

# Euro wrap-up

## Overview

- Bunds rallied as the ECB raised rates but signalled the likelihood that the peak in rates has been reached.
- Gilts also rallied as a UK residential property market survey indicated an acceleration in house price declines over the summer.
- Friday will bring data for euro area labour costs and a BoE household inflation attitudes survey, while the coming week will bring flash PMIs, UK inflation data and the BoE's monetary policy announcement.

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### Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.133	-0.028
OBL 2.4 10/28	2.611	-0.063
DBR 2.6 08/33	2.588	-0.058
UKT 3½ 10/25	4.924	-0.035
UKT 4½ 01/33	4.475	-0.074
UKT 3¼ 01/33	4.275	-0.065

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

## Euro area

### ECB hikes rates but signals that the peak has probably now been reached

After weeks of speculation, the ECB today raised its main policy rates once again by 25bps. Most notably, that took the deposit rate to a record high of 4.00%, and the cumulative tightening since last July to 450bps. However, the Governing Council signalled that rates have now probably reached their terminal levels for this hiking cycle. In particular, the policy statement noted that “the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target.” So, while the statement also repeated that policy will remain data dependent and that “rates will be set at sufficiently restrictive levels for as long as necessary”, euro area government bonds rallied on the announcement. And in line with our view, the swap market priced in the likelihood that rates will be cut by July 2024.

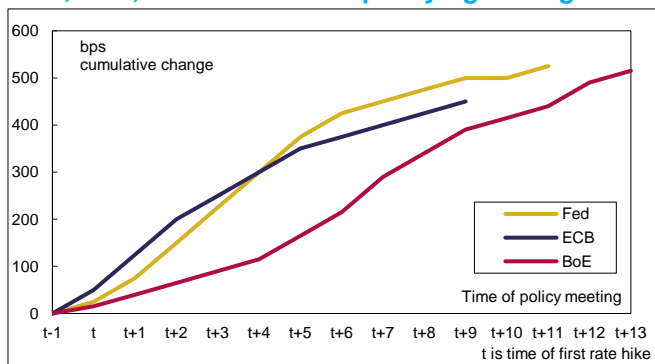
### ECB revises up its near-term inflation outlook

Today's rate increase reflected the Governing Council's assessment that inflation is still expected to remain “too high for too long”. Indeed, it judged that the near-term inflation outlook had deteriorated, principally due to the recent increase in energy prices. In particular, the ECB's projection for headline inflation was revised up by 0.2ppt this year and next to 5.6% and 3.2% respectively. While the forecast for headline inflation in 2025 was revised down by 0.1ppt, at 2.2% it was still above the ECB's target. And inflation is not projected to decline below 2.0% until Q425 – too far off in the future for the majority of Governing Council members. Nevertheless, the outlook for core inflation (excluding food and energy) was judged to have improved slightly, with the full-year projections for 2024 and 2025 revised down by 0.1ppt apiece to 2.9% and 2.2%. And with core inflation expected to be just 2.1% in Q425, the ECB also attached a probability of about 40% that it will be below 1½% by then.

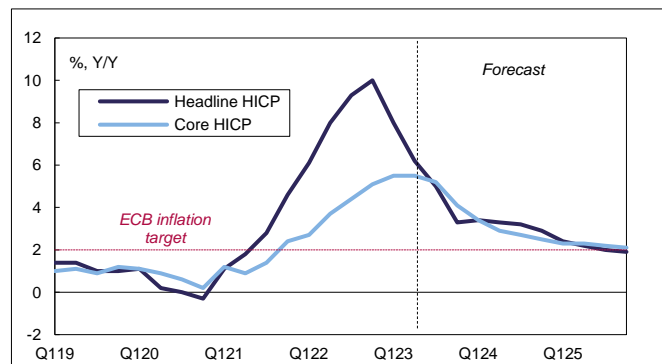
### But its GDP projection is revised down significantly across the horizon

The downwards revision to the ECB's outlook for core inflation in part reflects its assessment that firms are no longer adding to price pressures by boosting profit margins. Indeed, unit profits are now expected to decline through to mid-2024 in response to the weakening of GDP growth. Domestic demand is judged to have slowed in response to high inflation and the transmission of monetary policy tightening to borrowing costs and credit conditions that is now assessed to have been faster than in previous cycles. And with external demand also having weakened, the ECB revised down significantly its GDP projection across the horizon. Notably, the ECB cut its full-year forecasts of economic growth in 2023 and 2024 by 0.2ppt and 0.5ppt to 0.7% and 1.0% respectively.

### ECB, BoE, Fed: Cumulative policy tightening



### Euro area: ECB baseline inflation forecasts



## GDP growth now expected to stall this quarter with a non-negligible risk of recession

Reflecting the recent deterioration in survey indicators, the expansion is expected to be softest over the remainder of this year, with the ECB now forecasting GDP growth to pause in Q3 and edge up only to 0.1%Q/Q in Q4. And so, with the ECB judging that the risks to the GDP outlook are skewed to the downside, it also sees a non-negligible probability of recession over the second half of this year. Indeed, Lagarde noted that the baseline forecast still assumes that private consumption is likely to recover thanks to the resilient labour market and stronger real wage growth. Admittedly, the euro area unemployment rate remained at its record low in July. And while data released today showed that they fell to their lowest level since Q421, vacancies remained high by historical standards in Q2. But given the preponderance of short-term and part-time work in services, a more marked loss of momentum in that sector following the summer tourism period could well transmit swiftly to a notable rise in unemployment by year-end, undermining hopes of an eventual rebound in household spending.

## Eventual pivot towards a loosening bias seems more likely than a further rate hike

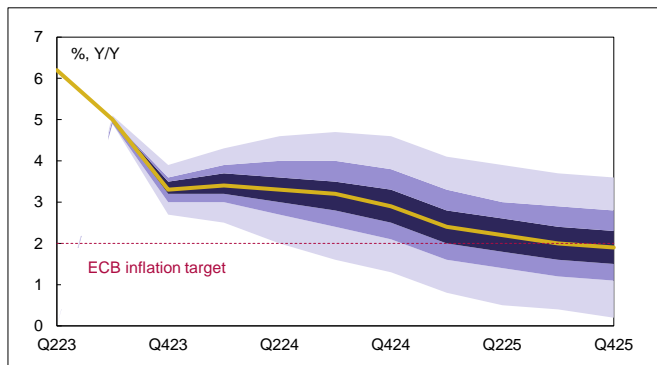
Of course, in her press conference, President Lagarde would not explicitly confirm that rates have now reached their peak. But she noted that some members of the Governing Council had already wanted to pause rather than raise rates further today. She also admitted that the focus of the debate would now be more on the duration of high rates rather than their level – underscoring the implicit message of the policy statement that the terminal rate has now probably been met. And while Lagarde also insisted that rates would remain restrictive for a while to come, given the deteriorating economic outlook, a pivot to an easing bias now appears more likely to occur over coming quarters than a further rate hike.

## The week ahead in the euro area

The data focus in the euro area tomorrow will be labour costs, growth of which in Q2 is likely to moderate slightly from 5.0%Y/Y in Q1 but remain high by historical standards.

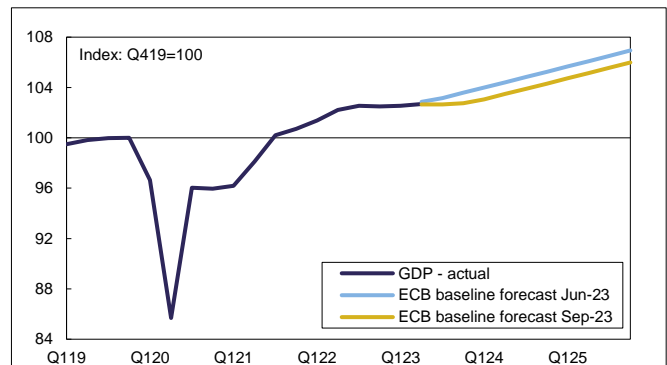
Turning to next week, revised euro area HICP figures for August will be published on Tuesday. These will provide more granular detail and allow for calculation of measures of underlying inflation watched by the ECB. The flash figures suggested that headline inflation moved sideways at 5.3%Y/Y amid a pickup in energy prices related not least to the jump in petrol prices. But core inflation moderated a further 0.2ppt to 5.3%Y/Y.

### Euro area: ECB headline inflation forecast\*



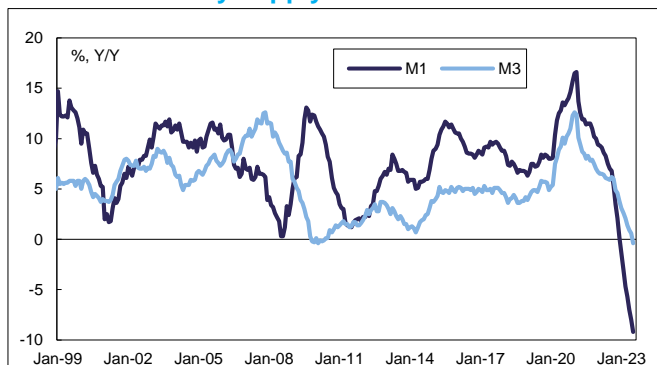
\*Bands from darkest to lightest depict 30%, 60%, 90% probabilities that inflation will fall within the respective intervals. Source: ECB and Daiwa Capital Markets

### Euro area: ECB GDP forecast



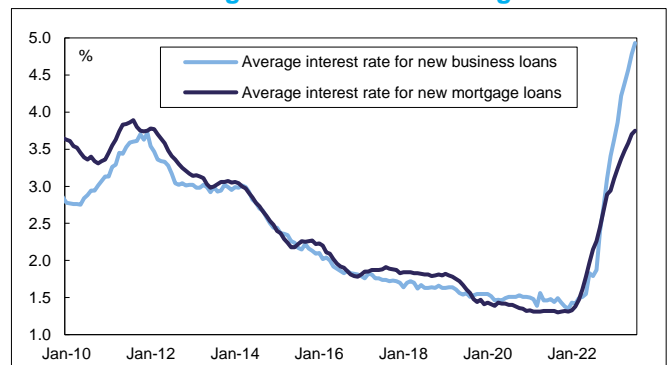
Source: ECB and Daiwa Capital Markets Europe Ltd.

### Euro area: Money supply



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

### Euro area: Average cost of new lending



Source: ECB and Daiwa Capital Markets Europe Ltd.

Given the recent weakening economic momentum, arguably of most focus in the coming week will be the survey results for September, including the flash PMIs from the euro area, Germany and France due on Friday. The euro area's headline composite output PMI (46.7) fell in August to its lowest level since the second Covid-19 wave in November 2020. The German (44.6) and French indices (46.0) also pointed to contraction as momentum in the services sector deteriorated and conditions remained extremely challenging in manufacturing.

Among other releases, Thursday will bring the preliminary Commission consumer confidence index for September. The French INSEE business confidence survey – which has often provided a better guide to French GDP growth than the PMIs – is also due that day and is likely to signal a lacklustre performance rather than a slump in economic activity. Indeed, the Bank of France survey this week suggested that sentiment had improved slightly in early September and the BoF revised up its forecast for GDP growth in Q3 to 0.2%Q/Q. Finally, euro area construction output figures for July are also due on Wednesday and are likely to report a (likely temporary) rebound in activity at the start of Q3 having fallen in three of the previous four months.

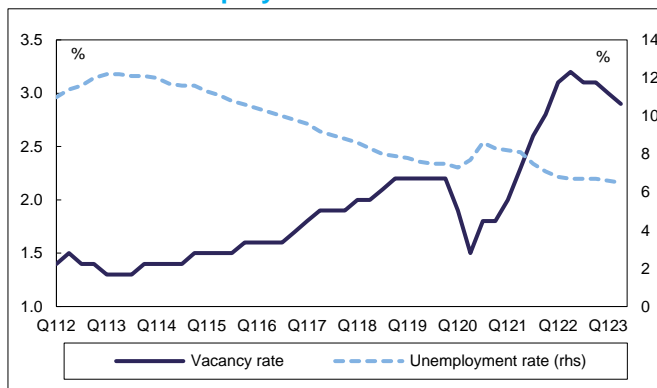
## UK

### Surveyors flag acceleration in house price falls as home demand hit by higher rates

With surveys implying a sharp slowdown in economic momentum at the start of Q3 and borrowing costs notably higher than in the first half of the year, today's RICS residential survey offered a particularly gloomy assessment of conditions in the housing sector. It was no surprise to see that demand remained very weak over the summer, with the RICS new buyer enquires balance in August (-47%) the lowest since the Truss-related blowout in interest rates in October last year. Indeed, barring this episode and the initial slump during the first Covid lockdown, demand was reportedly the weakest since 2008. With house prices falling, new vendor instructions also dropped sharply in August, with the respective survey balance the lowest for almost two years. And surveyors reported that the number of agreed sales was the weakest in more than 15 years when excluding the first two months of the pandemic. While the demand-supply gap narrowed slightly in August, the headline RICS house price balance fell a steeper-than-expected 13ppts in August to -68%, the lowest since the global financial crisis in early 2009. But surveyors were a touch less negative about the outlook for prices than in July, perhaps reflecting the slight moderation in interest rates over the past month.

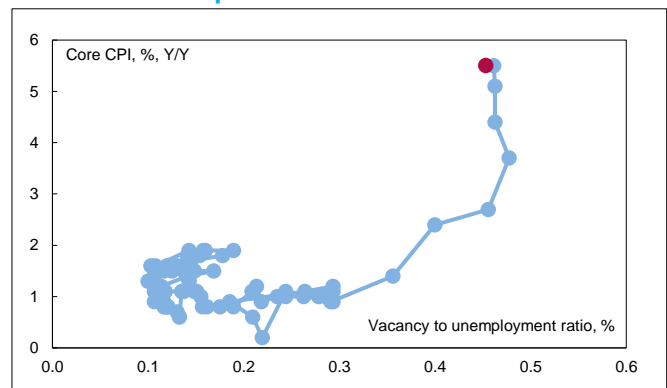
Of course, borrowing costs remain substantially higher than in recent years – for example, the average rate on a 2-year mortgage with a loan-to-value (LTV) ratio of 75% stood at 6.21% in August, some 260bps higher than a year earlier and

#### Euro area: Unemployment and vacancies rates



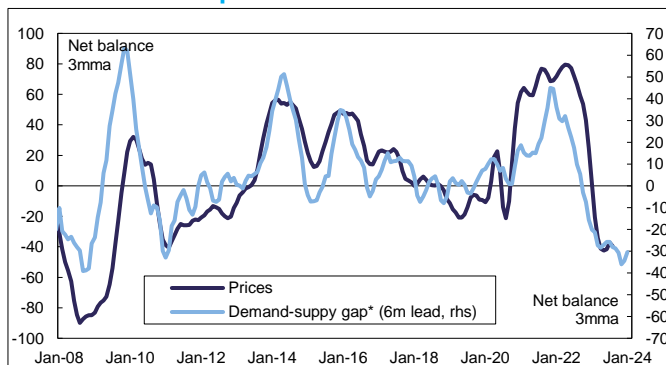
Source: Eurostat, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

#### Euro area: Phillips curve\*



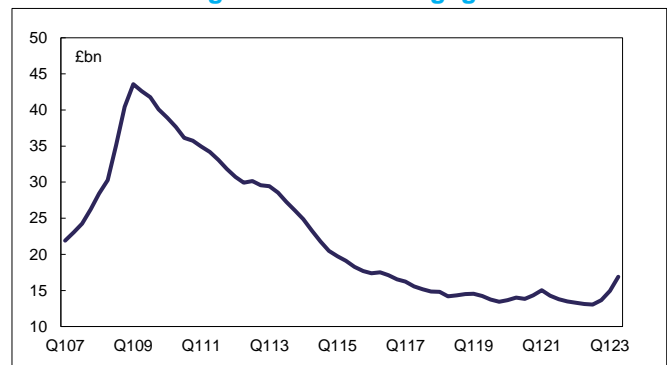
\*Red dot represents latest observation for Q223. Source: Eurostat, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

#### UK: RICS house price indices



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

#### UK: Outstanding balance of mortgages in arrears



Source: BoE and Daiwa Capital Markets Europe Ltd.

500bps higher than two years ago. And data published earlier this week suggested that the balance of mortgages in arrears rose at a double-digit pace for a second-successive quarter in Q2 to a seven-year high of £16.9bn. With unemployment rising, this might be expected to trend higher over coming quarters. But the level still remains historically low and well below the global financial crisis peak (£43.6bn) in Q109.

### The week ahead in the UK: MPC to hike Bank Rate by 25bps on Thursday?

After today's focus on the ECB, the main event in the coming week will be the BoE's monetary policy announcement on Thursday. As for the ECB, given recent economic data, the rate decision is too uncertain to predict with confidence. On balance, we expect the MPC to hike Bank Rate by a further 25bps to 5.50%. However, we do not reject entirely the possibility that rates will be left unchanged. Certainly, the vote on the Committee will be split.

At the [previous policy meeting](#) in August, the MPC slowed the pace of rate hikes to 25bps from 50bps in June. It also judged that policy was now restrictive and thus bearing down on growth and inflation. It pledged to keep Bank Rate "sufficiently restrictive for sufficiently long" to return inflation sustainably back to target, while making it clear that policy will remain data dependent. Its updated projections suggested that the inflation target was expected to be met at the end of the forecast horizon if rates were left unchanged or if rates followed a path in line with market pricing, whereby Bank Rate was hiked further to just over 6.00% this year before being cut in 2024. However, the risks to that inflation outlook were skewed to the upside, albeit not quite as much as earlier in the year.

### Inflation & pay point to further hike; increased unemployment & weak growth point to a pause

Since the August meeting, the macroeconomic data have been mixed. Two of the most important variables in the BoE's current reaction function – [services inflation](#) and [private sector wages](#) – have so far exceeded the MPC's forecasts. But another key variable – tightness in the labour market – has moderated much further than anticipated, with Tuesday's figures reporting a bigger-than-expected [drop in employment and rise in unemployment](#) in the three months to July. And that softening of the labour market tallies with yesterday's GDP data and recent surveys which suggest that the BoE's growth forecast for the current quarter (0.4%Q/Q) is too strong. How the MPC responds to the data is unclear. The most hawkish MPC member (Mann) has already signalled her willingness to vote for another hike, while the most dovish (Dhingra) will vote for no change. Importantly, Governor Bailey and Chief Economist Pill have sounded much more dovish of late. Nevertheless, given the persistent strength in private sector pay and services inflation, and in the absence of a significant downside surprise in the August CPI data due Wednesday, we expect the majority to back one last hike in Bank Rate this cycle to 5.50%.

### MPC likely to agree acceleration in pace of QT

As well as deciding whether to raise rates again, the MPC will also discuss quantitative tightening (QT). In line with the preference expressed by Deputy Governor Ramsden, we expect the MPC to agree to increase the pace of balance sheet reduction over the twelve months from October. With the Gilt market having been untroubled by QT since the BoE started active sales last November, we would not be surprised to see the intended annual rate of reduction increased from about £80bn in the year to September to £100bn. With automatic run-off of the BoE's bond-holdings set to rise from £35bn in the current period to £50bn over the twelve months from this October, active Gilt sales would still increase only modestly in the new period, by £5bn also to £50bn. If the Committee was keen to keep yields higher across the curve, the risks to that forecast could be skewed to the upside.

### The data week ahead in the UK – CPI report in focus ahead of the BoE decision



In a busy week for top-tier UK data, all eyes will be on the August CPI report on Wednesday. Given the recent rise in the price of Brent crude oil and associated pick up in petrol prices, headline inflation is likely to have edged slightly higher last month, with our expectation for an increase of 0.3ppt to 7.1%Y/Y, admittedly still the second-lowest reading since the Russian invasion of Ukraine and roughly 4ppts below last October's peak. But while we think that services inflation merely moved sideways at a still-lofty 7.4%Y/Y, above the BoE's forecast of 7.1%Y/Y, a further moderation in non-energy industrial goods inflation should see the core CPI rate ease back slightly, by 0.2ppt to 6.7%Y/Y, a five-month low.

Before the CPI data are released, tomorrow's BoE's household inflation attitudes survey will also be watched by the MPC – with all of the survey measures of household inflation expectations having dropped over the past two quarters, the key medium-term (5-years ahead) measure could well fall further to a two-year low below 3.0%Y/Y. Meanwhile, as in the euro area, a key focus at the end of the week will be the flash September PMIs, which are likely to remain consistent with contraction in the services and manufacturing sectors at the end of Q3. Indeed, we wouldn't expect any significant improvement on the August readings for services and manufacturing output of 49.5 and 44.1 respectively. Friday will also bring retail sales figures for August. Recent retailer surveys have been mixed. But while we might expect some partial rebound from the weather-dampened drop in July (-1.2%M/M), they are likely to suggest lacklustre consumer spending over the summer. Certainly, the latest GfK consumer confidence survey (also due Friday) is likely to suggest that sentiment remains relatively subdued despite being above the recent trough.

## European calendar

### Today's results

#### Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area 	ECB deposit (refinancing) rate %	Sep	<b>4.00 (4.50)</b>	<u>4.00 (4.50)</u>	3.75 (4.25)	-
UK 	RICS house price balance %	Aug	<b>-68</b>	-55	-53	-55








#### Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

### Tomorrow's releases

#### Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area 	10.00	Labour costs Y/Y%	Q2	-	5.0
	10.00	Trade balance €bn	Jul	-	12.5
France 	07.45	Final HICP (CPI) Y/Y%	Aug	<u>5.7 (4.8)</u>	5.1 (4.3)
Italy 	10.00	Final HICP (CPI) Y/Y%	Aug	<u>5.5 (5.5)</u>	6.3 (5.9)
	10.00	Trade balance €bn	Jul	-	7.7
Spain 	08.00	Labour costs Y/Y%	Q2	-	6.2
UK 	09.30	BoE inflation attitudes survey, 12 months ahead Y/Y%	Aug	-	3.5

#### Auctions and events




























- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

**The next edition of the Euro wrap-up will be published on 19<sup>th</sup> September 2023**

## The coming week's data calendar

### The coming week's key data releases

Country	BST	Release	Period	Market consensus/ <i>Daiwa</i> <i>forecast/actual</i>	Previous
<b>Monday 18 September 2023</b>					
UK		00.01 Rightmove house price index M/M% (Y/Y%)	Sep	-	-1.9 (-0.1)
<b>Tuesday 19 September 2023</b>					
Euro area		09.00 ECB current account balance €bn	Jul	-	35.8
		10.00 Final CPI (core) Y/Y%	Aug	<u>5.3 (5.3)</u>	5.3 (5.5)
<b>Wednesday 20 September 2023</b>					
Euro area		07.00 EU-27 new car registrations Y/Y%	Aug	-	15.2
		10.00 Construction output M/M% (Y/Y%)	Jul	-	-1.0 (-0.3)
Germany		07.00 PPI Y/Y%	Aug	-	-6.0
UK		07.00 CPI (core) Y/Y%	Aug	<u>7.1 (6.7)</u>	6.8 (6.9)
		07.00 PPI output (input) Y/Y%	Aug	-	-0.8 (-3.3)
		09.30 House price index Y/Y%	Jul	-	1.7
<b>Thursday 21 September 2023</b>					
Euro area		15.00 European Commission preliminary consumer confidence	Sep	-	-16.0
France		07.45 INSEE business (manufacturing) confidence	Sep	-	99 (96)
		- Bank of France retail sales Y/Y%	Aug	-	-2.1
UK		07.00 PSNB (excl. banks) £bn	Aug	-	3.5 (4.3)
		12.00 Bank rate %	Sep	<u>5.50</u>	5.25
<b>Friday 22 September 2023</b>					
Euro area		09.00 Preliminary manufacturing (services) PMI	Sep	-	43.5 (47.9)
		09.00 Preliminary composite PMI	Sep	-	46.7
Germany		08.30 Preliminary manufacturing (services) PMI	Sep	-	39.1 (47.3)
		08.30 Preliminary composite PMI	Sep	-	44.6
France		08.15 Preliminary manufacturing (services) PMI	Sep	-	46.0 (46.0)
		08.15 Preliminary composite PMI	Sep	-	46.0
Spain		08.00 Final GDP Q/Q% (Y/Y%)	Q2	<u>0.4 (1.8)</u>	0.5 (4.2)
UK		00.01 GfK consumer confidence	Sep	-	-25
		07.00 Retail sales including auto fuels M/M% (Y/Y%)	Aug	-	-1.2 (-3.2)
		07.00 Retail sales excluding auto fuels M/M% (Y/Y%)	Aug	-	-1.4 (-3.4)
		09.30 Preliminary manufacturing (services) PMI	Sep	-	43.0 (49.5)
		09.30 Preliminary composite PMI	Sep	-	48.6
		11.00 CBI industrial trends, total orders (selling prices)	Sep	-	-15 (8)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

### The coming week's key events & auctions

Country	BST	Event / Auction
<b>Monday 18 September 2023</b>		
- Nothing scheduled -		
<b>Tuesday 19 September 2023</b>		
UK	 10.00	Auction: £2.75bn of 3.75% 2053 bonds
<b>Wednesday 20 September 2023</b>		
- Nothing scheduled -		
<b>Thursday 21 September 2023</b>		
Euro area	 23.45	ECB Chief Economist Lane scheduled to speak – 'Inflation and monetary policy in the euro area'
France	 09.50	Auction: Fixed-rate and index-linked bonds
Spain	 09.30	Auction: Fixed-rate bonds
UK	 12.00	BoE monetary policy announcement, summary and minutes published
	 12.00	BoE publishes Agents' summary of business conditions
<b>Friday 22 September 2023</b>		
Euro area	 12.00	ECB's de Guindos scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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