Euro wrap-up

Overview

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- Bunds made losses despite a larger-than-expected deterioration in euro area consumer confidence in September, while a French survey pointed to stable business conditions.
- As the BoE left interest rates unchanged, but maintained a tightening bias and announced an increase in the pace of reduction in its Gilt holdings, Gilts largely made losses.
- Friday will bring the flash September PMIs, along with figures for UK retail sales and consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.251	+0.003
OBL 2.4 10/28	2.758	+0.031
DBR 2.6 08/33	2.741	+0.045
UKT 3½ 10/25	4.811	-0.007
UKT 4½ 06/28	4.406	+0.030
UKT 3¼ 01/33	4.295	+0.087

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

Euro area

Euro area consumer confidence drops for second successive month to 6-month low

According to the Commission's flash estimate, euro area consumer confidence deteriorated for a second successive month in September. The drop of 1.8ppts was twice as large as last month and bigger than expected. And it left the index at a six-month low. Admittedly, it remains well above the range in the twelve months following the Russian invasion of Ukraine early last year. But it is also firmly below the long-run average, and at a level previously only reached during the first wave of Covid-19, euro crisis and global financial crisis. No detail was published with today's preliminary survey result. But while rising real disposable income should mean that households' financial situations are improving, with business surveys signalling rising recession risks, we suspect that confidence in the economic outlook has deteriorated and fear of unemployment has risen. And major purchase intentions are likely to have remained below the long-run average, consistent with very subdued private consumption.

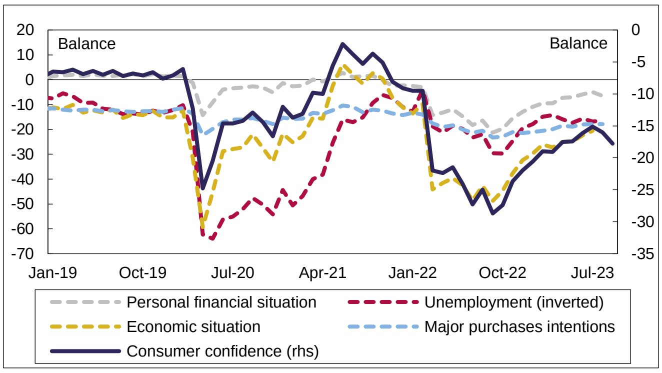
French INSEE business survey suggests stable conditions at end-Q3

French business surveys have provided mixed messages about the country's economic performance over the third quarter. Admittedly, they all suggest a loss of economic momentum in certain sectors over the summer, but to varying degrees. The French PMIs have been most downbeat, with the composite output index having been consistent with flat GDP growth in Q2 – a notable miss compared to the acceleration in actual GDP growth to 0.5%Q/Q – and signalling sharp contraction since June. While the Bank of France business surveys also signalled slowing recovery momentum over the spring and summer, the latest survey suggested some recovery in early September. And today's INSEE business survey suggested that conditions have been broadly stable throughout Q3. In particular, the headline business climate indicator moved sideways at the long-run average of 100 for a fifth consecutive month in September. Moreover, the employment climate index bucked the recent downwards trend in September, rising 2pts to a well above-average 104 amid an improvement in the services sector. So, while tomorrow's flash September PMIs are likely again to imply contraction, like the Bank of France, we maintain our view that French GDP grew between 0.1-0.2%Q/Q in Q3.

Improvement in manufacturing conditions offsets deterioration in retail sentiment

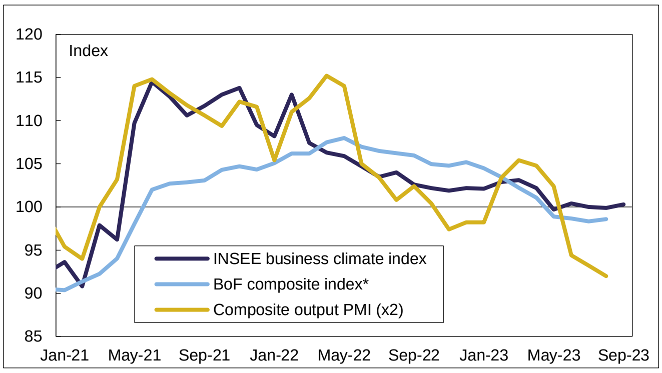
Within the INSEE survey detail, manufacturers were more upbeat in September, with the respective index up 2pts to 99. Admittedly, this was the second-lowest reading since February 2021, with firms reporting the steepest decline in output for more than three years. But manufacturers were also notably more upbeat about the outlook for production over the coming three months, with particular optimism in the autos subsector amid a pickup in orders. While the services index was

Euro area: Consumer confidence indices*



*Preliminary estimate for September 2023. Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

France: Business confidence indices



*Weighted average of BoF survey indices. Source: BoF, INSEE, S&P Global, Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

unchanged at an above-average 102, the business climate differed significantly among the various subsectors. Indeed, an improvement in real estate and road freight services was offset by a notable deterioration in expected demand in hospitality, with the respective index back below the long-run average for the first time since January 2022. While the construction sector index reversed the modest increase in August, at 105 it remained comfortably above the long-run average. But having reported a marked improvement in conditions at the start of the third quarter, retailers were a touch less upbeat in September, with the headline index down for a second successive month, by 2pts to 103. And today's Bank of France retail survey was particularly downbeat, suggesting that retail sales fell 1.2%M/M in August, amid weaker spending on clothing and footwear, consumer electronics, furniture and household appliances. This left retail sales down 4.0%Y/Y and trending some 0.6% below the Q2 average.

The day ahead in the euro area

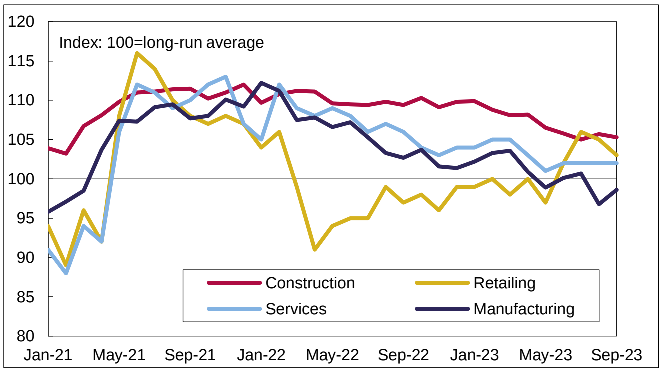
A key focus tomorrow will be the flash PMI results for September, which are expected to show little improvement from the weakness recorded in August. Indeed, the euro area's headline composite output PMI (46.7) fell in August to its lowest level since the second Covid-19 wave in November 2020. The German (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. Having ticked slightly higher in August, developments in the price PMIs will also be watched. Friday will also bring updated Q2 national accounts figures from Spain and the Netherlands. Previous estimates showed GDP rising a solid 0.4%Q/Q in Spain, but contracting 0.3%Q/Q in the Netherlands.

UK

BoE pauses tightening cycle but 5-4 vote on MPC illustrates finely balanced nature of decision

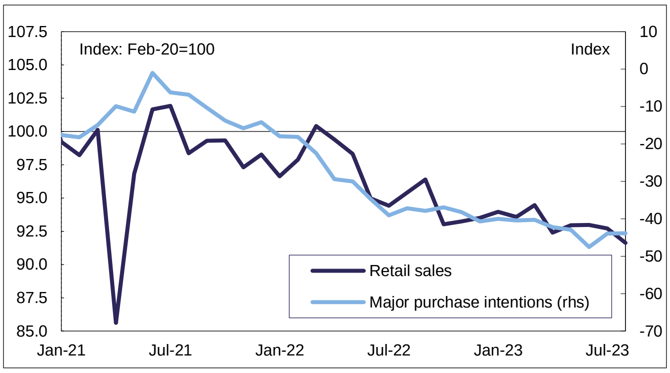
Given the significant surprises in the recent UK economic data, today's BoE interest rate decision had looked increasingly finely balanced as the meeting approached. In the event, the MPC voted to keep Bank Rate unchanged at 5.25%, representing the first pause since the tightening cycle began in late 2021. But the very close-run nature of the decision was reflected in the MPC's vote, with four out of nine members having supported a further rate hike of 25bps. With three of those four dissenting members being external representatives, the decision to pause relied on the backing of four of the five members from its own staff, including Governor Bailey. The perennially dovish Dhingra was the only external member to support today's rate decision. And we suspect that at least one of the Bank staff voting for the pause – Deputy Governor Ramsden – might not have taken much persuasion to have voted for another hike. Indeed, like the Fed yesterday, the

France: INSEE business confidence indices



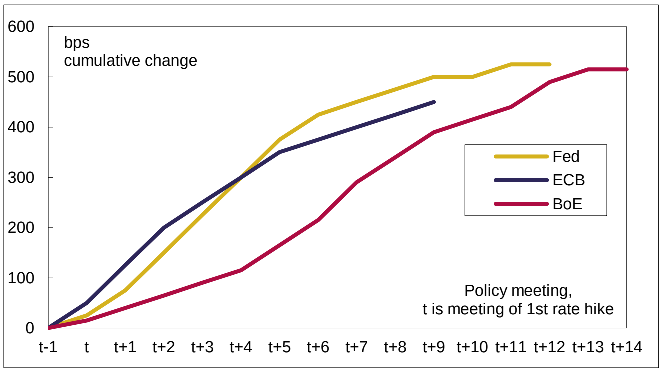
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

France: Retail sales & purchase intensions indices



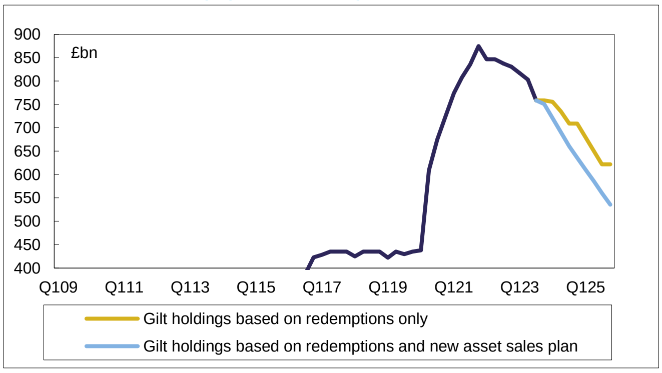
Source: BoF, INSEE, Refinitiv Datastream, Bloomberg and Daiwa Capital Markets Europe Ltd.

BoE, ECB & Fed: Cumulative tightening cycle



Source: BoE, ECB, Fed, Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Outstanding gilt holdings by the BoE



Source: BoE and Daiwa Capital Markets Europe Ltd.

Committee's policy statement retained a tightening bias, repeating the message from previous meetings that "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressure". And, echoing the ECB last week, the Committee insisted that "Monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term".

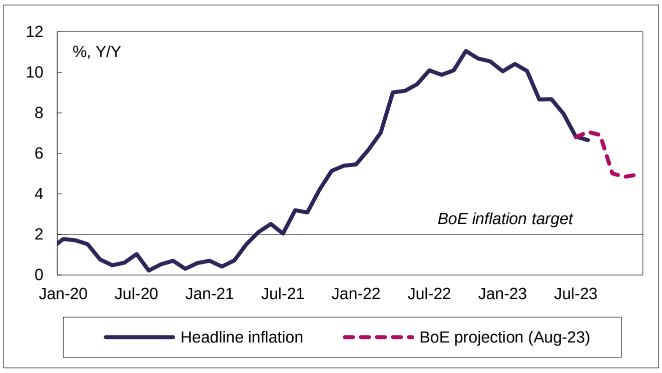
Recent data largely softer than BoE expected, underscoring that policy stance is now restrictive

The MPC's statement flagged the significant softening in several recent key indicators which suggested that its August projections were already out of date. For example, given the 0.5%M/M drop in GDP in July and soft economic surveys, Bank staff had revised down their forecast for GDP in Q3, by 0.3ppt to 0.1%Q/Q in line with our own projection. The statement also noted that inflation had slowed further than it had forecast last month. While core goods inflation had been much weaker than expected, the MPC also noted that services inflation – to which it has attached most weight – had also been below forecast. And the statement also flagged further signs of loosening in the labour market, and that the unemployment rate had risen above the Bank's expectation. Indeed, while average weekly earnings growth had recently been above-forecast, the MPC appeared to raise doubts about the reliability of those data, noting that they had been inconsistent with other recent signals on pay such as survey indicators and settlements. Overall, therefore, the MPC saw increasing evidence that the 515bps of cumulative monetary tightening to-date has been materially impacting the labour market and arresting growth momentum, reinforcing last month's judgement that the policy stance is now restrictive.

Bank Rate now likely at peak for the cycle but rate cuts unlikely before Q324

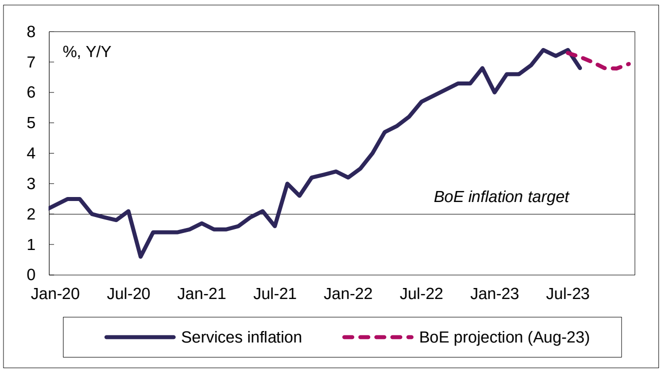
While the MPC maintained its tightening bias, the terminal Bank Rate for the cycle now looks highly likely to have been reached. Its forecasts published last month had already suggested that inflation was expected to return to target by mid-2025 even if rates were hiked no further. And when the MPC next meets in November, the BoE is likely to revise down its near-term projections for both GDP and inflation, and revise up its near-term profile for unemployment. Moreover, by then, the only Bank staff member of the Committee to vote for a hike today – Deputy Governor Cunliffe – will have been replaced on the MPC by incoming Deputy Governor Sarah Breeden, who we suspect might initially be more reluctant to vote against her colleagues. However, today's decision not to raise rates further will be more supportive of economic growth and inflation than a further hike. So, we still think that broad stagnation in GDP is more likely over the near term than recession. And while headline inflation is bound to take a significant step down in October due to the cut in the regulated household energy price cap, the core measure will remain elevated by historical standards throughout the first half of next year. So, the easing cycle is unlikely to come for several quarters. In the absence of new shocks, and in line with current market pricing, we expect the

UK: CPI inflation vs BoE forecast



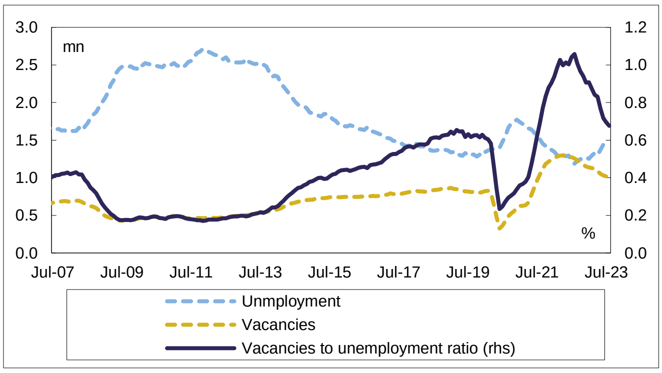
Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Services inflation vs BoE forecast



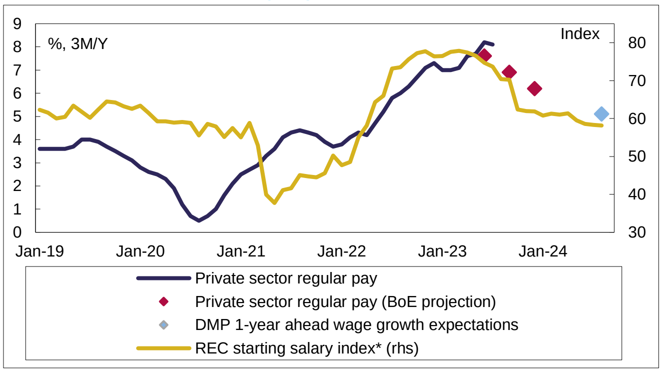
Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Vacancy-unemployment ratio



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Indicators of wage growth



**Permanent staff, 12-month lead. Source: BoE, REC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

first rate cut to come in Q324, when core inflation should fall below 3.0%Y/Y and the 2.0% inflation target – which we currently expect to be met in Q125 – should be firmly within sight.

BoE to accelerate reduction in its gilt holdings without materially increasing active sales

Meanwhile, in terms of quantitative tightening, the MPC agreed unanimously to step up the pace of reduction in its Asset Purchase Facility gilt holdings. As expected, it decided to accelerate the pace of gilt stock reduction from about £80bn over the past year to £100bn over the coming twelve months. With more of its gilt holdings set to mature over the coming twelve months than over the past year, the pace of active gilt sales will be kept broadly steady. And given the reduction of more than £18bn in the BoE's stock of corporate bonds over the past twelve months, to just £642mn, the MPC noted that the overall reduction in its APF asset holdings had already been close to £100bn. So, it expects the faster pace of gilt sales to be absorbed without any adverse impact on market functioning.

The day ahead in the UK

It will be a busy end to the week for top-tier UK economic releases. Like in the euro area, one focus will be on the preliminary PMIs for September, 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. The price PMIs will also likely signal a further moderation in inflationary pressures in September. The CBI's industrial trends survey will also offer an update on conditions in the manufacturing. Tomorrow 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 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/ *Daiwa forecast*	Previous	Revised
Euro area	European Commission preliminary consumer confidence	Sep	**-17.8**	-16.5	-16.0	-
France	INSEE business (manufacturing) confidence	Sep	**100 (99)**	98 (95)	99 (96)	100 (97)
	Bank of France retail sales Y/Y%	Aug	**-4.0**	-	-2.1	-1.8
UK	PSNB (excl. banks) £bn	Aug	**10.8 (11.6)**	9.8 (11.1)	3.5 (4.3)	-1.2 (-0.4)
	Bank Rate %	Sep	**5.25**	*5.50*	5.25	-

Auctions

Country	Auction
France	sold €4.70bn of 2.50% 2026 bonds at an average yield of 3.27%
	sold €2.79bn of 0.75% 2028 bonds at an average yield of 3.12%
	sold €3.51bn of 0.75% 2029 bonds at an average yield of 3.14%
	sold €651mn of 0.10% 2029 index-linked bonds at an average yield of 0.57%
	sold €609mn of 0.10% 2032 index-linked bonds at an average yield of 0.58%
	sold €488mn of 0.10% 2038 index-linked bonds at an average yield of 0.82%
Spain	sold €2.59bn of 2.8% 2026 bonds at an average yield of 3.527%
	sold €1.98bn of 0.0% 2028 bonds at an average yield of 3.426%
	sold €1.73bn of 0.5% 2031 bonds at an average yield of 3.591%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		09.00	Preliminary manufacturing (services) PMI	Sep	44.0 (47.6)	43.5 (47.9)
		09.00	Preliminary composite PMI	Sep	46.5	46.7
Germany		08.30	Preliminary manufacturing (services) PMI	Sep	39.5 (47.1)	39.1 (47.3)
		08.30	Preliminary composite PMI	Sep	44.7	44.6
France		08.15	Preliminary manufacturing (services) PMI	Sep	46.1 (46.0)	46.0 (46.0)
		08.15	Preliminary composite PMI	Sep	46.0	46.0
Spain		08.00	Final GDP Q/Q% (Y/Y%)	Q2	*0.4 (1.8)*	0.5 (4.2)
UK		00.01	GfK consumer confidence	Sep	-26	-25
		07.00	Retail sales including auto fuels M/M% (Y/Y%)	Aug	0.5 (-1.2)	-1.2 (-3.2)
		07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Aug	0.7 (-1.3)	-1.4 (-3.4)
		09.30	Preliminary manufacturing (services) PMI	Sep	43.2 (49.4)	43.0 (49.5)
		09.30	Preliminary composite PMI	Sep	48.7	48.6
		11.00	CBI industrial trends, total orders (selling prices)	Sep	-17 (-)	-15 (8)
Auctions and events						
Euro area		12.00	ECB's de Guindos scheduled to speak			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.