Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made significant losses, particularly at the short end, as euro area GDP beat expectations in Q3 and German inflation surprised to the upside in October, reducing the likelihood of a jumbo 50bps rate cut in December.
- Gilts also made losses as the UK government announced higher borrowing over coming years to fund public investment.
- Thursday will bring the flash estimates of euro area inflation in October and unemployment figures in September.

Daily bond market movements

Bond	Yield	Change
BKO 2 12/26	2.250	+0.115
OBL 2½ 10/29	2.255	+0.100
DBR 2.6 08/34	2.386	+0.051
UKT 4⅛ 01/27	4.291	+0.043
UKT 4⅛ 07/29	4.215	+0.029
UKT 4¼ 07/34	4.347	+0.033

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

Euro area

Euro area GDP growth beats expectations in Q3 to take a 50bps cut in December off the table

Contrasting survey signals of slowing growth momentum, today's preliminary estimates of euro area GDP in Q3 beat expectations, with the rise of 0.4%Q/Q marking the sixth consecutive quarterly expansion and the firmest for two years. Importantly, growth in Q3 was double that projected by the ECB just last month, effectively taking a jumbo 50bps cut at December's policy meeting off the table. To two decimal places the figure for Q3 was a touch less emphatic at 0.37%Q/Q. Moreover, growth in Q3 was flattered by certain one-off factors, such as the Paris Olympics and bumper growth in Ireland (2.0%Q/Q) linked to activities of multinationals based there for tax purposes. Indeed, despite the acceleration in euro area economic activity last quarter, the annual rate of growth was still underwhelming and arguably below potential at 0.9%Y/Y. And while euro area GDP in Q3 was a little more than 4½% above the pre-pandemic level in Q419, this was still almost 7ppts lower than US economic activity against the same benchmark. Furthermore, it was still almost 2% below the pre-Covid trend, suggestive of persistent scarring from the pandemic, Russia's invasion of Ukraine and, perhaps too, excessively tight monetary policy. As such, we maintain our view that the ECB will press ahead with a further rate cut of 25bps in December, taking the Deposit Rate to 3.00% by year-end.

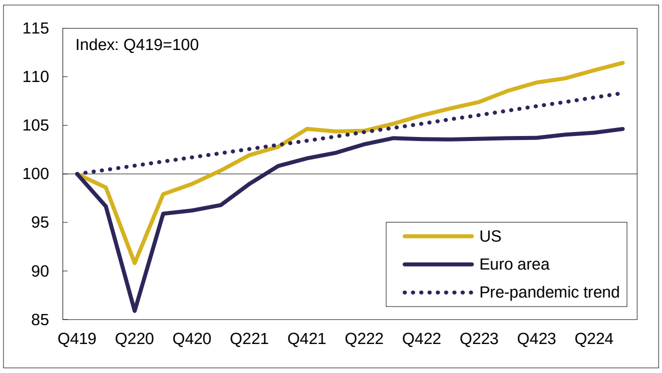
Spanish GDP continued to outperform, but German and French growth surprise to upside too

Among the larger member states, Germany's economic performance surprised to the upside in Q3, with GDP growth of 0.2%Q/Q defying expectations that the economy slipped into recession over the summer. But the rebound was in part payback for a steeper pace of contraction in Q2 (for which growth revised down 0.2ppt to -0.3%Q/Q). Indeed, German GDP has alternated between expansion and contraction every quarter since Q222, leaving the level in Q3 down 0.2%Y/Y and up just 0.2% from the pre-Covid 19 benchmark, the weakest post-pandemic recovery of any member state with the exception of Finland and Estonia. Boosted by the Paris Olympics and Paralympics Games, French GDP growth accelerated to 0.4%Q/Q – the firmest for three quarters – to leave economic output up 1.3%Y/Y and more than 4% above the Q419 level. And for the fifth consecutive quarter, Spain's economy outperformed the other larger member states, with growth steady at 0.8%Q/Q to leave the level of output up 3.4%Y/Y and 6.6% higher than in Q419. In contrast, Italian GDP disappointed expectations merely moving sideways in Q3, albeit at a level still more than 4½% higher than the pre-pandemic benchmark.

Household and government consumption offset drag from investment and net trade

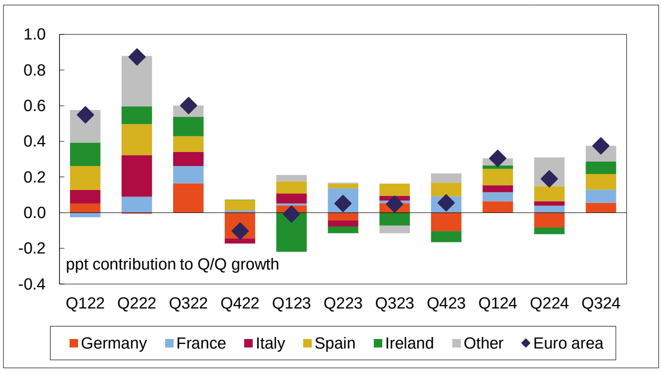
The euro area expenditure breakdown will only be published with the third estimate on 6 December. But the limited detail provided by the various member states suggested that, in line with the ECB's expectations, household consumption provided

Euro area & US: GDP levels*



Euro area pre-pandemic trend Q213 to Q419. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Country contributions to GDP growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

a positive contribution last quarter. In particular, French household spending added 0.3ppt to that country's GDP growth in Q3, with INSEE attributing roughly half of that to Olympics-related expenditure on recreational services. Spanish household consumption also accounted for roughly three-quarters of that country's GDP growth in Q3. But government spending in Spain also rose for a tenth consecutive quarter and (perhaps implausibly) by the most in more than two decades. Destatis also suggested that the German GDP rebound was led by household and government spending. But we see a risk that tomorrow's German retail sales figures for September will lessen the positive contribution from private consumption. Meanwhile, in contrast to the ECB's expectation of a rebound in private investment, today's French and Spanish detail reported a further decline in capex in both countries, with the former marking the fifth consecutive quarterly contraction. Net trade also provided a modest drag in Italy and Spain.

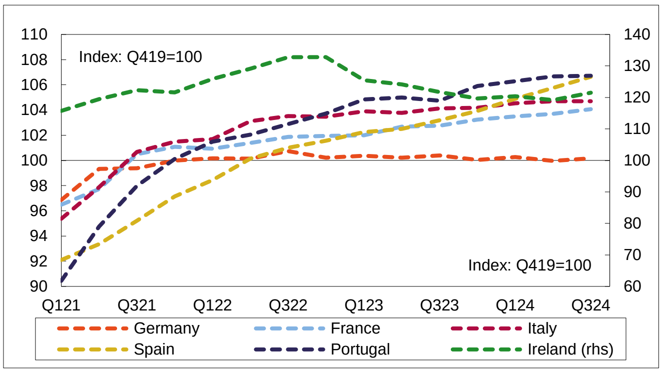
Deterioration in economic sentiment in October led by a worsening in manufacturing conditions

While the flash PMIs pointed to ongoing economic stagnation in October, today's Commission economic survey offered an even more pessimistic assessment of conditions at the start of Q4, reinforcing our view that underlying growth momentum remains minimal. In particular, the headline Economic Sentiment Index (ESI) fell for the fourth month out of the past five to an eight-month low (95.6) some 4½% below the long-run average. The survey suggested a notable deterioration in French and Spanish sentiment in October, with the former down to a 14-month low well below the long-run average. But while the German ESI (90.2) remained some 10% below the long-run norm, it was up marginally from September to suggest that the bottom might have finally been reached. Within the sectoral breakdown, the deterioration was led by manufacturing, whereby firms were the most downbeat since the first Covid-19 lockdown as a worsening in production expectations reflected a further shrinking in order books and increase in inventories. Indeed, almost 40% of industrial firms flagged a lack of demand as a key factor a limiting production. But today's survey was not all bad. Services sentiment was unchanged at September's eight-month high. And perhaps supported by a further improvement in consumer confidence, retailers and constructors were the least downbeat since May and January respectively. Overall, given the likely reversal of certain one-off effects in Q3, today's survey supports our view that economic growth will slow but avoid a contraction in Q4 – indeed, our expectation is now for GDP growth of 0.1%Q/Q, which would leave the level of output at end-2024 just 0.1% above the ECB's projection.

German inflation surprises to the upside in October

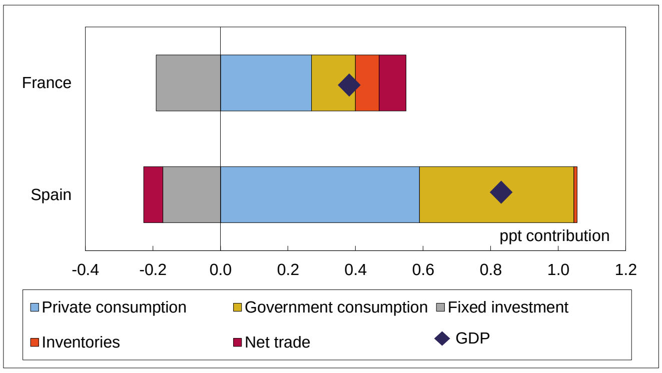
Like today's GDP data, today's flash estimate of inflation in October from various member states came in on the high side. Indeed, while headline inflation was expected to rise from September's multi-year lows, the EU-harmonised HICP rate jumped a chunky 0.6ppt to 2.4%Y/Y, while the national CPI measure rose 0.4ppt to 2.0%Y/Y, both three-month highs. The uptick in CPI inflation was broad-based across the key components. Admittedly, an unfavourable base effect saw the energy

Euro area: GDP levels by member state



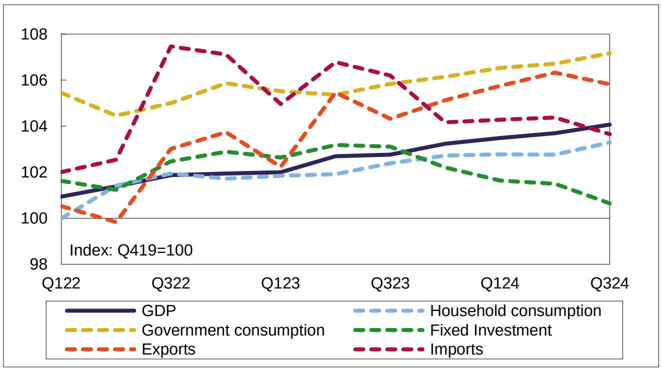
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France & Spain: Contributions to GDP growth



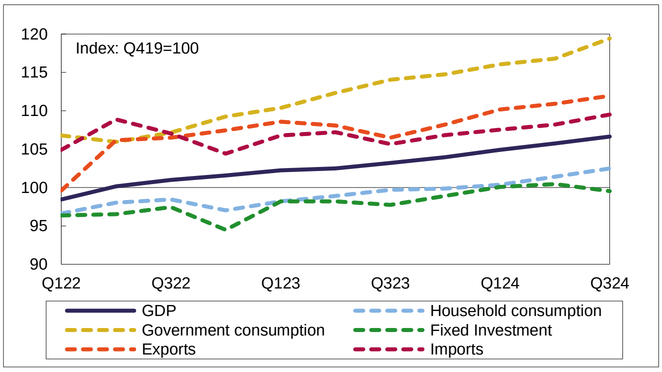
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: GDP expenditure components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Spain: GDP expenditure components



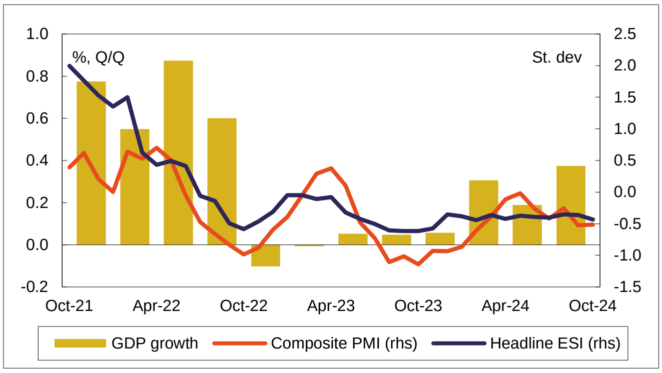
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

component rise almost 2ppts to -5.5%Y/Y in October, while food inflation (2.3%Y/Y) jumped to a nine-month high. But our estimate of core goods inflation was also up around ½ppt to a three-month high, just above 1%Y/Y. Disappointingly, the 0.3%M/M increase in services prices was the strongest in any October since the series began in 1991, pushing the annual rate up 0.2ppt to 4.0%Y/Y, the highest in 13 months. Regional data suggest that this in part reflected a smaller decline in package holiday prices this year compared with last, while insurance inflation in NRW state rose to a new high. As such, core CPI inflation increased 0.2ppt to a three-month high of 2.9%Y/Y, albeit still almost 3ppts below the peak in June 2023. Flash HICP estimates from Spain (up 0.1ppt to 1.8%Y/Y), Belgium (up 0.3ppt to 4.7%Y/Y) and Ireland (up 0.1ppt to 0.1%Y/Y) also nudged higher. As such, we see upside risks to our forecast for tomorrow's euro area inflation estimates. We expect the headline HICP rate to rise 0.2ppt to 2.0%Y/Y. But in part given differences in the way that German package holidays are calculated in the respective CPI and HICP measures, we expect core euro area HICP inflation to move sideways at 2.7%Y/Y.

The day ahead in the euro area

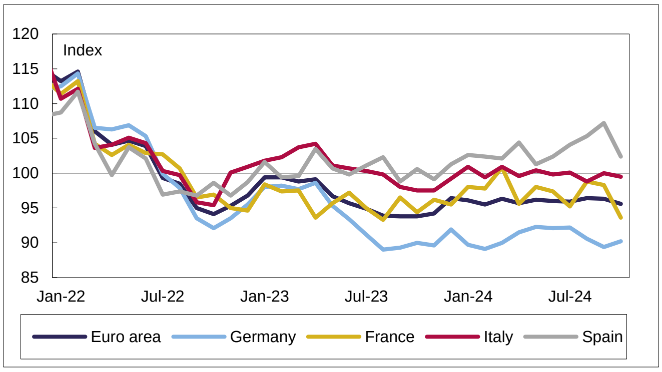
The key focus tomorrow will be the aforementioned flash estimates of euro area inflation in October, where we expect headline inflation to return to the ECB's 2%Y/Y target, with the core rate unchanged at 2.7%Y/Y. With still roughly 55% of the region to publish numbers, much will depend on developments in France and Italy, where the HICP rates are expected to

Euro area: GDP growth & survey indices



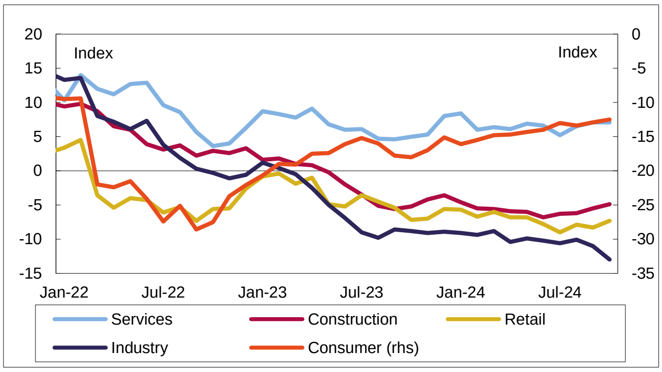
Source: EC, S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ESIs by member state



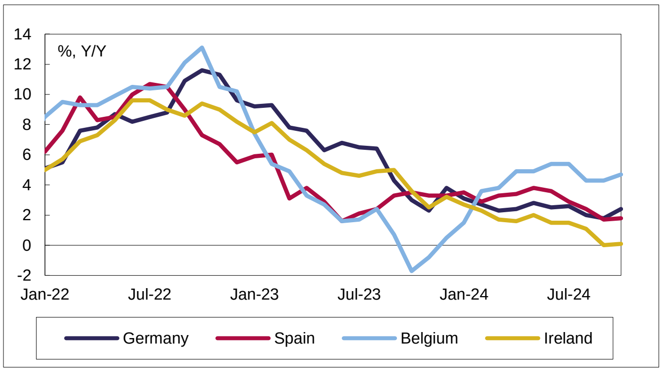
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ESIs by sector



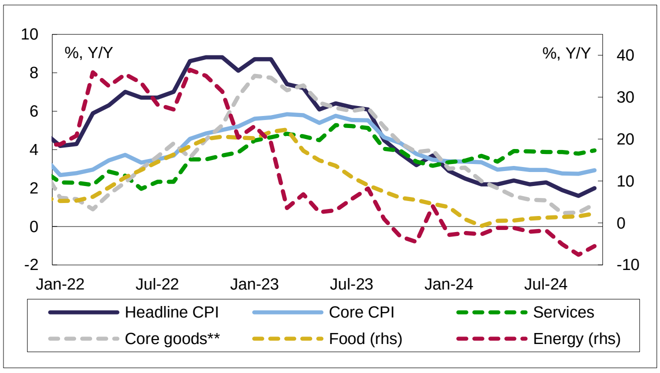
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation in selected member states



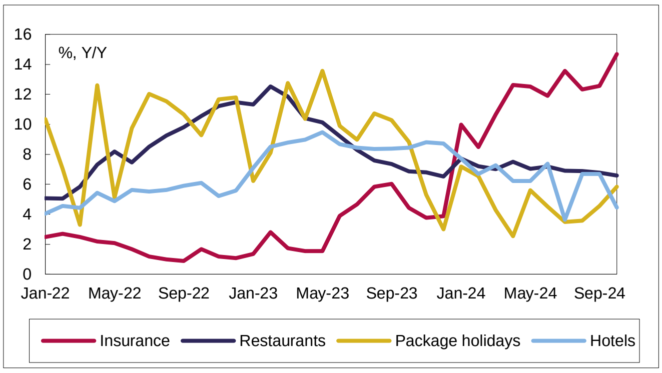
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Selected services components in NRW



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

rise just 0.1ppt to 1.5%Y/Y and 0.2ppt to 0.9%Y/Y respectively. Thursday will also bring the euro area's jobless figures for September, which might well see the unemployment rate edge slightly higher from August's series low (6.4%). Indeed, today's German figures saw the claimant count rate for September revised up by 0.1ppt to 6.1%, the highest since February 2021. Tomorrow will bring German retail sales data for September, which are expected to report some payback for the strength seen over the summer – indeed, the Bloomberg survey consensus is for a decline of 0.6%M/M following growth of around 1½%M/M in July and August.

UK

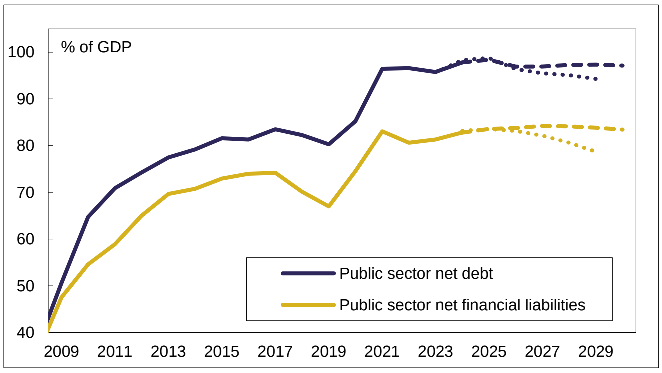
Government Budget details deliverable & credible despite upwards revision to Gilt issuance

After the politically-generated volatility of recent years, including the fiasco of the Truss premiership, the new Labour government's first Budget announcement today had multiple objectives, not least of which was to establish its fiscal credibility. It had long been clear that Chancellor Rachel Reeves would present plans for extra borrowing to avoid the substantive (and likely economically-damaging) cuts in public investment planned by the previous government. But the magnitude of that extra borrowing had to be digestible for the Gilt market and presented with sufficient institutional guardrails as to be considered by investors to be deliverable and sustainable. Indeed, it had to be consistent with an eventual decline in government debt as a share of GDP. Reeves would also have wanted to avoid a sudden marked impact on the likely future path of Bank Rate. Moreover, given the recent slippage from the OBR's projections and the failure of the previous government to adequately budget for certain (foreseeable) spending pressures, the tax hikes to be presented in order to balance the current budget (i.e. excluding public investment) over coming years had to be proportionate and relatively well-targeted to minimise the adverse impact on economic activity. The initial Gilt market response to today's announcements suggested that Reeves had achieved her aims. But that rally eventually reversed as the DMO announced a slightly larger-than-expected increase of almost £20bn in its planned Gilt sales this fiscal year to around £297bn, the second highest on record after the Covid-related blowout £485.8bn) in FY20/21. The market also likely responded unfavourably to the OBR's projection that the central government net cash requirement – which broadly tallies with Gilt issuance – would be more than £110bn higher than previously signalled over the coming 4½years. But unlike the Truss mini-Budget, we are broadly reassured by the new government's fiscal framework and think that the market should be able to digest the extra issuance.

OIS market pricing slightly fewer rate cuts on higher borrowing profile

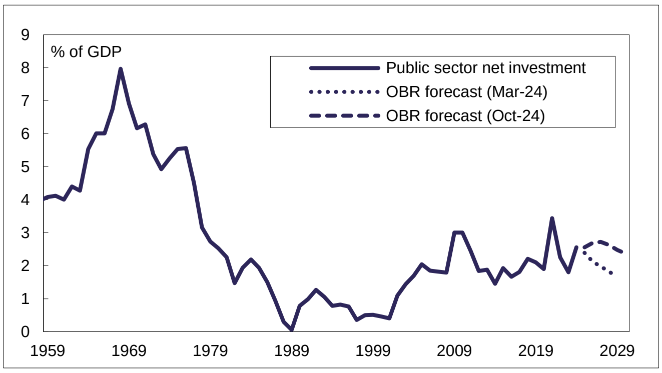
Public sector net borrowing is now projected to be 4.5% of GDP this fiscal year, unchanged from last year but almost 1½ppt above the OBR's projection in March. But taxes will be hiked by almost £25bn (0.8% of GDP) in FY25/6 and by more than

UK: Public debt & balance sheet measures*



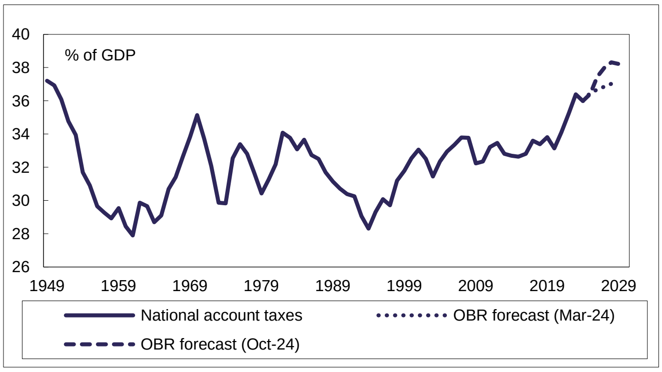
*Dashed (dotted) lines show the OBR forecast for October (March) 2024
Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Public sector net investment



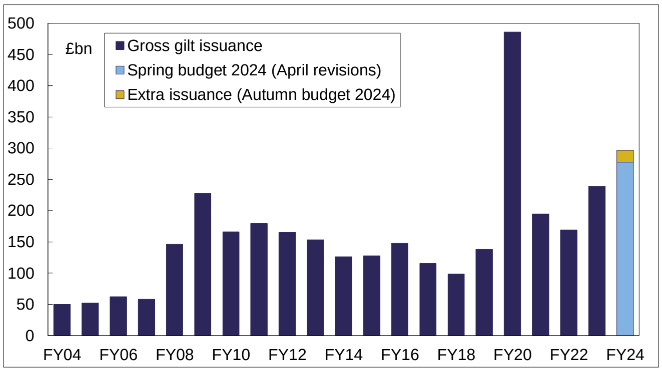
Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: National account tax revenues



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Gross gilt issuance



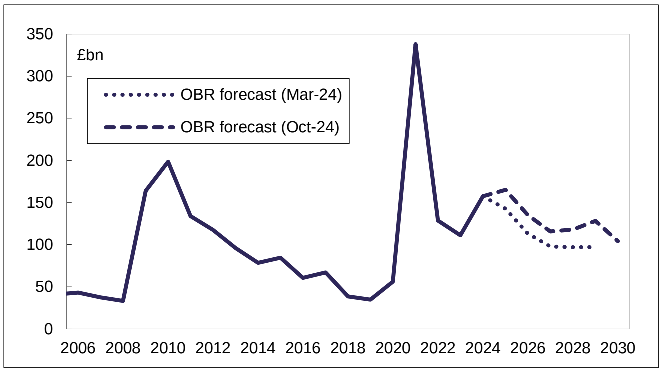
Source: UK DMO and Daiwa Capital Markets Europe Ltd.

£40bn (1.2% of GDP) in four years' time. An increase in employers' National Insurance Contributions (NICs) and a freezing of personal income tax thresholds will do the lion's share of the revenue-raising, with several other tax changes – including those related to capital gains, carried interest and inheritance – making a relatively modest contribution to filling the deficit. As a result, the current budget (i.e. excluding public investment) is projected to shift from a deficit of 2.0% of GDP this fiscal year to a surplus of 0.3% of GDP in three years' time, meeting one of the government's two fiscal rules. Similarly, public sector net borrowing (PSNB) is projected by the OBR to decline almost 1ppt in FY25/6 and more than 2ppts to 2.1% of GDP by FY29/30. And while the stock of general government gross debt will continue to rise over the term of the parliament to 106.1% of GDP, the government's new target debt measure, public sector net financial liabilities, will peak in FY26/7 (at 84.2% of GDP) before declining gradually thereafter. Meanwhile, as had been long expected, as opposed to being cut steadily over coming years as planned by the previous government, public sector net investment will be held broadly steady at around 2½% of GDP, about ½ppt above the average of the past 25 years. While the OBR judges that extra investment will support longer-term economic growth potential, the associated extra borrowing over the monetary policy horizon meant that the OIS market today pushed higher the expected path of Bank Rate by some 15bps in twelve months' time. The market still expects the BoE to ease policy, but is now pricing a cumulative 100bps of cuts by next September, almost 50bps less than was priced a month ago.

The day ahead in the UK

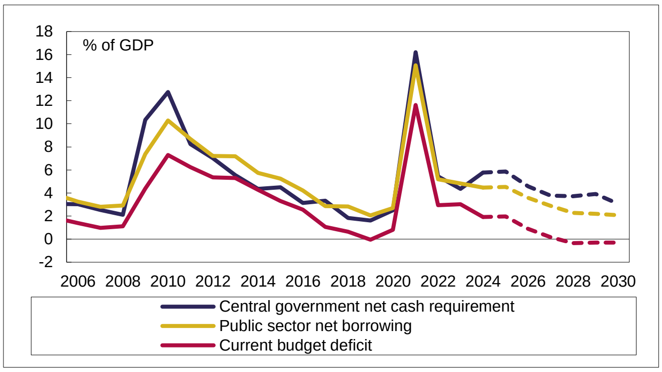
It should be a quiet day for UK economic news, with no data due for release on Thursday.

UK: Central government net cash requirement



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Government borrowing measures



Source: OBR 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		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.4 (0.9)**	*0.2 (0.7)*	0.2 (0.6)	-
		Commission economic sentiment indicator	Oct	**95.6**	96.3	96.2	96.3
		Commission industrial (services) confidence indicator	Oct	**-13.0 (7.1)**	-10.5 (6.6)	-10.9 (6.7)	-11.0 (7.1)
		Final Commission consumer confidence indicator	Oct	**-12.5**	-12.5	-12.9	-
Germany		Unemployment rate % (change 000s)	Oct	**6.1 (27.0)**	6.1 (15.0)	6.0 (17.0)	6.1 (19.0)
		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.2 (-0.2)**	*-0.1 (-0.3)*	-0.1 (0.0)	-0.3 (-0.3)
		Preliminary HICP (CPI) Y/Y%	Oct	**2.4 (2.0)**	2.1 (1.8)	1.8 (1.6)	-
France		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.4 (1.3)**	*0.4 (1.2)*	0.2 (1.0)	-
		Consumer spending M/M% (Y/Y%)	Sep	**0.1 (-0.1)**	0.1 (0.0)	0.2 (0.0)	-
Italy		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.0 (0.4)**	*0.1 (0.7)*	0.2 (0.9)	- (0.6)
		PPI Y/Y%	Sep	**-2.7**	-	-1.1	-
Spain		GDP – first estimate Q/Q% (Y/Y%)	Q3	**0.8 (3.4)**	*0.5 (2.8)*	0.8 (3.1)	- (3.2)
		Preliminary HICP (CPI) Y/Y%	Oct	**1.8 (1.8)**	1.8 (1.7)	1.7 (1.5)	-

Auctions

Country		Auction
Italy		sold €2bn of 3% 2029 bonds at an average yield of 2.96%
		sold €3.5bn of 2033 floating bonds at an average yield of 4.19%
		sold €3.5bn of 3.85% 2035 bonds at an average yield of 3.57%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Preliminary headline (core) HICP Y/Y%	Oct	*2.0 (2.7)*	1.8 (2.7)
		10.00	Unemployment rate %	Sep	6.4	6.4
Germany		07.00	Retail sales M/M% (Y/Y%)	Sep	-0.6 (1.2)	1.6 (2.4)
France		07.45	Preliminary HICP (CPI) Y/Y%	Oct	1.5 (1.1)	1.4 (1.1)
		07.45	PPI Y/Y%	Sep	-	-6.3
Italy		10.00	Preliminary HICP (CPI) Y/Y%	Oct	0.9 (0.8)	0.7 (0.7)

Auctions and events

Country		GMT	Event
Euro area		09.00	ECB to publish Economic Bulletin
UK		10.00	Auction: to sell £2.25bn of 1.5% 2053 green bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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