Euro wrap-up

Overview

- Bunds followed USTs lower despite some very weak euro area industrial production data, which confirmed a fourth successive quarterly contraction in Q3.
- Gilts also made losses even as UK inflation fell sharply in October to a two-year low below the BoE's recent projection.
- After a day bereft of top-tier European data tomorrow, Friday will bring updated euro area inflation figures and UK retail sales data for October.

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.999	+0.019
OBL 2.4 10/28	2.579	+0.030
DBR 2.6 08/33	2.643	+0.044
UKT 3½ 10/25	4.579	+0.029
UKT 4½ 06/28	4.219	+0.050
UKT 3¼ 01/33	4.224	+0.077

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

Euro area

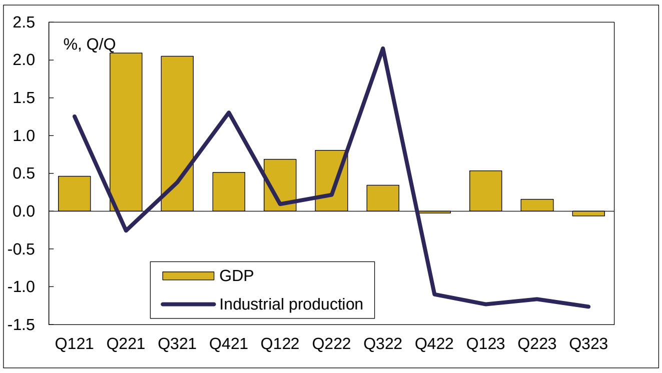
Euro area industrial production ends Q3 on the back foot

While yesterday's second estimate of euro area GDP confirmed a modest contraction in Q3, today's industrial production figures for September suggested a marked contraction in the sector for the fourth consecutive quarter. In particular, euro area industry output fell 1.1%M/M in September, to its lowest level since June 2021, to leave it down 1.2%Q/Q in Q3, almost 7% lower than a year ago and 2½% below the pre-pandemic benchmark in February 2020. More than half of the member states reported a decline in production in September, including Germany (-1.6%M/M), France (-0.5%M/M) and Ireland (-2.9%M/M), while Italy recorded no growth. And the weakness across sectors was relatively broad-based, led by a drop in production of consumer goods (-2.0%M/M) to its lowest level since 2021, with sizeable falls in clothing, furniture, food and pharmaceutical products. And despite a fourth monthly rise out of the past five in the chemicals subsector, intermediate goods output fell (-0.3%M/M) to its lowest level since July 2020 and some 5½% below the February 2020 benchmark. Meanwhile, the first rise in four months in machinery and equipment helped to offset renewed weakness in the autos sector, to leave capital goods production broadly flat in September (+0.3%M/M), but nevertheless down a steep 2.6%3M/3M in Q3. And while output from energy-intensive subsectors rose for a third successive month, it remained some 10% below the pre-pandemic level, while energy production fell to a new series low.

Decline in imports in Q3 outpaces drop in exports

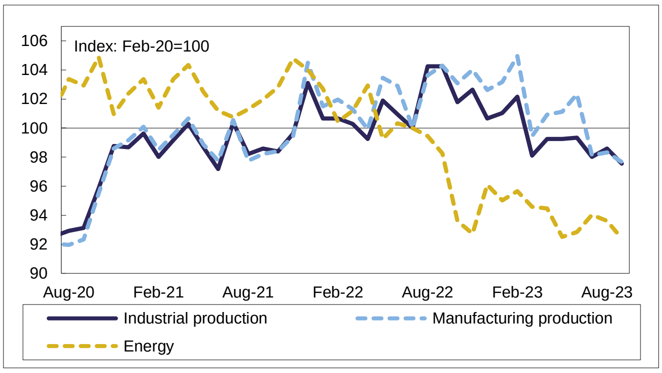
The negative carry over from the decline in September means that output started Q4 at a low level, while surveys suggest that the outlook for the manufacturing sector remains extremely challenging. Certainly, the output PMI (43.1) remained firmly in contractionary territory in October, while the Commission's industry sentiment index fell amid a deterioration in confidence of capital goods manufacturers. Although the Commission's survey suggested that stock levels are not quite as excessive as previously thought, they remain elevated. And with orders continuing to decline sharply amid soft domestic and external demand, manufacturers remain downbeat about near-term production expectations. The fragile external outlook was illustrated by today's euro area goods trade figures, which saw export values decline for the third month out of the past four in September, by 0.5%M/M. This left them down 9.4%Y/Y and on average in Q3 almost 1% below the Q2 level. While the respective data are published with a one-month lag, export volumes were similarly trending in July and August some 1% below the Q2 average, suggesting a drag on GDP growth in Q3. But while import values increased marginally in September (+0.3%M/M), they fell for the fourth successive quarter in Q3, by 4%3M/3M, to be down almost 24%Y/Y. And with import prices having risen a further 1.3%M/M in September, today's figures suggest a further decline in import volumes that month

Euro area: GDP & industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

to leave them down between 2½-3%Q/Q in Q3. While this tallies with weak domestic demand, it also suggests that net trade provided a non-negligible positive contribution to GDP growth in Q3.

The coming two days in the euro area

After a day bereft of top-tier euro area releases tomorrow, Friday will bring updated euro area HICP figures for October, which are expected to confirm the findings from the flash release, which saw headline inflation drop 1.4ppts to a 27-month low of 2.9%Y/Y and core inflation decline 0.3ppt to a 15-month low of 4.2%Y/Y. Indeed, while final figures from Italy brought downwards revisions – with the harmonised headline and core rates nudged down from the flash estimates by 0.1ppt apiece – the equivalent releases from German, France and Spain aligned with preliminary figures. While the drop in the euro area's headline rate was driven by base effects associated with last year's energy price spike, the granular detail will also likely suggest a broad-based easing in underlying price pressures.

UK

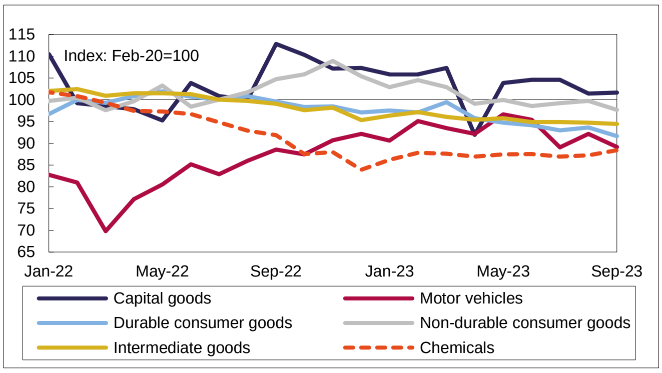
UK inflation falls sharply to lowest in two years, thanks principally to base effects

As had been widely expected, UK inflation took a significant step down in October, thanks principally to the cut in the regulated household energy price cap and significant base effects associated with the sharp rise in electricity and gas bills a year earlier. Indeed, with consumer prices merely moving sideways on the month – a touch below the norm for the time of the year and compared with the jump of 2.0%M/M last October – the headline CPI inflation rate fell a slightly steeper-than-expected 2.1ppts – the most since April 1992 – to 4.6%Y/Y. While this remains above inflation in the US (3.2%Y/Y) and euro area (2.9%Y/Y), it was nevertheless the lowest for two years, some 6½ppts below last October's peak and 0.2ppt below the BoE's forecast published in its latest Monetary Policy Report earlier this month. The main driver for the decline in inflation was energy, prices of which fell 3.3%M/M in October having surged 14.6%M/M in the same month last year, with the 7-7½%M/M decline in electricity and gas prices more than offsetting a third successive monthly increase in auto fuels. So, the annual energy inflation rate plunged 15.5ppts to -15.7%Y/Y, the lowest since records began in January 1989 and knocking 1.3ppts off headline inflation. With the rise in food prices (0.1%M/M) in line with pre-pandemic average for the month of October, the annual rate for that component also eased significantly, down 1.5ppt to 10.3%Y/Y, a sixteen-month low.

Core components suggest an easing in underlying prices pressures

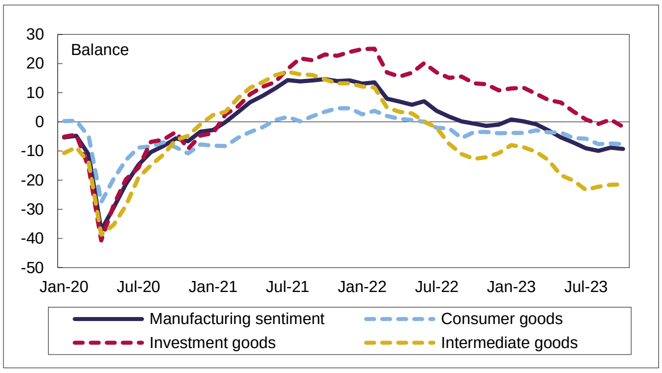
More encouragingly perhaps, there were signs that services prices were also better behaved in October, rising 0.4%M/M, just 0.1ppt above the long-run average rate for that month. As such, annual services inflation moderated more than

Euro area: Manufacturing production



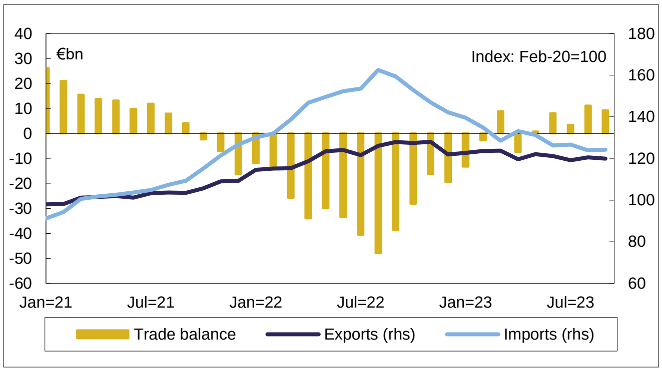
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing sentiment indices



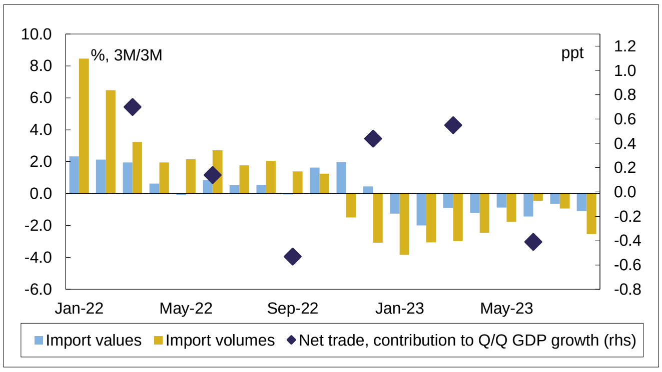
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods export & import values



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods export & import volumes



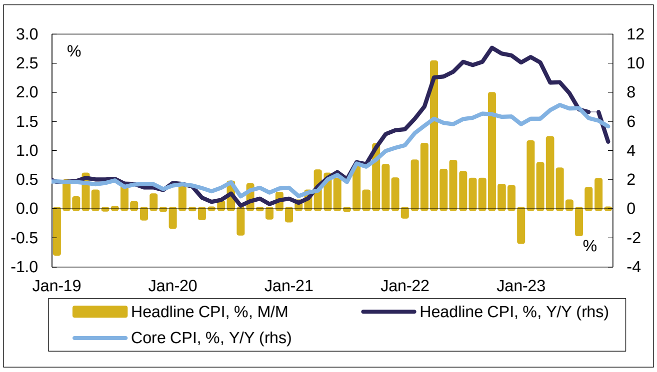
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

expected, by 0.3ppt to a seven-month low of 6.6%Y/Y and 0.3ppt below the BoE's forecast. Admittedly, this still contributed a chunky 3.0ppts to headline inflation. But there were signs that subdued demand might be starting to have an impact, with monthly price developments in tourism-related items (i.e. accommodation services and airfares) more favourable than a year earlier to leave the annual inflation rates down to the lowest since summer 2021. While the rise in non-energy industrial goods prices (0.2%M/M) was slightly firmer than the long-run average, it was bang in line with the average in the five years before the pandemic. And with prices having risen by roughly one third of the pace a year ago, core goods inflation fell for a fifth consecutive month, by 0.4ppt to 4.3%Y/Y, the lowest for two years. Within this category, inflation of furniture and furnishings fell to a near-three-year low (2.1%Y/Y), new cars a nineteen-month low (3.8%Y/Y) and clothing a nine-month low (6.6%Y/Y). As such, core CPI inflation fell 0.4ppt to 5.7%Y/Y, the softest rate since March 2022 but nevertheless still above equivalent rates in the US (4.0%Y/Y) and euro area (4.2%Y/Y).

Services inflation to remain sticky over near term, but pressures will subsequently start to dissipate

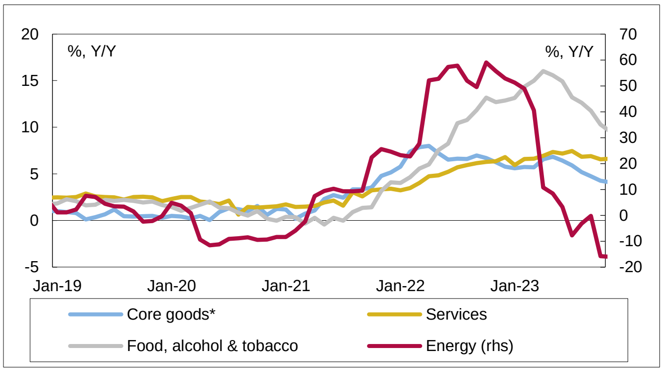
While the share of items in the CPI basket with inflation above 2% remained at a lofty 79%, the share of items with inflation of 3% or more fell to the lowest since February 2022 (71%). And the NIESR estimate of trimmed mean CPI eased 0.8ppt to 6.5%Y/Y, further suggesting a broader easing in underlying price pressures. Admittedly, given base effects associated with the spike in prices last year, as well as the recent decline in petrol prices, energy inflation will continue to provide the most significant negative contribution to headline inflation over coming months, although the drag will start to moderate at the turn of the year as the impact of base effects fades. But with producer output food prices having fallen for a third successive month to leave the annual rate down 1.1ppts to 3.0%Y/Y, some 13½ ppts below April's peak, food CPI inflation should continue to decline steadily over coming months. Given the moderation in overall producer output price inflation, reflecting the improved supply-demand balance and diminished pass-through of input cost burdens, non-energy industrial goods inflation should maintain a steady disinflationary trend too. However, against a backdrop of still-elevated wage growth, as well as indexation, services inflation is likely to remain relatively sticky over coming months, albeit below the BoE's forecast (6.9%Y/Y in Q4). Overall, therefore, we expect CPI inflation to edge only slightly lower by the end of this year (to 4.5%Y/Y), before resuming a steady downtrend from February when price pressures in services should start to dissipate amid softer wage demands and as subdued consumer spending weighs. Indeed, our expectations for headline and core inflation to fall back to the 2% target by mid-2025 supports our view that the BoE will be in a position to start cutting interest rates next summer.

UK: Consumer price inflation



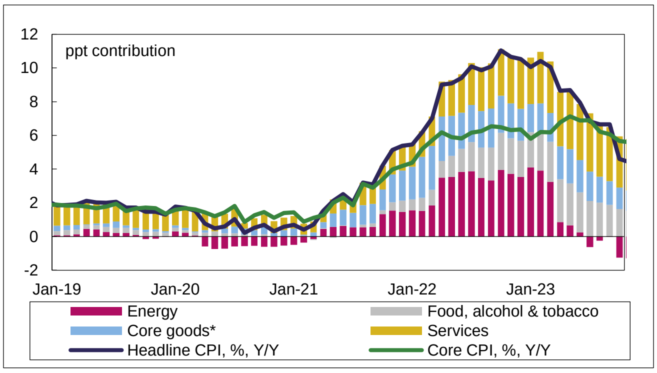
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Key CPI components



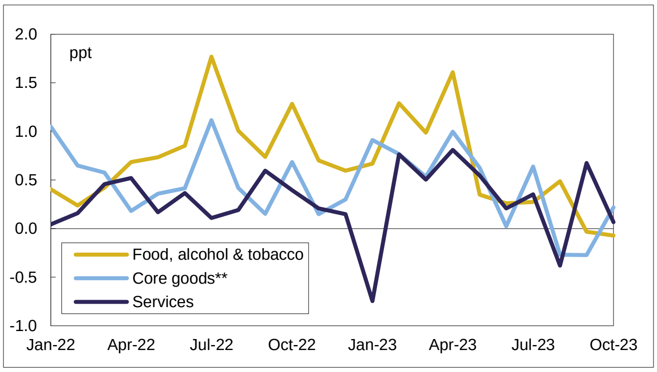
**Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Contributions to CPI inflation



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

UK: Deviations from long-run average price change*

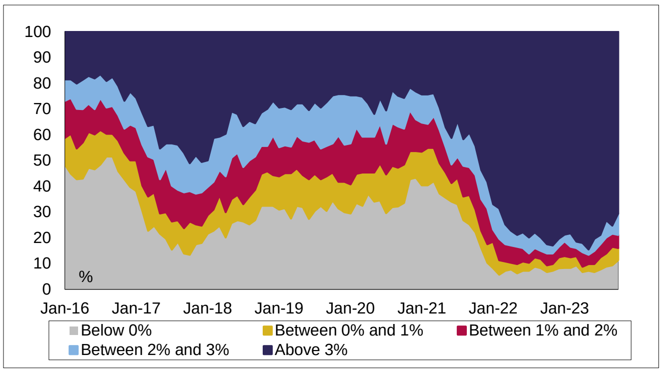


**Pre-pandemic long-run average. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

The coming two days in the UK

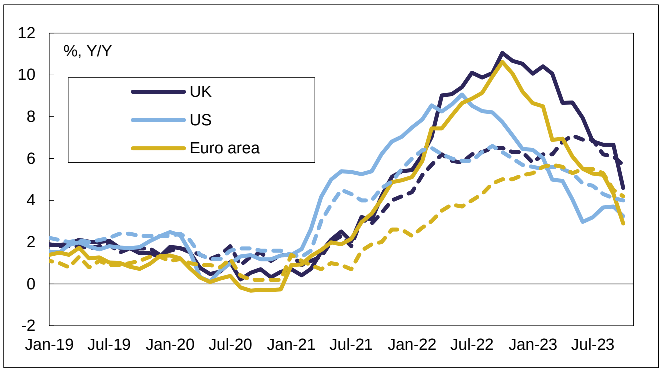
The focus over the coming two days in the UK will be on the latest retail sales report for October, which will be published on Friday. Given the improvement in households' real disposable incomes and the weakness in sales reported over the summer, we might expect to see some rebound in retail spending in October. But surveys suggest that, against the backdrop of historically low confidence and purchase intentions, sales remained weak for the time of the year at the start of Q4. And so, any bounce back last month will lack vigour. Indeed, the Bloomberg survey consensus sees a modest 0.5%M/M increase in October, which would leave sales down 1.5%Y/Y.

UK: Share of CPI basket by inflation rate



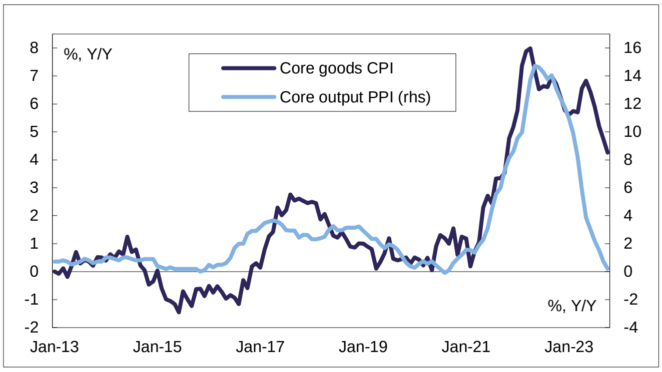
Source: ONS and Daiwa Capital Markets Europe Ltd.

Euro area, UK & US: Consumer price inflation*



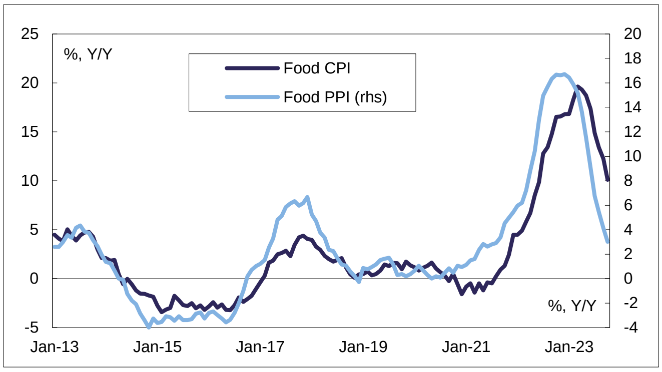
**Dashed lines represent core inflation. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Producer & consumer goods inflation*



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

UK: Producer & consumer food inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 17th November 2023

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Industrial production M/M% (Y/Y%)	Sep	**-1.1 (-6.9)**	*-1.1 (-6.2)*	0.6 (-5.1)	-
		Trade balance €bn	Sep	**9.2**	6.7	11.9	11.1
France		Unemployment rate %	Q3	**7.2**	-	6.9	7.0
		Final HICP (CPI) Y/Y%	Oct	**4.5 (4.0)**	*4.5 (4.0)*	5.7 (4.9)	-
Italy		Final HICP (CPI) Y/Y%	Oct	**1.8 (1.7)**	*1.9 (1.8)*	5.6 (5.3)	-
UK		CPI (core CPI) Y/Y%	Oct	**4.6 (5.7)**	*4.7 (5.7)*	6.7 (6.1)	-
		Output (input) PPI Y/Y%	Oct	**-0.6 (-2.6)**	-1.0 (-3.3)	-0.1 (-2.6)	0.2 (-2.1)
		House price index Y/Y%	Sep	**-0.1**	-0.7	0.2	0.8

Auctions

Country		Auction
Germany		sold €810mn of 0.0% 2052 bonds at an average yield of 2.76%
		sold €806mn of 1.8% 2053 bonds at an average yield of 2.81%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy		09.00	Trade balance €bn	Sep	-	2.1

Auctions and events

Country		GMT	Event
France		09.50	Auction: 2.50% 2026 bonds
		09.50	Auction: 2.75% 2029 bonds
		09.50	Auction: 0.75% 2028 bonds
		10.50	Auction: 0.1% 2029 index-linked bonds
		10.50	Auction: 0.1% 2036 index-linked bonds
		10.50	Auction: 0.1% 2053 index-linked bonds
Spain		09.30	Auction: 2.80% 2026 bonds
		09.30	Auction: 3.55% 2033 bonds
		09.30	Auction: 3.45% 2043 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	ECB current account balance €bn	Sep	-	27.7
		10.00	Final HICP (core HICP) Y/Y%	Oct	*2.9 (4.2)*	4.3 (4.5)
Spain		09.00	Trade balance €bn	Sep	-	-4.4
UK		07.00	Retail sales incl. auto fuels M/M% (Y/Y%)	Oct	0.5 (-1.5)	-0.9 (-1.0)
		07.00	Retail sales excl. auto fuels M/M% (Y/Y%)	Oct	0.5 (-1.5)	-1.0 (-1.0)

Auctions and events

Country		GMT	Event
Euro area		08.00	ECB President Lagarde scheduled to speak – 'Navigating in a world at risk of fragmentation'
UK		13.10	BoE Deputy Governor Ramsden scheduled to speak at the Society of professional economists

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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