Euro wrap-up

Overview

- Bunds ended the day little changed after euro area headline inflation rose in line with expectations but core inflation remained predictably subdued.
- After making significant losses in the morning session, Gilts subsequently recovered, similarly ending the day little changed.
- Tuesday will bring the latest euro area bank lending survey and UK inflation data.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.657	+0.003
OBL 0 10/21	-0.488	-0.004
DBR 0 08/26	0.057	-
UKT 1¼ 07/18	0.197	-0.018
UKT 3¾ 09/21	0.467	+0.005
UKT 1½ 07/26	1.118	+0.021

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

Euro area

Higher headline CPI no cause for celebration at ECB

After the preliminary estimates from Germany, France and Italy were all confirmed last week, today's final euro area inflation figure for September also predictably aligned with the respective flash estimate, confirming the 0.2ppt rise in headline CPI to 0.4%Y/Y, the highest rate in twenty-three months. While that might appear a cause for encouragement, the detailed figures suggest that underlying price pressures are little improved, with the increase in annual inflation due only to a smaller drag from energy prices, which dropped 3.1%Y/Y, the least in twenty-two months. In contrast, inflation measures for services (1.1%Y/Y) and non-energy industrial goods (0.3%Y/Y) were both unchanged from August. So, euro area core CPI remained stubbornly low at 0.8%Y/Y, stuck towards the bottom of the recent range, with the equivalent measures for each of the four largest member states close to or below the average of the past year too.

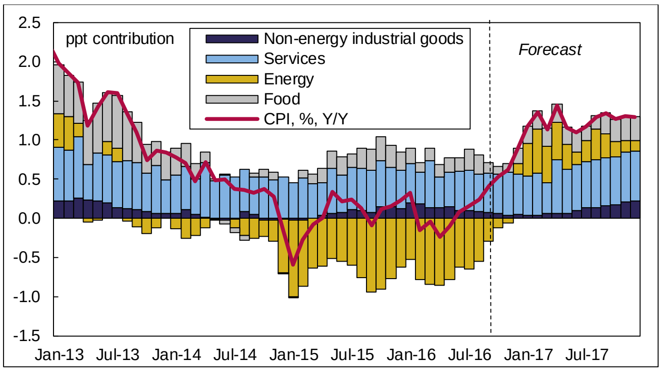
Persistent weak core inflation justifies ongoing monetary support

Looking ahead, as energy inflation gradually turns positive, we expect headline CPI to rise gradually back above 1%Y/Y at the start of next year and to move a touch higher thereafter too. That will no doubt provide some relief for the ECB as deflationary risks further subside. However, concerns about the economic costs of persistent low inflation will not disappear. We expect core inflation to remain close to current rates over the near term not least on account of persistent large economic slack, which should keep cost pressures muted. Indeed, we currently forecast core CPI to remain below 1%Y/Y until April. And so, given that we do not expect euro area GDP growth to accelerate above the recent trend of 0.4%Q/Q on a sustained basis, nor do we expect the euro to weaken significantly from current levels on a trade-weighted basis, we expect both headline and core inflation to remain subdued below 1½%Y/Y over the forecast horizon. Therefore, just as for the past three years, the ECB will likely continue to fail to meet its price stability target for at least the next two years. And, when it updates its own economic forecasts in December, it will also likely see the need to extend its QE programme at the current pace of €80bn per month beyond next March.

The day ahead in the euro area and US

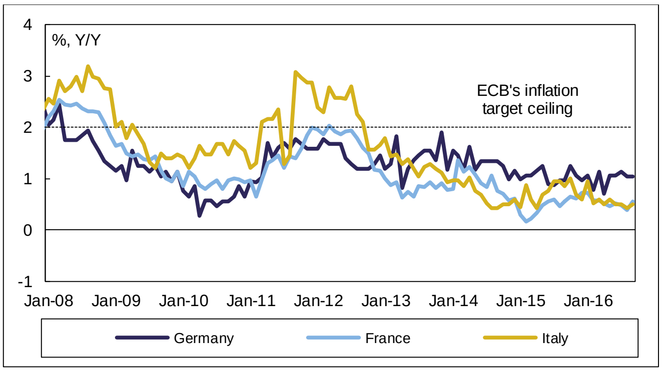
Tuesday brings the ECB's latest quarterly bank lending survey, which is likely to suggest further easing of credit conditions and increases in loan demand. In the US, Tuesday brings September's CPI figures with higher energy prices expected to lead to a jump of 0.3%M/M in the headline index to take the annual rate to 1.5%Y/Y, the highest in almost two years. However, monthly core inflation seems likely to be maintained close to 0.2%M/M, the norm since early 2015, leaving the annual core rate unchanged at 2.3%Y/Y. In addition, October's NAHB housing market survey is due along with the August TIC capital flow figures.

Euro area: Inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation in selected member states



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK

Brexit threatens key UK sectors

While the result of the EU referendum has clearly hit the UK economy already, with growth in Q3 likely to have been only around half the 0.7%Q/Q rate seen in Q2, the greater damage to the UK economy from Brexit was always going to come in the longer term. Having spent 43 years in the EU, the UK's economic structures have become intimately tied to those of the wider EU. This is no truer than in the car and financial services industries. In both sectors, membership of the Single Market has attracted world-leading firms (typically foreign-owned) to locate and thrive in the UK. Brexit threatens to undermine both sectors. The financial services sector will likely lose automatic access to EU clients when Brexit occurs, forcing firms to relocate at least some activities to the EU. For the car industry, meanwhile, Brexit threatens the imposition of tariffs on car exports from the UK to the EU, while operating outside the EU customs union will add enormous expense to UK-based car companies, all of which rely on international and highly-complicated supply chains. With Nissan threatening to suspend further investment in the UK until the details of the post-Brexit trade arrangements are clear, and financial services firms already indicating that they are looking at relocating parts of their businesses, it appears to have started to dawn on at least some in Government that Brexit threatens to significantly damage both of these important sectors.

Talk of "special deals" wishful thinking

The Government has therefore let it be known that it is examining potential ways of keeping car firms within the customs union, while also hoping that paying continued contributions to the EU budget even after Brexit will secure continued access for UK-based financial services firms to EU customers. But while appealing at face value, thinking about both proposals for more than one minute highlights their implausibility. For a start, the UK Government has said that it is looking for a bespoke agreement with the EU, not an off-the-shelf one (i.e. EEA membership). But that raises the question of what institutional arrangement any such special-status deals would operate within. While it is true that Switzerland has an ad hoc arrangement with the EU that provides broad Single Market membership (but, crucially, not for financial services), that arrangement has proved a tricky one to manage, not least given the lack of any institutional framework within which to ensure Swiss compliance with EU regulations (except the nuclear option of suspending the agreements in their entirety) and is not one that the EU would repeat. For that reason alone, the proposals seem nothing more than wishful thinking. And even in the unlikely event that the issue of institutional arrangements could be resolved, the risk that they could be cancelled by the EU at short notice (the 'equivalence' rules for financial services, for instance, allow access to be withdrawn with just 30 days' notice), means that firms will not dare to rely upon them – there would simply be too much risk of massive business disruption in the event that Single Market access was revoked at short notice. As such, while it is good to see that it is finally dawning on at least parts of the Government that Brexit means disaster for some of the UK's most successful industries, what they are currently proposing provides nothing more than newspaper headlines, presumably aimed at calming jittery financial markets, rather than concrete deliverable proposals to allow the UK economy to thrive outside of the EU.

The day ahead in the UK

A busy day for new economic data releases in the UK tomorrow brings the latest inflation figures, which are expected to show that the headline CPI rate increased sharply in September, from 0.6%Y/Y to 0.9%Y/Y, which would be the highest level since the end of 2014. The increase is likely to be driven mainly by changes in the energy component. But the data are also expected to suggest that the sharp depreciation in sterling since the referendum has already started to push prices up, with core inflation likely to inch up by 0.1ppt to 1.4%Y/Y. Meanwhile, the UK House Price Index, also due tomorrow, will probably show that house price growth is moving in the opposite direction, with the headline rate expected to have fallen below 8%Y/Y in August from 8.3%Y/Y in July.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		ECB public sector asset purchases €bn	Weekly	**18.1**	*16.2*	18.1	**-**
		Final CPI (core CPI) Y/Y%	Sep	**0.4 (0.8)**	*0.4 (0.8)*	0.2 (0.8)	**-**
Italy		Trade balance total €bn	Aug	**2.5**	-	7.8	**-**
UK		Rightmove house price index M/M% (Y/Y%)	Oct	**0.9 (4.2)**	-	0.7 (4.0)	**-**
Country		Auction					
UK		BoE APF operation purchased £1.17bn of 3-7Y Gilts (3.05 cover ratio)					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		09:30	CPI (core CPI) Y/Y%	Sep	*0.9 (1.4)*	0.6 (1.3)
		09:30	PPI input (output) price inflation Y/Y%	Sep	7.4 (1.1)	7.6 (0.8)
		09:30	House price index Y/Y%	Aug	*7.6*	8.3

Auctions and events

Country		BST	Auction / Event
EMU		09.00	ECB publishes the Euro Area Bank Lending Survey
UK		14:50	BoE APF operation: To purchase 15Y+ Gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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