Daiwa Capital Markets

Euro wrap-up

Overview

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- Despite some unusually firm euro area industrial output data, Bunds followed USTs higher as an investor survey reported a further deterioration in perceptions of current German economic conditions.
- Gilts also made gains as UK pay growth continued to moderate and job vacancies continued to decline.
- Data on Wednesday will likely report that UK inflation fell back below 2.0% in September.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.215	-0.042
OBL 2½ 10/29	2.084	-0.050
DBR 2.6 08/34	2.226	-0.046
UKT 4⅛ 01/27	4.130	-0.044
UKT 4⅛ 07/29	4.036	-0.046
UKT 4¼ 07/34	4.168	-0.069

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

Euro area

Euro area IP returns to growth in August, but unlikely to offer significant support to Q3 GDP

In line with expectations, euro area industrial production returned to positive growth in August, rising 1.8%M/M, the strongest increase in 18 months. But this followed a modest downward revision at the start of the third quarter (-0.5%M/M) and so left the level of output up just 0.1%Y/Y and more than 6% below the post-pandemic peak two years ago. Over the first two months of Q3, it was trending just 0.3% above the Q2 average, with the strength of growth in August and unfavourable survey indicators and fundamentals pointing to the likelihood of some payback to come in September. Indeed, while manufacturing production also returned to positive growth (1.5%M/M) for the first month in five in August, this left the level of factory output trending more than ½% below the Q2 average. As is often the case, today's figures were distorted by activities in Ireland, where output rose 3.7%M/M and a whopping 15.8%Y/Y in August. But this time around, production managed to rise in 14 out of the 20 member states, including Germany (3.3%M/M) and France (1.4%M/M). This notwithstanding, German manufacturing output was trending around 1½% below the Q2 level. And while France should provide some offset, industrial output in Italy and Spain is also lower so far in Q3.

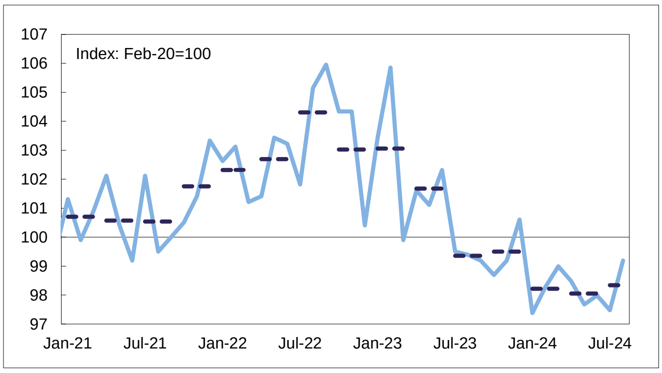
Manufacturing on track for 6th quarterly decline out of 7 despite boost from autos & pharmaceuticals

Within the manufacturing detail, the pickup in August was driven by the autos subsector, with the acceleration (15.9%M/M) the fastest since the resumption of operations following the first Covid-19 lockdown. While that left output at the highest level in 14 months, we suspect that this largely reflects the timing of summer maintenance periods this year. Indeed, having fallen sharply in July, car production was trending just 1% higher compared with Q2, albeit suggestive of a positive contribution to GDP growth in Q3 for the first time this year. Output of pharmaceutical products rose to a 17-month high and was trending almost 6% above the Q2 level. In marked contrast, output of machinery and equipment fell to the lowest level since February 2021 to be trending more than 1% below the Q2 average. Despite rising in August, electrical machinery was averaging some 3% lower than in Q2. And while production of basic metals was on track to provide a boost in Q3, chemicals fell to the lowest level since January. Overall, given the downbeat tone of the PMIs and Commission indices, which signalled a deterioration in September, the sector is highly likely to have subtracted from GDP growth in Q3 for a sixth quarter out of the past seven.

Investor survey flags ongoing challenges in Germany at the start of Q4

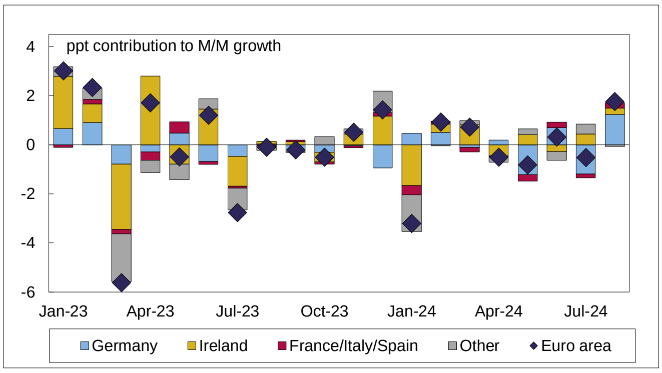
Not least reflecting ongoing weaknesses in manufacturing, Germany's economy looks to have slipped into mild recession over the summer. And while the results of today's ZEW investor survey for October were mixed, it nevertheless flagged ongoing significant challenges at the start of Q4. In particular, the current-situation balance fell for a third successive month

Euro area: Industrial production*



*Dashed dark blue lines represent quarterly averages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

in October, to -86.9, the lowest since July 2020, with almost 90% of respondents, the highest share since the global financial crisis outside of the pandemic, judging conditions to be “negative”. Admittedly, investors were somewhat more upbeat about the outlook for the coming six months, with the respective index rising 9.5pts to 13.1, albeit still the second-lowest level in the year to date. With more than 90% of respondents to the survey expecting the ECB to cut rates again over coming months, investor expectations for the construction sector were the most positive in five months in October. But while conditions were still considered positive in services, the outlook was the least upbeat since December. And notwithstanding an improvement from September, the profit outlook was still unfavourable in the autos, steel, chemicals and banking subsectors.

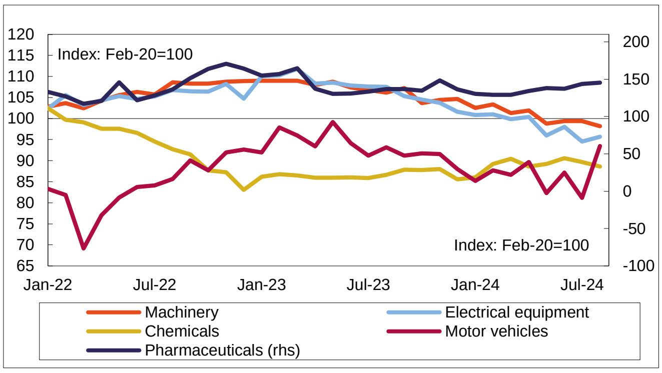
ECB survey reports surge in demand for mortgage loans

Ahead of this week’s Governing Council policy meeting, the results of the ECB’s Bank Lending Survey (BLS) for Q3 predictably signalled a further relaxation in credit standards and increase in loan demand amid expectations of gradual monetary easing. But while the improvement in lending conditions was greater than had been expected three months ago, it follows steady tightening over the past three years in response to the ECB’s increasingly restrictive monetary policy and cyclical weakness. And with loan demand increasing from extremely low levels, today’s survey seems highly unlikely to deter a rate cut on Thursday or a further cut in December too. Admittedly, amid a net loosening of lending standards due to increased competition among lenders, rate cuts and the associated recent improvement in housing market prospects, demand for mortgage lending jumped sharply in Q3, with the net increase (39%) the highest since Q215 and expectations of further growth in Q4. Mortgage demand rose sharply in Q3 in Germany (44%), France (67%) and Italy (45%).

But loan demand from firms remains subdued as economic uncertainties persist

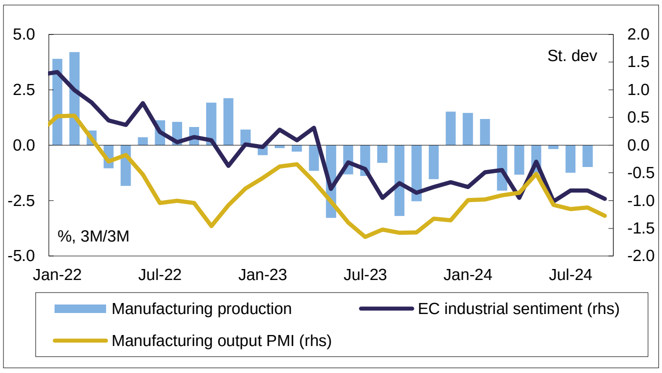
Despite reported support from improved household confidence and spending on durable goods, demand for consumer credit (7%) increased more moderately in Q3. And while firms’ net loan demand increased (4%) for the first quarter since Q122, it was softer than expected three months ago and still well below the average net increase in the five years before the pandemic (10%). Perhaps unsurprisingly given the recent contrasting economic performance of the two countries, the BLS reported that risk perceptions related to the economic outlook were having a tightening impact on credit standards in Germany but an easing impact in Spain. This notwithstanding, the BLS reported a larger net increase in demand for business loans among German, French and Spanish banks, with the increase in the latter two member states supposedly to support fixed investment plans. But business loan demand continued to fall in Italy and half of the other 16 member states.

Euro area: Manufacturing production



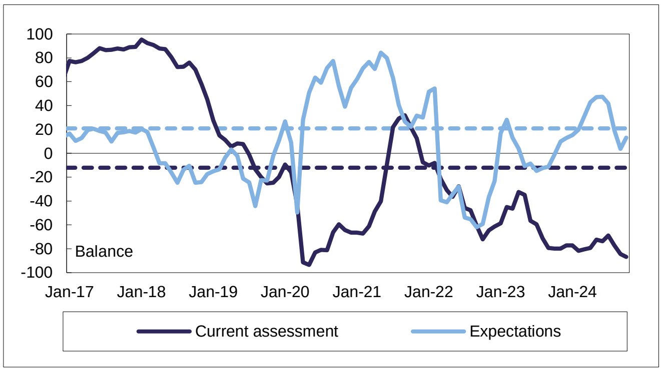
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing production & sentiment



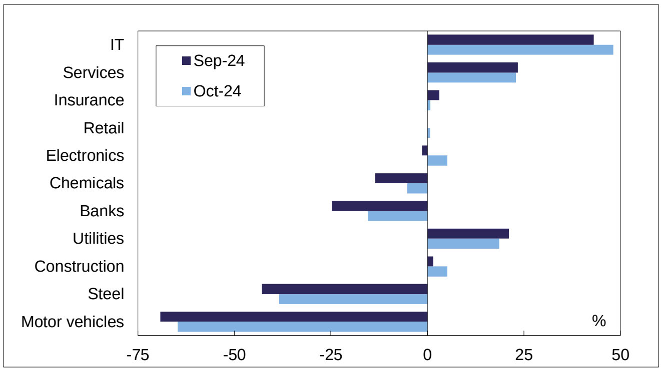
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW investor sentiment indices*



**Dashed lines represent long-run average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Germany: ZEW investor profit expectations



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

With attention firmly fixed on Thursday's Governing Council announcement, Wednesday will be a quiet day for euro area data releases, with just final Italian CPI data for September. The flash release showed the headline HICP rate easing 0.4ppt to a four-month low of 0.8%Y/Y. Meanwhile, core inflation fell 0.5ppt to 1.8%Y/Y, the softest since March 2022, helped by lower inflation of non-energy industrial goods (-0.2%Y/Y) and services (3.1%Y/Y).

UK

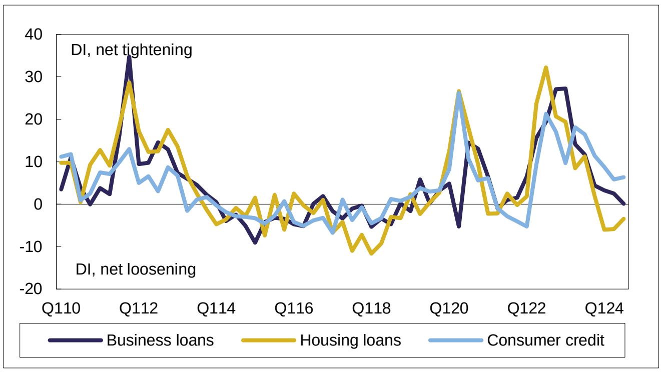
Pay pressures continue to ease, particularly in services, reinforcing case for a further rate cut

Today's labour market data strongly suggested that underlying disinflation persists in line with the BoE's expectation, thus making a further rate cut next month extremely likely. Certainly, the MPC has hoped that lower inflation outcomes and better anchored inflation expectations will support a gradual easing in pay growth back towards levels more consistent with sustained achievement of its target. And so, the policymakers will be encouraged that growth in private sector regular pay (excluding bonuses) slowed in August by a further 0.2ppt to 4.8%3M/Y, the softest rate since April 2022. Indeed, with the single-month rate down a steeper 0.4ppt to 4.5%Y/Y, the weakest since end-2021, the BoE's projection for September (4.8%3M/Y) now looks likely to be undershot. Notably too with respect to the inflation outlook for that subsector, regular pay in services slowed to a 26-month low (4.9%3M/Y) despite a modest pickup in hospitality (5.1%3M/Y) and a steady reading for manufacturing (6.0%3M/Y). Meanwhile, public sector regular pay growth moderated to a 19-month low (5.2%3M/Y) despite some recent high-profile settlements. And as one-off payments to public sector workers a year earlier fell out of the calculation, growth in total pay (including bonuses) slowed 0.3ppt to 3.8%3M/Y, the lowest since late 2020 and just 0.5ppt above the long-run average.

Vacancies maintain downtrend to suggest that labour demand continues to wane

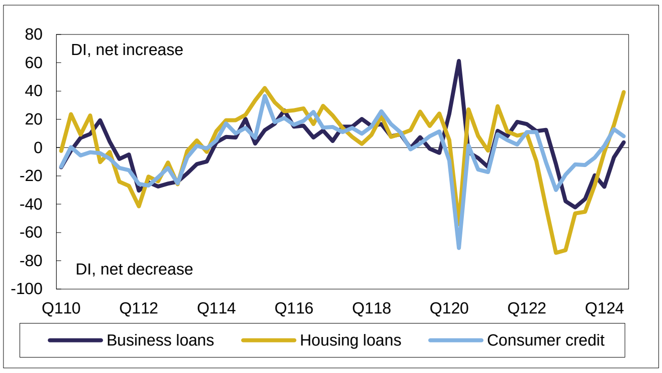
While pay growth is moderating, evidence on the tightness of the labour market remains mixed. Most importantly perhaps, the number of vacancies maintained the steady downtrend of the past two years, dropping in the three months to September to 841k, the lowest since April 2021, and falling in more than 80% of all sectors. That left them down 14.4%Y/Y and less than 15k above the average in the year ahead of the pandemic, with the ratio of vacancies to unemployed people in August (0.62) bang in line with the 2019 level. In addition, according to provisional data (which are typically subsequently revised lower) the number of payrolled employees fell in September for the third month out of the past four to the lowest level so far this year.

Euro area: Bank Lending Survey – credit standards



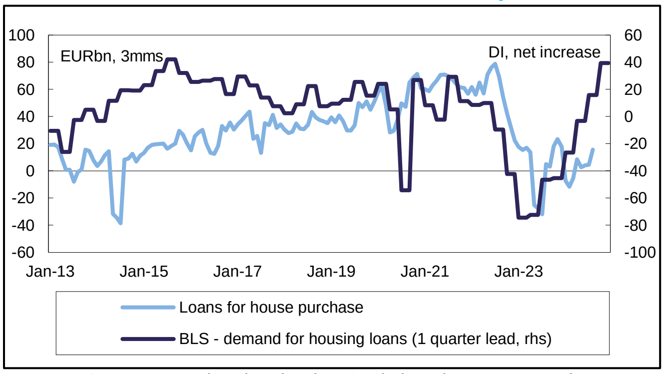
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Bank Lending Survey – loan demand



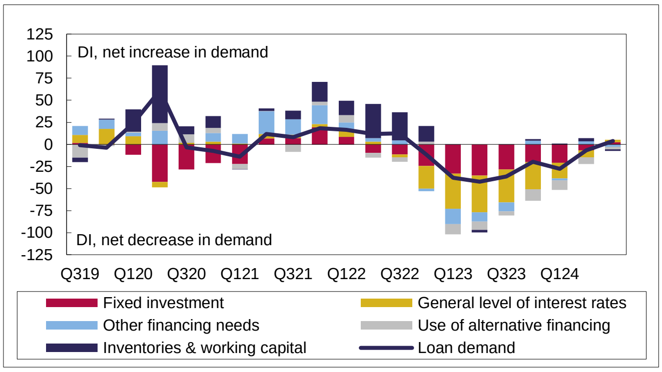
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Demand for loans for house purchase



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Factors impacting business loan demand



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Admittedly, the LFS measure of the unemployment rate fell in the three months to August to a nine-month low of 4.0%, some 0.4ppt below the BoE's projection for Q3. However, that reflected a barely believable jump in the LFS measure of employment of 373k, which would be a series high, alongside a second quarterly drop in inactivity. Redundancies fell to a 10-month low to suggest that most firms are not actively cutting headcount. And there still likely exists little in the way of labour market slack, But due to changes in sample size and data collection methods, the BoE (like most independent observers) will consider the LFS figures now to be unreliable to the point of uselessness. Instead, for the being, they will take their cue from pay data, which – notwithstanding the outside chance of a big upside surprise in tomorrow's September inflation print – appear to give the green light ahead for a November rate cut.

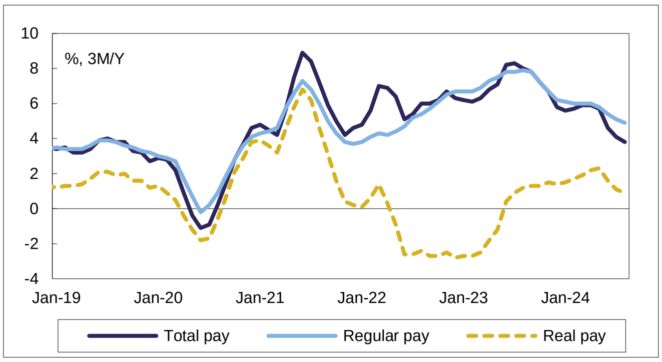
Job protection legislation & employer NICs hike likely to impact labour demand & pay at the margin

Looking further ahead, labour market conditions will likely remain difficult to interpret with confidence. In part, that will be due to ongoing structural shifts in the UK economy, including numerous policy reforms planned by the new government. Forthcoming draft measures to strengthen workers' rights (the so-called "Plan to Make Work Pay") might in due course weigh on demand for employees. But the measures will not be fully legislated immediately and are likely to be watered down from original proposals. Moreover, while changes to minimum wage arrangements might add to pay pressure at the low end of the scale, increases over the past two decades have largely failed to have a noticeable impact on overall labour demand. By the same token, the impact on labour demand of any increase in employers' National Insurance Contributions (NICs), which now seems likely to be announced in the government's forthcoming Budget on 30 October, is difficult to predict with confidence, with such a measure capable of weighing on pay growth. The accumulation of so many labour market reforms will at the margin, however, impact the relationship between labour slack and pay. And those MPC members – perhaps Chief Economist Pill and external member Mann – who are already concerned that past structural shifts in wage- and price-setting mean that policy is less restrictive than might otherwise be the case could become even more entrenched in their view that rates will have to stay higher for longer.

The day ahead in the UK

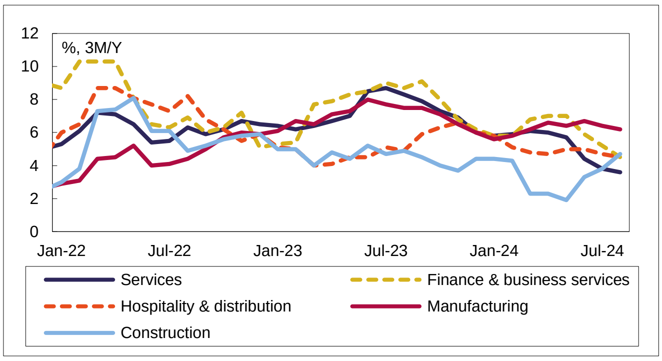
The headline release in the UK tomorrow will be September's CPI report, which is expected to show that price pressures continued to dissipate last month. Indeed, having moved sideways in August (2.2%Y/Y), we expect headline inflation to decline to just 1.8%Y/Y – back below the BoE's 2% inflation target for the first time since April 2021 and encouragingly below the 2.1%Y/Y forecast in the August Monetary Policy Report. This steeper descent is expected to be precipitated by lower petrol prices, which fell by around 4.0%M/M in September. But importantly for monetary policymakers, a disinflationary trend in services should resume. Indeed, following the temporary jump in August due to one-off effects, we expect services

UK: Total & regular pay growth



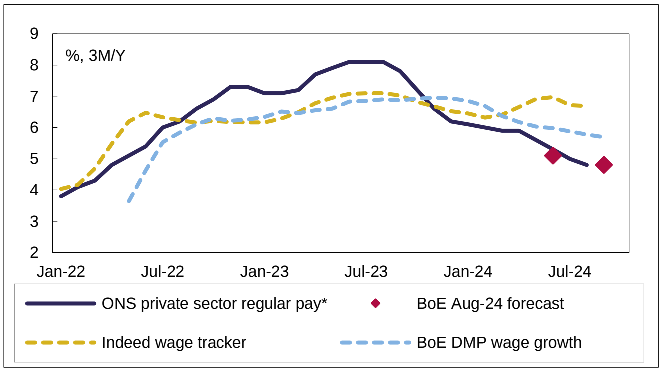
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Total pay growth



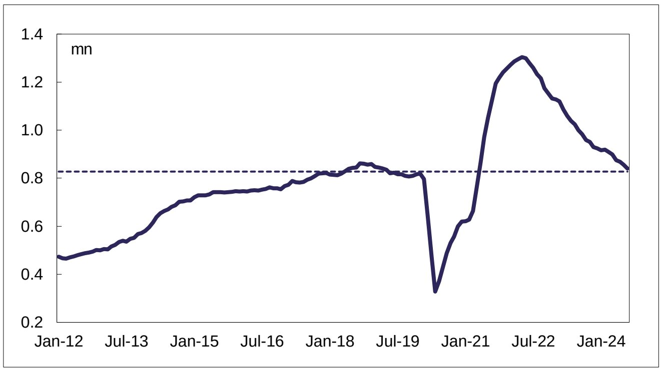
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Measures of pay growth



**Data between January & November 2022 are BoE estimates of regular pay growth. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

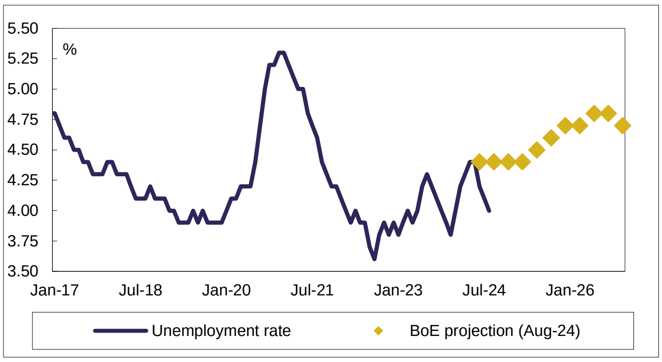
UK: Job vacancies*



**Dashed line represents 2019 average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

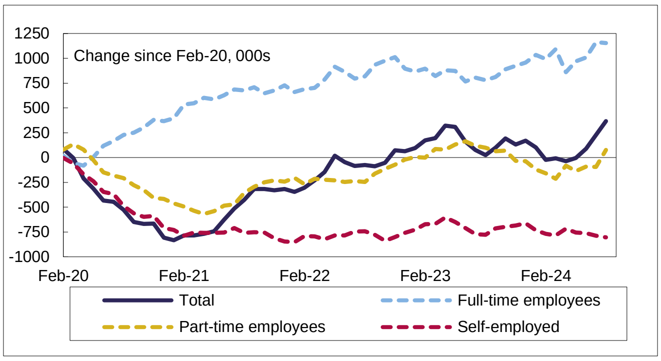
inflation to drop 0.6ppt to 5.0%Y/Y, well below the Bank's projection in August. So, while non-energy industrial goods inflation might tick marginally higher, core inflation is expected to reverse the 0.3ppt increase in August back to 3.3%Y/Y. Such progress would strengthen confidence in our prediction that the BoE will look to cut interest rates by 25bps at next month's MPC meeting, when updated macroeconomic projections will be published. Elsewhere, tomorrow's PPI data are likely to corroborate still very subdued goods cost pressures, with both input (-2.2%Y/Y) and output price inflation (-0.6%Y/Y) expected to tick downwards. Meanwhile, the ONS house price index will likely show that house prices rose in August after a temporary decline in July.

UK: Unemployment rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Change in employment



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		Industrial production M/M% (Y/Y%)	Aug	**1.8 (0.1)**	1.8 (-1.0)	-0.3 (-2.2)	-0.5 (-2.1)
Germany		ZEW investor survey – current situation (expectations) balance %	Oct	**-86.9 (13.1)**	-84.0 (10.0)	-84.5 (3.6)	-
France		Final HICP (CPI) Y/Y%	Sep	**1.4 (1.1)**	*1.5 (1.2)*	2.2 (1.8)	-
Spain		Final HICP (CPI) Y/Y%	Sep	**1.7 (1.5)**	*1.7 (1.5)*	2.4 (2.3)	-
UK		Average wages (excluding bonuses) 3M/Y%	Aug	**3.8 (4.9)**	3.7 (4.9)	4.0 (5.1)	4.1 (-)
		Unemployment rate 3M%	Aug	**4.0**	4.1	4.1	-
		Employment 3M/3M change 000s	Aug	**373**	240	265	-
		Payrolled employees M/M change 000s	Sep	**-15**	-3	-59	-35
		Claimant count rate % (change 000s)	Sep	**4.7 (27.9)**	-	4.7 (23.7)	4.6 (0.3)

Auctions

Country		Auction
UK		sold £2.25bn of 4.375% 2054 bonds at an average yield of 4.735%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy		09.00	Final HICP (CPI) Y/Y%	Sep	*0.8 (0.7)*	1.2 (1.1)
UK		07.00	CPI (core CPI) Y/Y%	Sep	*1.8 (3.3)*	2.2 (3.6)
		07.00	PPI – output (input) prices Y/Y%	Sep	-0.6 (-2.2)	0.2 (-1.2)
		09.30	House price index Y/Y%	Aug	2.3	2.2

Auctions and events

Country		BST	Auction
Germany		10.30	Auction: to sell €1bn of 0% 2050 bonds
		10.30	Auction: to sell €1bn of 2.5% 2054 bonds
UK		10.00	Auction: to sell £3.5bn of 4% 2031 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.