Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- As the BoE raised interest rates by 75bps, Gilts made sizeable losses despite the MPC's suggestions that market pricing of the future path of Bank Rate remains too aggressive.
- Bunds followed Gilts lower as the euro area unemployment rate fell to a new series low.
- Friday brings euro area PPI, German factory orders and French IP data.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	2.066	+0.115
OBL 1.3 10/27	2.111	+0.105
DBR 1.7 08/32	2.239	+0.109
UKT 1 04/24	3.095	+0.067
UKT 1¼ 07/27	3.443	+0.077
UKT 4¼ 06/32	3.521	+0.111

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

UK

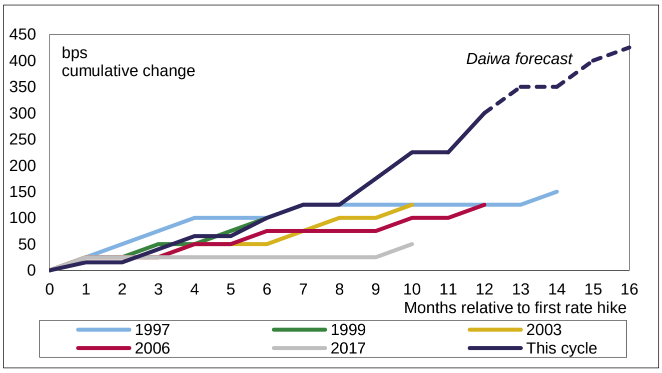
BoE hikes by 75bps but suggests that market pricing of Bank Rate remains too aggressive

In line with expectations, and matching the latest rate hikes by the Fed and ECB, the BoE tightened its monetary stance by 75bps today, taking Bank Rate to 3.0%. That took the cumulative increase in rates over the past eleven months to 290bps, extending significantly the BoE's most aggressive tightening cycle since independence in 1997. Seven out of the nine policy-makers of the MPC voted in favour of the decision, with external members Tenreyro and Dhingra having preferred a smaller increment of 25bps and 50bps respectively. The statement pointed to further tightening ahead if the economy evolves broadly in line with the Bank's updated economic projections. And with the risks to the inflation outlook judged still to be skewed significantly to the upside, the MPC also made clear that it would be ready to respond "forcefully" if required. However, its projections also suggested that the terminal rate for the cycle will be closer to the new level than the peak of 5.2% used in its (now somewhat outdated) scenario based on a market-implied path for Bank Rate. While much will depend on the government's updated plans for fiscal policy to be announced on 17 November, as well as the nature of any further shocks that might hit the UK economy over coming months, we have nudged down our own forecast for the terminal rate to near the mid-point of those two extremes, to 4.25%.

Ongoing squeeze on purchasing power set to deliver lengthy recession and higher unemployment

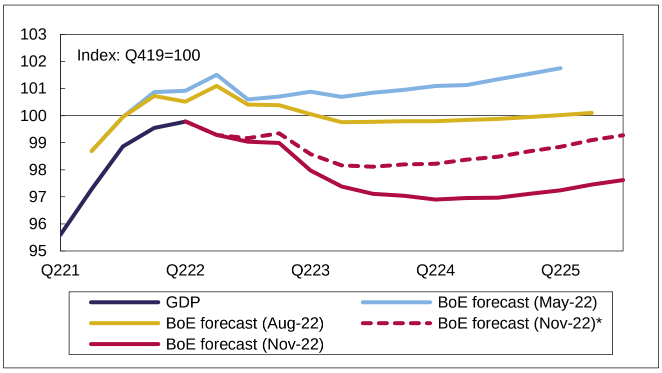
While today's BoE rate rise was in line with yesterday's hike from the Fed, MPC members in the post-meeting press conference argued rightly that economic conditions in the UK were much more challenging than those in the US. Admittedly, recent fiscal policy decisions – notably the energy bills until April and further (more limited) support to cope with high energy bills thereafter – will lower the peak in inflation and provide some additional support to demand, so that GDP around the turn of the year now might not contract quite as sharply as the BoE thought back in August. And the marked tightening of financial conditions following the announcement of the Truss government's short-lived mini-Budget proposals, has to some extent reversed. However, mortgage rates and borrowing costs for non-financial corporations remain significantly higher than in the summer. And the squeeze on real post-tax household income – which is expected to decline almost 2% over this year and next assuming no additional tax hikes – will hit spending over several quarters. So, GDP is expected to have declined by 0.5%Q/Q in Q3 while, as suggested by today's final October PMIs, a further contraction of similar amount is likely in Q4. And, even assuming no further changes to Bank Rate, economic output is now projected to drop in five out of six successive quarters with the peak-to-trough decline of about 1¾% - a weaker outlook than the vast majority of private-sector forecasts. Moreover, on the basis of the BoE's forecast conditioned on a market-implied path for Bank Rate, GDP is projected to contract for eight successive quarters, which would mark a particularly long-lasting recession by historical standards. On this

UK: BoE tightening cycles compared



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: BoE GDP forecast comparison



**Constant Bank Rate at 3.00% Source: BoE and Daiwa Capital Markets Europe Ltd.*

basis, the projected peak-to-trough decline in GDP through to Q224 would be almost 3%, and would be expected to push the unemployment rate up from 3½% in August to about 6½% by the end of the projection period.

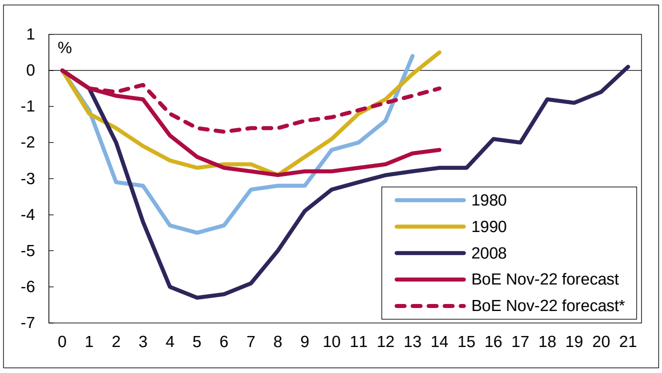
Wages fueling domestically-driven inflation, but recession should bring inflation back to target

As ever, of course, the MPC will be setting policy primarily on the basis of the inflation outlook. Over the near term, domestic price pressures are expected to remain strong, reflecting the tight labour market and elevated wage growth, which has been stronger than the MPC expected and is estimated by the Bank to add almost ½ppt to inflation in two years' time. However, inflation is expected to peak this quarter at around 11%Y/Y, and fall back from early 2023 as past increases in energy prices drop out of the calculation. And as the cumulative impact of BoE rate hikes continues to be felt, GDP steadily contracts, the unemployment rate picks up, and the current large margin of excess of demand eventually transforms into a much bigger amount of economic slack, inflation is expected to fall back significantly. Assuming no change in rates, inflation is projected by the MPC to fall back to just above the 2.0%Y/Y target in two years' time, and well below target in 2025. And assuming Bank Rate peaks at 5.25%, inflation is projected to fall firmly below target in two years' time and to zero in three years' time. The further decline in 2025 in part reflects assumptions of significantly lower natural gas prices that year, and so will not necessarily provide an accurate guide to underlying inflation. Moreover, importantly, the upside skew to the projections is now at a historical high, in part due to the rising risks of persistently high wage growth and a lasting change to firms' price-setting behavior flagged by recent surveys. So, while the government's forthcoming fiscal plans are expected to add downwards pressure on GDP over coming quarters, until the labour market softens sufficiently to cause a moderation of wage growth, and firms also start to refrain from automatically passing on costs to consumers, the MPC might be reluctant to call a halt to the tightening cycle.

The day ahead in the UK

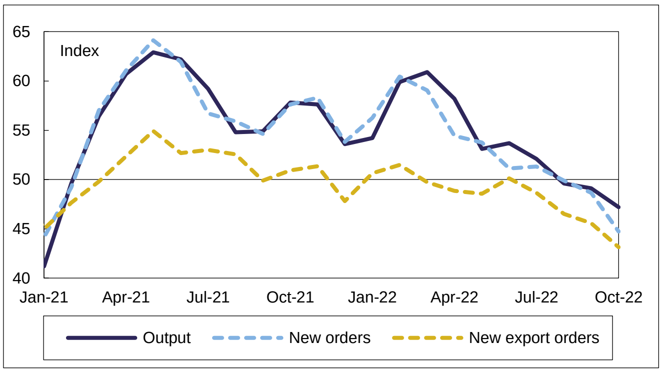
It will be a relatively quiet end to the week for UK economic releases, with just October's construction PMIs expected to show subdued activity in the sector, reflecting not least the slowing housing market amid rising borrowing costs. Despite subdued demand, new car registrations figures should have risen further on the back of easing supply constraints.

UK: Change in GDP from pre-recession peak



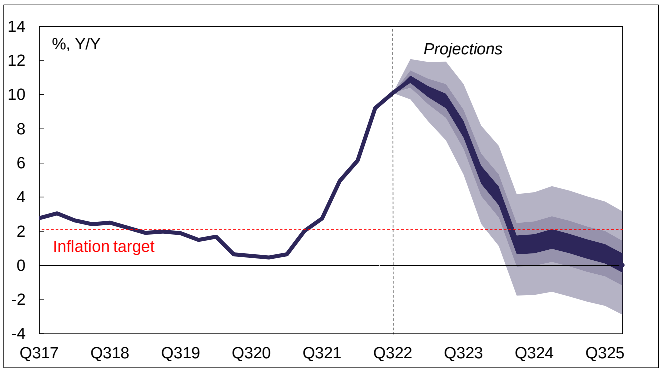
*Constant Bank Rate of 3.00%. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Selected composite PMIs



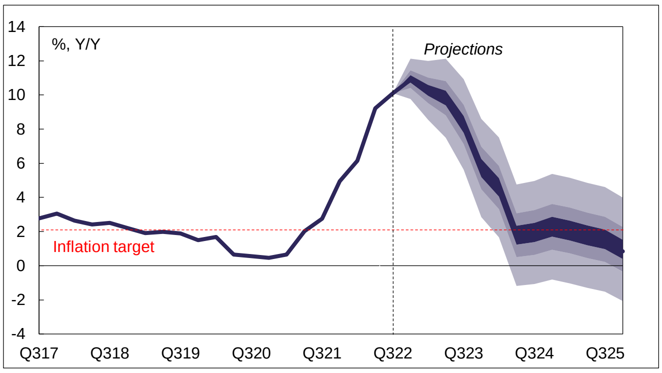
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: BoE CPI forecast, market-implied Bank Rate*



*Assumes Bank Rate peaks at 5.25% in Q323 before easing to 4.50% by end-2025. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE CPI forecast, constant Bank Rate at 3%



Source: BoE and Daiwa Capital Markets Europe Ltd.

Euro area

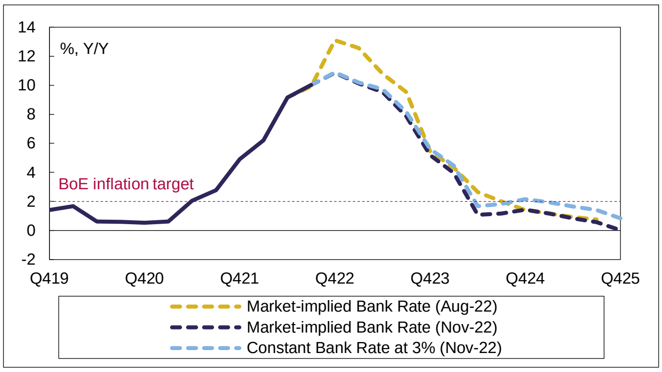
Euro area unemployment rate falls to new series low

While surveys have implied a marked deterioration in euro area business and consumer sentiment over the summer and GDP slowed sharply in third quarter, today's figures suggest the labour market remains relatively resilient. In particular, the number of jobless workers in the euro area fell for the 16th month out of the past 17 in September and by 66k, the most since April. This saw the unemployment rate edge down to a new series-low of 6.6%, from an upwardly revised 6.7% in August, some 0.7ppt lower than a year ago and 2ppts below the pandemic peak. The downwards shift almost fully reflected a drop in France (-60k) to leave the unemployment rate down 0.2ppt to a joint-series low of 7.1%, with equivalent rates unchanged in Germany (3.0%), Italy (7.9%) and Spain (12.7%). And today's Spanish figures reported an unexpectedly large drop in unemployment claims in October, by 104.9k, the most since last November to leave unemployment at its lowest level since October 2008. However, several surveys, including the composite PMIs and European Commission employment expectations indices (EEI), suggest a (perhaps inevitable) slowing in the pace of jobs growth over coming months. Indeed, the euro area's EEI fell in October for the seventh month out of the past eight to its lowest level since April 2021. Nevertheless, with the tight labour market seemingly adding to risks of second-round effects from high inflation on wage growth, the ECB might be wary of halting its tightening cycle before the unemployment rate starts to rise.

The day ahead in the euro area

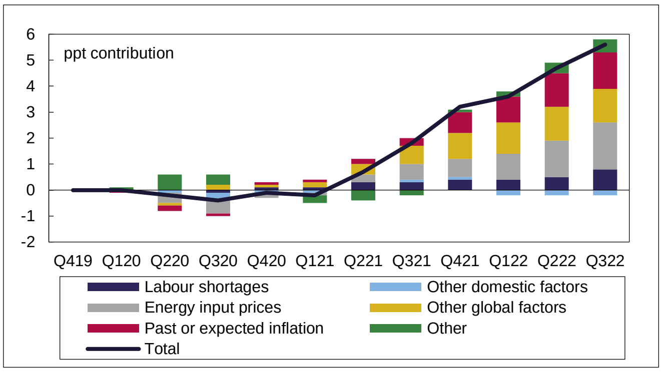
Friday will bring a number of economic data releases including the euro area's PPI figures for September. In line with recent signals in sentiment surveys, these might well suggest that producer goods inflation has now peaked, with the headline rate expected to drop more than 1ppt from August's record-high 43.3%Y/Y. The final services PMI surveys are also due from the euro area and expected to confirm that the headline activity index declined for the fifth consecutive month in October, to a twenty-month low of 48.2. Among the member state releases, focus will turn to the manufacturing sector with German factory orders and French industrial production data for September due. Separately, ECB President Lagarde is scheduled to give opening remarks at an event organized by the central bank of Estonia.

UK: BoE CPI forecasts



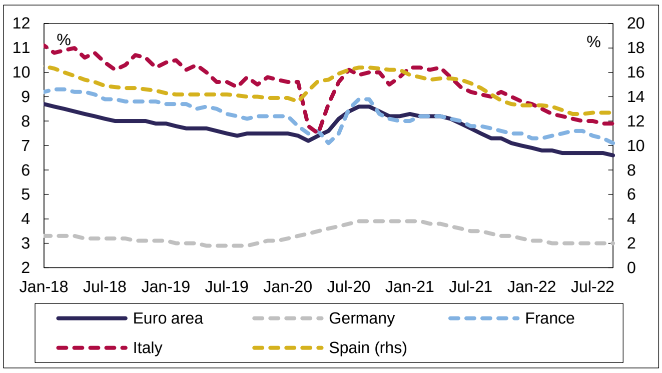
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Drivers of firms' selling-price rises



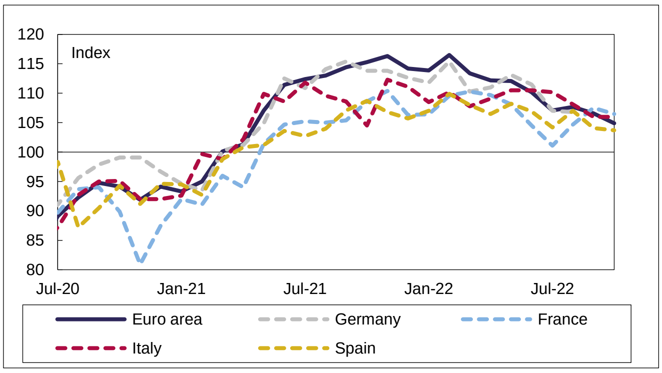
**Cumulative change in firms' realised price inflation since Q419 cited by DMP Survey respondents. Source: BoE and Daiwa Capital Markets Europe Ltd.*

Euro area: Unemployment rates



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Employment expectations indicators



Source: Refinitiv, EC 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		Unemployment rate %	Sep	**6.6**	6.6	6.6	**6.7**
Spain		Unemployment change '000s	Oct	**-27.0**	23.5	17.7	-
UK		Final services (composite) PMI	Oct	**48.8 (48.2)**	47.5 (47.2)	50.0 (49.1)	-
		BoE Bank Rate %	Nov	**3.00**	*3.00*	2.25	-

Auctions

Country		Auction
France		sold €5.06bn of 2% 2032 bonds at an average yield of 2.76%
		sold €2.64bn of 1.25% 2036 bonds at an average yield of 3.00%
		sold €2.30bn of 0.75% 2053 bonds at an average yield of 3.00%
Spain		sold €1.50bn of 0% 2027 bonds at an average yield of 2.667%
		sold €1.43bn of 2.55% 2032 bonds at an average yield of 3.306%
		sold €823mn of 1% 2042 bonds at an average yield of 3.586%
		sold €454mn 1% 2030 index-linked bonds at an average yield of 0.583%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Final services (composite) PMI	Oct	48.2 (47.1)	48.8 (48.1)
		10.00	PPI M/M% (Y/Y%)	Sep	1.6 (41.8)	5.0 (43.3)
Germany		07.00	Factory orders M/M% (Y/Y%)	Sep	-0.5 (-7.2)	-2.4 (-4.1)
		08.55	Final services (composite) PMI	Oct	44.9 (44.1)	45.0 (45.7)
France		07.45	Industrial production M/M% (Y/Y%)	Sep	-1.0 (1.2)	2.4 (1.2)
		08.50	Final services (composite) PMI	Oct	51.3 (50.0)	52.9 (51.2)
Italy		08.45	Services (composite) PMI	Oct	48.5 (47.4)	48.8 (47.6)
Spain		08.00	Industrial production M/M% (Y/Y%)	Sep	-0.3 (3.7)	0.4 (5.5)
		08.15	Services (composite) PMI	Oct	48.3 (48.0)	48.5 (48.4)
UK		09.30	Construction PMI	Oct	50.8	52.3
		09.30	New car registrations Y/Y%	Oct	-	4.6

Auctions and events

Country		GMT	Event
Euro area		09.30	ECB President Lagarde scheduled to give speech at Bank of Estonia conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs