Euro wrap-up

Overview

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- Shorter-dated Bunds made modest gains as German inflation fell below 2% for the first time in 2½ years and ECB President Lagarde signalled a possible October rate cut.
- While UK GDP growth was revised lower in Q2, Gilts made losses as UK mortgage lending and house prices rose the most since 2022.
- Tuesday will bring the flash September inflation estimates from the euro area.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.062	-0.009
OBL 2½ 10/29	1.947	-0.002
DBR 2.6 08/34	2.127	-0.003
UKT 4⅛ 01/27	3.981	+0.048
UKT 4⅛ 07/29	3.860	+0.039
UKT 4¼ 07/34	4.005	+0.029

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

Euro area

Soft September inflation data prompt signal from Lagarde of likely October rate cut

After Friday's flash estimates of French and Spanish inflation in September surprised on the downside, today's equivalent German and Italian data aligned with expectations. But they too fell significantly from August to underscore the likelihood of a non-negligible decline in tomorrow's flash euro area inflation figure. As such, they further enhanced the probability of a rate cut at the ECB's next policy meeting on 17 October. Indeed, in a speech to the European Parliament this afternoon, President Lagarde stated that "the latest developments strengthen our confidence that inflation will return to target in a timely manner" and that the Governing Council "will take that into account in our next monetary policy meeting".

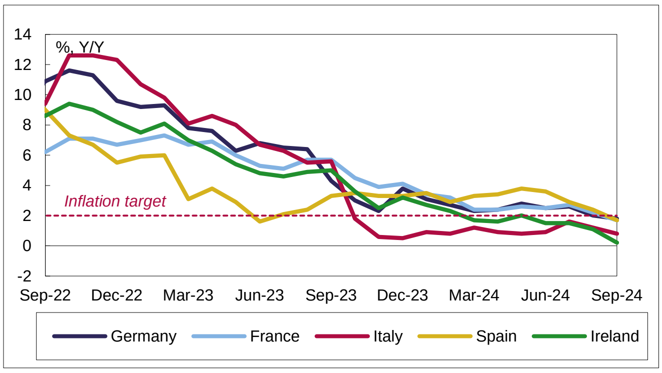
German inflation falls below 2% target for first time in 3½ years

In particular, German inflation on the EU-harmonised HICP measure fell 0.2ppt to 1.8%Y/Y, the first sub-target reading since March 2021. And the national CPI measure dropped 0.3ppt to 1.6%Y/Y, also a 3½-year low. As expected, the detail on the national measure showed that 0.2ppt of that decline was related to the energy component, which fell 2.5ppts to a four-year low of -7.6%Y/Y due principally to falling prices of auto fuel and heating oil. However, services inflation also ticked lower by 0.1ppt to a five-month low of 3.8%Y/Y. And while food inflation ticked up marginally to an eight-month high of 1.6%Y/Y, our estimate of core goods inflation was steady at 0.7%Y/Y. As a result, German core inflation on the national measure edged down 0.1ppt to 2.7%Y/Y, the lowest since January 2022.

Italian inflation falls below 1%Y/Y with core rate sub-2% for 1st time in 2½ years

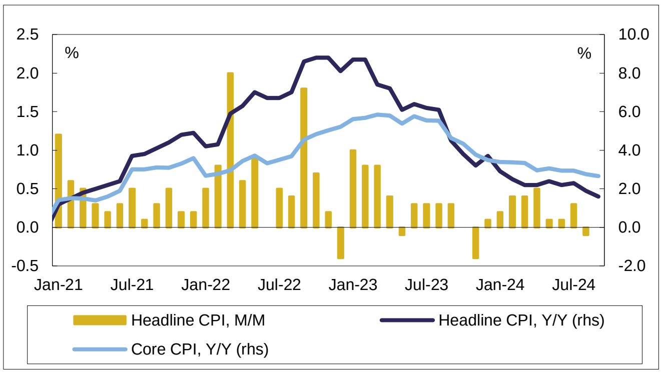
In Italy, the headline HICP rate fell 0.4ppt to 0.8%Y/Y, marking the sixth month of sub-1% inflation this year. Like in the other large member states, energy prices provided a notable drag this month, with the annual rate of that component declining 2.5ppts to -8.7%Y/Y. Admittedly, this was in part offset by higher inflation of food, alcohol and tobacco (up 0.3ppt to 1.6%Y/Y). But core goods inflation also fell sharply, by 0.5ppt to a more than three-year low of -0.2%Y/Y, as clothing and footwear inflation fell more than 1ppt into negative territory. Like elsewhere, there was better news with respect to services inflation too, with the respective HICP rate down 0.3ppt to 3.1%Y/Y, the joint-softest rate since April 2022. And the detail suggested moderation across a range of sub-categories, including recreation and culture, restaurants and hotels, education and communication. So, when excluding food and energy, core Italian inflation fell 0.5ppt to a 2½-year low of 1.8%Y/Y. Beyond the largest member states there has been some variation, with inflation down sharply in Ireland to just 0.2%Y/Y but up in Belgium and Portugal. However, based on the figures published from just over 80% of the region, we maintain our view

Euro area: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

that euro area headline inflation fell 0.4ppt in September to 1.8%Y/Y. And we now expect core inflation to have eased 0.2ppt to 2.6%Y/Y, which would be the lowest since January 2022.

The day ahead in the euro area

The main focus tomorrow will be the aforementioned flash estimates of euro area inflation, where we expect the headline HICP rate to drop below the 2%Y/Y target for the first time since June 2021. The decline this month will be led by energy as petrol and heating oil prices were trending in the first three weeks of the month lower by between 3½-4½%M/M. But with services inflation also set to moderate and the core goods component to remain subdued, we expect core inflation also to ease 0.2ppt to a more than 2½-year low of 2.6%Y/Y. Tuesday will also bring the final manufacturing PMIs for September, which are expected to align with the flash release that saw the euro area output index fall to a nine-month low of 44.5. The manufacturing PMIs from Italy and Spain will be published for the first time.

UK

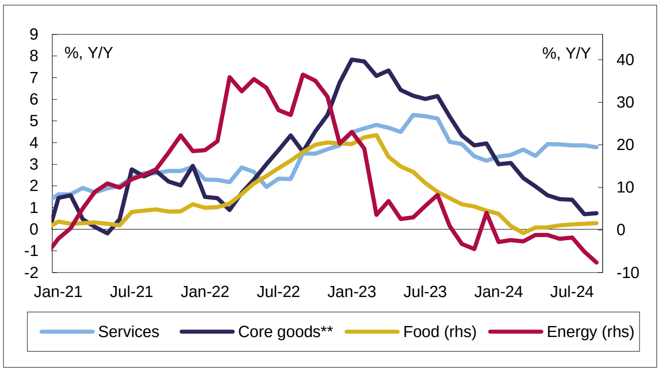
UK GDP revised slightly lower in Q2, with GDP per capita still well below pre-pandemic level

Today's updated UK national accounts figures brought a modest downwards revision to economic activity in Q2, although the growth rate of 0.5%Q/Q still appeared relatively firm after the surprisingly strong rebound of 0.7%Q/Q in Q1. Admittedly, this was 0.2ppt softer than the rate in Q2 assumed by the BoE in its August monetary policy report. And to two decimal places (0.45%Q/Q) it was close to a larger revision. As a result, GDP was up just 0.7%Y/Y in Q2 and 2.9% above the pre-pandemic level of Q419, a performance better only than Germany among the G7 countries against that benchmark. Moreover, reflecting strong population growth, GDP per capita rose just 0.2%Q/Q in Q2 to be still some 0.6% below the pre-pandemic level. Of course, the BoE had already assumed that underlying economic momentum in the first half of the year was softer than implied by headline GDP growth. Nevertheless, today's downwards revision bolsters the case for a further rate cut at the MPC's next meeting at the start of November.

Government spending underpinned GDP growth in Q2, while households preferred to save

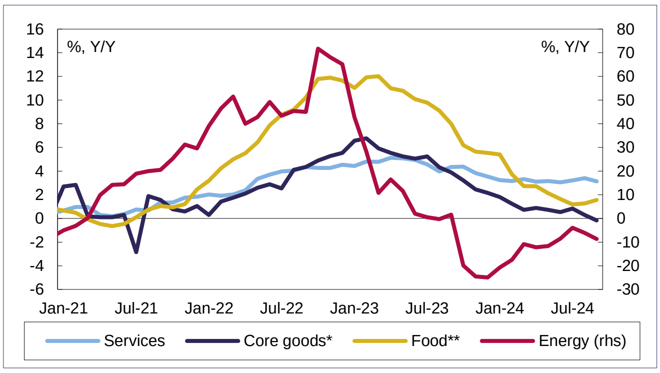
The downwards revision to GDP in Q2 reflected slightly softer growth in government spending (1.1%Q/Q) than previously estimated, although that category still contributed 0.2ppt to GDP growth. Despite a further rise in real disposable incomes, consumer spending remained subdued in Q2 (0.2%Q/Q) adding just 0.1ppt to growth, while the household savings ratio rose to a three-year high of 9.8%. Indeed, household consumption still remained some 1½% below the pre-pandemic level. The

Germany: Key CPI inflation components*



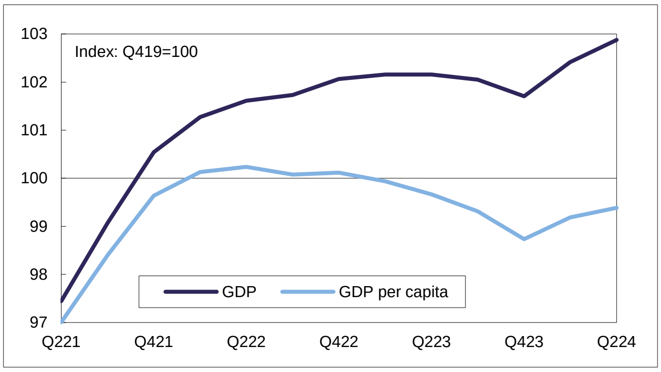
**National measure. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Italy: Key HICP inflation components



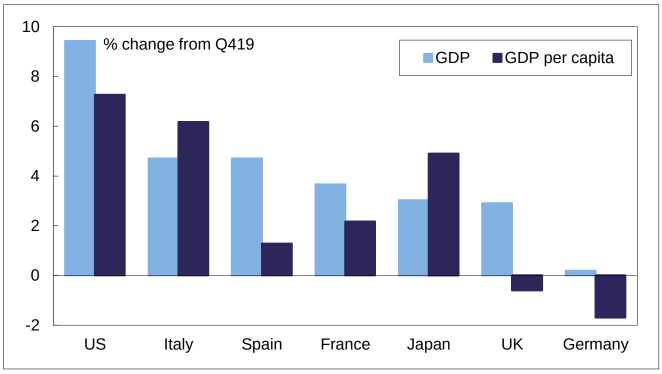
**Non-energy industrial **Food, alcohol & tobacco. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: GDP & GDP per capita



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Major economies: GDP & GDP per capita



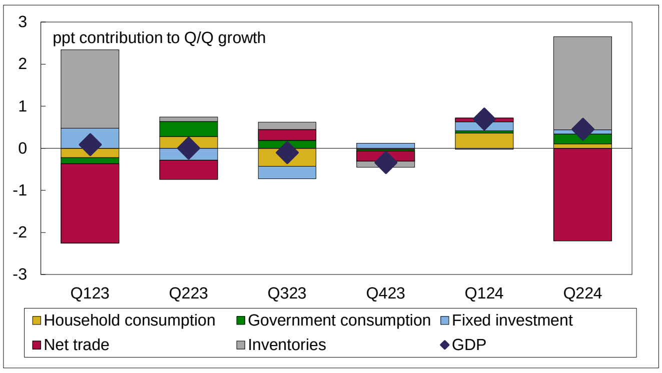
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

contribution from fixed investment was also unrevised in Q2 at 0.1ppt, with growth in business investment up for a third successive quarter (1.4%Q/Q) as higher investment in transport equipment, intellectual property and other buildings and structures offset lower spending on machinery and private dwellings. While fixed investment was almost 4% above the pre-pandemic level, business investment was up just 1% against the same benchmark. And both remained well below their respective pre-Brexit trends. Overall, final domestic demand fully accounted for GDP growth in Q2. Meanwhile, the sizable contribution from private inventories (2.2ppts) was offset by a similar drag in net trade, with both components exaggerated by transactions in non-monetary gold. Notably, export volumes fell for a second successive quarter while imports jumped the most in nine quarters. Given the associated deterioration in the trade deficit in Q2 to 2.3% of GDP, the current account deficit widened 2.0ppts to 4.0% of GDP, the largest in nine quarters. When excluding precious metals, however, the trade deficit widened somewhat less to 1.4% of GDP, with the current account deficit widening a more modest 0.8ppt to 3.2% of GDP.

Household deposits continue to rise, while mortgage lending picks up

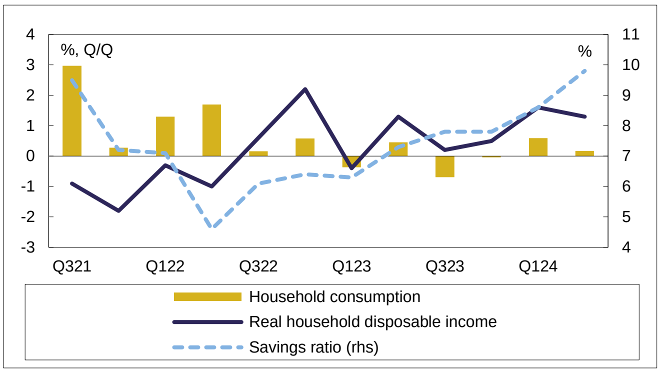
Despite rising household disposable income, consumer confidence surveys have suggested that households maintained a preference to save rather than spend in Q3. These tally with today's BoE's monetary figures, which showed that households deposited an additional £7.3bn into banks in August, broadly in line with the average over the previous six months and well above the pre-pandemic norm (£4.2bn). But while consumer credit remained relatively subdued over the summer, today's

UK: Contributions to GDP growth



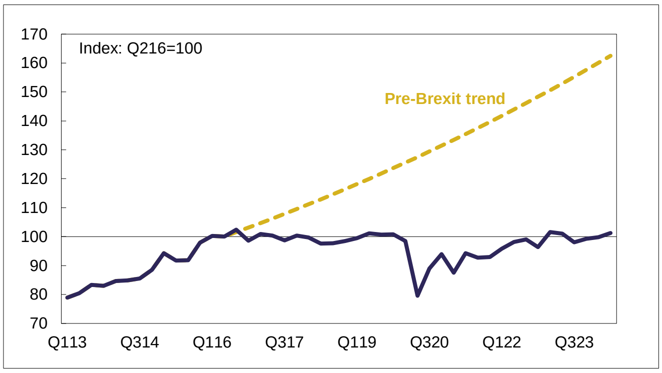
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Household consumption, income & savings



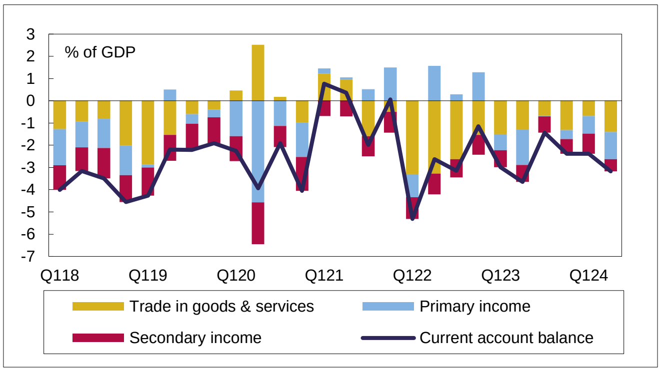
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Business investment



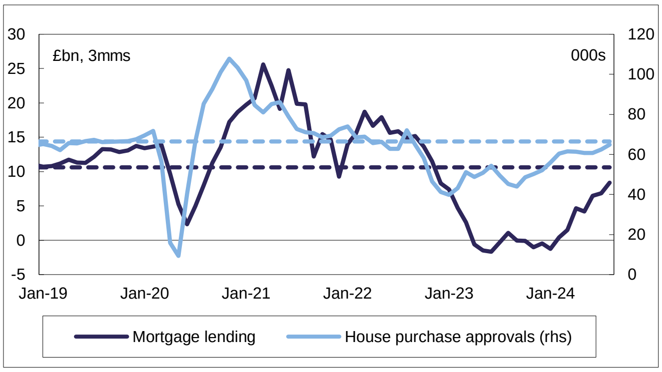
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Current account balance*



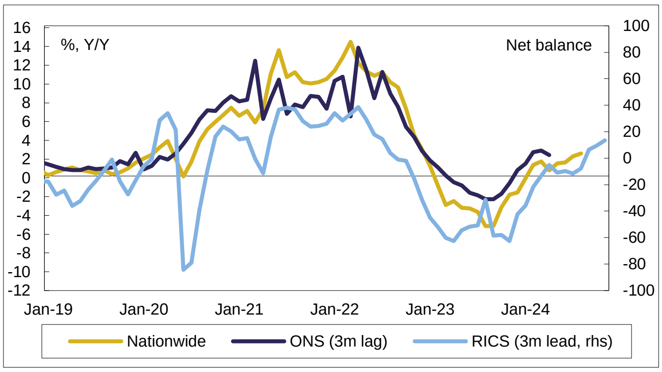
**Excluding precious metals. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Mortgage lending & approvals*



**Dashed lines represent pre-pandemic five-year average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: House price indicators



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

release reported a further pickup in mortgage lending as borrowers looked to benefit from a further reduction in mortgage interest rates. Indeed, the net increase of £2.9bn was the firmest since November 2022 and took the cumulative increase in the three months to August to £8.4bn. The further rise in new mortgage approvals by more than 2k to a near-two-year high of 64.9k points to a further pickup in mortgage lending over coming months. Today's Nationwide report also signalled renewed momentum in the housing market in September, with the monthly increase in house prices (0.7%M/M) the firmest since February taking the annual rate (3.2%Y/Y) to the highest since November 2022.

The day ahead in the UK

A relatively quiet day for UK top-tier releases tomorrow will bring the BRC shop price survey for September along with the final manufacturing survey for the same month. The BRC's measure of shop price inflation is expected to remain in negative territory (-0.3%Y/Y), reflecting not least ongoing deflation in non-food goods on the High Street. In contrast, the final manufacturing price PMIs are expected to align with the flash release that saw output prices rise the most in 16 months in September amid a further pickup in input costs. In terms of activity, the manufacturing output PMI slipped back to a three-month low (53.5), albeit signaling ongoing expansion.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Preliminary HICP (CPI) Y/Y%	Sep	**1.8 (1.6)**	1.8 (1.7)	2.0 (1.9)	-
Italy	Preliminary HICP (CPI) Y/Y%	Sep	**0.8 (0.7)**	0.8 (0.7)	1.2 (1.1)	-
UK	GDP – final estimate Q/Q% (Y/Y%)	Q2	**0.5 (0.7)**	*0.6 (0.9)*	0.7 (0.3)	-
	Current account balance £bn	Q2	**-28.4**	-33.0	-21.0	-13.8
	Nationwide house price index M/M% (Y/Y%)	Sep	**0.7 (3.2)**	0.2 (2.7)	-0.2 (2.4)	-
	Net consumer credit £bn (Y/Y%)	Aug	**1.3 (7.6)**	1.4 (-)	1.2 (7.8)	-
	Net mortgage lending £bn (mortgage approvals 000s)	Aug	**2.9 (64.9)**	2.8 (63.9)	2.8 (62.0)	- (62.5)
	Lloyds business barometer (own price expectations)	Sep	**47 (65)**	-	50 (54)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data					
Euro area	09.00	Final manufacturing PMI	Sep	44.8	45.8
	10.00	Preliminary headline (core) HICP Y/Y%	Sep	*1.8 (2.6)*	2.2 (2.8)
Germany	08.55	Final manufacturing PMI	Sep	40.3	42.4
France	08.50	Final manufacturing PMI	Sep	44.0	43.9
Italy	08.45	Manufacturing PMI	Sep	49.0	49.4
Spain	08.15	Manufacturing PMI	Sep	50.2	50.5
UK	00.01	BRC shop price index Y/Y%	Sep	-0.3	-0.3
	09.30	Final manufacturing PMI	Sep	51.5	52.5
Auctions and events					
Germany	10.30	Auction: to sell €4bn of 2.5% 2029 bonds			
UK	10.00	Auction: to sell £2.25bn of 4.75% 2043 bonds			
	15.00	BoE Chief Economist Pill to deliver speech at the CBI Economic Growth Board			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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