100bps at the November rate-setting meeting followed by an additional 75bps in December, taking Bank Rate to 4.00% by year end.

House price growth slows in August, but much larger adjustment on its way

Today's official UK house price data confirmed that the annual rate of home price inflation slowed in August, by 2.4ppts to 13.6%Y/Y, with the moderation broad-based across regions. Admittedly, the July figure (upwardly revised to 16.0%Y/Y) was inflated by base effects related to past changes to stamp duty. And price growth in August was still the second-strongest since 2004. But surveys suggest that a marked deterioration in housing affordability is underway, stretched by rising inflation, falling real incomes and higher borrowing costs. Certainly, Nationwide's house price-to-earnings ratio of 7.0% has never been higher since the series began in the early 1980s, with London's ratio still in double digits (10.9%). And the RICS survey suggested that house price growth slowed sharply at the end of the third quarter – the headline balance fell 19ppts to 32%, the lowest since July 2020 – with new buyer enquiries and seller instructions in decline as well. Meanwhile, Rightmove saw growth in asking prices moderate to a nine-month low of 7.8%Y/Y in October. And despite Liz Truss's cut in stamp duty announced in her fateful mini-Budget last month, this downtrend seems bound to be amplified by the recent surge in mortgage costs amid the government's recent policy blunders. Indeed, data published by the BoE yesterday reported that quoted rates on a 2Y fixed mortgage with a 75% LTV ratio increased more than 50bps in September to 4.17%, the highest since 2009, while Moneyfacts saw the average 2-year fixed rate reach 6.53% over recent days from less than 4% at the beginning of August and just 2.34% at the end of last year.

The day ahead in the UK

Tomorrow is set to be a quiet day for UK economic data, with no top-tier releases due.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final CPI M/M% (Y/Y%)	Sep	**1.2 (9.9)**	*1.2 (10.0)*	0.6 (9.1)	-
	Final core CPI Y/Y%	Sep	**4.8**	*4.8*	4.3	-
	Construction output M/M% (Y/Y%)	Aug	**-0.6 (2.3)**	-	0.3 (1.5)	**- (2.1)**
UK	CPI M/M% (Y/Y%)	Sep	**0.5 (10.1)**	*0.5 (10.1)*	0.5 (9.9)	-
	Core CPI Y/Y%	Sep	**6.5**	*6.5*	6.3	-
	PPI output prices M/M% (Y/Y%)	Sep	**0.2 (15.9)**	0.4 (15.7)	-0.1 (16.1)	**0.1 (16.4)**
	PPI input prices M/M% (Y/Y%)	Sep	**0.4 (20.0)**	-0.4 (18.7)	-1.2 (20.5)	**-0.9 (20.9)**
	House price index Y/Y%	Aug	**13.6**	-	15.5	**16.0**

Auctions

Country	Auction
UK	sold £3.25bn of 1% 2032 bonds at an average yield of 4.109

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	EU27 new car registrations Y/Y%	Sep	**9.6**	-	4.4	-
Germany	ZEW current assessment (expectations) balance	Oct	**-72.2 (-59.2)**	-66.5 (-68.5)	-60.5 (-61.9)	-
Italy	Trade balance €bn	Aug	**-9.6**	-	-0.4	-
Spain	Trade balance €bn	Aug	**-7.9**	-	-6.6	-

Auctions

Country	Auction
Germany	sold €1.78bn of 2.10% 2029 bonds at an average yield of 2.23%
UK	sold £2.50bn of 1.25% 2051 bonds at an average yield of 4.409%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

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

Auctions and events

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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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