Euro wrap-up

Overview

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- Ahead of the Fed's policy announcement, Bunds followed the global trend lower while the final estimates of euro area inflation in August confirmed that the uptick in the services component was related to a likely-temporary boost to transport fares.
- Gilts also made losses, while UK inflation aligned with market expectations but undershot the BoE's projections.
- The BoE is likely to leave Bank Rate unchanged at 5.00% tomorrow, but might signal that a further cut is likely to come in November; the MPC will also probably extend the current pace of QT for another 12 months.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.259	+0.038
OBL 2½ 10/29	2.068	+0.041
DBR 2.6 08/34	2.188	+0.047
UKT 4⅛ 01/27	3.896	+0.080
UKT 4⅛ 07/29	3.713	+0.081
UKT 4¼ 07/34	3.845	+0.079

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

Euro area

Energy-led drop in inflation in August confirmed

The final estimates of euro area inflation in August provided no major surprises, confirming the sizeable drop in the headline rate and slight moderation in the core measure. Indeed, the headline HICP rate was unrevised at the three-year low of 2.2%Y/Y, down 0.4ppt from July and more than 8ppts below the peak. But with the monthly increase in consumer prices a touch softer than initially reported, headline inflation was close to rounding lower (2.17ppt to two decimal places). Among the larger member states, inflation fell in Germany (2.0%Y/Y), France (2.2%Y/Y) and Spain (2.4%Y/Y) to multi-year lows and remained extremely weak in Italy (1.2%Y/Y). And inflation rose in only a quarter of the euro area's 20 member states which accounted for just 5% of the overall basket. As in the flash release, the downwards shift in August principally reflected a lower contribution from energy – down to a six-month low of -3.0%Y/Y – amid a sharp decline in prices of petrol and other liquid fuels.

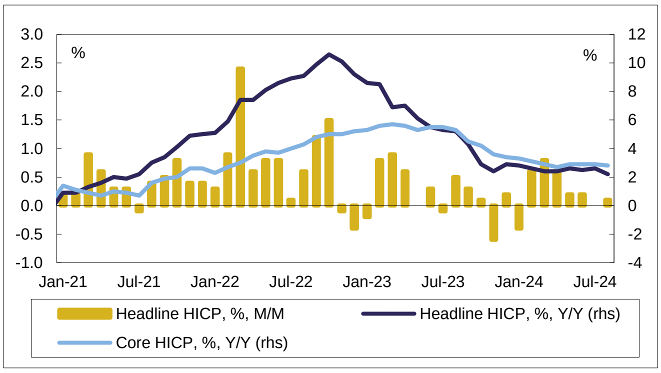
Uptick in services related to a temporary boost to transport

Among other goods, the component for food, alcohol and tobacco was revised a touch lower to be unchanged at July's more than 2½-year low of 2.3%Y/Y. Within core goods, there was a further weakening to a five-year low in the second-hand car component, ongoing deflation in furniture, furnishings and household appliances, and a notable step-down in clothing due to base effects likely associated with the timing of seasonal discounting. That pushed non-energy industrial goods inflation down 0.3ppt to 0.4%Y/Y, the lowest since April 2021. In contrast, services inflation ticked slightly higher in August, by 0.1ppt to 4.1%Y/Y, more than double the ECB's 2% target. As such, the moderation in core inflation was modest, down just 0.1ppt to 2.8%Y/Y. But today's detail suggests that the upwards price pressures in services largely related to one-off factors. Indeed, normal seasonal volatility pushed inflation of airfares up 6.2ppts to a five-month high, while a temporary hike in fares on the Parisian public transport system during the Olympics pushed rail transport inflation up 1.5ppts to a ten-month high. In contrast, catering services inflation moderated to the softest rate since April 2022, while insurance eased to an eight-month low. Overall, just 46% of items in the HICP basket had an inflation rate above the 2% target, the lowest share since September 2021.

Services momentum eased to a six-month low

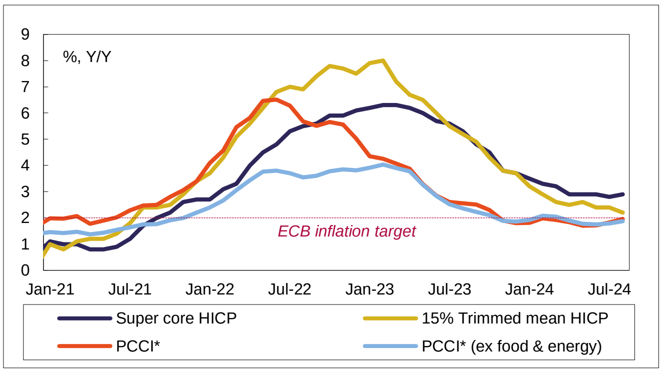
The ECB's seasonally adjusted estimates again suggested that the increase in services prices was 0.3%M/M for a third successive month in August, some 0.1ppt below the average in the first five months of the year. As such, momentum of this component eased 0.5ppt to a six-month low (4.4%3M/3M annualised). And while momentum in core goods prices rose to a

Euro area: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected measures of underlying inflation



**Persistent and Common Component of inflation. Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.*

five-month high (0.9%3M/3M annualised), this in part reflected the pickup in prices in July, while price moves were in line with the long-run average in August. Alternative measures of underlying pressures also maintained a downwards trend. For example, the 10% and 15% trimmed mean measures fell 0.2ppt apiece to three-year lows of 2.2%Y/Y, while the ECB's supercore measure – which excludes items that are typically subject to one-off adjustments – edged down to a 30-month low of 2.9%3M/Y. Admittedly, its principal common component estimate, which ECB staff think often provide the best guide to underlying pressures, ticked up slightly to 2.0%3M/Y, but when excluding food and energy it remained below the 2% target for a fifth successive month.

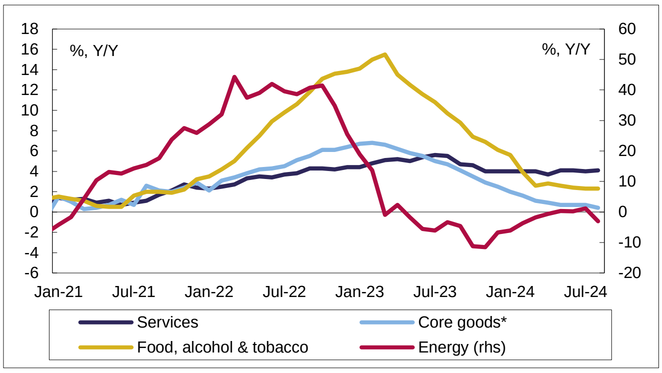
Inflation output to remain choppy due to base effects

The near-term inflation outlook will remain choppy, not least due to base effects in energy. As noted by ECB President Lagarde in her press conference last week, headline inflation will likely take a step down this month, with our expectation for a (temporary) return to the 2% target for the first time since June 2021. This largely reflects our expectation that energy inflation in September will be the most negative since January thanks to the ongoing decline in petrol and heating oil prices – currently trending some 3-4% below the August average. Soft demand should continue to keep a lid on firms' ability to pass on costs to consumers. Moreover, the recent decline in shipping freight costs from China to Europe – which last week recorded the largest weekly decline (-17%) since November 2022 – as well as new deflationary pressures in the goods sector emerging from China should help to alleviate some of the recent pickup in factory input costs. Of course, what matters most for ECB policymakers is developments in services inflation. And given unfavourable base effects, we expect this component to remain sticky, above 4%Y/Y through to next year. As such, core inflation is likely to remain around current rates (or slightly above) through to spring, which might underscore the more hawkish Governing Council members' reluctance to cut rates again next month.

The day ahead in the euro area

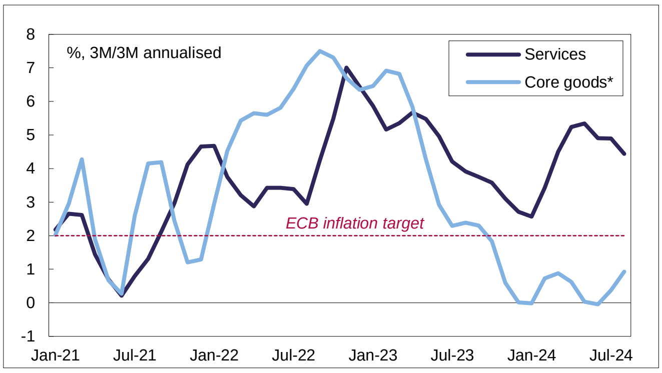
Thursday should be a quiet day for euro area economic news, with just the release of new car registrations figures for August scheduled. Figures published by the member states – Germany (-27.8%Y/Y), France (-21.1%Y/Y), Italy (-13.4%Y/Y) and Spain (-6.5%Y/Y) – suggest that euro area registrations will post a far sharper year-on-year decline in August than they did in July (just -1.0%Y/Y).

Euro area: Key HICP components



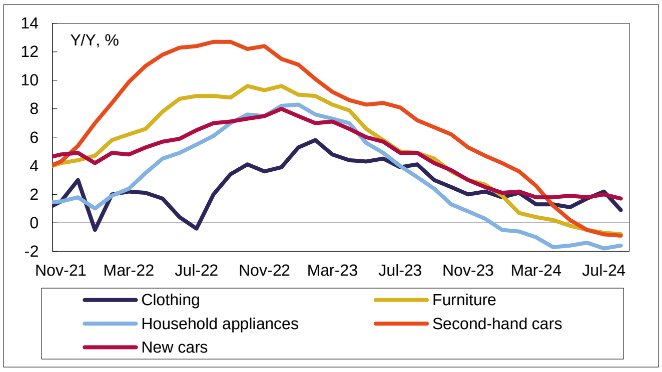
Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum



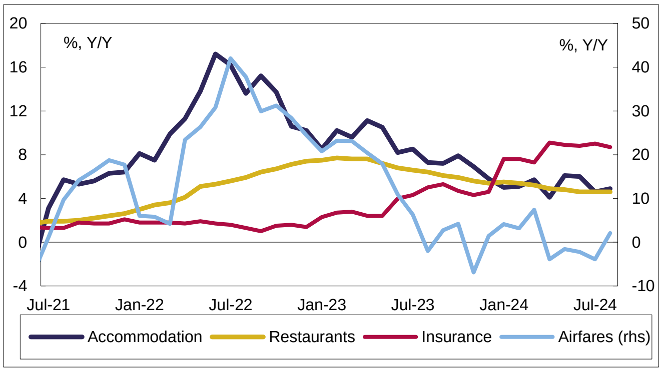
Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

UK

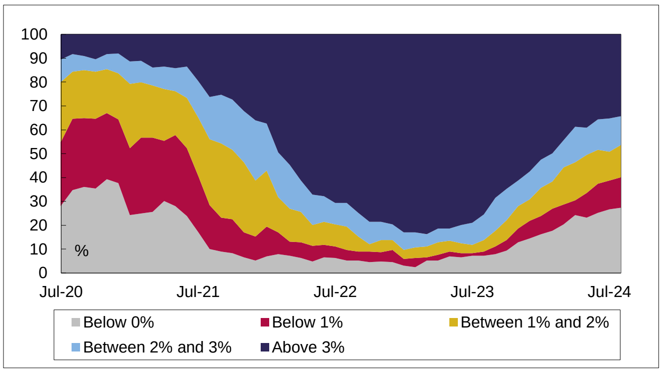
August inflation match market expectations but undershoot BoE projections

The August inflation data broadly aligned with market expectations. The headline CPI rate was unchanged at 2.2%Y/Y, 0.2ppt above the three-year low reached earlier in the summer. The core CPI rate rose 0.3ppt to a four-month high of 3.6%Y/Y with the services component up 0.4ppt to 5.6%Y/Y. The increases in the core and services measures from July appeared to reinforce the market expectation that the BoE will leave Bank Rate unchanged at 5.00% tomorrow. And that remains our expectation too, in part because inflation will take a significant if temporary step up in October when Ofgem's household energy price cap will be hiked by roughly 10%. Nevertheless, both headline inflation and the services component were 0.2ppt softer than the BoE had projected last month, marking a second successive undershoot of its expectation. Moreover, despite the pickup in core and services inflation in August, the data were consistent with continued gradual cooling in underlying inflation. Indeed, the NIESR trimmed mean measure, which excludes items with the highest and lowest 5% rates of inflation, fell to 1.4%Y/Y, illustrating that above-target headline inflation is being caused by prices in a relatively small share of sectors. As such, we do not entirely reject the possibility that the MPC will surprise with a further rate cut tomorrow.

Services detail remains consistent with steady disinflation

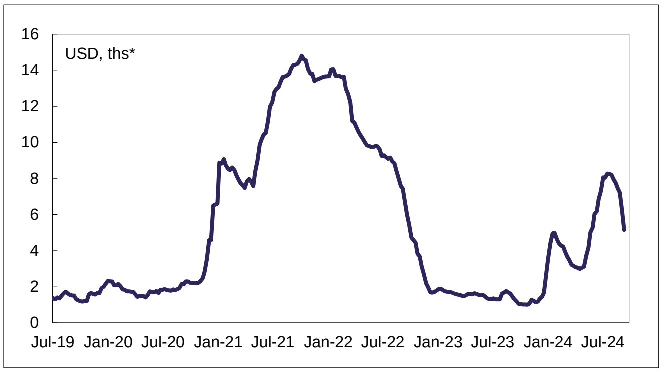
The rise in the services component added 0.2ppt to headline CPI inflation in August. That was principally caused by airfares, which rose sharply in August this year but declined a year earlier, contributing to the leap of more than 20ppts in the respective annual inflation rate to almost 12%Y/Y. In addition, an adverse base effect associated with ticket prices for cinemas, theatres and concerts, as well as regular volatility in the maintenance and repair category, also contributed positively to inflation. In contrast, some of the key services components that had until recently been subject to significant upwards pressure continued to ease, with catering, accommodation and insurance all falling to their lowest rates in 2½ years or more. And overall, the services detail was consistent with continued steady disinflation in the sector. Excluding some of the most volatile items (airfares, package holidays, education and rents), one of the BoE's preferred measures of core services inflation was unchanged at 4.5%Y/Y, the lowest since March 2022 and 1.6ppts below the level in January. And despite the unusually large increase in airfares, the monthly increase in services prices overall of 0.5%M/M was bang in line with the August average in the two decades ahead of the pandemic.

Euro area: Share of HICP basket by inflation rate



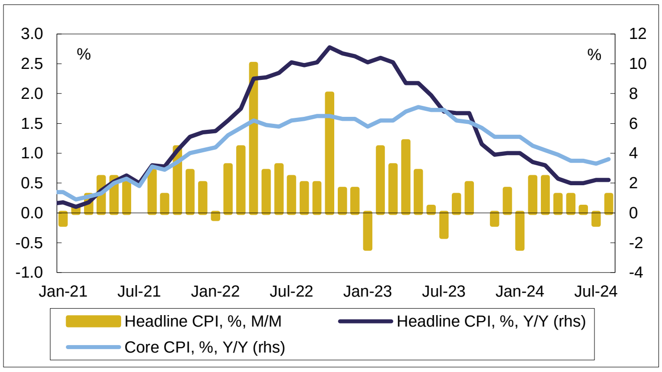
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Shanghai to Rotterdam container freight costs



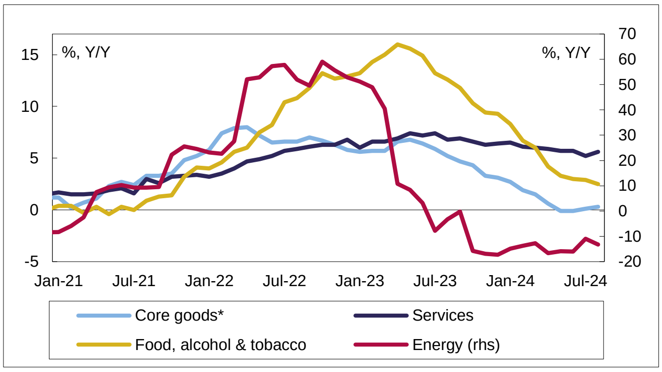
**Rate per 40ft box. Source: Bloomberg*

UK: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key CPI components



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

Goods price pressures remain subdued while lower petrol prices provide further relief

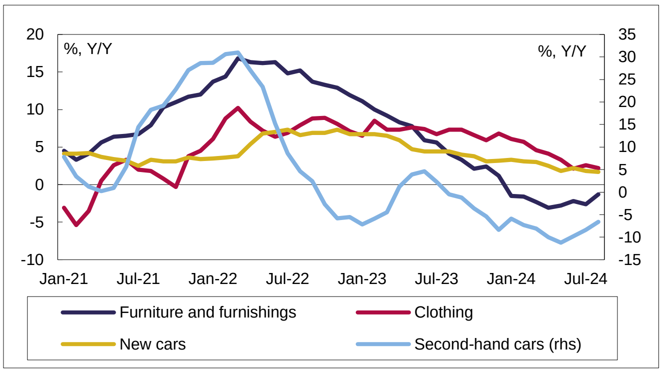
In contrast to services, goods inflation has been relatively well behaved for some time. The increase of non-energy industrial goods prices in August of 0.6%M/M was 0.1ppt below the long-run average for the month. But given the softer rise a year earlier, the annual rate rose 0.2ppt to 0.3%Y/Y, a four-month high but still very soft. Within the detail, a pickup in inflation from very low levels in the furniture and second-hand car categories was only partly offset by a softening in clothing. A moderate pickup in producer manufactured goods price inflation to a 12-month high of 1.3%Y/Y suggests that the related CPI category will pick up slightly towards year-end too despite the recent fall in freight costs. Finally, beyond the core items, due to a favourable base effect associated with a rise in duty a year earlier, inflation in food, alcohol and tobacco fell almost ½ppt to a near-three-year low of 2.5%Y/Y. Lower petrol prices pushed energy inflation down more than 2ppts to -13.2%Y/Y to take 0.1ppt off headline inflation. And auto fuel prices fell almost 3% in the first two weeks of September compared to the August average. So, we now expect a further drop in the energy component to push headline inflation back below 2.0%Y/Y this month before it contributes to a rebound back above-target from October to next spring.

The day ahead in the UK

All eyes tomorrow will be on the BoE's latest monetary policy announcement, which is expected to leave Bank Rate unchanged at 5.00%. The MPC will likely repeat its guidance that policy "will remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term have dissipated further". It will also probably repeat that it will continue "to monitor closely the risks of inflation persistence and will decide the appropriate degree of monetary policy restrictiveness at each meeting." However, we also expect a signal that rates are likely to be cut again at the following meeting in November. Indeed, we expect at least one MPC member (Swati Dhingra) to vote for another cut at this month's meeting. And the replacement of one of the MPC hawks (Jonathan Haskel) with a new member (Alan Taylor) whose views on rates are unclear adds further uncertainty about the extent of pressure for immediate easing.

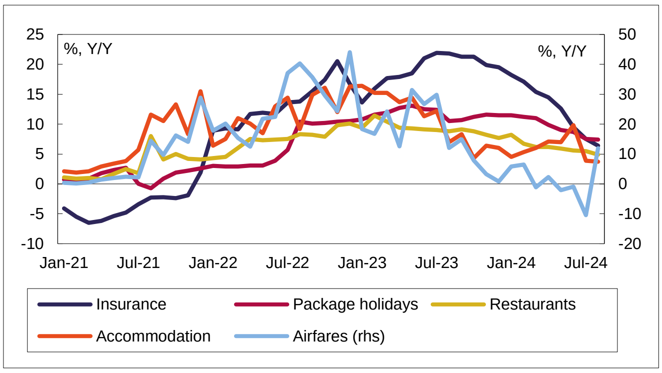
In terms of quantitative tightening, we currently expect the BoE to aim to reduce its Asset Purchase Facility (APF) holdings by roughly £100bn over the coming twelve months. That would broadly maintain the pace of balance sheet reduction of the past year. But it would also imply a slowdown in the pace of active Gilt sales offset by an increase in the pace of roll-off of maturing bonds. It would also push the total stock of bank reserves down close to levels that the BoE considers to be optimal. Given the recent marked uptrend in take-up of the Short-term Repo Facility, however, we do not rule out that the BoE might slow the pace from March to mitigate any perceived risks of unintentional and possibly destabilizing bank reserve scarcity arising next year.

UK: Selected goods CPI components



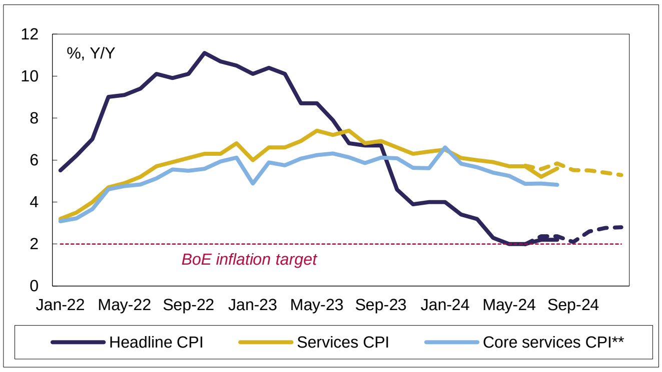
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services CPI components



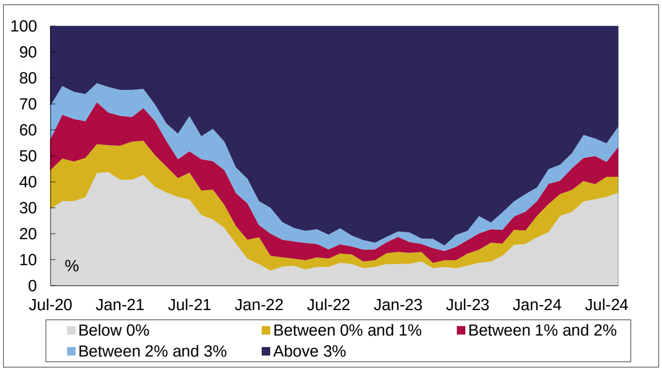
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & services inflation*



**Dashed lines represent BoE projections from August MPR. **Excluding airfares, accommodation & rents. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Share of CPI basket by inflation rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final HICP (core HICP) Y/Y%	Aug	**2.2 (2.8)**	*2.2 (2.8)*	2.6 (2.9)	-
		Construction output M/M% (Y/Y%)	Jul	**0.0 (-2.2)**	-	1.7 (1.0)	0.6 (-1.3)
UK		CPI (core CPI) Y/Y%	Aug	**2.2 (3.6)**	*2.2 (3.7)*	2.2 (3.3)	-
		PPI – output (input) prices Y/Y%	Aug	**0.2 (-1.2)**	0.5 (-0.8)	0.8 (0.4)	- (0.2)
		House price index Y/Y%	Jul	**2.2**	-	2.7	-
Auctions							
Country		Auction					
Germany		sold €820.2mn of 2.5% 2054 bonds at an average yield of 2.44%					
		sold €813.5mn of 1.8% 2053 bonds at an average yield of 2.44%					
Italy		sold €1.34bn of 2.5% 2032 bonds at an average yield of 3.219%					
		sold €1.13bn of 4% 2035 green bonds at an average yield of 3.467%					
		sold €532mn of 0.95% 2037 bonds at an average yield of 3.635%					
UK		sold £2.75bn of 0.875% 2033 bonds at an average yield of 3.731%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		05.00	New car registrations Y/Y%	Aug	-	-1.0
		09.00	Current account balance €bn	Jul	-	50.5
UK		12.00	BoE Bank Rate %	Sep	*5.00*	5.00
Auctions and events						
France		09.50	Auction: to sell up to €12bn of 2.5% 2027, 0.75% 2028, 2.75% 2030 & 2% 2032 bonds			
		10.50	Auction: to sell up to €2bn of 0.1% 2032, 3.15% 2032, 1.8% 2040 & 0.1% 2053 inflation-linked bonds			
Spain		09.30	Auction: to sell up to €6bn 5.15% 2028, 3.1% 2031 and 3.45% 2043 bonds			
UK		12.00	BoE monetary policy announcement and minutes to be published			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs