Daiwa Capital Markets

Euro wrap-up

Overview

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- As wholesale energy prices fell, Bunds made gains while euro area IP softened at the start of Q3.
- Gilts outperformed even as higher petrol prices pushed UK inflation up to a five-month high and the core rate remained unchanged.
- On Thursday, the BoE will likely leave interest rates unchanged but adopt a more hawkish tone and provide updated QT plans. Euro area inflation detail for August is also due.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	3.215	-0.032
OBL 2.9 10/31	3.317	-0.031
DBR 3 08/36	3.508	-0.025
UKT 4 05/29	4.762	-0.125
UKT 4⅛ 03/31	4.851	-0.110
UKT 4⅞ 07/36	5.303	-0.083

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

Euro area

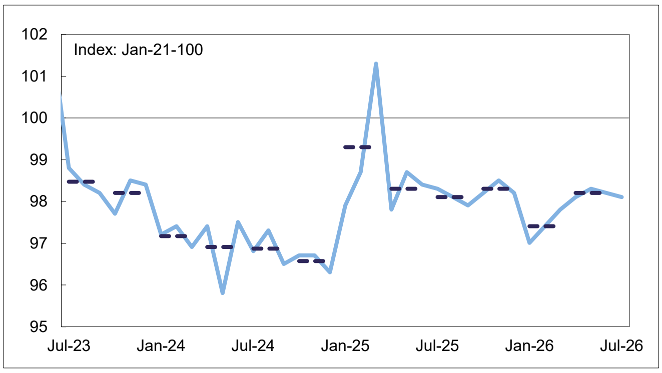
Manufacturing output fell at the start of Q3 due to retooling in the autos sector

Given the expressed optimism of recent sentiment surveys, today's euro area industrial output figures were relatively lacklustre. As expected, production edged down slightly at the start of Q3, by 0.1%M/M for a second-consecutive month following a downwards revision to June's figure. Overall, that left IP merely flat on an annual basis and tracking 0.1% below the Q2 average. July's decline might also have been starker if it were not for a third month of growth in energy production (3.0%3M/3M, highest since October 2020), no doubt in part due to the persistently high summer temperatures. In contrast, manufacturing output fell 0.3%M/M. However, that weakness was exaggerated by a drop in autos production (-10.3%M/M), reflecting a similarly sized fall in Germany attributed to seasonal shutdowns. Disruption to river freight caused by the low depths on waterways such as the Rhine might also have had a limited effect. But lulls in pharmaceuticals (-3.8%M/M), other transport equipment (-3.3%M/M) and metals (-0.7%M/M) appear broadly consistent with payback for strength in preceding months. And machinery (1.5%M/M) and chemicals (0.8%M/M) recouped some lost momentum to provide some offset while support from defence- and AI-exposed subsectors continued to stand out. In particular, production of electrical equipment ticked up to its highest level in 32 months with computers up to a 37-month high after an advance of 8.8%M/M. Those drivers should provide ongoing impetus over the coming months judging by the strength of recent Germany manufacturing orders and upbeat signals from business surveys. And while autos production may only recover gradually being still faced with major structural headwinds, and rising input costs will pose a further challenge to energy-intensive subsectors, IP should still eke out a positive contribution to GDP in Q3 for a second consecutive quarter.

The day ahead in the euro area

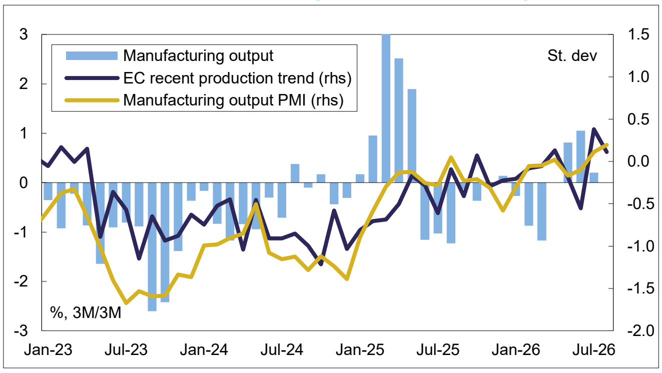
Today's Italian inflation data offered little surprise, confirming the flash HICP estimate of 3.2%Y/Y, up 0.3ppt from July. But revisions elsewhere still imply a chance that August's final euro area inflation print could be rounded down from the initial estimate of 3.3%Y/Y (3.256%Y/Y to 3 decimal places). Such a revision would be negligible, of course, and won't affect the main messages to be drawn from Thursday's release. Indeed, the final release will still confirm a notable acceleration in the headline HICP rate, from 2.9%Y/Y in July. And the detail will ascribe that increase to energy, and principally higher auto fuel prices. Of most interest will likely be the source of the softness in services inflation, whose weakness in the flash estimate (down 0.3ppt to 3%Y/Y) infers a continued lack of indirect inflationary pressures via channels such as transport services and package holidays. That helped to nudge core inflation back down to 2.4%Y/Y, despite a rise in core goods inflation to 1.2%Y/Y, a 2½-year high, likely due to changes to the timing of summer discounting of clothing and footwear but perhaps also reflecting ongoing pressures in certain ICT-related components. And while initial estimates reported no intensification in food inflation from July's five-year low, that aspect of the detail might also be of interest owing to certain pressures apparent in fresh food categories in a few member states.

Euro area: Industrial production*



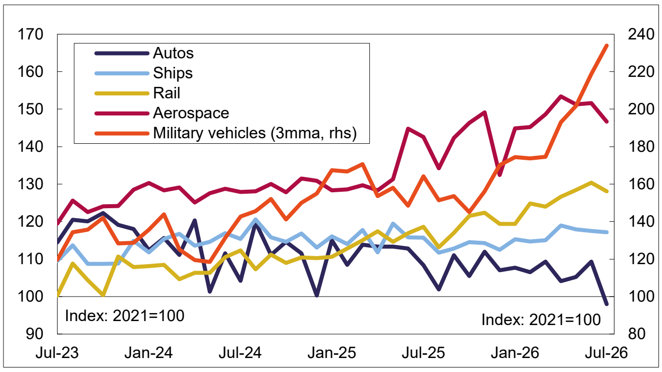
*Dashed dark blue lines show quarterly averages.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output & survey indices



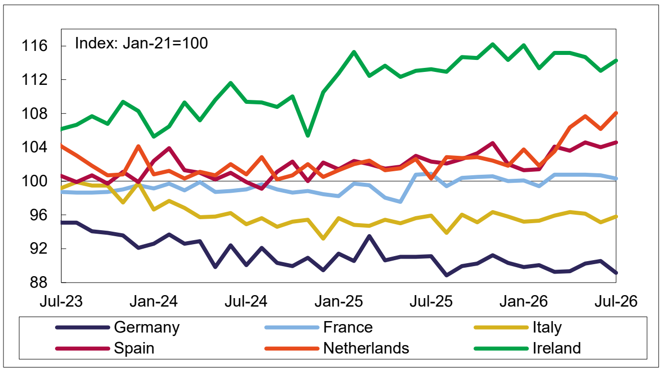
Source: EC, S&P Global & Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Transport equipment production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production of member states



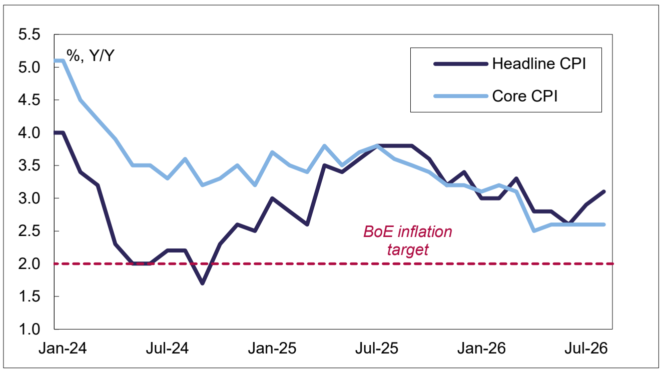
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK

Inflation up to 5-month high above BoE projection but core rate unchanged again

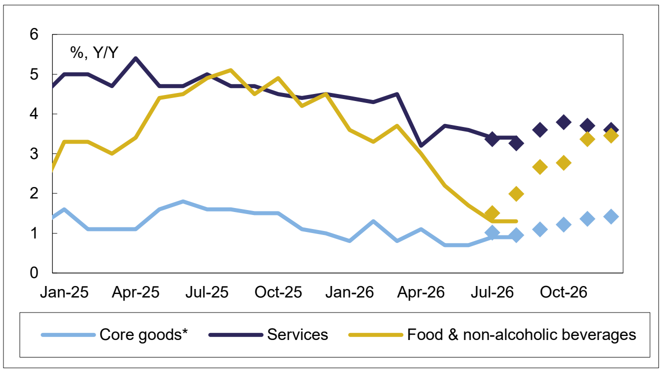
UK inflation rose for a second successive month in August and by 0.2ppt to a five-month high of 3.1%Y/Y. While that was in line with the consensus view, it was 0.3ppt above the BoE's projection in its July Monetary Policy Report, principally due to the subsequent sharp increase in wholesale energy prices above the Bank's assumption. Indeed, for a second successive month, energy inflation (up to a 3½-year high of 13.8%Y/Y) more than fully accounted for the increase in the headline CPI rate. But while the rise in Ofgem's household energy price cap was the key driver of inflation in July, auto fuel prices provided the main impetus in August. In contrast, inflation of food fell to the lowest rate in almost six years, with the broader category of food and non-alcoholic beverages steady at 1.3%Y/Y, some 0.7ppt below the BoE's July projection. Core goods inflation (0.9%Y/Y) also undershot very slightly the BoE's expectation with a softening in a range of items from clothing to furniture and household appliances. And despite prior concerns about pressures in items related to AI demand, inflation of audiovisual and data processing equipment also fell back. In contrast, services inflation was steady at 3.4%Y/Y, slightly above the BoE's projection as falls in the components for accommodation, package holidays and insurance were offset by higher restaurant prices and rents and a slowing in the pace of decline of airfares. Measures of underlying services inflation, which are also watched by the BoE, were also broadly steady. And overall core CPI inflation was unchanged at 2.6%Y/Y for a fourth successive month, suggesting that pass-through of the energy shock to other categories of prices remains very limited.

UK: Headline & core inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected inflation components & BoE forecasts

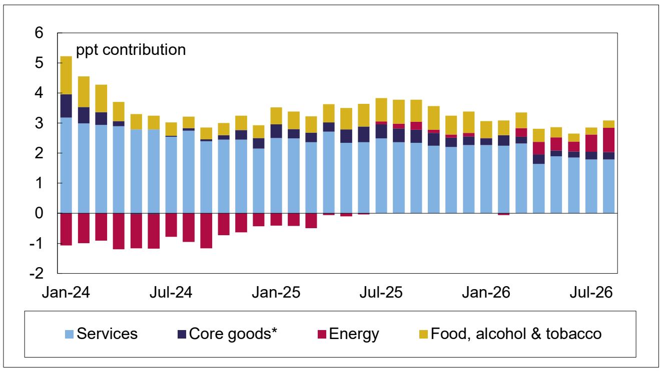


**Non-energy industrial goods. Diamonds represent BoE forecast.*
Source: BoE Jul-26 MPR, Macrobond and Daiwa Capital Markets Europe Ltd.

Producer price pressures still far from broad-based & second-round effects should be limited

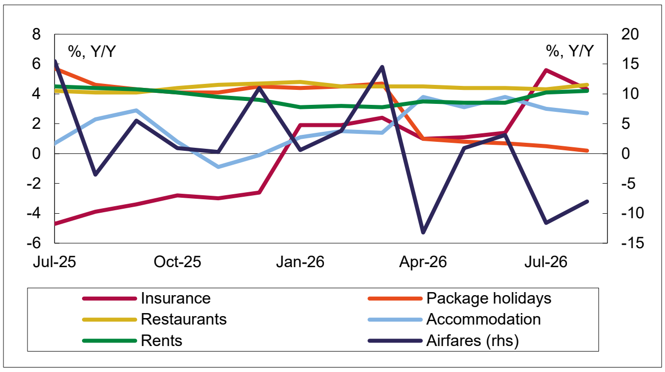
While the indirect effects of the energy price shock have so far been limited, there remains plenty of pressure in the pipeline that might in due course be passed on to consumers. Having moderated the prior month, manufacturing producer input price inflation picked back up to 6.1%Y/Y in August while output price inflation rose to a four-month high of 3.7%Y/Y. As for the CPI, refined petroleum prices represented key sources of input and output producer price pressures. PPI inflation rates of various energy-intensive items, such as chemicals and metals, also remained high. But domestic input (-2.2%Y/Y) and output price inflation of food remained exceptionally soft, falling deeper into negative territory to decade lows, raising hopes that consumer food inflation will remain well below the BoE's projected path for a few months more. And output price inflation for items such as clothing (-4.2%Y/Y) and autos (-4.7%Y/Y) remained significantly negative too. Of course, until today's announced deal between Iran and Oman with respect to freight transit via the Strait of Hormuz, wholesale prices of energy and refined products had trended higher still this month. And so, we expect headline inflation to rise further this month too and the core rate to edge higher on slightly larger indirect effects. But given continued moderation of pay pressures amid persistent labour slack, firms' signals on output price and way expectations should remain down on the spring. And while a further sharp hike in the household energy price cap could well push headline CPI inflation back up close to 4%Y/Y or more in January, the extent of second-round effects on inflation should still prove limited, supporting a gradual decline in CPI inflation from Q227 on as long as events in the Middle East permit.

UK: Selected inflation components



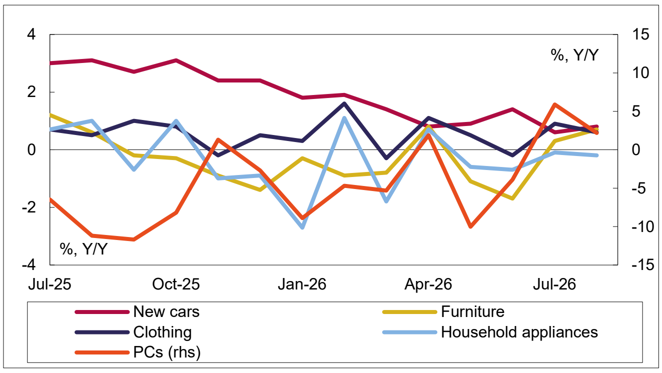
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services CPI components



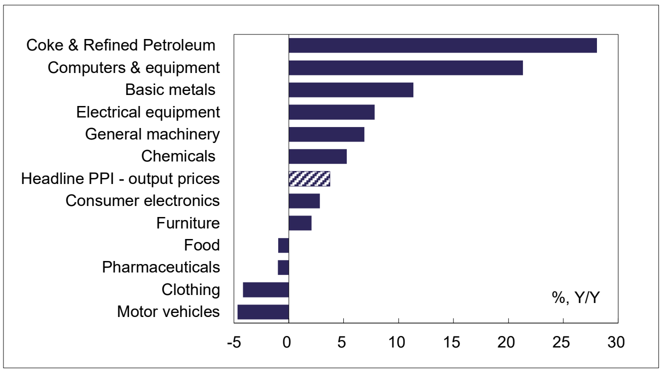
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected goods CPI components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Producer output price inflation, August 2026



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

The absence of broader inflationary pressures in today's data and still-soft labour demand reinforce our expectation that the BoE will hold Bank Rate steady at 3.75% for a sixth consecutive meeting on Thursday. However, while at the previous meeting in July Governor Bailey notably cautioned journalists against "thinking that the BoE is edging towards a hike", the MPC's communications this month will likely to convey a much more hawkish tone. A narrower majority in favour of the policy decision from 6-3 in July cannot be ruled out too. And certainly, we expect the MPC to suggest a renewed willingness to raise Bank Rate as soon as November if the upside risks to the inflation outlook posed by persistently high energy prices do not subside. Indeed, as noted above, escalations in the Middle East have sent wholesale oil and gas prices well above the outdated assumptions embedded in the BoE's July baseline projections, raising the prospect of inflation rising to around 4%Y/Y at the start of 2027. And while evidence of second-round inflation pressures has so far remained elusive, the relative strength of economic activity might also increase policymakers' attentiveness to upside risks, compounding concerns regarding the possible future impact of higher refinery margins, AI-related price pressures and the effects of weather events. On the other hand, most rate-setters will judge that the further marked tightening in financial conditions over recent weeks justifies continued caution for now. And waiting until November will allow policymakers to incorporate developments in energy markets, financial conditions, autumn wage settlements, and the Burnham government's first Budget announcement into their updated projections.

Separately, the MPC will also tomorrow announce its plans for its Quantitative Tightening programme for the coming 12 months. We expect the BoE to further slow its pace of reduction in its stock of Gilt holdings within its Asset Purchase Facility from £70bn over the past year to £50bn. That would reflect a smaller contribution from redemptions but maintain active sales close to the level of the past 12 months. We also expect that the share of sales accounted for by long-term Gilts will be reduced from 20% over the past year. Indeed, a media report this week suggested that long-term Gilts sales would be reduced to zero.

Our full discussion of the BoE's interest rate decision and announcement on QT can be found in Friday's Euro wrap-up.

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%)	Jul	**-0.1 (0.0)**	*-0.1 (-0.2)*	0.0 (0.1)	-0.1 (-0.3)
		Final labour costs Y/Y%	Q2	**3.1**	*3.1*	3.2	-
Italy		Final HICP (CPI) Y/Y%	Aug	**3.2 (3.3)**	*3.2 (3.3)*	2.9 (2.9)	-
UK		Headline (core) CPI Y/Y%	Aug	**3.1 (2.6)**	*3.2 (2.8)*	2.9 (2.6)	-
		PPI – output (input) prices Y/Y%	Aug	**3.7 (6.1)**	3.3 (5.4)	3.1 (4.9)	3.3 (5.8)
		House price index Y/Y%	Jul	**1.4**	-	2.0	1.5

Auctions

Country		Auction
Germany		sold €864mn of 3.4% 2047 bonds at an average yield of 3.88%
		sold €1.257bn of 2.9% 2056 bonds at an average yield of 3.90%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Final headline (core) HICP Y/Y%	Aug	*3.3 (2.4)*	2.9 (2.5)
UK		12.00	BoE Bank Rate %	Sep	*3.75*	3.75

Auctions and events

Country		BST	Event
Euro area		11.00	ECB Governing Council member and Bank of Finland Governor Rehn to participate in a roundtable discussion in London
France		09.50	Auction: to sell up to €13bn 2.4% 2029, 2.7% 2031, 3.25% 2032 and 2% 2032 bonds
		10.50	Auction: to sell up to €2.5bn of 2.1% 2037 inflation-linked bonds
Spain		09.30	Auction: to sell 0.7% 2032, 3.45% 2034 & 3.4% 2036 bonds
UK		12.00	BoE monetary policy announcement, statement & minutes to be published
		12.00	BoE to publish market notice regarding APF gilt sales for the 12 months from October

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research reports at:
https://www.uk.daiwacm.com/ficc-research/research-reports