Euro wrap-up

Overview

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- While the broad-based drop in euro area inflation in September was confirmed and construction output remained on track for a drop in Q3, Bunds followed USTs lower.
- Gilts underperformed as UK CPI inflation failed to fall in September.
- Thursday will bring the French INSEE business survey results for October.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.184	+0.011
OBL 2.4 10/28	2.830	+0.023
DBR 2.6 08/33	2.918	+0.039
UKT 3½ 10/25	4.969	+0.133
UKT 4½ 06/28	4.687	+0.155
UKT 3¼ 01/33	4.648	+0.140

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

Euro area

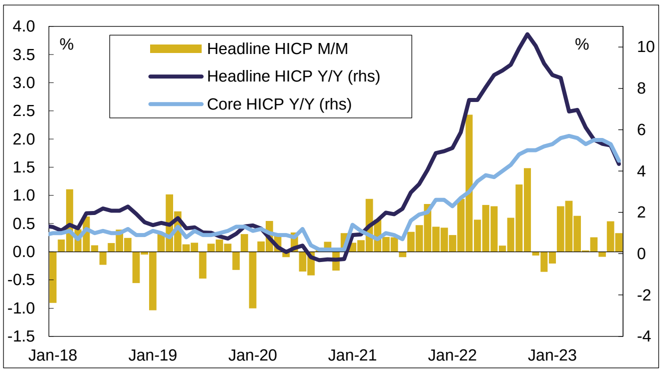
Euro area inflation confirmed at lowest level in almost two years

While a couple of weeks ago there had been a modest downside surprise in the euro area's flash inflation estimates for September, there were no surprises from today's final figures. Indeed, these confirmed that the headline inflation rate fell 0.9ppt on the month – the biggest since March – to 4.3%Y/Y, the lowest level since October 2021 and 6.3ppts below the peak last October. And this left headline inflation in Q3 at 4.9%Y/Y, a touch below the ECB's macroeconomic projection published last month. The moderation was principally led by Germany, which fell 2.1ppts to a two-year low of 4.3%Y/Y, as base effects from last year's discounted travel pass fell out of the calculation. But inflation also eased in thirteen other member states, with particularly hefty drops in the Netherlands, Belgium and Ireland, helping to offset modest increases in Italy and Spain, while inflation moved sideways in France. Encouragingly, with the respective rates falling back in seventeen out of the twenty member states, euro area core inflation fell in September by 0.8ppt – matching the biggest drop on the series – to a twelve-month low of 4.5%Y/Y, leaving the quarterly rate in Q3 (5.1%Y/Y) similarly 0.1ppt below the ECB's forecast.

Base effects in transport services played key role, but easing price pressures were broad based

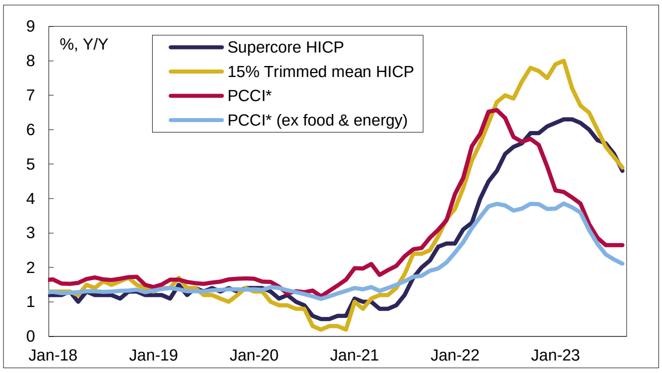
As in the preliminary release, the largest negative contribution to the decline in headline inflation related to services, with prices down 0.9%M/M, the most in three years and a steeper decline than average for the month of September. That pushed the respective annual rate down 0.8ppt to an eight-month low of 4.6%Y/Y. The weakening in services inflation was principally driven by the aforementioned base effects in transport services, for which inflation fell a hefty 56ppts to -16.1%Y/Y, despite a pickup in airfares likely related to higher oil prices. But while package holiday inflation also ticked higher, the annual rates of increase in restaurant and accommodation prices fell to their lowest since early 2022. Tallying with recent declines in producer prices, weak demand and reduced supply disruptions supported a further easing in core goods inflation to a sixteen-month low of 4.2%Y/Y, with a moderation in price pressures reported across various components including cars, household appliances and clothing. With the rise in food, alcohol and tobacco prices also below the monthly norm for the first time in two years, the respective annual rate also fell to its lowest level in sixteen months, at 8.8%Y/Y. And despite increased prices of auto fuel, base effects associated with the sharp increase in household electricity and gas bills a year earlier meant that energy inflation slowed 1.3ppt to -4.6%Y/Y.

Euro area: HICP inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



**Persistent and common component of inflation. Source: ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

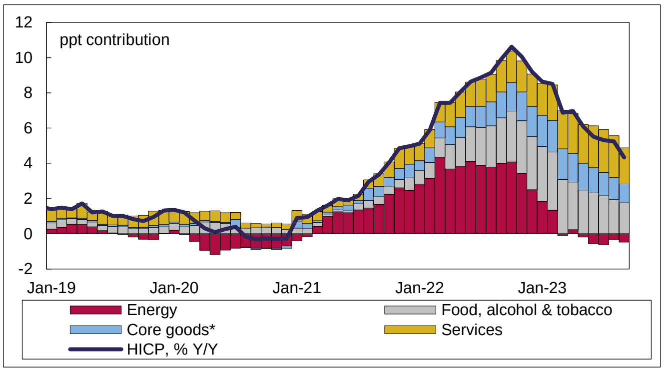
Inflation now rising for fewer than one quarter of items in the inflation basket

Notwithstanding the significant role of base effects in September’s headline rate, recent momentum in services inflation has improved markedly, with the 3M/3M annualised rate down 1.3ppts on the quarter to 4.0% in Q3, the lowest in more than a year. And while momentum in core goods edged slightly higher – up 0.3ppt on the same basis to 3.1%3M/3M annualised – this was still down more than 5ppts from its peak a year earlier. Other measures of underlying price pressures showed further improvement too. The 15% trimmed mean HICP rate fell 0.3ppt to a nineteen-month low of 4.9%Y/Y, while the supercore measure of the most output gap-sensitive items edged down 0.3ppt to a fifteen-month low of 5.3%Y/Y. The share of items in the HICP basket with inflation above 2% fell to the lowest in over a year, albeit still lofty at 82%. And the share of items with increasing inflation fell to just 24%. While the ECB’s model-based measure of persistent and common component of inflation (PCCI), which the Governing Council believes can provide one of the most reliable guides to future inflation, was unchanged for a third consecutive month above levels consistent with the inflation target at 2.6%Y/Y, core PCCI (excluding energy and food) fell 0.1ppt to 2.1%Y/Y, the lowest since December 2021. With price movements now more closely in line with seasonal norms, we expect core inflation to fall further over coming months, to below 4.0%Y/Y by year-end. Energy price base effects will remain a significant drag in October and November too, not least reflecting last year’s spike in Italian regulated energy prices. And the food component will continue to fall steadily too. So, while there remain plenty of uncertainties to both sides, we see the risks to the ECB’s HICP forecast of 3.3%Y/Y in Q4 as skewed to the downside. And in the absence of major new shocks, our baseline projection currently foresees a return to the 2% target around next summer.

Construction activity fell back in August, with the near-term outlook for the sector unfavourable too

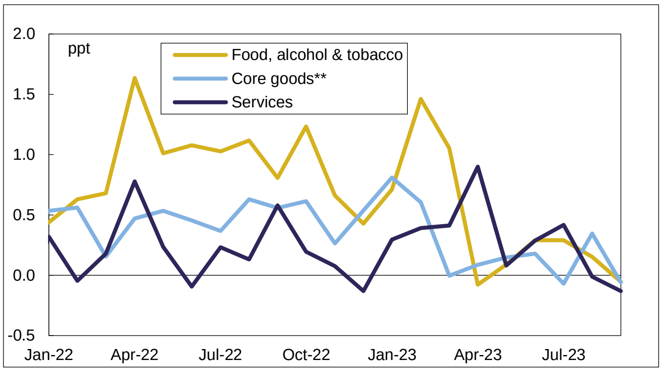
The weakness in the economic backdrop was illustrated by today’s euro area construction output figures, which saw activity in the sector drop 1.1%M/M in August. This more than reversed the upwardly revised increase reported in July to leave output at its lowest level since December, broadly unchanged compared with a year earlier and trending some 0.3ppt below the Q2 average. The deterioration in August was broad based with building work down for a second month out of three (-0.7%M/M), while civil engineering declined (-2.1%M/M) by the most since December. Among the member states to publish data, the contraction was led by Germany (-2.4%M/M) and France (-1.5%M/M). The Commission survey suggested that weather played a factor in the weakness in August. But given the uncertain economic outlook, higher borrowing costs and declining house prices, the near-term outlook remains extremely weak, particularly for residential building. Indeed, despite edging higher in September, the housing construction PMI (39.4) implied ongoing significant contraction at the end of Q3.

Euro area: HICP inflation & contributions



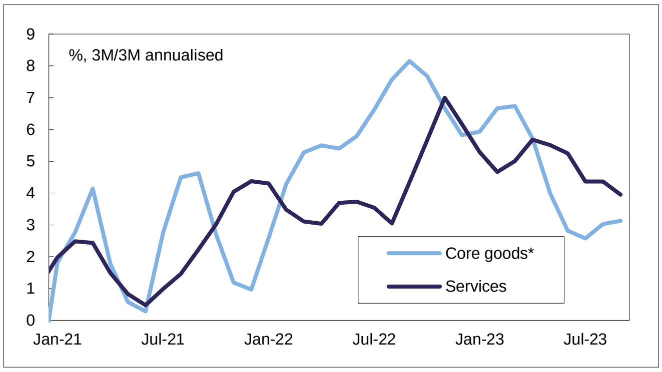
*Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Deviations from long-run price change*



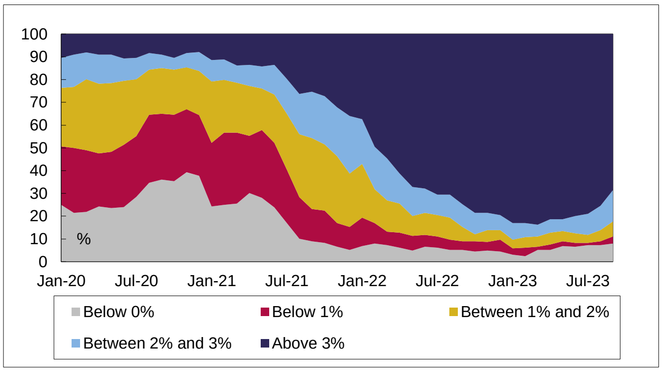
*Monthly change in prices compared to average for the month in the decade ahead of the pandemic. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Services & core goods momentum



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

Euro area: Share of HICP basket by inflation



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

And while the Commission confidence index for the sector remained above the long-run average, it fell in September to its lowest since November 2020, with order books at their smallest for more than three years and the share of firms reporting demand as a limiting factor on activity the highest for more than six years. Furthermore, with euro area building permits down almost one quarter from the peak in March 2022 to the lowest since mid-2016 (when excluding the first Covid lockdown), and residential permits down by almost a third on the same basis, construction activity looks highly likely to subtract from GDP growth well into 2024.

The day ahead in the euro area

Tomorrow will bring an update on French economic conditions at the start of Q4 with the release of the INSEE business sentiment survey for October. Having moved sideways at the long-run average (100) in the previous five months, the headline index is expected to have edged slightly lower in October, by 1pt to 99, which would mark the lowest reading since April 2021. It would still, however, be consistent with broadly stable conditions and mildly positive growth.

UK

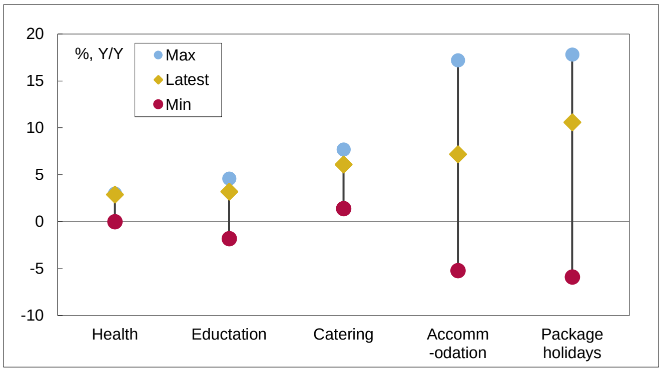
CPI inflation sticky in September due principally to higher fuel prices

In line with our forecast, but just above the Bloomberg consensus expectation, headline CPI inflation was unchanged in September at the prior month's 18-month low of 6.7%Y/Y. That, however, was still 0.2ppt below the BoE's Monetary Policy Report projection for September. And the principal reason for the stickiness of inflation last month was higher prices of petrol, which increased 3.4%M/M in response to shifts in global crude oil prices. Given the fall in such prices a year earlier, motor fuel inflation rose a hefty 6.7ppts to a five-month high (-9.7%Y/Y). And overall energy inflation rose 3ppts to a three-month high of -0.2%Y/Y. That impact was only partially offset by flat food prices in aggregate, including further falls in prices of certain staples reflecting recent developments in wholesale prices, as well as a drop in prices of non-alcoholic beverages on the month. Together, inflation of food and non-alcoholic drinks fell 1.5ppts to a fifteen-month low (12.1%Y/Y).

Core inflation slightly lower as goods price weakness more than offsets persistence in services

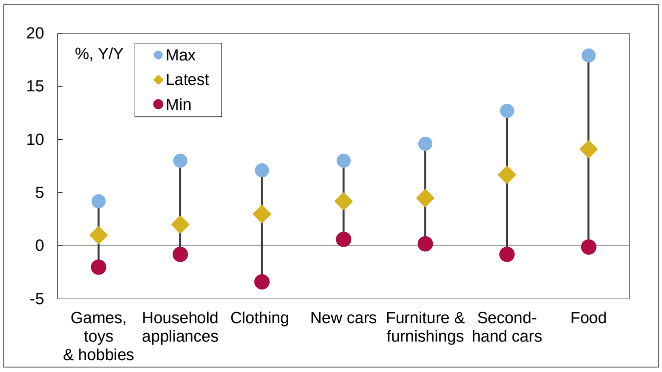
Within the core components, tallying with recent falls in producer output price inflation, and reflecting the improved supply-demand balance and diminished pass-through of past increases in costs of energy and other inputs, non-energy industrial

Euro area: Services inflation, selected components*



**Maximum and minimum inflation rates since January 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Euro area: Goods inflation, selected components*



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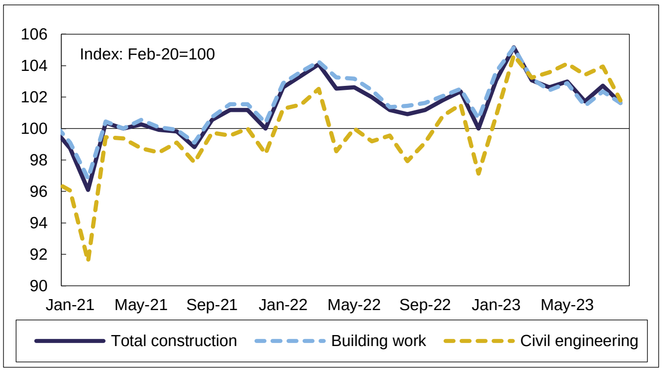
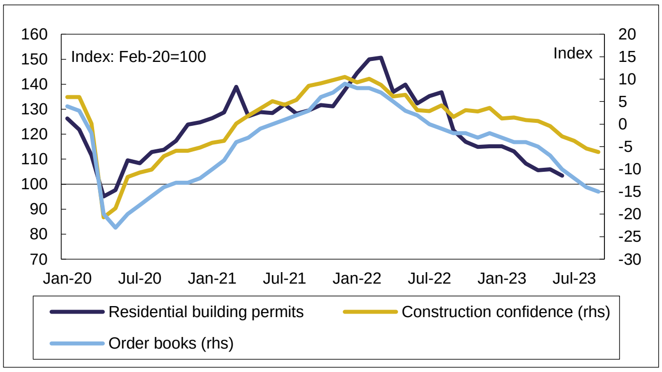
Euro area: Construction output



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Construction confidence, orders & permits



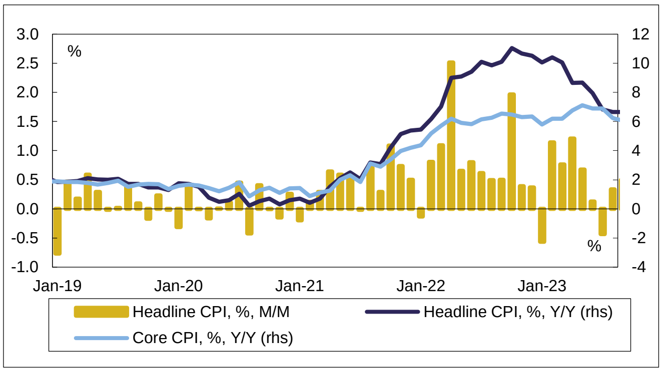
Source: Eurostat, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

goods prices rose significantly less than the average for the second successive month. So, core goods inflation fell for the fourth month in a row and by 0.5ppt to 4.7%Y/Y, the lowest in almost two years. Within this category, inflation of furniture and furnishings fell to a 2½-year low (3.3%Y/Y), some 13.5ppts down from the recent peak. New car inflation slowed 0.4ppt to an 18-month low of 4.0%Y/Y more than 3ppts below the recent peak. And the used car component dropped to a six-month low of -1.2%Y/Y. In contrast, however, a significant hike in private school and nursery fees at the start of the new school year (6.0%M/M), as well as smaller declines than a year ago in holiday-related components (hotels, airfares and package holidays) contributed to stickiness in services inflation. Indeed, with services prices rising 0.3%M/M in contrast to the declines that were the norm for September before the pandemic, the respective inflation component increased 0.1ppt to 6.9%Y/Y. That, however, was still 0.1ppt below the BoE's projection. So, like yesterday's labour market data, today's inflation figures should reinforce expectations that Bank Rate will not be hiked any further this cycle.

Despite oil price risks, inflation will take a big step down in October and fall further in H124

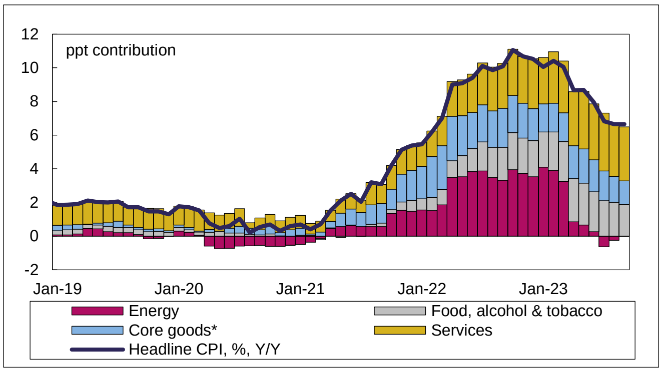
Looking forward, inflation is bound to drop sharply in October. Given events in the Middle East, the path of petrol prices remains highly uncertain. But the 7% cut in the regulated household energy price cap from the start of the month, coupled

UK: CPI inflation



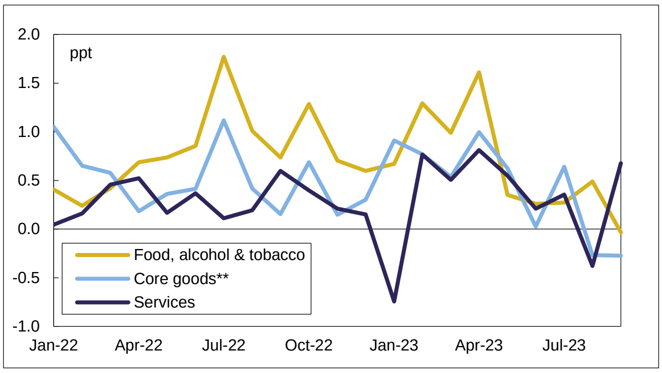
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation & contributions



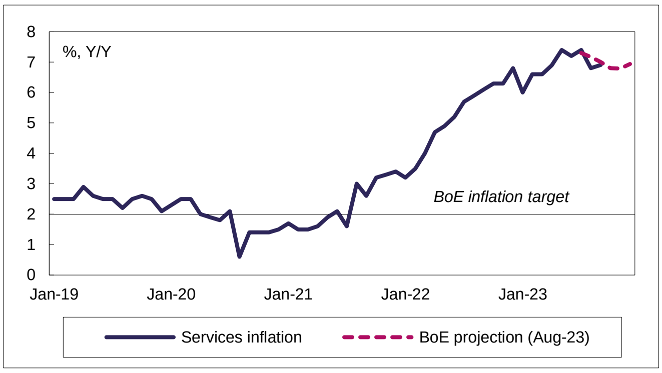
**Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Deviations from long-run average price change*



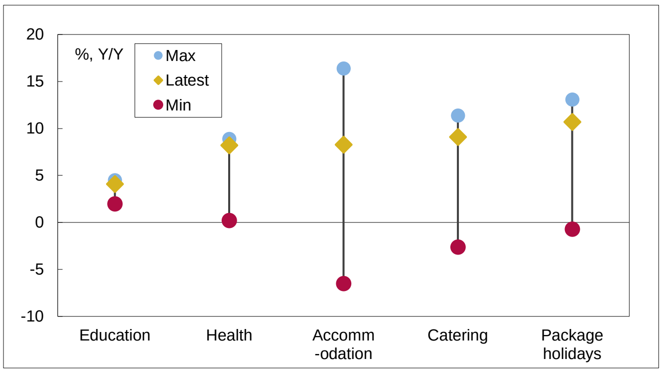
**Monthly change in prices compared to average for the month in the decade ahead of the pandemic. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Services inflation vs BoE projection



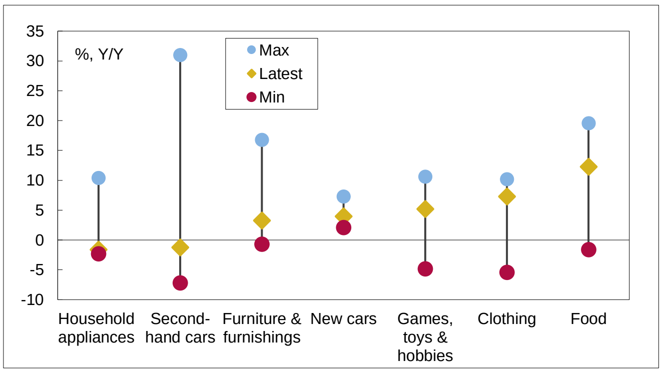
Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Services inflation, selected components*



**Maximum and minimum inflation rates since January 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Goods inflation, selected components*



**Maximum and minimum inflation rates since January 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

with the base effect associated with the sharp rise in electricity and gas bills a year earlier, means that the energy component should drop 15ppts or more. And that would subtract up to 1¼ppt from headline inflation. With producer output food prices falling for a fourth successive month in September, food CPI inflation should continue to decline steadily over coming months, while non-energy industrial goods prices should continue to rise no more than seasonal norms. In part due to still-high wage growth as well as pressures related to housing rents, indexation and other idiosyncrasies, increases in services prices will on average remain higher than the respective monthly averages ahead of the pandemic. And so, services inflation is likely to remain relatively sticky over coming months. However, it is likely to remain close to the path projected by the BoE in August, which averaged 6.8%Y/Y in Q4. Overall, we expect CPI inflation to fall to about 4¾%Y/Y in October and a little below that by year-end. And we also think that pressures will continue to dissipated to allow it to fall below 3.0%Y/Y in Q224, and close to 2.0%Y/Y by the end of next year.

The day ahead in the UK

It should be a quiet day for UK economic news on Thursday with no top-tier releases due.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final headline (core) HICP Y/Y%	Sep	**4.3 (4.5)**	*4.3 (4.5)*	5.2 (5.3)	-
	Construction output M/M% (Y/Y%)	Aug	**-1.1 (-0.1)**	-	0.8 (1.0)	1.0 (1.2)
Italy	Trade balance €bn	Aug	**2.1**	-	6.4	-
UK	Headline (core) CPI Y/Y%	Sep	**6.7 (6.1)**	*6.7 (6.0)*	6.7 (6.2)	-
	PPI output (input) prices Y/Y%	Sep	**-0.1 (-2.6)**	-0.2 (-2.6)	-0.4 (-2.3)	-0.5 (-2.0)
	House price index Y/Y%	Aug	**0.2**	-	0.6	0.7

Auctions

Country	Auction
Germany	sold €3.3bn of 2.6% 2033 bonds at an average yield of 2.9%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France	07.45	INSEE business (manufacturing) confidence index	Oct	99 (98)	100 (99)
Spain	09.00	Trade balance €bn	Aug	-	-4.9

Auctions and events

Country	Time	Event
France	09.50	Auction: 2.50% 2026 bonds
	09.50	Auction: 2.75% 2027 bonds
	09.50	Auction: 2.75% 2029 bonds
	09.50	Auction: 2.50% 2030 bonds
	10.50	Auction: 0.1% 2026 index-linked bonds
	10.50	Auction: 0.1% 2029 index-linked bonds
	10.50	Auction: 0.1% 2036 index-linked bonds
Spain	09.30	Auction: 2.15% 2025 bonds
	09.30	Auction: 0.8% 2029 bonds
	09.30	Auction: 3.55% 2033 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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