Euro wrap-up

Overview

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- Bunds made gains as euro area data confirmed a contraction in GDP in Q3 and a big drop in inflation in October.
- Gilts also made gains as a UK survey suggested that shop price inflation fell further in October.
- The main economic event in Europe over the coming two days will be Thursday's BoE interest rate announcement and publication of updated economic forecasts.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.992	-0.010
OBL 2.4 10/28	2.637	-0.026
DBR 2.6 08/33	2.792	-0.027
UKT 3½ 10/25	4.765	-0.018
UKT 4½ 06/28	4.453	-0.051
UKT 3¼ 01/33	4.505	-0.054

*Change from close as at 4:00pm GMT.
Source: Bloomberg

Euro area

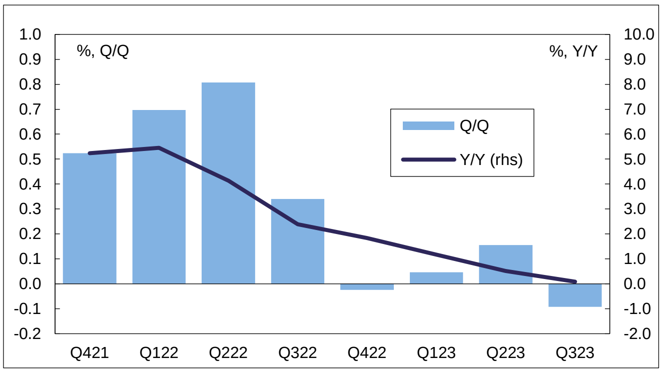
GDP falls slightly in Q3 to run below the ECB's projection

Euro area GDP declined in Q3 by 0.1%Q/Q (-0.09%Q/Q to two decimal places), a touch below the consensus forecast and also weaker than the ECB's projection of no change from Q2, but in line with our own forecast. Growth in the second quarter was revised up from the prior estimate by 0.1ppt to 0.2%Q/Q (0.16%Q/Q to two decimal places). However, that was also 0.1ppt below the rate assumed in the ECB's projection. So, the level of euro area GDP in Q3 was about 0.2% below the ECB's forecast, a non-negligible shortfall, which illustrates that the economy has weakened to a greater extent than the Governing Council had anticipated. Surveys also signal that momentum deteriorated over the course of Q3, suggestive of a negative carry-over into Q4. And there is certainly a non-negligible probability of another quarter of contraction in euro area economic output in Q4, which would contrast with the ECB's projection of growth of 0.1%Q/Q this quarter. Meanwhile, compared to a year earlier, GDP in Q3 was up just 0.1%Y/Y. And while it was 3.0% above the pre-pandemic level in Q419, the level of economic output was more than 2.0% below the level expected in the past quarter by the ECB in December 2019 just before the pandemic and in December 2021 just before the Russian invasion of Ukraine, illustrating the lasting adverse effects from those two unanticipated shocks.

Significant variation again among the member states

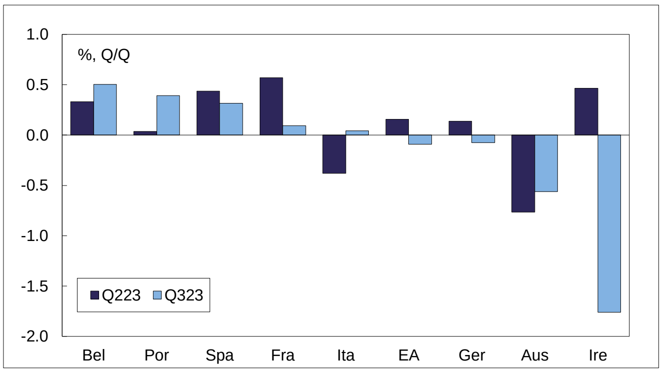
There were, inevitably, significant contrasts between the performances of the member states in Q3, although more than half of the eleven countries to report data saw growth weaken from Q2. Figures released before and after the weekend had already told us that GDP in Germany (-0.1%Q/Q), Austria (-0.6%Q/Q) and Ireland (-1.8%Q/Q) contracted in the past quarter, but also that Spain (0.3%Q/Q) and Belgium (0.5%Q/Q) had registered positive growth. Today we also learned that French GDP registered a third successive quarter of positive growth, but slowed 0.5ppt in Q3 to 0.1%Q/Q in line with consensus. Meanwhile, Italian GDP was unchanged from Q2, when it had contracted 0.4%Q/Q. Portuguese economic output declined for the first time in ten quarters, dropping 0.2%Q/Q in Q3 following growth of just 0.1%Q/Q the prior quarter. Compared to the pre-pandemic level in Q419, Germany's performance remains the weakest of all the euro area member states, up just 0.3%. Among all EU countries, only Czechia, where GDP remains below the pre-Covid benchmark, has fared worse. Meanwhile, French economic output has also been relatively lacklustre since the pandemic, rising just 1.8% from Q419. While Italy (+3.3%) and Spain (+2.2%) have fared a bit better over that period, the strongest performances have been in Portugal (+4.6%) and Greece (more than 7.0%), where post euro crisis catchup has given an impetus, and Ireland (up more than 25%) where GDP is flattered by activities of multinational corporations.

Euro area: GDP growth



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth in selected member states



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Domestic demand supported growth in France, but contracted in Italy

Eurostat will not publish an expenditure breakdown of euro area Q3 GDP until December. And unfortunately, the limited information published so far by the national authorities leaves the picture for the region as a whole unclear. Yesterday, Destatis merely reported that German household consumption fell last quarter while fixed investment in machinery and equipment increased. This view was reinforced today by some disappointing German retail figures for September, which saw sales volumes decline for a fourth successive month (-0.8%M/M) to be down some 1.2%3M/3M. But in Spain, while capex on machinery and equipment similarly rose, so too did household consumption as real disposable incomes picked up. In contrast, higher interest rates took their toll on Spanish construction investment and exports were weak despite the continued tourism sector recovery. Today, without providing more detail, ISTAT reported that Italian domestic demand fell while net trade made a positive contribution. But in France the opposite was the case. For the euro area as a whole, we think that final domestic demand made a modest positive contribution, with growth in consumption and investment on machinery and equipment offset by weaker construction. But, consistent with the ongoing downtrend in manufacturing production and monthly exports figures, net trade likely subtracted from euro area GDP growth. And inventories also probably subtracted from growth as firms tried to run down stocks as new orders and work backlogs fell.

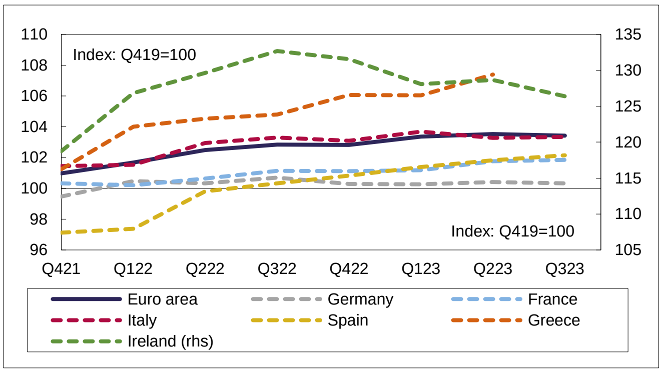
A broad-based pickup in French consumption and capex, but exports and inventories weaken

In France, which along with Spain published most granular information, household consumption returned to growth in Q3, rising 0.7%Q/Q following a flat Q2. In particular, French consumers spent a lot more on motor vehicles and food, while expenditure on services slowed. French fixed investment also accelerated, by 0.5ppt to 1.0%Q/Q, thanks to firm capex on machinery, equipment and transport goods, while construction spending was perhaps surprisingly steady. In contrast, net trade subtracted from GDP growth for a second successive quarter in Q3, and by 0.3ppt. French export volumes fell 1.4%Q/Q in Q3 weighed by declines in shipments of transport equipment (after the Q2 figure was flattered by delivery of a cruise ship) and other capital goods, while exports of services also fell. And despite the pickup in domestic demand, French imports also fell in Q3 (-0.5%Q/Q) due to lower imports of refined oil and capital goods, the latter perhaps auguring badly for the outlook for fixed investment in Q4. Finally, having supported economic growth in Q2, inventories subtracted from French GDP growth last quarter.

Euro area inflation takes another large step down in October

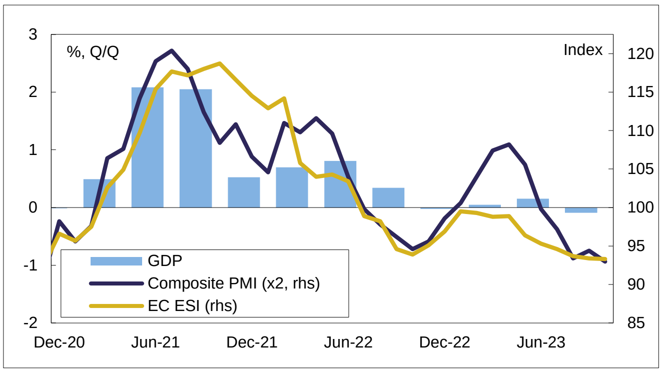
Euro area inflation took another large step down in October as weakening economic activity reinforced sizeable base effects associated with last year's spikes in energy and food prices. Indeed, in line with our forecast but below the consensus, the

Euro area: GDP levels



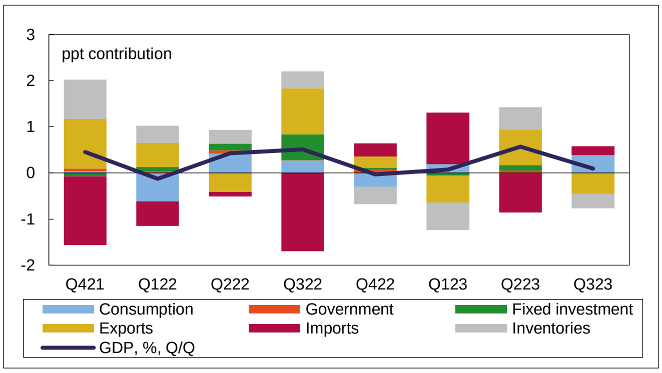
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & sentiment indices



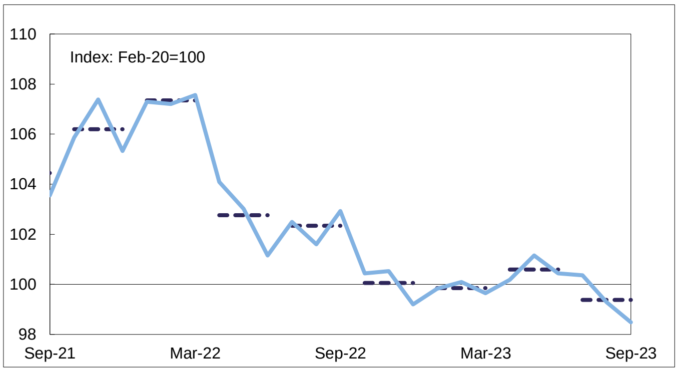
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

France: Contributions to GDP growth



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Retail sales*



**Dashed lines represent quarterly average. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

headline HICP rate dropped 1.4ppts to 2.9%Y/Y in October, representing the second-largest monthly drop on the series and the softest inflation rate since July 2021. It also took inflation well below the ECB's forecast for Q4 as a whole (3.3%Y/Y). Following the moderation reported yesterday in Germany (down 1.3pts to 3.0%Y/Y), today's data confirmed significant falls in France (down 1.2ppts to a 20-month low of 4.5%Y/Y), Italy (down a very steep 3.7ppts to a 27-month low of 1.9%Y/Y) and the Netherlands (down 0.7ppt to a euro-era low of -1.0%Y/Y). Among the main components, the main driver for the decline inflation in each of these member states was energy, prices of which in the euro area as a whole fell 1.1%M/M in October having surged 6.2%M/M this month last year. So, the annual energy inflation rate plunged 6.5ppts to -11.1%Y/Y, the lowest since May 2020, knocking more than one percentage point off headline inflation. With the rise in food prices (0.2%M/M) also more in line with the norm for the time of year, the annual rate for that component also eased significantly, down 1.3ppt to 7.5%Y/Y, a seventeen-month low.

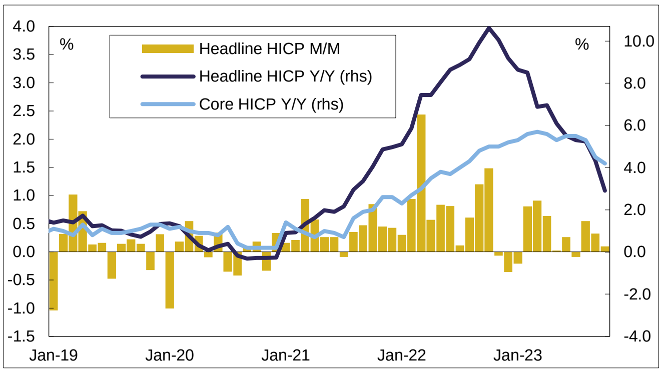
Core inflation declines to lowest since July 2022 as momentum continues to fade

Notwithstanding the significant base effects related to food and energy, the moderation in inflation in October also reflected better behaved price movements in the core components. Admittedly, the fall in services inflation in October (-0.1ppt to 4.6%Y/Y) was small compared with September (-0.8ppt), when base effects associated with German public transport subsidies were particularly favourable. And while it stood at its softest rate since January, services inflation still contributed a chunky 2ppts to headline inflation. But with the monthly increase in core goods prices (0.7%M/M) just half that seen a year ago, the respective annual rate eased for an eighth consecutive month, by 0.6ppt to 3.5%Y/Y, the lowest since Russia's invasion of Ukraine. As such, overall core inflation fell for a third successive month, by 0.3ppt to 4.2%Y/Y, the lowest since July 2022 and 1.5ppts below March's series high. And with momentum in core goods inflation fast dissipating (down 0.8ppt to a 22-month low of 2.3%3M/3M annualised), and fading gradually in services inflation too (down 0.2ppt to a 14-month low of 3.8%3M/3M annualised), we expect core inflation to fall below 4.0%Y/Y by year-end and a touch below the ECB's forecast in Q4 (4.1%Y/Y).

Inflation looks set to fall more rapidly than ECB is currently projecting

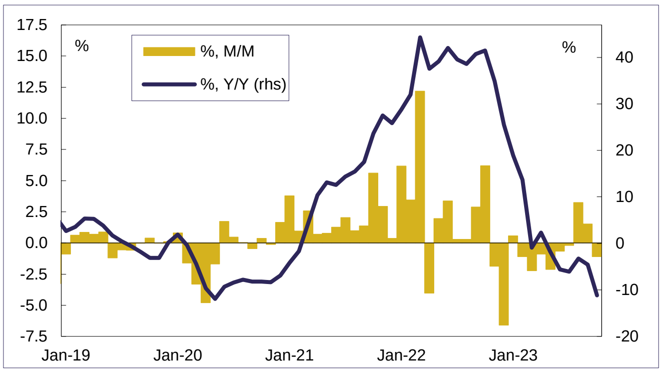
Admittedly, energy price base effects will become less favourable from November on and so we expect the headline rate to temporarily tick higher at the turn of the year. However, the food component – which accounts for roughly one fifth of the inflation basket, almost double the share of energy – will continue to fall steadily. And with surveys and producer prices consistent with diminishing factory pipeline pressures, we expect core goods inflation to drop significantly further over

Euro area: Consumer price inflation



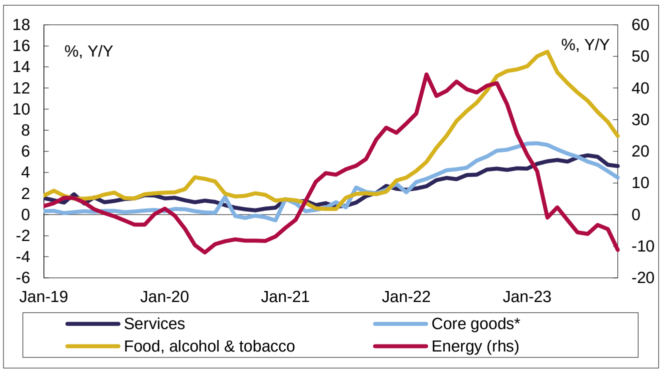
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer energy price inflation



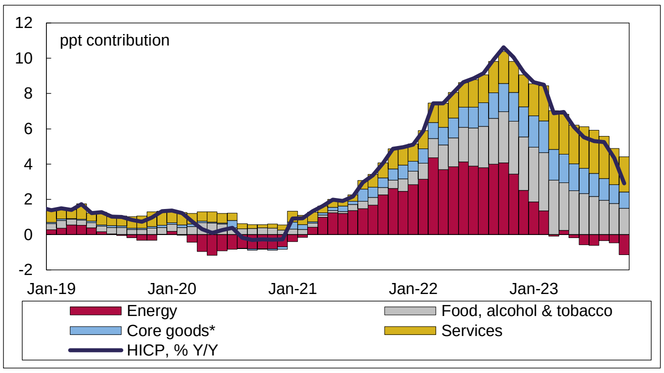
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Key HICP inflation components



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

Euro area: Contributions to HICP inflation



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

coming months. As such, we see the risks to the ECB's HICP forecast of 3.3%Y/Y in Q4 as skewed to the downside. Indeed, our current forecast sees headline inflation fall below 2%Y/Y in the second half of 2024, with core inflation set to fall below 2% in Q224, supporting our view that the first rate cut will come early in the summer next year, if not before.

The coming two days in the euro area

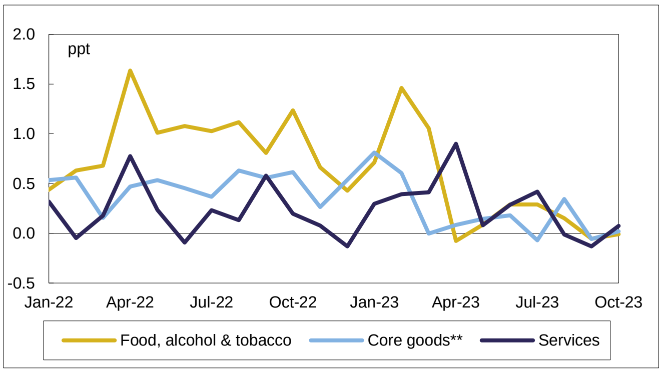
Following the observation of All Saints' Day in various euro area member states on Wednesday, Thursday will bring the final manufacturing PMIs for October. The flash estimates showed the euro area output index moving sideways at 43.1, close to the bottom of the recent range and consistent with ongoing marked contraction in the sector at the start of the fourth quarter. There was an improvement in the respective German PMI, which increased 2.8pts to a four-month high of 41.4, albeit still implying a hefty decline in output. But this was partly offset by a further deterioration in the French output PMI, by 0.9pt to 41.7, the lowest level since the euro crisis when excluding the first Covid wave. And Thursday's release is likely to report a slight deterioration elsewhere in the region, albeit the indices will remain consistent with a smaller pace of contraction. Thursday will also bring an update on Germany's labour market at the start of Q4, with the claimant count rate expected to have edged slightly higher, by 0.1ppt to 5.8%, which would mark the highest reading since June 2021.

UK

Shop price inflation maintains disinflationary trend to a fourteen-month low

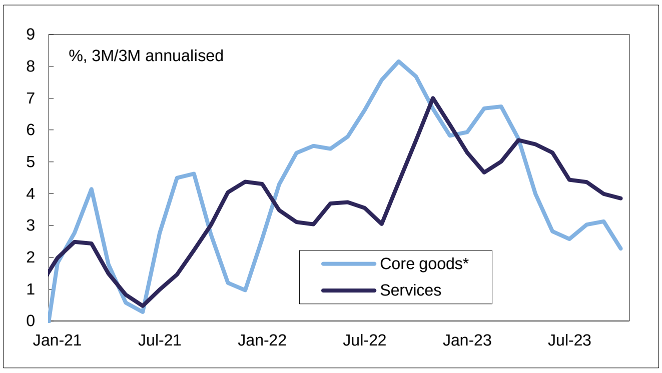
According to the latest BRC survey, UK shop price inflation moderated for a fifth successive month in October to a fourteen-month low, dropping a further 1.1ppt to 5.2%Y/Y. This marked the largest monthly drop since the global financial crisis and left shop price inflation some 4.8ppts below May's peak. Despite reports of some exchange rate-related pressures on imported goods prices, the easing in price pressures was widespread, with non-food inflation dropping 1.0ppt to a thirteen-month low of 3.4%Y/Y. Indeed, the disinflationary trend reportedly intensified in several categories, with inflation of DIY-related items falling to its lowest since July 2022, and electrical goods and clothing prices remained in mild deflation. The BRC measure of food inflation also maintained a steady downwards trajectory, by 1.1ppt to 8.3%Y/Y, the lowest in fifteen months, with prices of domestically produced foods such as fruit lower than in September. The steady decline in consumer goods inflation is positive news for households, and taken with the drop in household energy bills this month will give a welcome boost to real disposable income growth. However, with consumer confidence historically subdued amid an uncertain economic outlook, retailers will likely have to offer heavy discounting in the run up to Christmas to encourage consumers to loosen their purse strings.

Euro area: Deviation from l-r average price change*



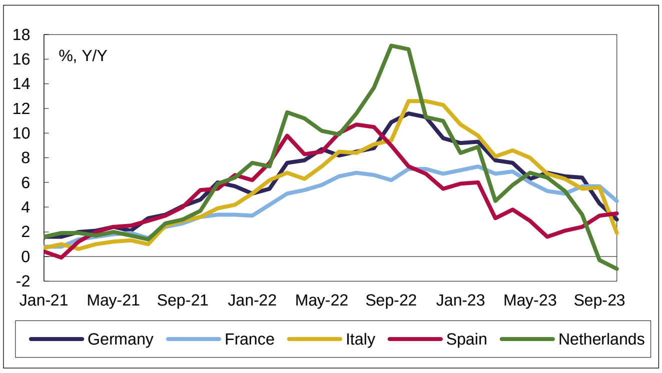
*Deviation from long-run average monthly price change. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Services & goods inflation momentum



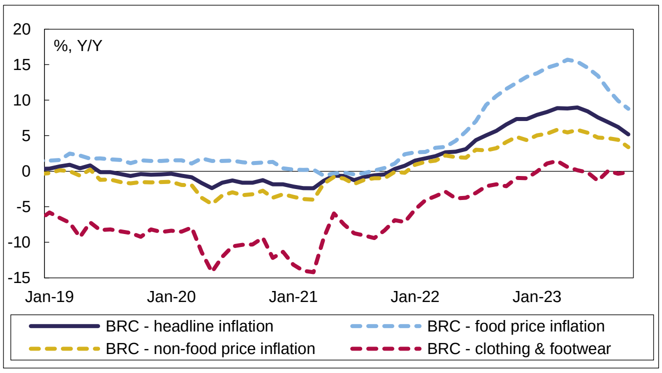
*Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area member states: HICP inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: BRC shop price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The coming two days in the UK

The main economic event in the UK over the coming two days will be the BoE's monetary policy announcement on Thursday. Having paused the policy tightening cycle in September, the MPC looks highly likely to keep Bank Rate unchanged at 5.25%. Indeed, while September's decision was a close one (with four members voting to hike), recent economic data arguably further diminish the case for a rate hike this week. Moreover, departing Deputy Governor Jon Cunliffe, one of the four MPC members to vote for a hike last month and only Bank staff member to do so, has now been replaced on the Committee by Sarah Breeden. At her first monetary policy meeting, we suspect that Breeden might be more inclined than Cunliffe to toe the line of the other staff members including Governor Bailey. So, we fully expect Bank Rate again to be left unchanged, and with a larger majority in favour of the decision than in September. It is also possible that one member (the uber-dove Swati Dhingra) will vote for a rate cut.

In terms of the Bank's Monetary Policy Report, recent economic data point to a weaker near-term performance than previously projected in August. Notably, however, since the August MPR was finalised, the post-pandemic profile of GDP, including growth in the first half of this year, has been revised up. Overall, given offsetting influences, we suspect that the Bank will maintain its full-year growth projections on market-based rate assumptions for both 2023 and 2024 at about ½%Y/Y. Nevertheless, given the drop in the market-implied path of Bank Rate that year, we see the possibility of an upwards revision to its 2025 growth forecast from ¼%Y/Y in August. In terms of inflation, given the recent profile, we the BoE's forecast for Q4 will be revised lower. The outlook further out is clouded by the uncertainties over the current tightness of the labour market that have arisen over the quality of the labour force survey results amid a decline in the survey response rate. given the questionable quality. Overall, despite the rise in auto fuel prices summer, as well as the drop in market expectations for Bank Rate, we expect the broad profile of its inflation forecast for 2024 or 2025 to be maintained. So, the mode inflation projection would still be close to 2.5%Y/Y by end-2024 and below the 2.0% target by Q225. And, despite an upside skew, the mean rate would also still be back on target by Q225.

Ahead of the BoE's announcements, tomorrow will bring the Nationwide's house price index, which is likely to report a renewed downtrend in prices at the start of October, in line with survey indicators and consistent with the decline in mortgage lending and approvals at the end of Q3. Wednesday will also bring the final manufacturing PMIs for October, which are expected to align with the flash estimates that showed the output component rising just 0.7pt to 45.3, still close to the bottom of the pandemic range.

The next edition of the Euro wrap-up will be published 2nd November 2023

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		GDP – first estimate Q/Q% (Y/Y%)	Q3	**-0.1 (0.1)**	*-0.1 (0.0)*	0.1 (0.5)	0.2 (-)
		Preliminary HICP (core HICP) Y/Y%	Oct	**2.9 (4.2)**	*2.9 (4.1)*	4.3 (4.5)	-
Germany		Retail sales M/M% (Y/Y%)	Sep	**-0.8 (-4.6)**	-	-1.2 (-1.9)	-1.1 (-)
France		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.1 (0.7)**	*0.1 (0.6)*	0.5 (1.0)	0.6 (1.1)
		Consumer spending M/M% (Y/Y%)	Sep	**0.2 (-3.0)**	0.4 (-2.8)	-0.5 (-1.9)	-0.6 (-1.6)
		Preliminary HICP (CPI) Y/Y%	Oct	**4.5 (4.0)**	4.5 (4.0)	5.7 (4.9)	-
		PPI Y/Y%	Sep	**-1.7**	-	-1.4	--
Italy		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.0 (0.0)**	*-0.1 (0.0)*	-0.4 (0.3)	- (0.3)
		Preliminary HICP (CPI) Y/Y%	Oct	**1.9 (1.8)**	2.3 (2.4)	5.6 (5.3)	-
		PPI Y/Y%	Sep	**-18.3**	-	-16.1	
UK		Lloyds business barometer	Oct	**39**	-	36	-
		BRC shop price index Y/Y%	Oct	**5.2**	-	6.2	-

Auctions

Country		Auction
Germany		sold €994mn of 1.8% 2053 green bonds at an average yield of 3.04%
Italy		sold €1.5bn of 2.2% 2027 bonds at an average yield of 3.84%
		sold €2.5bn of 4.1% 2029 bonds at an average yield of 4.12%
		sold €3.5bn of 4.2% 2034 bonds at an average yield of 4.76%
		sold €1.25bn of 2028 floating-rate 2053 bonds at an average yield of 5.16%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		09.30	Final manufacturing PMI	Oct	*45.2*	44.3
		09.30	Nationwide house prices M/M% (Y/Y%)	Oct	-0.4 (-4.8)	0.0 (-5.3)

Auctions and events

Country		GMT	Event
Germany		10.30	Auction: €3.0bn of 2.4% 2030 bonds
UK		10.00	Auction: £4.0bn of 4.5% 2028 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		09.00	Final manufacturing PMI	Oct	*43.0*	43.4
Germany		08.55	Final manufacturing PMI	Oct	*40.7*	39.6
		08.55	Unemployment change '000s (rate %)	Oct	15.0 (5.8)	10.0 (5.7)
France		08.50	Final manufacturing PMI	Oct	*42.6*	44.2
Italy		08.45	Manufacturing PMI	Oct	46.5	46.8
Spain		08.15	Manufacturing PMI	Oct	47.3	47.7
UK		12.00	BoE Bank rate %	Nov	*5.25*	5.25
		12.30	DMP 1-year ahead CPI (output price) expectations Y/Y%	Oct	-	4.9 (4.8)
Auctions and events						
France		09.30	Auction: To sell 2033, 2044, 20544 and 2072 fixed-rate bonds			
Spain		09.30	Auction: To sell 2029, 2032 and 2052 fixed-rate bonds, and 2033 index-linked bonds			
UK		12.00	BoE monetary policy decision, statement and Monetary Policy Report published			
		12.30	BoE Governor Bailey to speak at press conference about the Monetary Policy Report			
		12.30	BoE to publish Decision Maker Panel survey results			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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