Euro wrap-up

Overview

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- Shorter-dated Bunds made gains as the ECB cut rates for the third time this cycle, acknowledging that disinflation is now well on track and recent economic activity has been softer than expected, opening the door wider to further easing in December.
- Gilts followed USTs lower on a quiet day for UK economic news.
- Friday will bring euro area construction activity figures for August and UK retail sales data for September.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.139	-0.023
OBL 2½ 10/29	2.047	+0.008
DBR 2.6 08/34	2.207	+0.025
UKT 4⅛ 01/27	4.018	+0.006
UKT 4⅛ 07/29	3.941	+0.020
UKT 4¼ 07/34	4.087	+0.024

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

Euro area

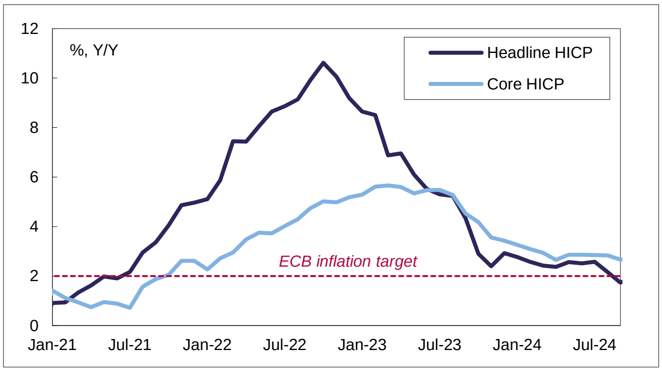
ECB cuts for second successive meeting as Governing Council acknowledges softer economic data

As had seemed increasingly likely following the recent soft survey and inflation data, as well as the more dovish noises from some of the Governing Council's hawks, the ECB today cut its key deposit rate for the second successive meeting by 25bps to take it back to 3.25%, the lowest level since June 2023. That marked the third cut of that magnitude, but the first back-to-back decision to ease policy, this cycle. Also as expected, the ECB's forward guidance predictably remained unchanged. The Council remained non-committal to future policy decisions, which it insisted would remain data-dependent and continue to be taken on a meeting-by-meeting basis. But it was arguably notable that President Lagarde confirmed that the rate cut was unanimous. And consistent with the recent change in tone of commentary of certain Governing Council members, the policy statement was more dovish. It acknowledged that disinflation is now well on track and that economic activity has recently surprised on the downside. And it left no doubt that policy remains restrictive. So, the statement reinforced our view that the ECB will cut rates again by 25bps at the next meeting in December and also at each meeting in Q1 next year. Thereafter, as many Governing Council might judge that rates might be close to neutral levels, the pace of easing might slow to just a single cut in Q2, particularly if economic growth momentum has picked up by then.

ECB growth & inflation projections likely to be revised down in December

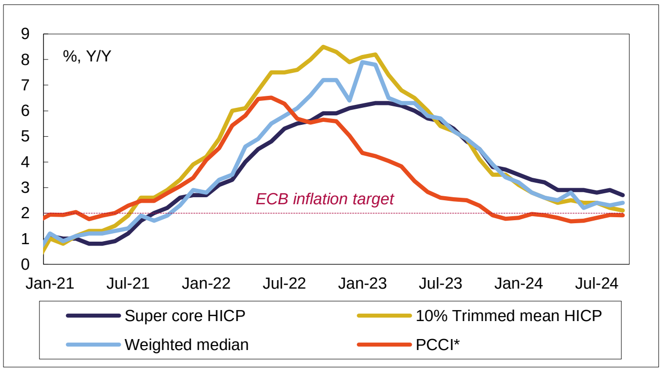
Just like the monetary policy statement, Lagarde was non-committal but dovish in her press conference. She refused to concede that today's cut represented the start of a more aggressive easing cycle over a prolonged period and was reluctant to give any indication where rates might end up by the time the ECB stops cutting. But she repeatedly acknowledged the deterioration in the economic dataflow. While she rejected the suggestion that the euro area economy risked slipping into recession, she noted the broad-based deterioration in the September PMIs and so judged that economic growth momentum had clearly softened since the end of the tourist season. And given also her recognition that inflation in both headline and underlying terms has moderated somewhat ahead of expectations, she stated that the risks to the ECB's September projections are now skewed more heavily to the downside. Indeed, she intimated that – in the absence of new shocks – the ECB's outlook for both GDP and inflation will probably be revised lower in December, a step that would merit a rate cut. In particular, we currently expect the ECB to bring forward to mid-2025 the date at which inflation is expected to return sustainably to target and also to signal the likelihood that inflation will undershoot slightly the 2% target in 2026 and 2027.

Euro area: Headline & core inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



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

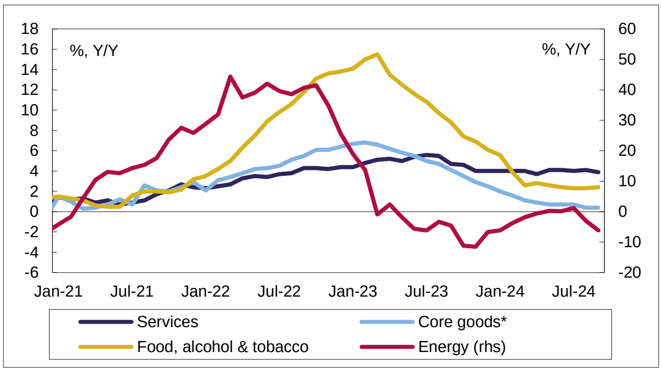
Final September inflation figures support cause for rate cuts

The case for a more dovish ECB was underscored by today's final euro area inflation data for September. While the flash estimates had already surprised to the downside, recording the first sub-2% reading since mid-2021, the final figures also brought a modest downwards revision to the headline rate, by 0.1ppt to 1.7%Y/Y, the softest since April 2021. To two decimal places the revision was very modest, down 0.03ppt to 1.74%Y/Y. Nevertheless, member states accounting for 84% of the region's GDP, and including the largest four, recorded sub-2% inflation in September. Admittedly, in large part, this reflected a large drag from energy (-6.1%Y/Y) due to a further sharp decline in auto fuel prices and a significant base effect in electricity prices. While core inflation was unrevised from the flash estimate in September, at 2.7%Y/Y it was still the joint-lowest since January 2022. And over the third quarter as a whole, both headline (2.2%Y/Y) and core inflation (2.8%Y/Y) were 0.1ppt below the ECB's projections presented just last month.

Services disinflation resumes as summer-related pressures dissipate

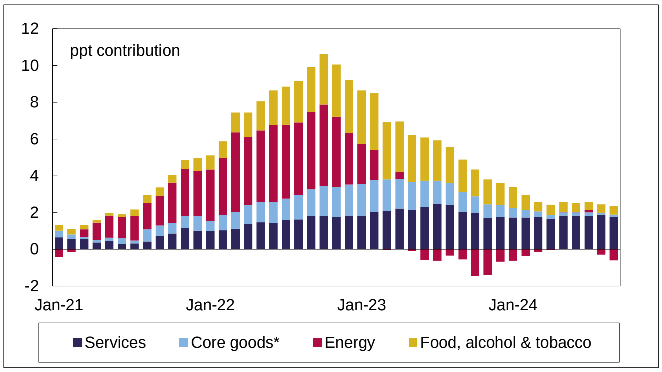
The unrevised core inflation rate reflected a very modest uptick in core goods inflation from the flash (up 0.03ppt to 0.44%Y/Y) as the pace of deflation in a range of goods including furniture, furnishings and household appliances dissipated slightly. But with seasonally-adjusted prices of non-energy goods unchanged in September, momentum remained very subdued (1.1%3M/3M). And encouragingly for ECB policymakers, services inflation eased a little more than initially estimated in September. Indeed, with services prices rising on a seasonally adjusted basis by just 0.1%M/M, the least in ten months, in her press conference Lagarde noted that momentum of this component (3.9%3M/3M) has also recently fallen significantly. Today's detail highlighted that the moderation in services principally relates to the highly volatile transport component as Olympics-related fare hikes on Parisian public transport were reversed and airfares and package holiday prices also fell back. Catering services inflation also moderated to a 2½-year low. In contrast, inflation of accommodation ticked slightly higher, while insurance costs remained stubbornly high. But a range of measures of underlying inflation were also on the whole reassuring, with the 10% trimmed mean (2.1%Y/Y) and supercore measure excluding items that are typically subject to one-off adjustments (2.7%Y/Y) down to their lowest rates since Q321. And the principal common component estimate, which ECB staff think often provides the best guide to underlying pressures, moved sideways at 1.9%3M/Y, the seventh successive sub-target reading.

Euro area: Key inflation components



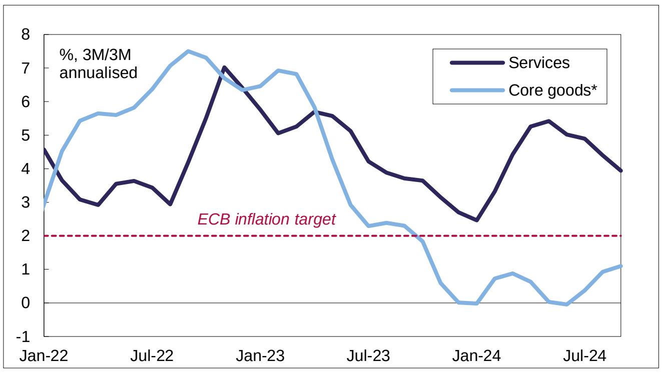
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to HICP inflation



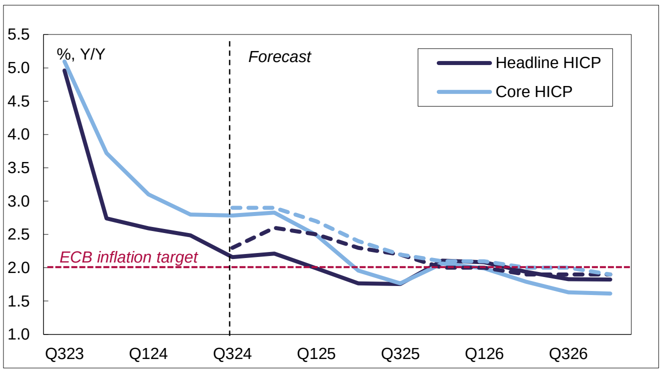
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum



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

Euro area: Inflation outlook*



*Dashed lines are ECB projections from September macroeconomic update. Solid lines represent Daiwa's projections. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Inflation to tick above target over near term but ECB should place greater weight on GDP weakness

As flagged in the ECB's policy statement today, inflation is set to rise temporarily over coming months due to base effects in energy prices. Indeed, we expect headline inflation to rise back to 1.9%Y/Y in October and above-target in November and December. But this would leave inflation merely moving sideways on a quarterly basis in Q4 at 2.2%Y/Y, some 0.4ppt below the ECB's projection. Notwithstanding some monthly volatility, we also now expect core inflation to move broadly sideways in Q4 at 2.8%Y/Y, again slightly undershooting the ECB's projection. And with economic recovery momentum having slowed over the summer, we continue to expect headline inflation to fall back below the 2% target again by Q225, two quarters earlier than the ECB currently projects. Moreover, while the ECB in September expected core inflation to only return to target by the end of the forecast horizon in Q426, we project it to drop back to 2% by the middle of next year, a profile that would justify the ECB placing much greater weight in its reaction function over coming quarters on supporting economic activity rather than fretting about a minimal rise in inflation back above target.

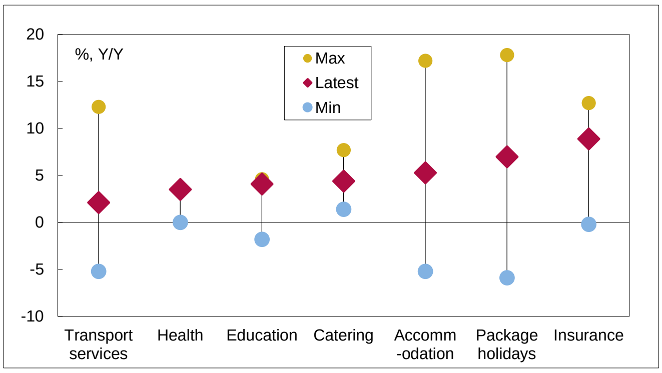
The day ahead in the euro area

In a relatively quiet end to the week on the data front, tomorrow's euro area construction output figures are likely to show that the sector returned to modest growth in August having been flat in July. Indeed, while surveys point to ongoing weakness over the summer, construction activity rose in a number of member states, including Germany (0.3%M/M) and France (0.6%M/M), as well as the strongest monthly increase in the often-volatile Dutch figure since March 2021 (6.3%M/M). Despite the recent decline in mortgage rates and pickup in house prices, Germany's numbers reported a further decline in building work in August, which might well underpin a fifth monthly decline out of six in that component in the euro area, leaving it some 6% below the pre-pandemic level in February 2022. Overall, euro area construction has fared slightly better, with the level a little more than 2% above the pre-pandemic benchmark.

The day ahead in the UK

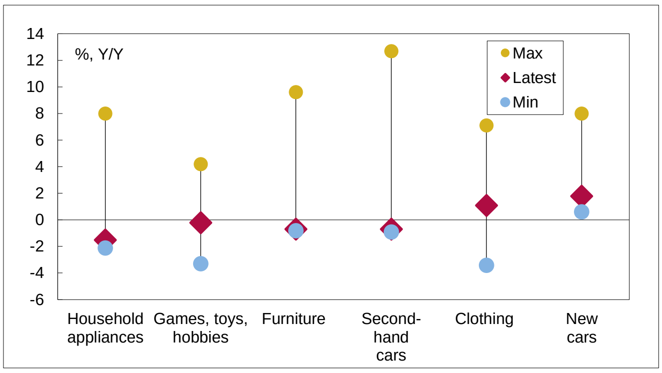
After a quiet day for UK economic news today, focus tomorrow will turn to September's retail sales data, which will provide some insight into household consumption at the end of Q3. While last week's BRC retail monitor reported the strongest like-for-like sales growth in September (1.7%Y/Y) since March, implying a third consecutive monthly increase in the ONS measure of sales volumes for the first since early 2021, this seems unlikely to us. Instead, given the strength in growth in August (1.0%M/M) and July (0.7%M/M), as well as some very wet weather in certain parts of England, we expect a moderate decline on the month. Indeed, the Bloomberg survey consensus is for retail sales growth to marginally slip back in September (by around 0.4%M/M).

Euro area: Selected services HICP components



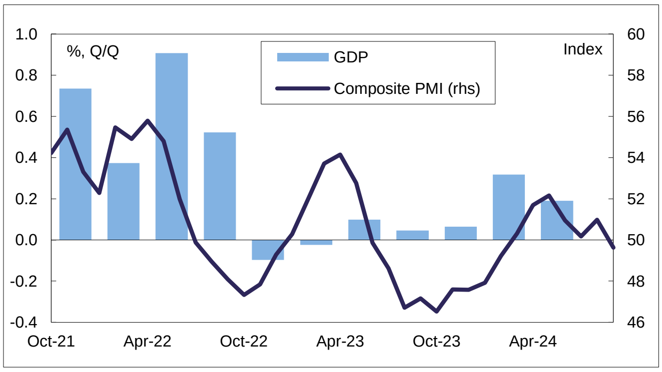
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP components



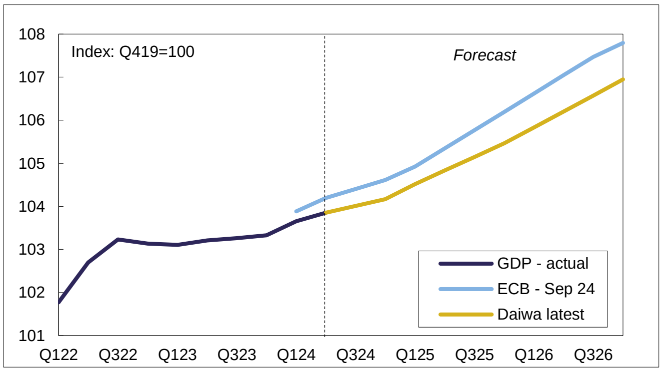
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & composite PMI



Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: ECB GDP level projection



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		ECB Deposit Rate (Refi Rate) %	Oct	***3.25 (3.40)***	*3.25 (3.40)*	3.50 (3.65)	-
		CPI (core CPI) Y/Y%	Sep	**1.7 (2.7)**	*1.8 (2.7)*	2.2 (2.8)	-
		Trade balance €bn	Aug	**11.0**	17.6	15.5	13.7

Auctions

Country		Auction
France		sold €3.932bn of 2.5% 2027 bonds at an average yield of 2.42%
		sold €1.396bn of 0.75% 2028 bonds at an average yield of 2.45%
		sold €3.64bn of 2.75% 2029 bonds at an average yield of 2.53%
		sold €3.027bn of 2.75% 2030 bonds at an average yield of 2.61%
		sold €843mn of 0.1% 2029 inflation-linked bonds at an average yield of 0.69%
		sold €548mn of 0.6% 2034 inflation-linked bonds at an average yield of 0.86%
		sold €513mn of 0.1% 2036 inflation-linked bonds at an average yield of 1.03%
		sold €351mn of 1.8% 2040 inflation-linked bonds at an average yield of 1.06%
Spain		sold €1.226bn of 3.1% 2031 bonds at an average yield of 2.646%
		sold €2.487bn of 3.45% 2034 bonds at an average yield of 2.921%
		sold €1.402bn of 2.7% 2048 bonds at an average yield of 3.507%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Current account balance €bn	Aug	-	39.6
		10.00	Construction output M/M% (Y/Y%)	Aug	-	0.0 (-2.2)
UK		07.00	Retail sales – including auto fuel M/M% (Y/Y%)	Sep	-0.4 (3.2)	1.0 (2.5)
		07.00	Retail sales – excluding auto fuel M/M% (Y/Y%)	Sep	-0.3 (3.1)	1.1 (2.3)

Auctions and events

Country		BST	Event
Euro area		09.00	ECB to publish Survey of Professional Forecasters for Q424

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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