Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds were little changed as euro area inflation data aligned with expectations while trade and car registration figures disappointed.
- Gilts made modest losses as the BoE's MPC acknowledged that near-term economic momentum had been stronger than it expected but left the door open to a further rate cut in November.
- Friday brings euro area labour cost data and a summit of EU leaders minus the UK.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.646	+0.001
OBL 0 10/21	-0.486	+0.008
DBR 0 08/26	0.032	+0.010
UKT 1¼ 07/18	0.149	-0.010
UKT 3¾ 09/21	0.310	-0.004
UKT 1½ 07/26	0.895	+0.020

*Change from close as at 4.30pm BST.
Source: Bloomberg

Euro area

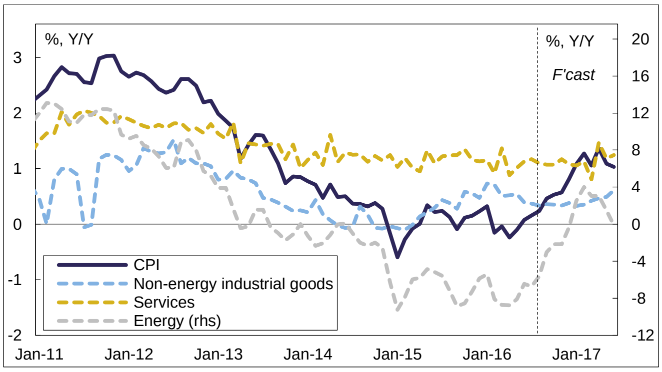
Soft final August inflation data meet expectations

Today's handful of new economic data releases from the euro area brought little in the way of surprises, but were all characterised by a soft tone. Certainly, the final estimates of inflation in August fully aligned with expectations with the flash headline and core figures confirmed, and minimal changes made from the preliminary estimates within the detail. So, headline inflation was unrevised at 0.2%Y/Y, matching July's six-month high. Meanwhile the main core rate was confirmed at 0.8%Y/Y, down 0.1ppt from July and no firmer than the average rate of the past two years, illustrating the difficulty policymakers face in shifting CPI back onto a higher plane towards the ECB's target of close to 2%Y/Y. Within the detail, inflation of both main core components – services (1.1%Y/Y) and non-energy industrial goods (an eleven-month low of 0.3%Y/Y) – were weaker, while food price inflation also softened to offset partly the impact of the slower rate of decline of energy prices. Despite the latest readings, we expect headline inflation to take a step up from September onwards as the contribution from energy prices fades and subsequently turns positive. As a result, we currently forecast CPI to rise to 0.5%Y/Y in September and to above 1.0%Y/Y in January. With core inflation measures likely to remain no firmer than 1.0%Y/Y through to year-end, the ECB will ultimately feel obliged to extend its asset purchase programme beyond March 2017. However, from that point on, the higher headline CPI rate might lead the ECB to reduce slightly the rate of purchase from the current pace of €80bn per month.

Goods trade and car registration data disappoint

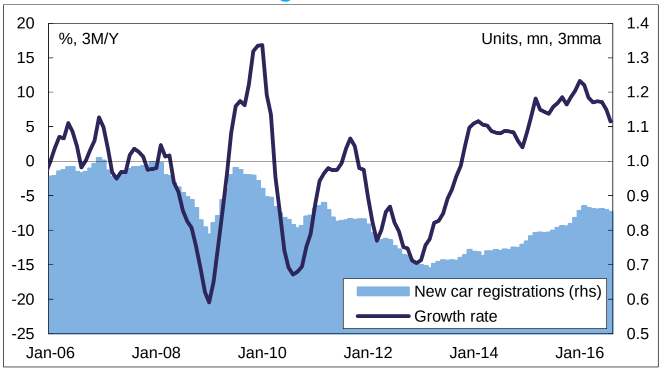
As had been foreshadowed by some weaker data from Germany, the euro area goods trade surplus dropped in July by the most in more than one year, down more than €3.7bn to a five-month low of €20.0bn, nevertheless still exceptionally high by historical standards. The value of exports fell more than 1%M/M in seasonally adjusted terms (and almost 10%Y/Y) to the lowest level since late 2014. In contrast, imports rose more than 1%M/M to the highest level since February. So, while relative price shifts are likely to exaggerate the weakness in volume terms – e.g. prices of imports of manufactured goods rose in July for the third successive month to leave their annual rate of decline at -2.7%Y/Y, the lowest since January – the figures strongly suggest that net trade subtracted from economic growth at the start of Q3 having made a positive contribution in Q2 for the first time in a year. However, not least since we strongly expect German exports subsequently to have rebounded, we also expect to see an improved performance for the euro area as a whole in August, and expect net trade overall to make little impact on GDP growth in Q3. Finally, the euro area's latest new car registrations data were also disappointing with drops of 0.3%M/M in seasonally adjusted terms in each of July and August following the dip of 1.0%M/M in June. So, having moved broadly sideways on this basis since the start of the year, car registrations appear to have slipped into reverse gear in the summer raising doubts about the strength of private consumption in the third quarter.

Euro area: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

Friday's most notable new economic data from the euro area will be labour cost figures for Q2. Following the marked slowdown in German labour cost growth, these figures seem likely to show a moderation in the euro area from the subdued 1.7%Y/Y rate of the first quarter, adding to evidence that core inflation will remain very subdued over coming quarters. On the political front, the informal EU-27 summit of leaders of all member states bar the Brits will kick off in Bratislava to discuss the future direction of the Union. Expect little new on what they intend to do about Brexit, and more on the common issues facing member states such as immigration and terrorism.

In the US, Friday will bring August CPI figures, expected to show an increase of just 0.1%M/M to take the headline rate to 1.0%Y/Y, the average rate so far this year. The 0.2%M/M expected increase in prices excluding foods and fuel would leave the annual core rate at 2.2%Y/Y, similarly in line with the average of the past seven months. The preliminary University of Michigan consumer confidence survey results for September are also due.

UK

MPC leaves the door open for another rate cut in November

As expected, the MPC left all policy settings unchanged in its September meeting. Today's statement suggested that policy makers were pleased with the market reaction to the package announced last month, with UK asset prices rising more than expected and average mortgage rates falling notably. With regards to the economic outlook, the MPC members judged that recent economic data had exceeded expectations, which suggested that the short-term momentum might be stronger than previously envisaged. However, the upward surprises have been concentrated in indicators related to the housing market and consumption, including today's retail sales figures. The slowdown in growth envisaged in the MPC's August forecast was not driven primarily by consumer spending, but instead by business investment. And the MPC believes that early data have indeed been consistent with a slowdown in business spending. Overall, the Committee views on "the contours of the economic outlook" had not changed from August and if the economic outlook in November, when the BoE publishes its new economic forecasts, remains broadly consistent with the August projections, the majority of the MPC members expect to support a further cut in Bank Rate.

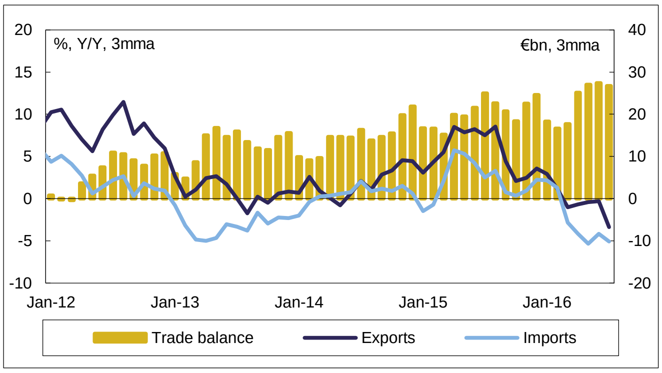
Retail sales continue to grow rapidly despite Brexit

While yesterday's labour market figures showed that employment fell in July and redundancies reached a twenty-eight-month high, today's retail sector indicators suggested that any weakness in the jobs market has yet to feed into retail sales. Indeed, a much smaller than expected 0.2%M/M fall in sales August left total retail sales up 6.2%Y/Y, only 0.1ppt below the upwardly-revised July pace of 6.3%Y/Y, which was the joint highest since November 2014. Within the detail, non-food sales, up 1.7%3M/3M, remained the key area supporting growth, with clothing and footwear stores performing particularly strongly. Interestingly, the latter subcategory is the only one where annual price deflation continued to intensify. Deflation in all of the other major categories, as well as overall sales, was below its six-month average in August. Meanwhile, looking at the quarterly performance, the July-August average is consistent with an increase of 1.5%Q/Q in Q3, a very similar pace to Q2.

The day ahead in the UK

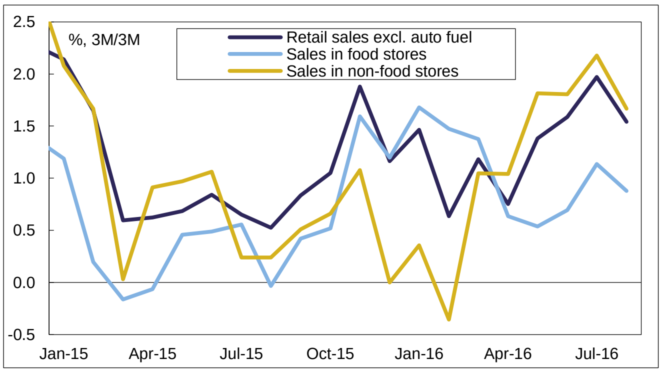
It will be a quiet end of the week with no notable economic data due for release.

Euro area: Goods trade*



*Exports and imports in nominal terms.
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Retail sales



Source: ONS, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	**Revised**
EMU		EU27 new car registrations	Aug	**10.0**	-	-1.4	**-**
		Trade balance €bn	Jul	**20.0**	22.0	23.4	**23.8**
		Final CPI (core CPI) Y/Y%	Aug	**0.2 (0.8)**	_0.2 (0.8)_	0.2 (0.9)	**-**
UK		Retail sales excluding petrol M/M% (Y/Y%)	Aug	**-0.3 (5.9)**	-0.7 (4.8)	1.5 (5.4)	**2.1 (5.8)**
		Retail sales including petrol M/M% (Y/Y%)	Aug	**-0.2 (6.2)**	-0.4 (5.4)	1.4 (5.9)	**1.9 (6.3)**
		BoE bank rate %	Sep	**0.25**	_0.25_	0.25	**-**
		BoE Gilt purchase target £bn	Sep	**435**	_435_	435	**-**

Auctions

Country		Auction
France sold		€3.2bn of 0% 2019 bonds (25-Feb-2019) at an average yield of -0.55%
		€2.8bn of 0% 2021 bonds (25-May-2021) at an average yield of -0.37%
		€0.8bn of 0.1% 2021 index-linked bonds (01-Mar-2021) at an average yield of -1.16%
		€0.5bn of 0.1% 2025 index-linked bonds (01-Mar-2025) at an average yield of -0.83%
Spain sold		€1.4bn 0.75% 2021 bonds (30-Jul-2021) at an average yield of 0.153%
		€1.3bn of 1.3% 2026 bonds (31-Oct-2026) at an average yield of 1.125%
		€1.2bn of 1.95% 2030 bonds (30-Jul-2030) at an average yield of 1.447%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ _Daiwa forecast_	Previous
EMU		10:00	Labour costs Y/Y%	Q2	-	1.7
Italy		09:00	Trade balance total €bn	Jul	-	4.7
Spain		08:00	Labour costs Y/Y%	Q2	-	-0.2

Auctions and events

Country		BST	Auction / Event
EMU		-	EU27 leaders scheduled to hold summit to discuss Brexit in Bratislava

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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