Euro wrap-up

Overview

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- Bunds followed USTs lower even as the account of the Governing Council's September policy meeting suggested that the ECB tightening cycle is now highly likely to be at an end.
- While UK GDP data for August met expectations to be consistent with stagnation in Q3, and surveys reported a continued tightening of credit conditions and weakening in the housing market, Gilts also made losses.
- Friday will bring euro area industrial production figures for August and final French and Spanish inflation data for September, while ECB President Lagarde and BoE Governor Bailey will speak publicly.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.142	+0.062
OBL 2.4 10/28	2.708	+0.058
DBR 2.6 08/33	2.782	+0.068
UKT 3½ 10/25	4.820	+0.072
UKT 4½ 06/28	4.457	+0.090
UKT 3¼ 01/33	4.419	+0.098

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

Euro area

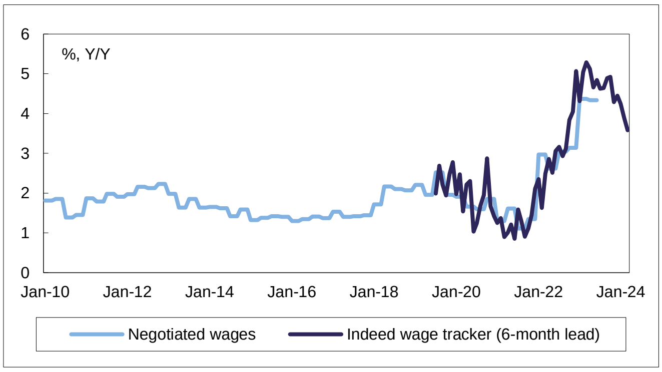
ECB account highlights that September rate hike was a "close call"

While some hawks on the ECB's Governing Council continue to flag the possibility of tightening to come, today's account of the September monetary policy meeting, when the deposit rate was hiked by a further 25bps to 4.00%, should reinforce expectations that rates have now reached the peak for this cycle. Among other things, the account reported that "comfort was drawn" from the fact that core inflation was no longer surprising to the upside, and that the overall process of disinflation appeared to be proceeding largely as expected. There were also greater concerns about the deterioration in the economic outlook, with explicit recognition that the euro area economy was "flirting with recession". It was noted that the effects of past monetary policy tightening could still increase over time and extend well beyond 2025. And so, it was acknowledged that "the risks of tightening too much and tightening too little had become more balanced". Indeed, most notably perhaps, the account recounted that "a range of model-based simulations suggested that a deposit facility rate in the region of 3.75% to 4.00%... should be consistent with a return of inflation to target within the projection horizon." And it stated that "members highlighted that the decision between raising rates and pausing was a close call".

Doves warned of overtightening while wage tracker points to moderation in labour cost pressures

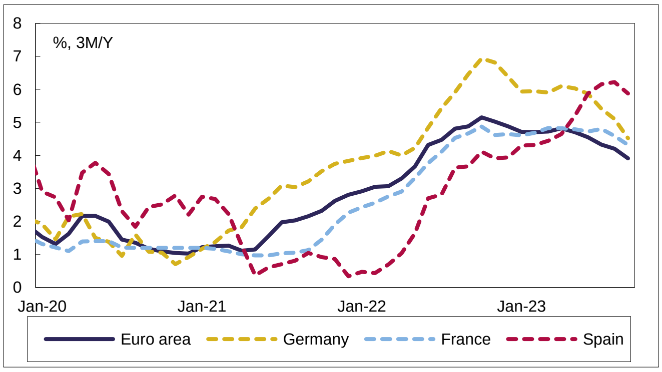
Ultimately, a "solid majority" of members of the Governing Council supported last month's 25bps rate hike. Among other things, they were concerned about the upwards revision to the ECB's near-term inflation forecast, which was largely due to higher oil prices. Being still preoccupied with second-round effects from the persistence of above-target inflation, they worried that additional supply shocks might translate into higher inflation expectations. And they fretted that evidence of a moderation in wage growth would not be available before next spring. However, the dovish minority argued that the data available since July had already strongly suggested that unchanged policy was appropriate. And additional information published since the meeting – including this week's Indeed wage tracker indices for September, presented in the charts below, which strongly suggested that pay growth is already moderating and that the ECB's forecast of employee compensation in 2024 could well be too high – will reinforce their case. Strikingly, today's account also reported that the doves warned last month that further tightening risked repeating the error of 2011 when rate increases had to be quickly reversed as the deterioration of the economic outlook became apparent as the euro crisis unfolded. While we still expect a modest recovery in euro area economic activity to get underway in the New Year, we sympathise with their concerns. And we think that view will also be more widely shared on the Governing Council at the next policy meeting in a fortnight.

Euro area: Negotiated wages & Indeed wage tracker



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

Euro area: Indeed wage tracker



Source: Indeed and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

The euro area economic data calendar concludes tomorrow with the release of euro area industrial production figures for August. Data published so far by member states have been mixed, with modest increases in Germany and Italy, while output fell in France, Span and the Netherlands. Nevertheless, given the sizeable increase in Ireland (+6.1%M/M), overall euro area IP is likely to rise around 0.4%M/M in August, albeit only partially reversing the drop of 1.1%M/M in July. Meanwhile, final French and Spanish HICP numbers are likely to align with the flash estimates that suggested a slight easing by 0.1ppt to 5.6%Y/Y and an increase of 0.8ppt to 3.2%Y/Y respectively. Beyond the economic data, ECB President Lagarde will speak publicly on a panel at the IMF annual meetings.

UK

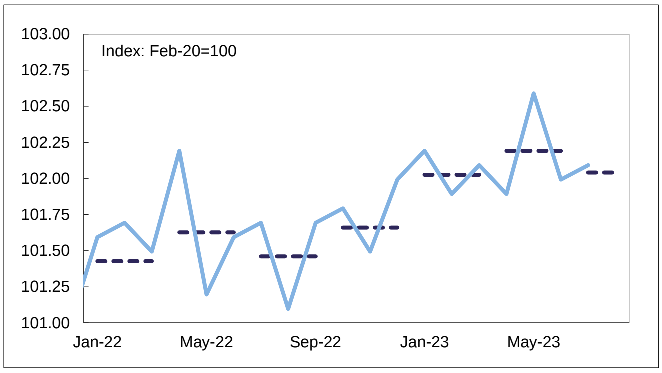
GDP rises in August, but on track for a modest contraction in Q3

In line with expectations, the UK's economy recovered somewhat in August following the weather-associated weakness in July. In particular, GDP rose 0.2%M/M, to leave it up 0.3%3M/3M – the strongest such growth for four months – and 0.5% higher than a year earlier. Moreover, the level of economic output is now estimated to be more than 2% above the pre-pandemic benchmark in February 2020. But the appearance of an improving trend is exaggerated by the weather-assisted strong manufacturing and construction performance in June. Indeed, given the steeper-than-previously-estimated decline in July, the level of GDP is currently trending so far in Q3 0.15% below the Q2 average. As such, in the absence of revisions, economic activity will need to rise by 0.3%M/M or more in September to avoid a contraction last quarter. And with economic surveys, including the PMIs, suggesting a further decline in activity that month, risks to the BoE's forecast for growth of 0.1%Q/Q appear skewed to the downside.

Services activity boosted by reduced strike action, but manufacturing and construction a drag

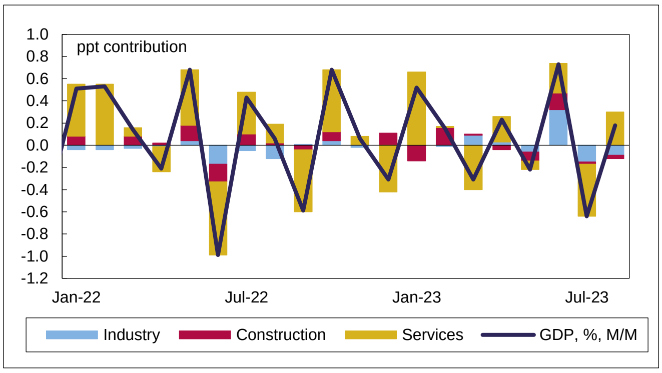
The rebound in August was led by services, where activity increased 0.4%M/M to provide the only positive contribution to GDP growth of the major sectors. Activity benefited from reduced strike action in the education and healthcare sectors, while computer programming and consultancy, as well as retailing, also provided support to services output that month. But having risen sharply in July, output from the arts, entertainment and recreation subsector provided the largest negative contribution in August, albeit still trending some 3% above the Q2 average. Sport and amusements also reported payback for a spike in July. And despite some support from accommodation services, activity in the consumer-facing sectors was down 0.6%M/M,

UK: GDP level*



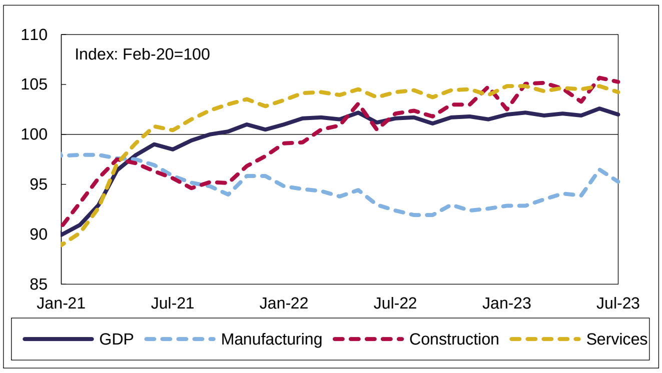
*Dashed line represents quarterly averages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly GDP growth



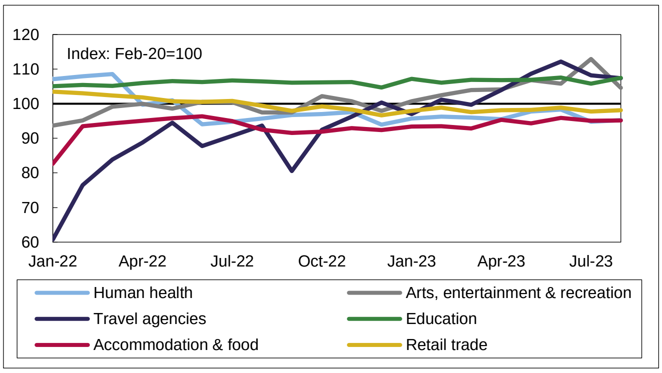
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Economic output by sector



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Services output by selected subsector



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

to be still more than 4½% below the pre-pandemic level. Overall, total services activity was trending some 0.2% below the Q2 average. Meanwhile, despite a pickup in production of transport equipment after breaks for maintenance, manufacturing output fell for a second successive month (-0.8%M/M), with 9 out of the 13 subsectors reporting a decline. Construction also slipped further (-0.5%M/M), with anecdotal evidence suggesting that heavy rainfall and lower-than-average temperatures delayed plans. Indeed, new private commercial work and house-building remained particularly weak, with the latter down around 15%Y/Y. Admittedly, given the positive carry over from the strength at the end of Q2, manufacturing and construction were still up 1.7%3M/3M and 0.9%3M/3M respectively. And while certain sectors – in particular retail – look to have been negatively impacted by the unseasonably warm weather in September, others – including construction – will likely have benefitted. Overall, we now anticipate zero growth in Q3 and see a non-negligible risk that the UK's economy contracted.

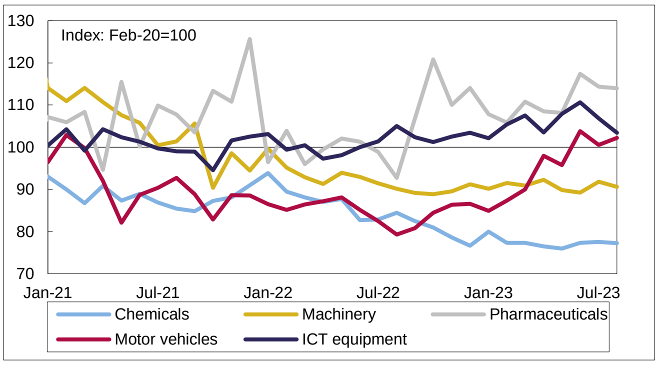
Net trade on track to provide a welcome boost to GDP growth in Q3 despite deterioration in August

Today's figures also reported that the UK's trade deficit widened in August, by a larger-than-expected £2bn to £3.4bn, the second biggest so far this year. The deterioration in part reflected a decline in the value of exports (-1.6%M/M) amid a notable drop in the shipments of goods to non-EU countries. When adjusting for the highly volatile precious metals items, exports were down a more modest 0.6%M/M, albeit reaching their lowest level since June 2022. The widening of the deficit also reflected the first increase in the value of imports (+1.1%M/M) for three months due not least to higher oil prices. Indeed, when adjusting for price shifts, import volumes were down for a third successive month (-0.3%M/M), to be trending so far in Q3 some 1.0% below the Q2 average. So, despite a drop in export volumes (excluding precious metals) in August of 1.5%M/M to suggest that exports remain on track for a modest contraction last quarter (-0.3% compared with the Q2 level), today's figures imply that net trade might have provided a boost to GDP growth in Q3 for the first quarter in four.

Banks expect demand for secured lending to fall further in Q4 as default rates rise to 14-year high

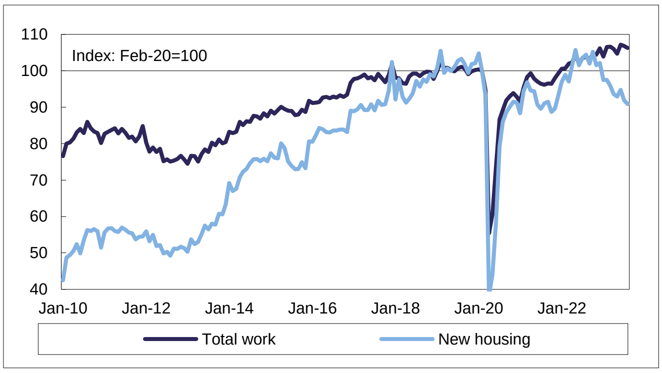
The results of the BoE's quarterly Credit Conditions Survey illustrated the dampening impact of the MPC's aggressive rate-hike cycle on the demand for and supply of bank loans. Given not least the lacklustre economic outlook, weakening expectations for house prices and tightening of wholesale funding conditions, the survey suggest that banks once again reduced the availability of credit in the three months to end-August. While the respective net balance of mortgage loan supply moderated (-20.1), it still marked the sixth negative balance out of the past seven quarters and was well below the long-run average to its third-lowest level since the global financial crisis. And lenders expected the availability of secured credit to fall again in the three months to November, albeit at a more moderate pace, likely compounding the challenges in the residential property market. Indeed, amid the surge in borrowing costs over the summer, today's survey suggested a significant slump in demand for secured lending in the three months to August, with the net decline (-54.9) the fourth

UK: Manufacturing output by selected subsector



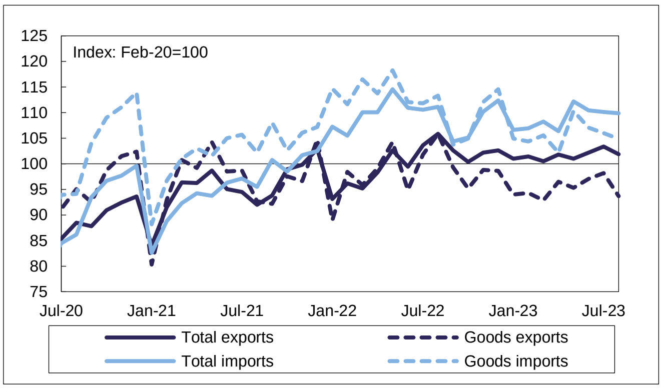
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Construction output



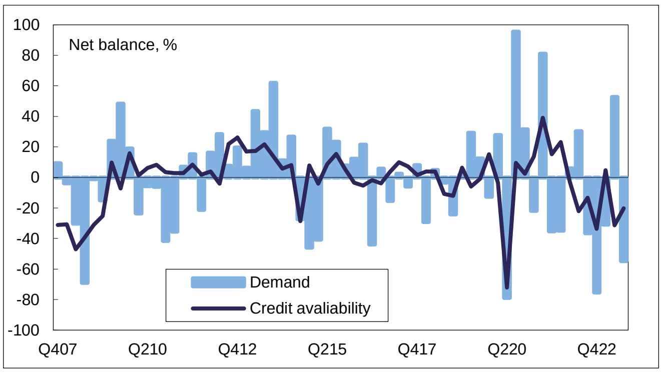
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Import and export volumes



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Demand & availability of mortgage loans



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

steepest since the series began in 2007. Although mortgage rates have started to moderate and the BoE appears to have completed its tightening cycle, banks expect demand to fall further in Q4. And with the value of mortgages in arrears as a share of total loans in Q2 (1.02%) having risen to its highest since 2018, lenders reported in today's survey that default rates rose to their highest level since the global financial crisis and were expected to rise further in Q4.

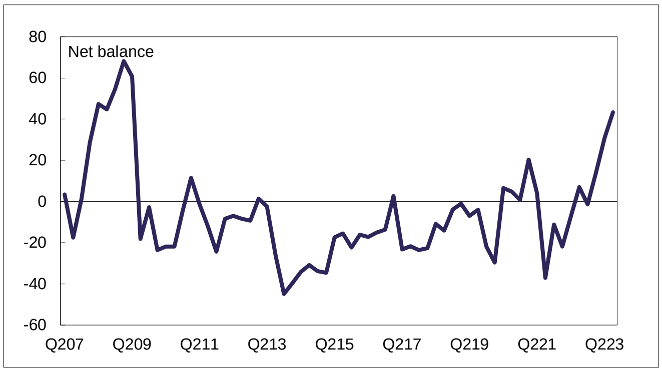
Survey suggests steepest drop in house prices since global financial crisis

Certainly, the findings from the latest RICS residential survey pointed to still very weak housing market conditions in September. Admittedly, the shares of surveyors indicating falling new buyer enquires, vendor instructions and agreed sales all eased slightly. But the respective balances still remained historically low. And the survey's headline price balance fell further in September, by 2ppts to -69%, the lowest since February 2009. While surveyors were slightly less downbeat about price expectations for the coming year, they remained firmly in negative territory over both a three- and twelve-month horizon at -48% and -33% respectively, maintaining the possibility of an eventual double-digit peak-to-trough percentage decline in house prices. Indeed, while the Nationwide house price index has already dropped more than 5% from the peak, affordability remains stretched by historical standards. And with signs consumer confide still subdued and the jobs market deteriorating, we see little chance of a marked revival in the residential market over coming quarters.

The day ahead in the UK

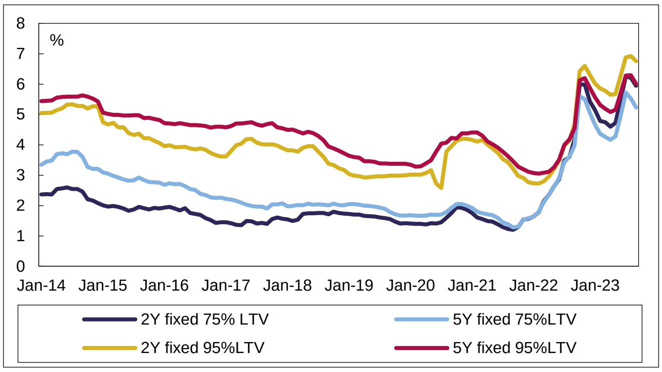
There are no top-tier UK economic data scheduled for release tomorrow, but BoE Governor Bailey will speak publicly.

UK: Change in lenders' mortgage default rates



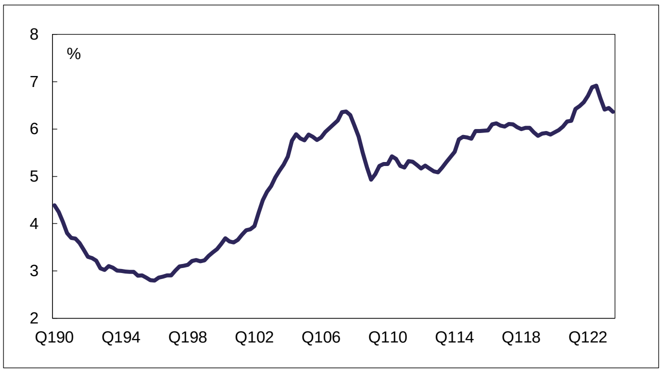
Source: BoE Credit Conditions Survey and Daiwa Capital Markets Europe Ltd.

UK: Average mortgage interest rates



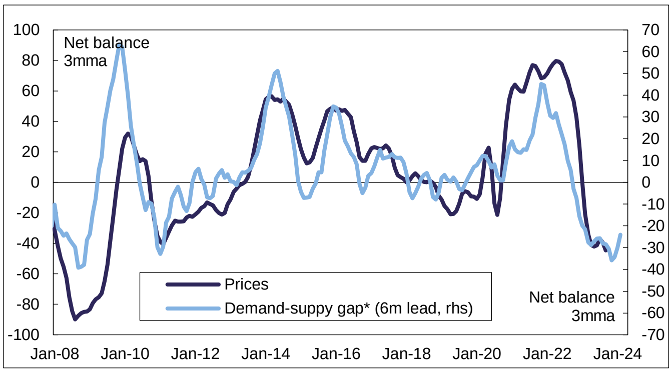
Source: BoE, Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: House price to earnings ratio



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

UK: RICS housing price indicators



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

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK		RICS house price balance %	Sep	**-69**	-60	-68	-
		GDP M/M% (3M/3M%)	Aug	**0.2 (0.3)**	0.2 (0.3)	-0.5 (0.2)	-0.6 (0.1)
		Industrial production M/M% (Y/Y%)	Aug	**-0.7 (1.3)**	-0.1 (1.7)	-0.7 (0.4)	-1.1 (1.0)
		Manufacturing production M/M% (Y/Y%)	Aug	**-0.8 (2.8)**	-0.3 (3.5)	-0.8 (3.0)	-1.2 (3.1)
		Index of services M/M% (3M/3M%)	Aug	**0.4 (0.1)**	0.3 (0.1)	-0.5 (0.1)	-0.6 (-0.1)
		Construction output M/M% (Y/Y%)	Aug	**-0.5 (2.3)**	0.0 (2.4)	-0.5 (2.8)	-0.4 (3.2)
		Total (goods) trade balance £bn	Aug	**-3.4 (-16.0)**	-3.7 (-15.0)	-3.4 (-14.1)	-1.4 (-13.9)

Auctions

Country		Auction
Italy		sold €2.75bn of 3.85% 2026 bonds at an average yield of 3.93%
		sold €2.75bn of 4.00% 2030 bonds at an average yield of 4.37%
		sold €1.50bn of 4.00% 2035 bonds at an average yield of 4.74%
		sold €1.00bn of 4.45% 2043 bonds at an average yield of 5.03%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Industrial production M/M% (Y/Y%)	Aug	*0.4 (-3.3)*	-1.1 (-2.2)
France		07.45	Final HICP (CPI) Y/Y%	Sep	*5.6 (4.9)*	5.7 (4.9)
Spain		08.00	Final HICP (CPI) Y/Y%	Sep	*3.2 (3.5)*	2.4 (2.6)

Auctions and events

Country		BST	Event
Euro area		14.00	ECB President Lagarde scheduled to speak
UK		09.00	BoE Governor Bailey scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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