

Euro wrap-up

Overview

- Bunds made modest gains as the ECB left policy unchanged but flagged concerns about the weakness of underlying inflation.
- Gilts were little changed as UK retail sales figures disappointed expectations.
- Friday will bring figures for euro area consumer confidence and UK public finances as well as an important decision on Portugal's credit rating.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.669	-0.002
OBL 0 10/21	-0.506	-0.006
DBR 0 08/26	0.003	-0.027
UKT 1¼ 07/18	0.220	+0.007
UKT 3¼ 09/21	0.473	+0.012
UKT 1½ 07/26	1.088	+0.006

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

Euro area

ECB leaves policy and forward guidance unchanged

The weeks preceding today's ECB announcement had brought increased speculation about whether it was close to tapering its asset purchases or might soon back away from its readiness to cut rates further into negative territory. Predictably, however, the ECB left its interest rates and QE programme unchanged, and also made no change to its forward guidance. So, while its asset purchases will be maintained at the current rate of €80bn per month at least through to March, Draghi also repeated that the ECB's policy rates are expected to remain at present levels or below for an extended period and well past the end of QE. Indeed, in the press conference he made a staunch defence of the ECB's interest rates stating unambiguously that 'they have worked', most notably to relax financial conditions significantly. He had little to say, however, about the ongoing work of the ECB's committees in their evaluation of options to ensure smooth implementation of the asset purchase programme.

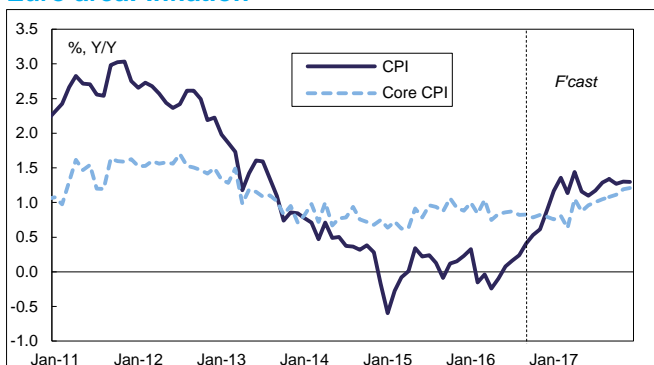
Future of ECB QE to be determined in December

While the Governing Council meeting was therefore inconsequential from the perspective of ECB policy, in his press conference Draghi made clear that the future of the QE programme – in terms of its extension beyond March, the amount of monthly asset purchases, and amendments to the rules to address bond scarcity issues – will be determined at the December meeting alongside the discussion of the ECB's updated economic forecasts. To be sure, an abrupt end to asset purchases should be ruled out, with Draghi stating that such a decision was both 'unlikely' and 'not present in anybody's mind... for obvious reasons'. And while Draghi welcomed the resilience of the euro area economy to continuing global economic and political uncertainty – most notable of which are Brexit risks – his overall economic assessment provided good reasons to expect the QE programme to be extended beyond March at the current pace of €80bn per month.

Flat-lining of core inflation means tapering should wait

In particular, Draghi flagged the importance of the future path of core rather than headline inflation in guiding policy. And he stated that the ECB is looking for a sustainable increase in inflation back to target and will therefore look through any short-term increase in headline CPI that might be related simply to 'blips' e.g. due to increases in the oil price. Moreover, the opening statement acknowledged that, in contrast to what is implied by the ECB's most recent forecasts, 'there are no signs yet of a convincing upward trend in underlying inflation'. So, the updated forecasts in December ought to revise down the expected profile for core inflation, pushing back the point at which the inflation target can be achieved on a sustainable basis. And given the subdued nature of underlying inflation as well as the still very low (albeit recently rising) levels of financial market measures of inflation expectations (see charts), there will be no tapering for a while yet. Indeed, with ECB staff

Euro area: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: 5Y5Y inflation expectations



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.



recently having assessed the first phase of QE to have boosted inflation by about 0.4ppt, an extension of QE at the current monthly pace of €80bn for a further six months to at least September 2017 would seem to be merited. And to be able to achieve those purchases, the ECB will also have to relax certain parameters of the QE programme, not least via an increase in the issue limit on bonds with no collective action clauses above the current share of 33% and probably also by formalising its tolerance of deviations in the share of asset purchases from the ECB's capital key.

The day ahead in the euro area and US

Friday will bring the release of the ECB's latest survey of professional forecasts, which is used by officials most notably to monitor inflation expectations, and the Commission's flash euro consumer confidence index for October. In addition, DBRS will announce the outcome of its crucial review of its Portuguese sovereign credit rating, but we do not expect to see the downgrade to junk status which would make PGBs ineligible for purchase by the ECB under its QE programme.

It should be an uneventful end to the week in the US with no economic data of note due for release.

UK

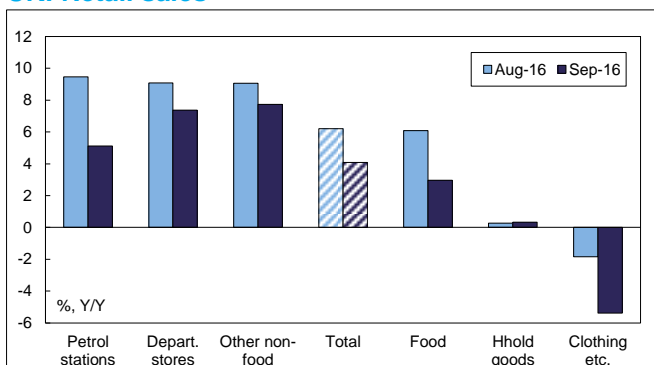
Retail sales growth eases as prices rise

Having remained buoyant in the immediate aftermath of the Brexit vote, sentiment in the UK retail sector looks to have taken a turn for the worse with the arrival of autumn. Today's figures showed that total sales were unchanged in September, leaving the annual pace of growth falling by more than expected, from 6.6%Y/Y to 4.1%Y/Y, below its recent average, but within the pre-referendum range. Sales in September were unimpressive in all major subsectors, with the exception of household goods, which saw a bounce back following a very weak August. The worst performer of all was textile, clothing and footwear sales, down 2.8%M/M after a similar decline the previous month. This category seems to have been hurt by rising prices, which also showed up in the CPI release this week. According to today's data, this was the only category, other than fuel, where prices exceeded their level a year ago. However, it is also notable that retail prices picked up significantly across almost all types of goods, and the overall annual pace of increase was the highest in more than two years. So while it is still early days, today's weaker than expected sales figures might be an early glimpse into how consumers might react to rising prices over the coming months and quarters. Nevertheless, with quarterly retail sales growth at 1.8%Q/Q, the highest since the end of 2014 and up from 1.1%Q/Q in Q2, consumer spending remained robust in Q3, suggesting that GDP growth last quarter could well be as strong as 0.4%Q/Q, twice the rate anticipated by BoE staff at last month's MPC meeting.

The day ahead in the UK

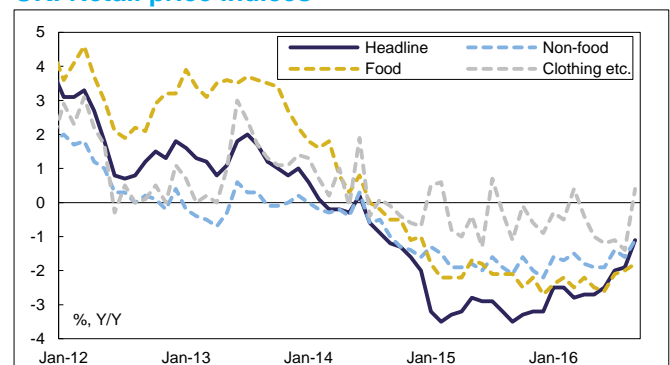
The end of the week brings September public finance figures. Borrowing so far this financial year has been higher than the OBR had previously expected, down by only 12.7% in the year to August versus the full-year forecast of a decline of more than 25% relative to FY15/16. And with the economy now slowing, the path for the public finances, both in the short and medium term, looks set to be significantly worse than that expected at the time of the latest budget announcement, which was before the EU referendum.

UK: Retail sales



















Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Retail price indices





Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results						
Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Current account balance €bn	Aug	29.7	-	21.0	27.7
	 ECB refinancing rate %	Oct	0.00	<u>0.00</u>	0.00	-
	 ECB deposit rate %	Oct	-0.40	<u>-0.40</u>	-0.40	-
	 ECB asset purchase target €bn	Oct	80	<u>80</u>	80	-
Italy	 Current account balance €bn	Aug	3.4	-	9.4	-
Spain	 Trade balance €bn	Aug	-2.6	-	-0.6	-
UK	 Retail sales excluding petrol M/M% (Y/Y%)	Sep	0.0 (4.0)	0.2 (4.4)	-0.3 (5.9)	-0.1 (6.2)
	 Retail sales including petrol M/M% (Y/Y%)	Sep	0.0 (4.1)	0.3 (4.7)	-0.2 (6.2)	0.0 (6.6)
	 BoE corporate bond purchases £mn	Weekly	1559	-	1042	-
Country	Auction					
France sold	 €4bn of 0% 2021 bonds (25-May-2021) at an average yield of -0.38%					
	 €2bn of 3% 2022 bonds (25-Apr-2022) at an average yield of -0.32%					
	 €593mn of 0.25% 2024 index-linked bonds (25-Jul-2024) at an average yield of -1.12%					
	 €405mn of 1.85% 2027 index-linked bonds (25-Jul-2027) at an average yield of -0.89%					
Spain sold	 €1.1bn of 3.45% 2066 bonds (30-Jul-2066) at an average yield of 2.688%%					
	 €1.2bn of 0.25% 2019 bonds (31-Jan-2019) at an average yield of -0.122%					
	 €1.5bn of 5.9% 2026 bonds (30-Jul-2026) at an average yield of 1.043%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases						
Economic data						
Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous	
EMU		15:00 Preliminary consumer confidence	Oct	-8.0	-8.2	
UK		09:30 Public sector net borrowing excluding interventions £bn	Sep	8.5	10.5	
Auctions and events						
Country	BST	Auction / Event				
- Nothing scheduled -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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