Euro wrap-up

Overview

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- Gilts made significant gains as the BoE's MPC left Bank Rate unchanged with a larger majority than in September, and its updated macroeconomic projections showed that it expects inflation to fall below target by the end of the horizon.
- Most Bunds also made gains as German jobless claims rose more than expected in October.
- Friday will bring data for euro area unemployment, German goods trade and French IP in September as well as the final UK services PMIs for October.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.973	+0.023
OBL 2.4 10/28	2.592	-0.015
DBR 2.6 08/33	2.713	-0.046
UKT 3½ 10/25	4.701	-0.067
UKT 4½ 06/28	4.327	-0.116
UKT 3¼ 01/33	4.377	-0.115

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

UK

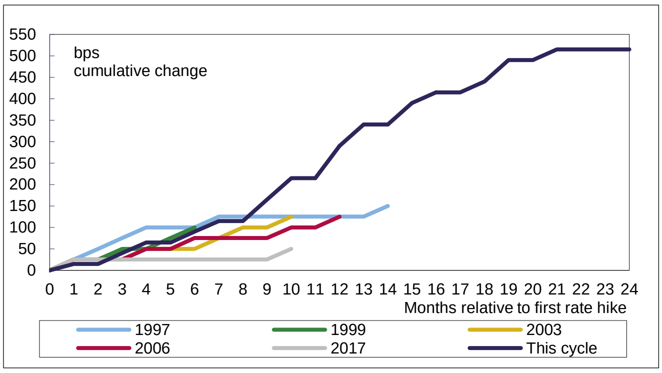
BoE leaves rates unchanged, & maintains "higher for longer" message with a tightening bias

As expected, the BoE today left Bank Rate unchanged at 5.25% for a second successive policy meeting. Also as expected, the vote was not as close as in September, with six MPC members – one more than at the previous meeting – voting for no change, while three members voted for a hike of 25bps. With new Deputy Governor Breeden voting in favour of the decision, in contrast to the vote of her predecessor Cunliffe in September, all five BoE staff members backed the majority. While the BoE revised down its assessment of the outlook for GDP and revised up its projection for unemployment, with inflation still relatively elevated, the MPC's forward guidance and subsequent comments from Governor Bailey sought to downplay the possibility that rates might soon be cut. Indeed, for a second successive meeting, the MPC stated that "Monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term". To avoid any doubts, today it added that a restrictive stance is likely to be needed "for an extended period of time". Given that it still considers the risks to the inflation outlook to be biased to the upside, it also retained a policy bias for higher rates, stating that "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures". And it continued to emphasise that developments in underlying labour market tightness, wage growth, and services inflation would be key in determining the near-term path of policy.

GDP expected to stagnate until mid-2025 in part due to monetary tightening

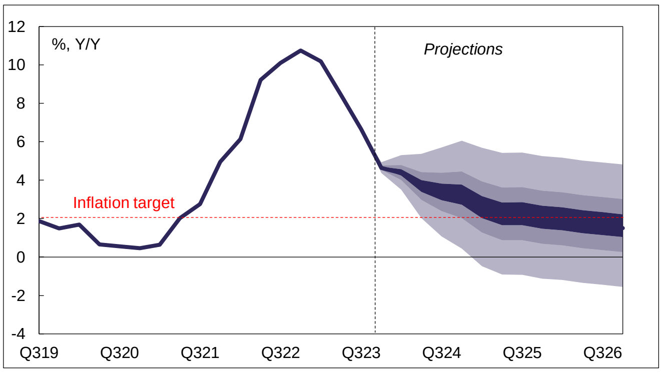
Nevertheless, in his press conference, Governor Bailey insisted that the BoE would "not keep policy restrictive for unnecessarily long". And as is currently priced into the swap market, we continue to expect the next move in Bank Rate to be down and the first cut to come next August. That would be consistent with the BoE's updated macroeconomic projections, which were also published today. It would also be consistent with a comment by Governor Bailey in his press conference that the MPC did not intend to shift the curve with its forward guidance. In terms of the economic outlook, the BoE now acknowledges that it was overoptimistic on growth. Indeed, it now thinks GDP was broadly flat in Q3 compared to its previous forecast of growth of 0.4%Q/Q. (Our forecast is now for a contraction of 0.1%Q/Q). And, conditioned on a market-implied path for rates that envisages gradual cuts from Q324 on, it revised down its projection for economic activity over the horizon. In particular, more downbeat than the consensus, it projects GDP to stagnate for more than a year, moving broadly sideways through to mid-2025, with a non-negligible risk of recession. That judgement in part reflects a more downbeat view of the strength of demand. To some extent, that relates to the impact of the cumulative 515bps of tightening implemented since the end of 2021. Indeed, the Bank estimates that less than half of that impact on GDP has come through so far. While

UK: BoE tightening cycles compared



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: BoE inflation forecast



**Based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.*

the effects have been felt more quickly on housing and investment, the BoE thinks that only about one third of the drag on private consumption from the tightening of financial conditions over the past two years – which could cumulatively amount to 6% or more by end-2026 – has impacted to-date. And given a weakening in recent indicators, including a signal of increased household willingness to save and diminished willingness to spend, the BoE revised down its outlook for private consumption.

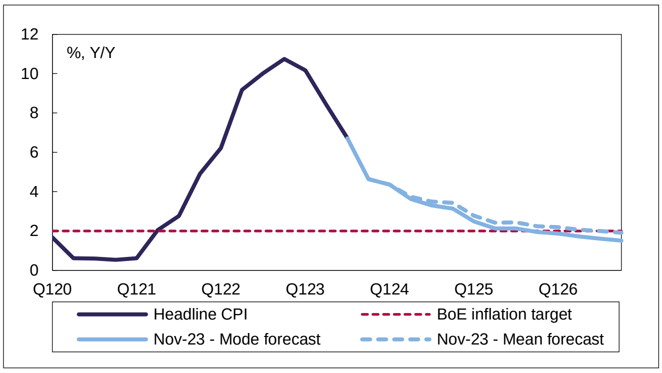
BoE takes a dimmer view of supply as well as demand

While the BoE is more downbeat about the outlook for demand, it is also more pessimistic about the economy's supply potential. It notes uncertainty about the precise state of the labour market, in part due to the suspension of the ONS's Labour Force Survey. But the MPC now forecasts that the unemployment rate will be about 4¼% during H223, a little higher than it previously expected. That aligns with its previous estimate of the equilibrium unemployment rate or NAIRU, which would be consistent with meeting the 2% inflation target over the medium term. However, the recent high rate of wage growth has led it to revise up its NAIRU estimate, to about 4½%. That could reflect a greater determination of workers to bid up their wages in compensation for recent high inflation. It could also reflect diminished efficiency in the way by which vacancies are being matched with job-seekers. And while, due to data quality issues, the full extent, causes and consequences of rising labour inactivity since the pandemic is judged uncertain, that is also probably having an impact on the equilibrium unemployment rate. Whatever the causes, however, due to the increase in the NAIRU, the Bank halved its view of supply growth next year to just around ¾% before rising back to about 1¼% over the medium term.

Rising slack expected to help reinforce decline in inflation next year and beyond

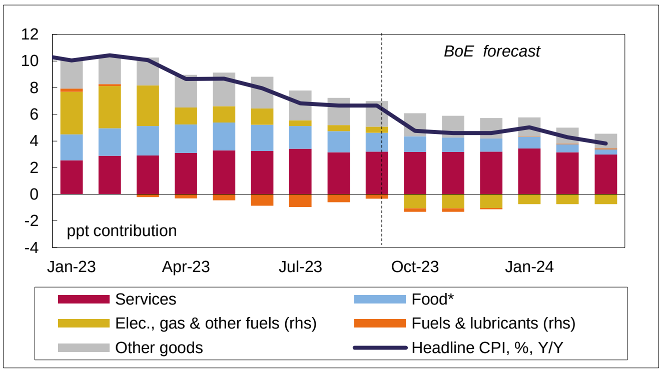
In terms of inflation, the BoE acknowledged that the CPI rate has already fallen a little further than it expected over the past few months. And it is bound to take another big step down in October due to the cut in the regulated energy price cap. But the BoE still expects inflation to average close to 4¾%Y/Y in the current quarter, and 3¾%Y/Y by Q224, little different to its previous projection and probably a bit above the consensus. Of course, the improvement so far principally reflects a moderation in the energy, food and core goods components. And, in part probably due to higher than anticipated pay growth, services inflation remains sticky and now accounts for the largest share of the CPI rate. However, with demand expected to flat-line for more than a year and remain sluggish thereafter, the unemployment rate is now expected by the BoE to rise further than it previously anticipated. Indeed, it is forecast to exceed the upwardly revised NAIRU estimate by the end of 2024, and continue rising to more than 5.0% by the end of the projection horizon at end-2026. So, overall economic slack is expected to emerge from the start of 2024 and widen steadily over the horizon too, reaching more than 1½% of potential

UK: BoE inflation forecasts*



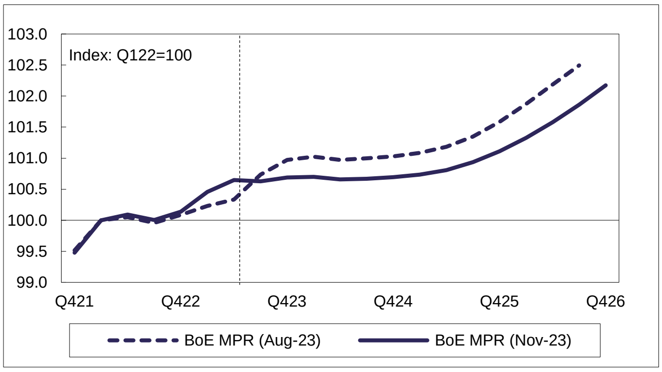
*Based on market-implied path for Bank rates. Source: BOE and Daiwa Capital Markets Europe Ltd.

UK: BoE forecast – contributions to inflation



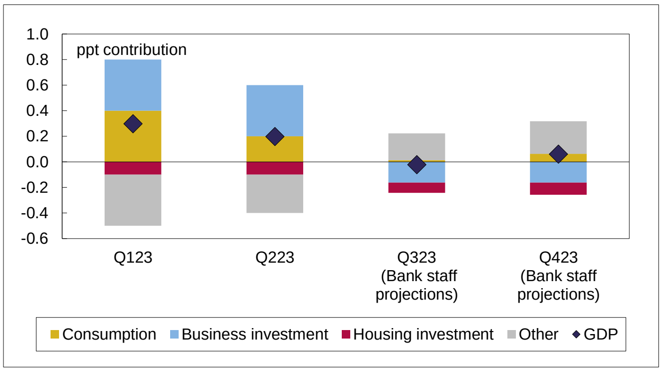
*Food & non-alcoholic beverages. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: GDP level forecasts*



*Based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Contributions to GDP growth



Source: BoE and Daiwa Capital Markets Europe Ltd.

GDP at the end of the forecast. And as slack steadily rises in the labour market, pay growth should moderate, allowing inflation, including in services, to continue to fall.

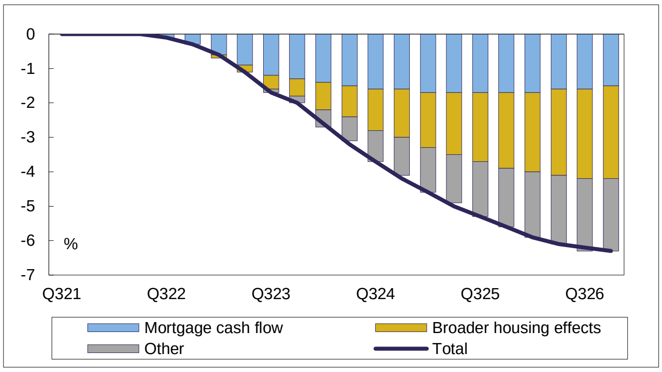
BoE thinks inflation should be below 2% in 2026, providing scope for rate cuts in due course

Given the expectation of rising slack, on an assumption of unchanged Bank Rate over the horizon, the BoE's modal projection therefore envisages inflation falling below the 2% target in Q225 and then declining steadily further to be below 1½%Y/Y by Q226. Assuming a market-implied path for rates whereby Bank Rate is first cut in Q324 and then declines steadily to 4¼% by end-2026, inflation is still expected to fall below target by the end of 2025 and further to 1½% by the end of the horizon. The skew to that outlook is appropriately to the upside – not least due to additional risks emerging from the Middle East – so that the mean inflation forecast is only slightly below 2.0%Y/Y at the end of the projection period. But if events pan out in line with the modal view, rates should indeed be cut next August, and perhaps before then if the economy falls into recession to put further upwards pressure on unemployment and downwards pressure on pay growth. And Bank Rate should thereafter also be cut more aggressively than assumed in the BoE's market-implied projection.

The day ahead in the UK

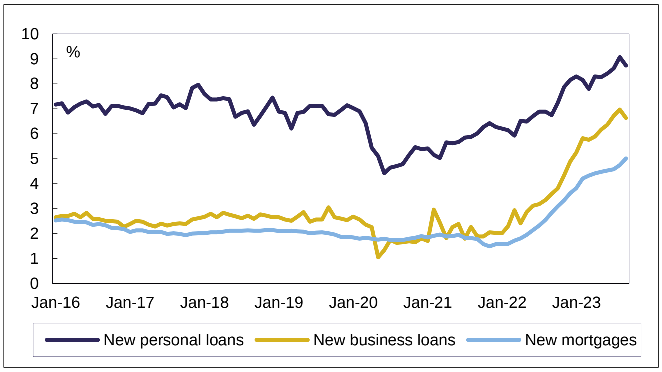
The end of the week will bring updated services PMI for October from the UK, which are likely to point to a lack of economic momentum at the start of Q4. Indeed, the flash readings showed the headline slip 0.1pt to 49.2, the lowest since January. And with the manufacturing output PMI having been revised down 1pt from the flash release to 44.3, we would expect to see the composite PMI similarly point to a steeper pace of contraction than initially signalled in October (48.6). The flash release also implied declining new business and employment, as well as a moderation in input price pressures. But the output price index ticked up to a three-month high. Separately, BoE Chief Economist Huw Pill will speak to the Bank's Agents about the BoE's latest forecasts in today's Monetary Policy Report.

UK: Impact of change in OIS curve on consumption



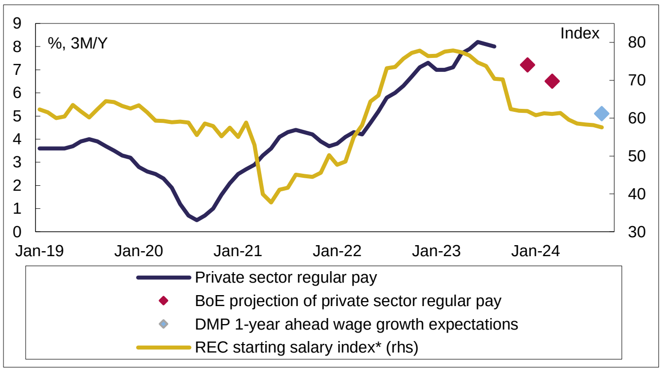
**BoE's estimated impact of changes in OIS curve since August 2021 on the level of consumption. on Source:* BoE and Daiwa Capital Markets Europe Ltd.

UK: Interest rates on loans



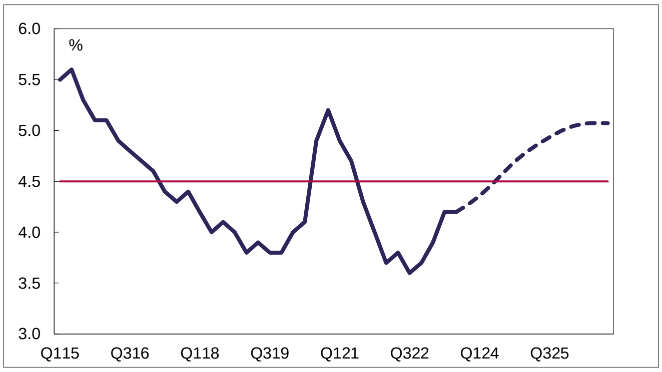
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Measures of pay growth



**Twelve-month lead. Source: BoE* and Daiwa Capital Markets Europe Ltd.

UK: BoE unemployment rate forecast*



**Red line represents BoE estimate of the equilibrium rate of unemployment. Source: BoE* and Daiwa Capital Markets Europe Ltd.

Euro area

The day ahead in the euro area

Friday will bring the release of euro area unemployment figures for September. Despite slowing economic momentum and surveys signalling a decline in jobs growth, tomorrow's figures are expected to report a still tight labour market, with the unemployment rate forecast to move sideways at a series low of 6.4%. Friday will also bring German trade figures for September, which are likely to report another monthly decline in export values that month – indeed, preliminary figures for exports to non-EU countries fell 3.4%M/M. And with import values having been boosted by prices that month (+1.6%M/M), Germany's trade surplus is likely to have narrowed. Tomorrow will also bring French industrial production figures for September, which are expected to show little change in output over the month.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final manufacturing PMI	Oct	**43.1**	*43.0*	43.4	-
Germany	Final manufacturing PMI	Oct	**40.8**	*40.7*	39.6	-
	Unemployment change '000s (rate %)	Oct	**30.0 (5.8)**	15.0 (5.8)	10.0 (5.7)	12.0 (-)
France	Final manufacturing PMI	Oct	**42.8**	*42.6*	44.2	-
Italy	Manufacturing PMI	Oct	**44.9**	46.3	46.8	-
Spain	Manufacturing PMI	Oct	**45.1**	47.0	47.7	-
UK	BoE Bank rate %	Nov	**5.25**	*5.25*	5.25	-
	DMP 1-year ahead CPI (output price) expectations Y/Y%	Oct	**4.6 (4.5)**	-	4.9 (4.8)	-

Auctions

Country	Auction
France	sold €5.29bn of 3.5% 2033 bonds at an average yield of 3.32%
	sold €2.34bn of 0.5% 2044 bonds at an average yield of 3.77%
	sold €2.18bn of 3.0% 2054 bonds at an average yield of 3.92%
France	sold €1.20bn of 0.5% 2072 bonds at an average yield of 3.36%
Spain	sold €1.34bn of 0.7% 2023 bonds at an average yield of 3.582%
	sold €2.40bn of 3.5% 2029 bonds at an average yield of 3.334%
	sold €1.67bn of 1.9% 2052 bonds at an average yield of 4.465%
	sold €479mn of 0.7% 2033 index-linked bonds at an average yield of 1.533%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	Final manufacturing PMI	Oct	**44.8**	*45.2*	44.3	-
	Nationwide house prices M/M% (Y/Y%)	Oct	**0.9 (-3.3)**	-0.4 (-4.8)	0.0 (-5.3)	0.1 (-)

Auctions

Country	Auction
Germany	sold €2.43bn of 2.4% 2030 bonds at an average yield of 2.7%
UK	sold £4.00bn of 4.5% 2028 bonds at an average yield of 4.474%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	Unemployment rate %	Sep	6.4	6.4
Germany	07.00	Trade balance €bn	Sep	16.3	16.5
France	07.45	Industrial production M/M% (Y/Y%)	Sep	0.0 (0.0)	-0.3 (-0.5)
Italy	09.00	Unemployment rate %	Sep	7.4	7.3
Spain	08.00	Unemployment change '000s	Oct	-	19.8
UK	09.30	Final services (composite) PMI	Oct	*49.2 (48.6)*	49.3 (48.5)
Auctions and events					
UK	12.15	BoE Chief Economist Pill to speak to regional agents about the Monetary Policy Report			
	16.00	BoE MPC member Haskel to speak on a panel about labour market dynamics at BoE Watchers' Conference			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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