

Euro wrap-up

Overview

- Bunds followed USTs lower, while ECB President Lagarde reiterated that rate cuts are not on a pre-determined path despite recent disinflation progress.
- Gilts also followed USTs lower as UK public borrowing continued to overshoot the OBR's previous projection.
- The data focus of the coming two days will be the euro area consumer confidence indicator (Wednesday) and the flash PMIs (Thursday) for October.

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Daily bond market movements

Bond	Yield	Change
BKO 2.7 12/26	2.159	-
OBL 2½ 10/29	2.141	+0.034
DBR 2.6 08/34	2.316	+0.036
UKT 4½ 01/27	4.065	+0.027
UKT 4½ 07/29	3.992	+0.032
UKT 4½ 07/34	4.165	+0.030

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

UK

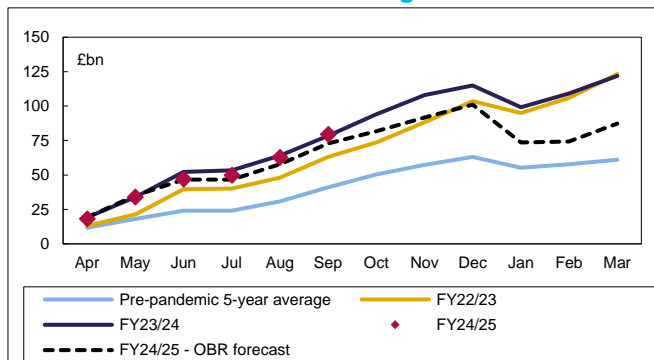
Public finances still overshooting OBR projection

Today's data shone light on the (relatively poor) health of the public finances for the last time ahead of next Wednesday's first Budget announcement since July's election. Net public sector borrowing (excluding banks) in September came in at £16.6bn and so exceeded the level in the same month a year earlier for the third month in a row. While it was a touch below the market consensus forecast, it also exceeded the OBR's projection for the fifth month in a row. As such, despite a modest downwards revision to prior months, cumulative net borrowing in the first six months of the current fiscal year reached £79.6bn, only marginally above the level in the same period last year but £6.6bn above the path consistent with the OBR's March forecast. That follows an overshoot of £7.8bn of the OBR's forecast for the last fiscal year. The main reason for exceeding the projection in the first half of the current fiscal year was higher public spending than previously planned. Despite falling debt interest payments, central government expenditure was up a cumulative £18.4bn (3.2%) from a year earlier, with local government spending also higher. And despite the prior government's pre-election cut to employee National Insurance Contributions (NICs), central government tax receipts were up £18.9bn (3.5%) from the same period last year due to higher revenues from Income Tax, Corporation Tax and VAT.

Reeves to confirm tax hikes next week to balance the current budget over coming years

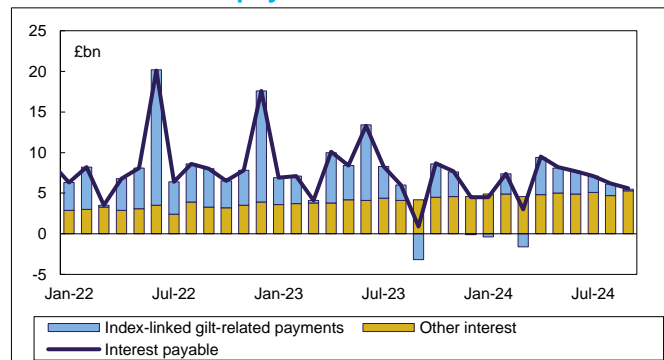
Shortly after coming to office, Chancellor Rachel Reeves announced that Treasury officials had already identified an overspend for the current fiscal year of about £22bn related to policy decisions taken but inadequately accounted for (e.g. associated with asylum-seekers) or deferred by the previous government (e.g. public pay settlements). Given the parlous state of public services, the real-terms cuts in most departmental expenditure programmes projected by the previous government would be politically undeliverable. The Labour manifesto also committed to respond to record NHS waiting lists with extra resources for healthcare. And new unavoidable spending pressures, e.g. huge compensation payments for past public scandals, have to be funded. Nevertheless, the Chancellor wants to balance the current budget (i.e. excluding public investment) by the end of the forecast period ending FY29. So, while last year the tax burden reached its highest level in more than seven decades, next week she will announce significant tax hikes, perhaps by as much as £40bn (about 1.4% of GDP) over the coming five years. The Labour party manifesto already pledged revenue-raising measures such as charging VAT on private school fees, and reforming the non-domiciled tax regime and taxation of carried interest, amounting to about £7.5bn by FY29. But it also committed to avoid increasing taxes on 'working people' by ruling out higher income tax rates, (employee) National Insurance Contributions and VAT. So, to make her sums add up, a hike of employer NICs now seems likely, as does a freezing of personal income tax thresholds, higher capital gains tax and the closing of inheritance tax loopholes. Other revenue-raising measures, such as a windfall levy on banks to reflect QE-related profits, might possibly also be in store.

UK: Public sector net borrowing



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

UK: Debt interest payments



Source: ONS and Daiwa Capital Markets Europe Ltd.

Public sector capex & borrowing plans to be revised higher too

As well as announcing higher taxes to fund an increase in public current spending, Reeves will also next week unveil the detail of her plans for extra public sector investment financed by higher government borrowing. Seemingly to provide it with scope for pre-election tax cuts, the previous government planned a reduction of more than one third in the share of GDP accounted for by net public investment over the coming five years to just 1.7%, which would have been the lowest in 14 years and second-lowest in 25 years. With both public and private sector investment as a share of GDP in the UK repeatedly among the lowest of all major industrialised economies, and the public capital stock inadequate and unfit for purpose, the previous government's plans appeared both economically harmful and politically undeliverable. The new government's interpretation of its second fiscal rule – which states that debt must be falling as a share of GDP by the fifth year of the forecast – will be key in determining the extent and pace of additional public investment and borrowing to come, with potential implications for the path of Bank Rate and Gilt yields alike.

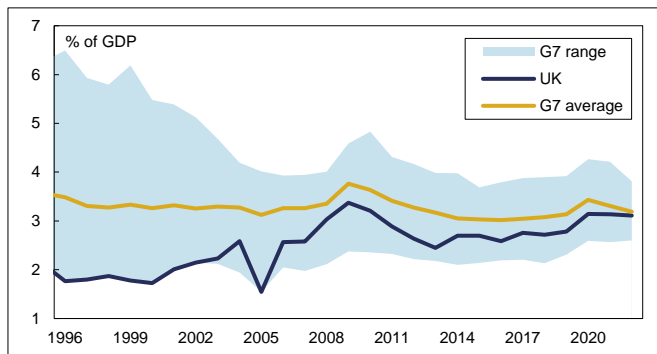
Interpretation of debt rule to determine scope for extra investment

The previous government constrained its own fiscal plans by targeting a reduction in the stock of public sector net debt excluding the BoE (projected by the OBR in March to drop just 0.3ppt of GDP in FY28/9 to 92.9%). But Reeves could justifiably choose to include the BoE's balance sheet (and hence net off the costs of QE losses) in the arithmetic or target a different measure altogether. By excluding the costs of QE-related losses from net public sector debt, she could provide about ½% of GDP (£16bn) of extra headroom for annual public net investment and borrowing by FY29. But about half as much again by FY28/9 would probably be required to keep net public investment steady over the horizon at its current share of GDP. If that higher amount of capex is her goal, she might alternatively target a decline in public sector net financial liabilities, which were previously projected to be falling by as much as 1.9ppt of GDP in the final year of the OBR's forecast. Or she could seek to protect public sector net worth, which was projected to decline by more than 2ppts at that point.

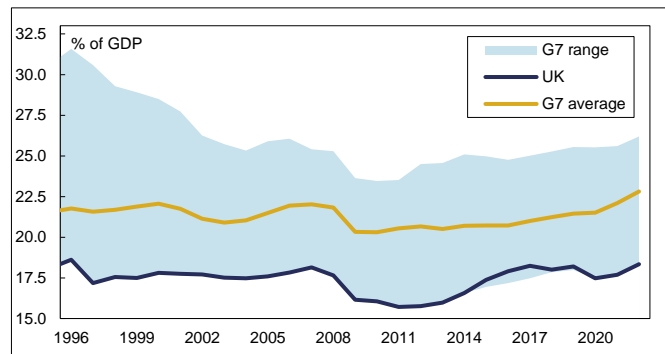
Budget plans to constrain only marginally scope for rate cuts

The overall magnitude and pace of the increase in net borrowing, taxes, and public current expenditure and investment to come, as well as the precise capex projects to be planned and institutional structure introduced to deliver them, will be watched next week by both the MPC and Gilt market. The rise in capex and associated net borrowing will likely be phased in only gradually. So, most MPC members will expect it to have a relatively modest, if non-negligible, impact on the inflation outlook over the time horizon relevant for monetary policy. The MPC should also look through the near-term inflationary impact of specific tax increases, which would likely be temporary and – in the case of the increase in employer NICs – might

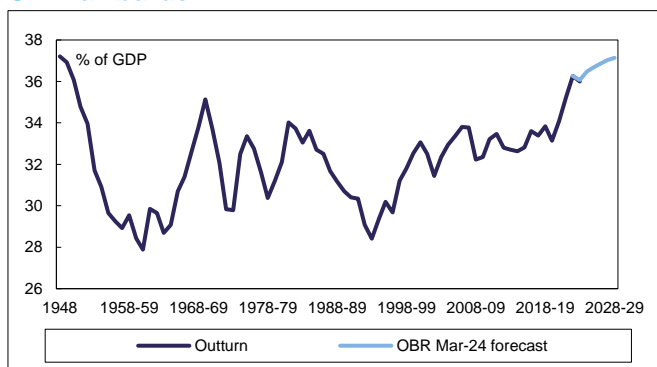
G7 countries: Public fixed investment



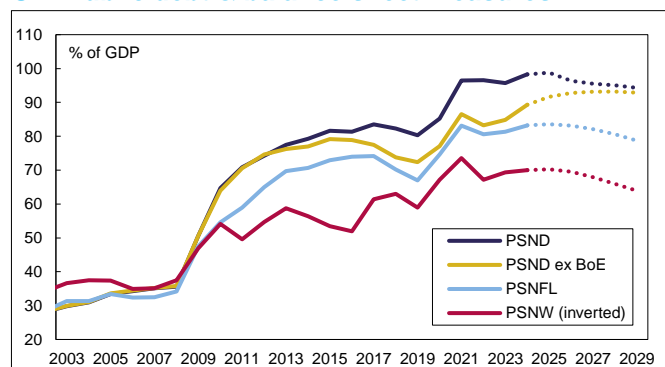
G7 countries: Total fixed investment



UK: Tax burden



UK: Public debt & balance sheet measures*



*Dotted lines show latest OBR economic and fiscal outlook forecasts (Mar-24).
 Source: Macrobond, OBR and Daiwa Capital Markets Europe Ltd.

act to weigh on wage growth. So, as the BoE judges the current monetary stance to be significantly restrictive, the plans in Reeves' Budget announcement will not prevent the MPC from continuing to cut rates over coming quarters, even if they will constrain the full extent of easing to be delivered. Meanwhile, beyond the horizon for monetary policy, if managed effectively, higher public capex should be expected to boost supply potential as well as demand in the economy. And the combined impact of higher borrowing, investment and potential supply might over the medium-to-longer term be a higher 'neutral' Bank Rate – if only by about 25bps – than might otherwise have been the case.

The coming two days in the UK

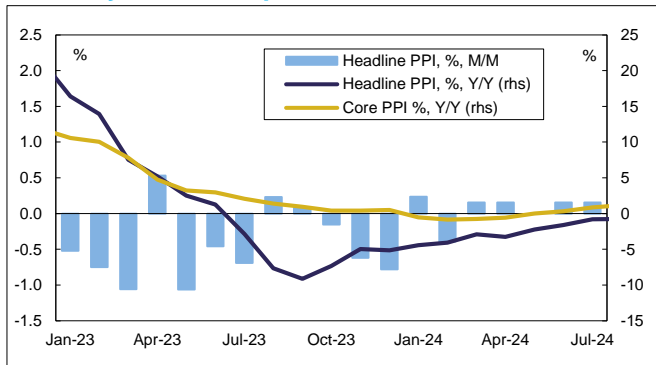
Like in the euro area, a key focus in the UK over coming days will be the flash October PMIs on Thursday. While the composite index declined in September (by 1.2pts to 52.6), business output growth expectations remained above their long-run average. Overall, the composite PMI is expected to be broadly unchanged this month, consistent with ongoing moderate expansion supported by services and manufacturing growth. In terms of the PMI price indices, particular focus will be on whether services price pressures continue to dissipate, with the recent output price PMI having declined to a 20-month low (54.7) in September. Having seen manufacturing input cost pressures (57.5) rise over recent months, we might see a modest uptick in the manufacturing output price index this month too. The CBI industrial trends survey (also Thursday) will include the quarterly survey indicators on investment and employment intentions for the coming year.

Euro area

German producer goods prices down again but energy costs still well above pre-Covid levels

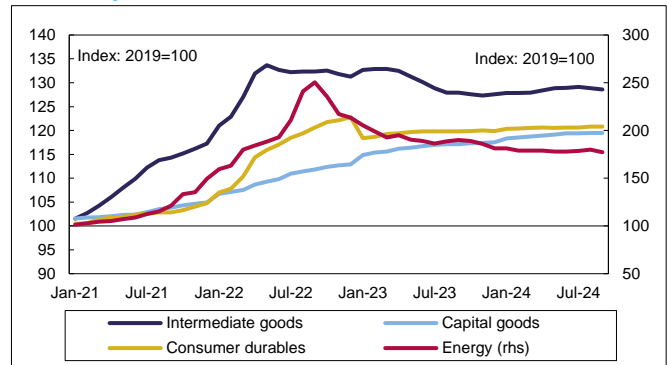
While German producer prices had been drifting gradually higher since March, the pass-through to consumer goods inflation remained limited as lacklustre demand continued to restrain firms' pricing power. In September, German consumer core goods inflation moved sideways at just 0.7%Y/Y, matching the lowest rate since April 2021. Moreover, yesterday's producer inflation figures suggested that pipeline pressures in the factory sector fell back at the start of autumn. In particular, industrial producer prices fell in September for the first month in seven, by 0.6%M/M, to leave them down 1.4%Y/Y. Admittedly, this principally reflected a drop in energy prices, by 1.5%M/M – the most since December – as crude oil prices fell (-5.9%M/M) and the price of electricity and gas supply eased back too. This left producer energy prices down 6.6%Y/Y and almost 30% below the peak in September 2022. But while Germany industrial gas prices have fallen back significantly from the spike following Russia's invasion of Ukraine – which at the peak were roughly 2½ times higher than equivalent prices in the US – the energy crisis persists, with the respective PPI component in September still a whopping 77% above the average in the year before the pandemic.

Germany: Producer price inflation



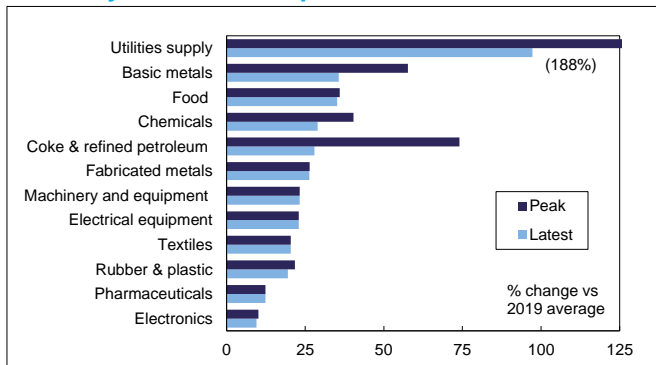
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Selected PPI indices



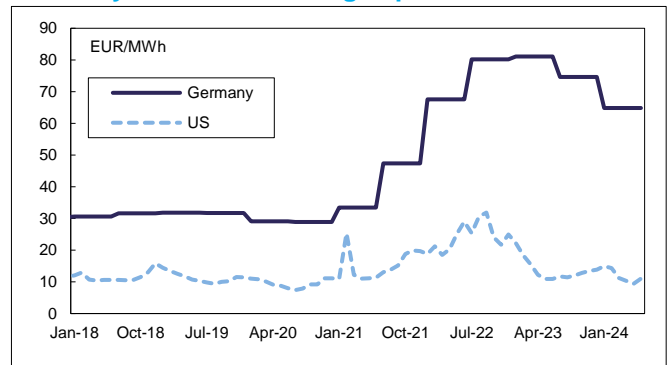
Source: Eurostat, EIA and Daiwa Capital Markets Europe Ltd.

Germany: PPI inflation peak vs latest



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany & US: Industrial gas prices



Source: Eurostat, EIA and Daiwa Capital Markets Europe Ltd.

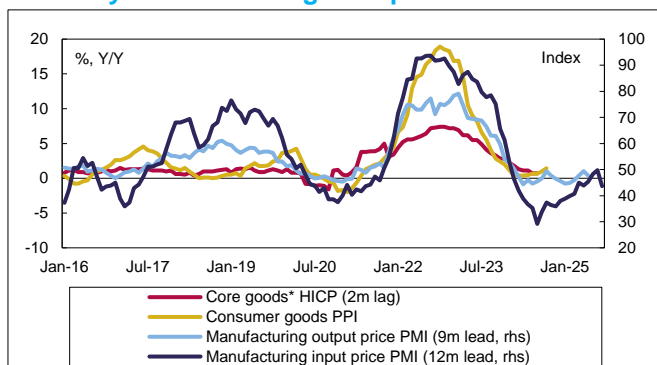
Momentum in underlying goods price pressures remain subdued

Beyond the energy category, underlying price pressures in the factory sector also remained relatively muted in September. Supported by weaker prices of imported items, non-energy industrial producer prices fell for the first time in ten months, by 0.1%M/M. While this left the core PPI inflation rate unchanged at 1.2%Y/Y, the joint-highest in 13 months, momentum on a three-month basis moderated to an eight-month low, down 0.6ppt to 0.8%3M/3M annualised and some 2ppts below the recent peak in May. Intermediate goods prices declined for a second successive month (-0.2%M/M) as prices of iron and steel and other fabricated metals fell back. As such, the annual rate of intermediate goods PPI eased slightly to just 0.5%Y/Y to leave the level of prices almost 4% below the peak, but still roughly 28% above the average in 2019. Prices of capital goods were unchanged to leave the annual rate steady at 2.0%Y/Y for a third successive month. And while prices of non-durable consumer goods rose for a ninth month out of the past ten, this in large part reflects higher food prices as inclement weather conditions hit harvests. In contrast, producer prices of consumer durables were unchanged for a second month out of three in September, leaving inflation still very subdued at less than 1%Y/Y. Recent surveys suggest that input cost pressures continued to fall back and remain well below the long-run average, implying that consumer goods inflation will remain largely absent for the time being.

The coming two days in the euro area

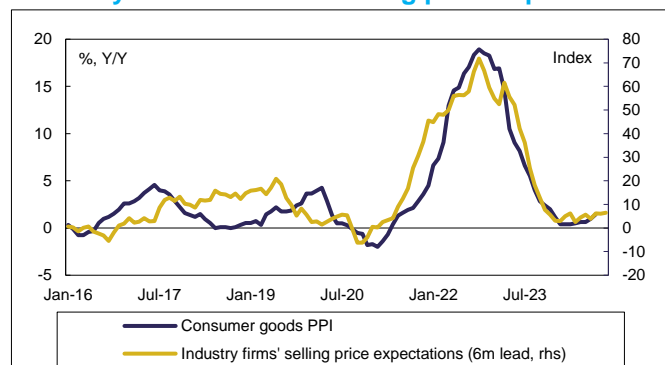
October sentiment surveys will dominate the euro area data flow over the coming two days. After [ECB President Lagarde](#) last week flagged the softening growth momentum implied by the September PMIs as a key cause of the Governing Council's more dovish tone, most attention will be on the flash October PMIs on Thursday. Given ongoing weakness in new orders, the headline euro area composite PMI is expected to have moved broadly sideways at September's 49.6, signalling stagnation at the start of Q4. The German composite PMI is again expected to imply contraction reflecting persisting challenges in the manufacturing sector. While the French composite index is also forecast to remain in contractionary territory, the INSEE business survey (also due Thursday), which has a significantly larger sample than the PMIs, has provided a more reliable guide to French economic growth over the summer and is likely to be consistent with modest growth at the start of Q4. Contrasting the relative pessimism of the PMIs, the Commission's preliminary consumer confidence indicator (due tomorrow) is expected to rise for a second successive month and the eighth time this year to its highest level since February 2022 supported by the recent decline in inflation and cut in interest rates. Aside from the data, ECB President Lagarde and Chief Economist Lane are due to speak tomorrow at separate events in Washington.

Germany: Measures of goods price inflation



*Non-energy industrial goods. Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: Goods HICP & selling price expectations







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

The next edition of the Euro wrap-up will be published on 24 October 2024




European calendar

Today's results

Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 New car registrations Y/Y%	Sep	-7.1	-	-19.9	-
UK	 Public sector net borrowing £bn	Sep	16.6	17.5	13.7	13.0
Auctions						
Country	Auction					
Germany	 sold €4.2bn of 2% 2026 bonds at an average yield of 2.16%					
UK	 sold £900mn of 0.625% 2045 inflation-linked bonds at an average yield of 1.328%					







Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany	 PPI Y/Y%	Sep	-1.4	-1.1	-0.8	-
France	 Retail sales Y/Y%	Sep	-0.5	-	0.2	0.1
UK	 Rightmove house prices M/M% (Y/Y%)	Oct	0.3 (1.0)	-	0.8 (1.2)	-
Auctions						
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.





Tomorrow's releases

Economic data						
Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous	
Euro area	 15.00	Preliminary Commission consumer confidence indicator	Sep	-12.5	-12.9	
Auctions and events						
Euro area	 15.00	ECB President Lagarde speaks on Europe's economic outlook at the Atlantic Council during IMF-World Bank week.				
	 15.00	ECB Chief Economist Lane speaks at the Institute for International Finance, Washington D.C.				
Germany	 10.30	Auction: to sell €4bn of 2.6% 2034 bonds				
UK	 10.00	Auction: to sell £4bn of 3.75% 2027 bonds				
	 21.30	BoE Governor Bailey speaks at the Institute for International Finance, Washington D.C.				


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area 	09.00	Preliminary manufacturing (services) PMI	Oct	45.1 (51.5)	45.0 (51.4)
	09.00	Preliminary composite PMI	Oct	49.7	49.6
Germany 	08.30	Preliminary manufacturing (services) PMI	Oct	40.8 (50.6)	40.6 (50.6)
	08.30	Preliminary composite PMI	Oct	47.6	47.5
France 	07.45	INSEE business (manufacturing) confidence indicator	Oct	98 (99)	98 (99)
	08.15	Preliminary manufacturing (services) PMI	Oct	45.0 (49.9)	44.6 (49.6)
	08.15	Preliminary composite PMI	Oct	48.9	48.6
UK 	09.30	Preliminary manufacturing (services) PMI	Oct	51.5 (52.4)	51.5 (52.4)
	09.30	Preliminary composite PMI	Oct	52.5	52.6
	11.00	CBI industrial trends survey – total orders (selling prices) balance %	Oct	-28 (9)	-35 (8)

Auctions and events

Euro area 	18.00	ECB Chief Economist Lane speaks at the Cleveland Fed's 'Inflation: Drivers and Dynamics Conference 2024'			
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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