Euro wrap-up

Overview

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- Ahead of this evening's FOMC announcement, Bunds made modest gains as German producer price inflation fell to a record low.
- Gilts outperformed as UK inflation fell much more than expected, with the core rate down by the most in three years, opening the door significantly wider to a dovish BoE policy stance.
- Thursday's BoE policy is now too close to call with confidence, while euro area consumer and French business sentiment indicators are also due tomorrow.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.251	-0.026
OBL 2.4 10/28	2.729	-0.033
DBR 2.6 08/33	2.699	-0.033
UKT 3½ 10/25	4.816	-0.164
UKT 4½ 06/28	4.375	-0.154
UKT 3¼ 01/33	4.215	-0.123

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

Euro area

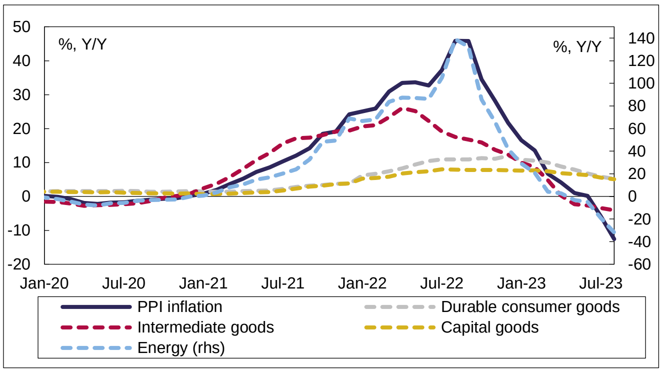
German producer price inflation at record low thanks to huge base effects

While German consumer goods price inflation moved broadly sideways in August, the stickiness over the summer was likely related to the timing of summer discounting as well as an acceleration in new car prices. And judging by today's producer goods inflation data, the prospects for a resumption of the disinflationary trend in the autumn look favourable. Indeed, despite rising for the first month in four (0.3%M/M) amid a pickup in energy prices, producer goods prices were down a substantial 12.6%Y/Y, more than double the drop in July and the steepest since data collection began in 1949. Inevitably, the base effect associated with the extreme surge in natural gas prices last summer helped to explain the sharp decline in producer prices compared to a year earlier. Indeed, a further 10%M/M drop in August left natural gas prices down a whopping 65%Y/Y and 75% below the peak last October. And despite ticking slightly higher on the month, the annual pace of decline in electricity prices was also striking (-38%Y/Y). But having jumped in August, the annual decline in producer petroleum prices moderated 8ppts to -8.7%Y/Y.

Underlying producer price pressures continue to moderate

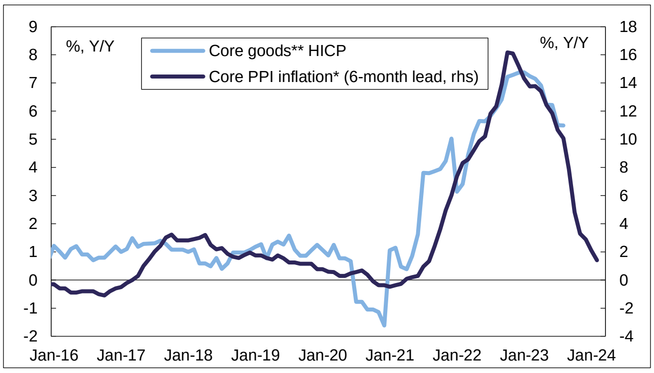
When excluding energy, producer prices fell for the fifth consecutive month, by 0.3%M/M, helping the respective annual rate to slow 0.7ppt to 1.4%Y/Y, almost 15ppts below last summer's peak. Reflecting better functioning supply chains, moderating input cost pressures, and weaker demand, intermediate goods prices fell for a sixth successive month (-0.6%M/M) to be down 4.1%Y/Y, the most since the global financial crisis. With food prices having eased for a second successive month, producer prices of non-durable consumer goods fell for the first time since December 2020. That left the annual rate of increase down 1.2ppts to 6.9%Y/Y, the lowest since Russia's invasion of Ukraine. And with producer prices of consumer durables and capital goods unchanged on the month, the respective annual rates slowed for a sixth and eighth successive month to 5.1%Y/Y and 5.2%Y/Y. Surveys suggest that the disinflationary trend should continue over the remainder of the year and into 2024. Certainly, the PMIs implied that factory input prices continued to fall sharply in August, and that these lower cost burdens were being increasingly passed on to consumers. In addition, based on its surveys, the ifo institute reported that fewer than half of all firms in any particular factory sub-sector reported material shortages for the first time since July 2021, and that the share of manufacturers planning to increase prices over the coming three months was negligible (3.7%) and the lowest since spring 2021.

Germany: Producer goods price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Consumer & producer goods inflation



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

Construction activity starts Q3 more positively, but outlook for the sector remains gloomy

Contrasting with the drop of 1.1%M/M in industrial production in July and the gloomy assessment presented in various surveys, euro area construction output rose 0.8%M/M at the start of Q3. Growth was underpinned by an increase in building work while civil engineering activity declined for the second successive month. Among the member states to publish figures, growth was firmest in Germany (2.6%M/M) and Belgium (2.9%M/M), with positive outturns in France (0.6%M/M), Spain (1.2%M/M) and the Netherlands (0.5%M/M). While construction output was up 1.0%Y/Y, the pickup in July failed to fully reverse the drop in June and left it down more than 1½%3M/3M and little changed compared with the Q2 average. Looking ahead, the steady downwards trend in residential building permits, which in May were down almost 30% from the peak in March 2022, suggests that construction activity will be subdued over the near term. Sentiment surveys also continue to signal ongoing challenges in the sector. Certainly, the PMIs implied relatively steep contraction over the summer as the residential market continued to be impacted by higher borrowing costs and falling house prices. And the Commission survey suggested that sentiment fell last month to its lowest since November 2020 amid a steady decline in orders, with weak demand and inclement weather becoming increasing restraints on output.

The day ahead in the euro area

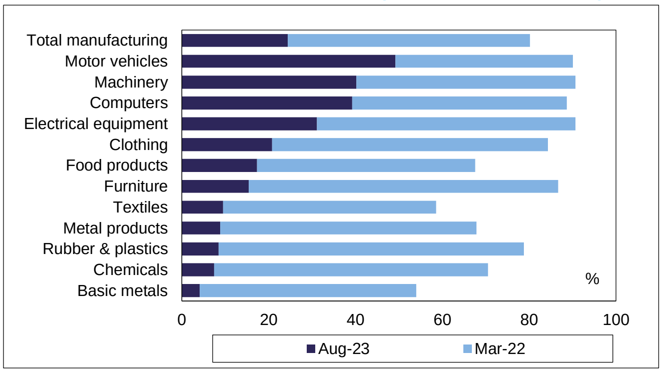
September sentiment surveys will dominate the euro area's data flow tomorrow. The European Commission's preliminary consumer confidence indicator will likely remain well above the range from Russia's invasion of Ukraine early last year through to this May. However, we expect a second successive modest deterioration in sentiment amid persisting concerns about the economic outlook, higher borrowing costs and the recent rise in petrol prices. Meanwhile, ahead of Friday's flash PMIs, the French INSEE business survey – which has often provided a better guide to French GDP growth than the PMIs – is also due and is likely to signal a lacklustre performance rather than a slump in economic activity. The Bank of France's measure of retail sales for August will also provide an update on consumer spending over the summer. Beyond the data, ECB President Lagarde and Chief Economist Lane are scheduled to speak at separate events, with their views on the near-term policy outlook set to be closely watched.

UK

Broad-based decline in inflation opens door much wider to dovish BoE policy

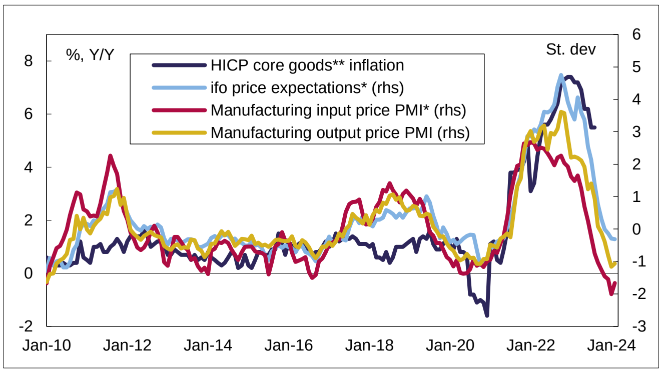
Ahead of tomorrow's BoE monetary policy announcement, the August consumer price inflation data surprised significantly on the downside raising the possibility of a dovish decision. Contrary to expectations of a rise, headline CPI inflation fell for a

Germany: Share of firms citing material shortages



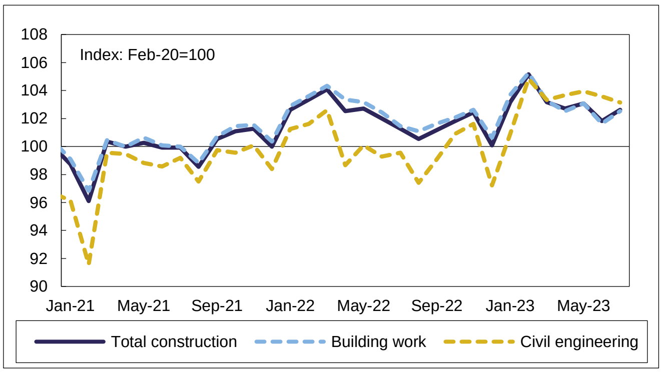
Source: ifo institute and Daiwa Capital Markets Europe Ltd.

Germany: Goods price indices



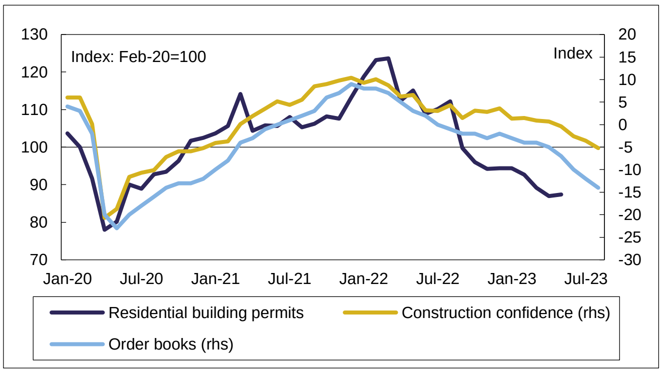
**Six-month lead. **Non-energy industrial goods. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area: Construction output



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Selected construction sector indicators



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

third successive month, easing back 0.1ppt to 6.7%Y/Y, 4.4ppts below October's peak and 0.4ppt below the BoE's forecast. An increase in inflation had been expected not least due to the recent pickup in crude oil prices, which meant that prices of auto fuel and lubricants rose for the first time in thirteen months and by a sizeable 3.8%M/M. As a result, energy inflation picked up for the first time since October, increasing 4.6ppts to -3.2%Y/Y. However, the other major categories all weakened, suggestive of a broad-based easing of price pressures. For example, while the introduction of new alcohol duties raised prices of spirits, wine and beer, overall food and drink inflation moderated for a fourth successive month to an eleven-month low of 12.6%Y/Y as prices of seasonal items fell for the second month in the past three.

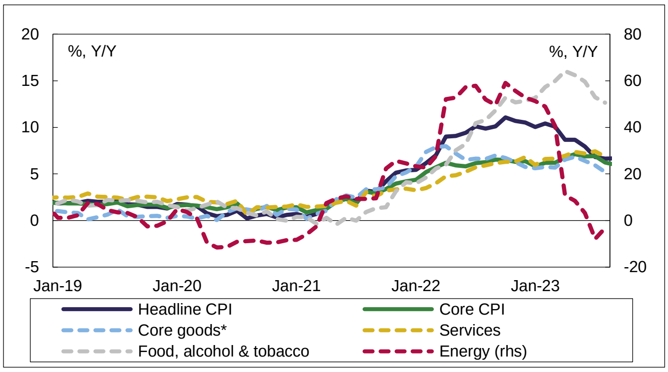
Steepest drop in core inflation in three years strongly suggests easing of underlying pressures

More notably, among the core items, inflation of non-energy industrial goods slowed 0.7ppt – the most in fifteen months – to 5.2%Y/Y, the lowest since late 2021. Within that category, prices of vehicles fell for the third month in a row in part due to developments in the used-car market. And inflation also eased for furniture, household appliances, recording media and pet-related products. Most importantly, services inflation fell 0.6ppt to a five-month low of 6.8%Y/Y, 0.4ppt below the BoE's forecast of 7.2%Y/Y. The big fall reflected lower prices of hotels and airfares – admittedly both typically volatile – as well as restaurants. As a result, the annual core CPI rate dropped 0.7ppt – the most in three years – to 6.2%Y/Y, some 0.6ppt below the consensus forecast. Moreover, the rise in core prices (0.4%M/M) was 0.3ppt below the long-run average for the month, the biggest such deviation since February 2021. And the monthly increases in prices of services and core goods were similarly both below their long-run averages together for the first time in 2½ years. Admittedly, the weakness in August will for certain categories have represented payback for exceptional strength in the prior month, which in the case of hotel prices and airfares likely reflected the proximity of the sampling week to the school holidays. However, taking the average of the past two months, the increase in services prices was no higher than the long-run average, signalling a notable softening of underlying inflation pressures.

Petrol prices to keep inflation elevated in September but key components to remain on downtrend

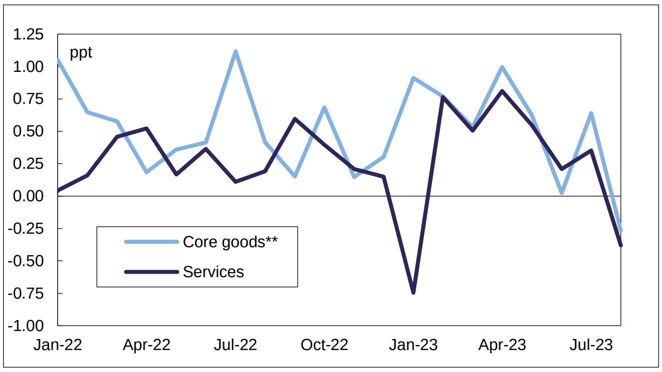
Looking ahead, energy inflation is set to rise again in September due to higher prices of petrol at the pump. And that could well prevent headline CPI inflation from falling further this month. But in October, the reduction in the regulated household energy price cap, coupled with substantive base effects, will knock about 1.5ppts off headline inflation. With food producer output price inflation down more than 1ppt in August to 5.2%Y/Y – the lowest since late 2021 – and further significant base effects to come, food CPI inflation will also decline steadily over coming months. Likewise, reflecting the better balance

UK: Consumer price inflation



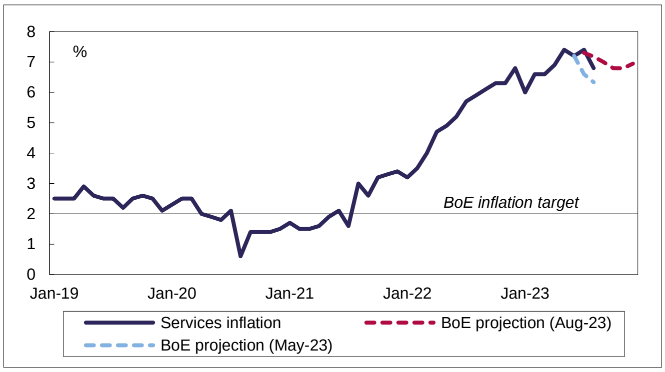
*Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Deviation from l-r average price change*



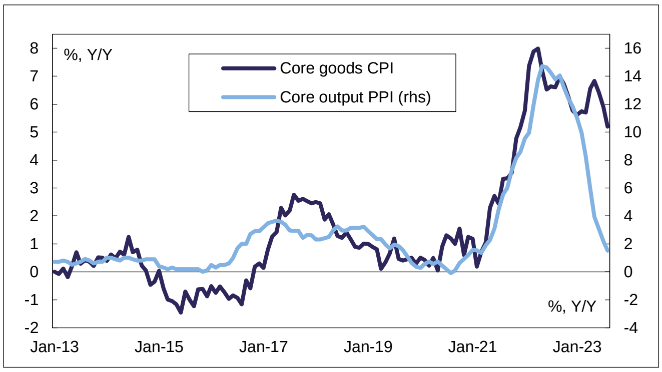
*Deviation in M/M rate of price increase from the long-run average for the month. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Services inflation & BoE forecast



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

UK: Consumer & producer goods inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

between global supply and demand, the drop in core producer output price inflation to just 1.5%Y/Y – the lowest since February 2021 – points to the likelihood of a steady further decline in core goods CPI inflation. And while some components of the services CPI, including social housing rents and mobile phone charges, will remain elevated due to their lagged relationship with past rates of headline inflation, others (such as insurance) will soon slow in response to easing goods inflation. More generally, the loss of momentum in demand signalled by recent surveys, as well as the softening of the labour market reported in last week's jobs and vacancy data, suggests that services firms' scope for and pressure to pass on costs to consumers has diminished. So, we expect both core goods and services inflation to continue to trend steadily lower over coming months.

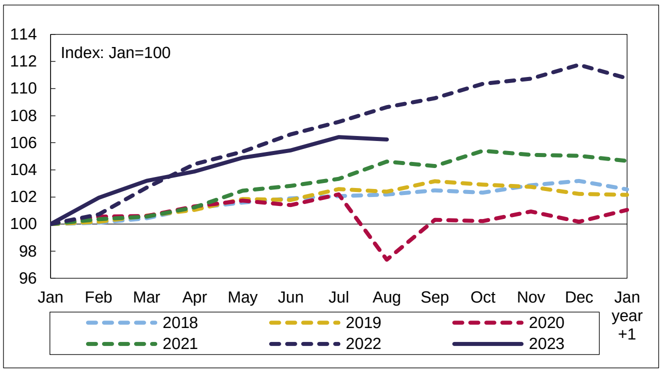
Probability of no change to rates tomorrow has risen significantly

Following the downside surprise in today's data for August, headline inflation in the first two months of Q3 averaged 0.3ppt less than the BoE's forecast. Moreover, services inflation – one of the MPC's key variables for determining the path of policy – has trended 0.1ppt below the BoE's forecast. Data last week also suggested that the labour market is loosening at a faster pace than the Bank expected, and that its GDP forecast for Q3 (0.4%Q/Q) is probably too strong. So, the downside risks to the BoE's inflation projection – which foresaw inflation returning to target by H125 and falling firmly below target by the end of the forecast horizon – have arguably increased. Admittedly, private sector pay looks set firmly to exceed the BoE's forecast this quarter. And on balance, persistent very strong wage growth might still just about persuade the majority on the MPC to vote for one final hike in Bank Rate tomorrow. But leading indicators for wages, including the REC survey starting salary index and today's data from XpertHR reporting a slowdown in basic pay growth in the three months to end-August, point to a softening of momentum in labour costs over the summer. And added together with recent dovish comments from BoE Governor and Chief Economist Pill, the chances that the MPC will vote tomorrow for no change to rates, and that the terminal rate for the cycle has already been reached, have undoubtedly risen very significantly. Certainly, the decision now looks too close to call with any confidence. And if Bank Rate is hiked again tomorrow, we would expect the statement to flag that policy is now considered to be sufficiently restrictive to return inflation to target over the projection horizon.

The day ahead in the UK

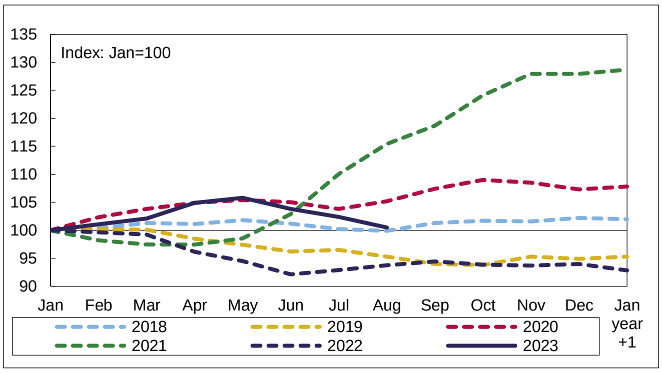
The main focus in the UK tomorrow will be the aforementioned BoE monetary policy announcement. And in light of today's CPI release, the outcome is even more uncertain to predict with confidence. Given the strength in private sector wages, the MPC might well vote to hike Bank Rate by a further 25bps to 5.50%. However, given also the softening of the labour market, weaker GDP data and recent surveys which suggest that the BoE's growth forecast for the current quarter (0.4%Q/Q) is too strong, we would also not be surprised to see rates left unchanged. Certainly, the vote will be split. The most hawkish MPC

UK: Hotel & restaurant prices



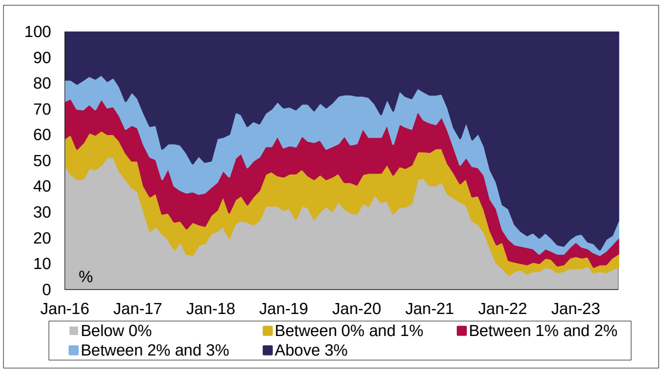
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Used car prices



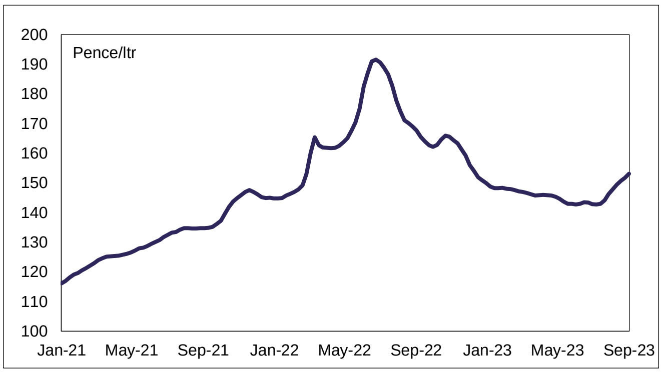
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Share of CPI basket by inflation rates



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Petrol price*



**Unleaded petrol at the pump. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

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, signalling their preference for a broadly stable path for rates rather than an extended period of further rate hikes followed shortly thereafter by a series of rate cuts, as was previously priced into the swap market. So, if the MPC increases interest rates tomorrow, we would expect its policy statement to be more dovish and, like the ECB, signal that Bank Rate has probably reached its peak for the current tightening cycle.

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.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		EU-27 new car registrations Y/Y%	Aug	**21.0**	-	15.2	-
		Construction output M/M% (Y/Y%)	Jul	**0.8 (1.0)**	-	-1.0 (-0.3)	-1.2 (-0.8)
Germany		PPI Y/Y%	Aug	**-12.6**	-12.5	-6.0	-
UK		CPI (core) Y/Y%	Aug	**6.7 (6.2)**	*7.1 (6.7)*	6.8 (6.9)	-
		PPI output (input) Y/Y%	Aug	**0.2 (-2.3)**	-0.6 (-2.6)	-0.8 (-3.3)	-0.7 (-3.2)
		House price index Y/Y%	Jul	**0.6**	-	1.7	1.9
Auctions							
Country		Auction					
- Nothing to report -							

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		15.00	European Commission preliminary consumer confidence	Sep	-16.5	-16.0
France		07.45	INSEE business (manufacturing) confidence	Sep	98 (95)	99 (96)
		-	Bank of France retail sales Y/Y%	Aug	-	-2.1
UK		07.00	PSNB (excl. banks) £bn	Aug	9.8 (11.0)	3.5 (4.3)
		12.00	Bank rate %	Sep	*5.50*	5.25
Auctions and events						
Euro area		23.45	ECB Chief Economist Lane scheduled to speak – 'Inflation and monetary policy in the euro area'			
France		09.50	Auction: 2.50% 2026 bonds			
		09.50	Auction: 2.75% 2029 bonds			
		09.50	Auction: 0.75% 2028 bonds			
		10.50	Auction: 0.10% 2029 index-linked bonds			
		10.50	Auction: 0.10% 2032 index-linked bonds			
		10.50	Auction: 0.10% 2038 index-linked bonds			
Spain		09.30	Auction: 2.8% 2026 bonds			
		09.30	Auction: 0.0% 2028 bonds			
		09.30	Auction: 0.5% 2031 bonds			
UK		12.00	BoE monetary policy announcement, summary and minutes published			
		12.00	BoE publishes Agents' summary of business conditions			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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