Euro wrap-up

Overview

- While the ECB's October meeting account noted that euro area wage growth has been weaker than expected, and the latest car and construction data disappointed, Bunds made gains while periphery bonds made losses.
- Gilts were little changed despite some strong UK retail sales figures.
- Friday will bring a speech from ECB President Draghi and the latest euro area balance of payments figures.

Chris Scicluna +44 20 7597 8326
Mantas Vanagas +44 20 7597 8318

Daily bond market movements

Bond	Yield	Change*
BKO 0 12/18	-0.638	-0.005
OBL 0 10/21	-0.347	-0.016
DBR 0 08/26	0.274	-0.023
UKT 1¼ 07/18	0.188	-0.009
UKT 3¾ 09/21	0.665	+0.016
UKT 1½ 07/26	1.392	+0.010

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

Euro area

October's inflation figures align with expectations

The final estimates of inflation in October provided no surprises whatsoever, with minimal revisions from the flash figures. So, while headline CPI rose to the highest rate in more than two years, at 0.5%Y/Y it was only 0.1ppt higher than in September and meant that inflation has now remained below 1%Y/Y for more than three years. Moreover, the pickup in the latest month was due only to the smaller drag from energy prices, which fell less than 1%Y/Y, the least since June 2014. In contrast, food inflation weakened to just 0.4%Y/Y, the lowest since January 2015. And with inflation of non-energy industrial goods (0.3%Y/Y) and services (1.1%Y/Y) unchanged from September, the core measure remained unchanged at 0.8%Y/Y for the third consecutive month, no higher than the average of the past two years and arguably about ½ppt below the levels that might be required before the ECB might feel sufficiently confident to start tapering its asset purchases.

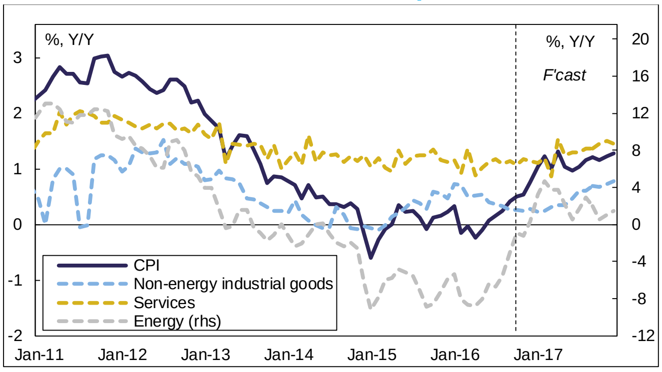
ECB acknowledges weakness of wages

Indeed, in a speech earlier this week, ECB Vice President Constâncio acknowledged that it was a 'cause for concern [that] core inflation…is not recovering'. And he attributed that adverse trend not least to subdued wage growth, which – as the account of the October Governing Council meeting released today revealed – has been notably weaker than the ECB expected. Indeed, given the large amount of spare capacity – with the euro area unemployment rate of 10% more than twice the US level – as well as increased labour market flexibility provided by reforms particularly in Spain, Italy and most recently France, wage growth will likely remain sub-par and overall cost pressures are likely to remain muted. So, looking ahead, we expect headline CPI to remain unchanged at 0.5%Y/Y in November before rising to 0.8%Y/Y in December and 1.0% Y/Y in January as energy prices start to add to inflation. However, we also forecast core CPI to remain at 0.8%Y/Y over those months, and to rise only gradually throughout 2017. And so, when it publishes updated forecasts early next month, we expect the ECB to nudge down its inflation projection and suggest that CPI will remain below target through at least to end-2018. And so, we also expect the ECB in December to extend its asset purchase programme for a further six months to at least September 2017, initially at the current rate of €80bn per month.

New car registrations fall at the start of Q4

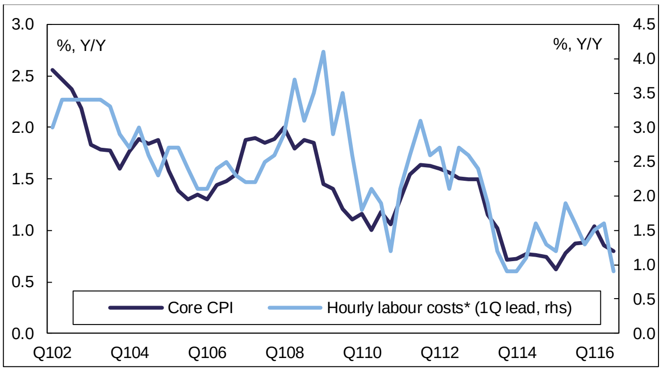
October's euro area car registrations figures were soft, down 1.2%Y/Y, the second weakest annual rate since August 2013. To some extent, this was payback for the notable strength of sales in September – indeed, in seasonally adjusted terms, the drop

Euro area: CPI inflation and components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: CPI inflation and labour costs*



**Excluding public sector.*
Source: Eurostat, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

in sales of 4.8%M/M in October almost fully reversed the gain the previous month, which was the strongest in four years. Indeed, these data are typically volatile, so somewhat higher readings might be expected in coming months. And registrations were still up 0.6% on a three-month basis and 7.8% in the year to date compared to the same period in 2015, so the figures were not overly alarming. But the underlying rate of growth in car sales and, indeed, other spending indicators in the euro area, has certainly moderated this year. And that trend might be expected to continue as real income growth also slows gradually over coming quarters.

Construction growth in Q3 strongest since end 2015

At face value, the latest construction output numbers were also disappointing, suggesting that the sector has yet to establish a solid upward trend. Indeed, following a broadly flat August, output in the sector fell 0.9%M/M in September as a modest gain in civil engineering was more than offset by a drop in building work. Nevertheless, compared to a year earlier, construction output was still 1.8% higher. And given the firm performance in July (up 1.5%M/M), over the third quarter as a whole construction output rose 1.5%Q/Q, the most since Q415. Indeed, of the large member states, there was firm growth in the sector in Q3 in Germany (1.3%Q/Q), France (2.8%Q/Q) and Spain (5.1%Q/Q) and a flat reading in Italy. And with confidence and order books in the sector at eight-year highs, benefiting not least from low mortgage interest rates, easier financial conditions and improved labour market prospects, conditions appear to be in place for continued expansion in the sector over coming quarters too.

The day ahead in the euro area and US

It should be a quiet end to the week for economic data from the euro area with the ECB's balance of payments figures for September the most notable new release. However, in the morning, ECB President Draghi will give the keynote speech to the European Banking Congress in Frankfurt.

It should also be a quiet day for economic data from the US, with no top-tier economic releases due. However, FOMC members Dudley, Kaplan, George and Bullard are all due to speak publicly.

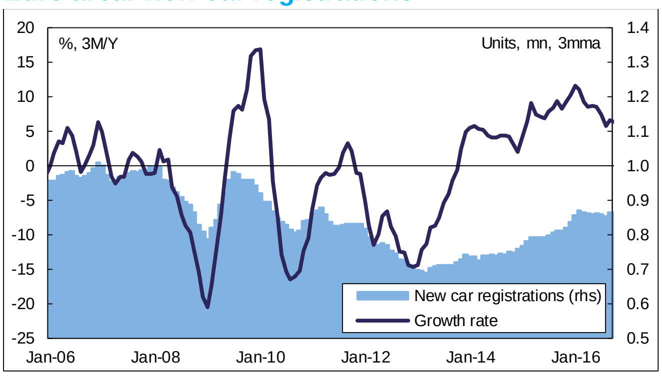
UK

Retail sales surged at the start of Q4

When the preliminary Q3 GDP estimate showed higher-than-expected growth of 0.5%Q/Q all eyes turned to private consumption, which looks to have remained the key driver of growth following the EU referendum. And today's retail sector figures for October suggested that momentum picked up further at the start of Q4, with sales up by nearly 2%M/M to leave the annual pace rising from 4.2%Y/Y to 7.4%Y/Y, the highest level since April 2002. Within the details, all major categories provided positive contributions, but non-food items, and in particular textile, clothing and footwear sales, saw the largest increase on the month.

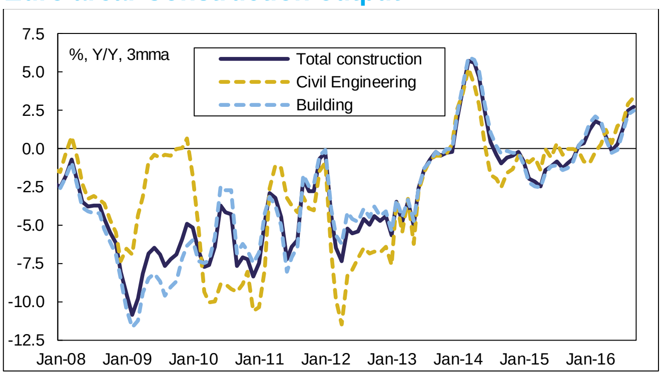
While some one-off factors, including weather effects and Halloween, might have boosted sales in October, the underlying strength in retail spending is at odds with expectations of a weaker economic outlook in the wake of the referendum. One possible explanation is that purchases are being brought forward in anticipation of higher future inflation. Certainly, as yet, despite some high-profile price increases, there is no strong evidence that the general price level has started rising yet as a result of the depreciation in sterling. Indeed, the retail sales deflator (excluding volatile fuel prices) suggests that the rate of change in prices inched up by only 0.1ppt to -1.3%Y/Y. However, it is now significantly above the pace seen

Euro area: New car registrations



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output



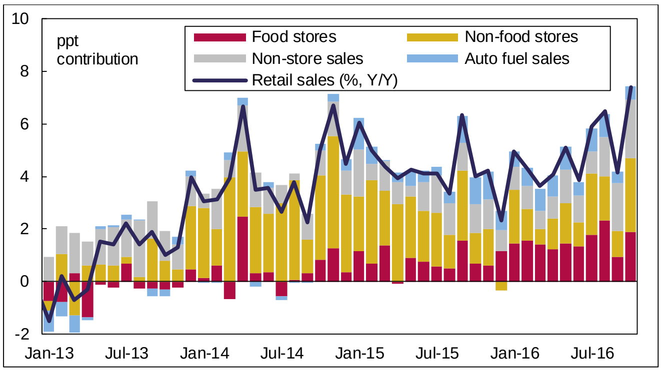
Source: Eurostat, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

before the EU referendum, and some categories are seeing significantly higher rates. Against this backdrop, with the upward pressure on prices set to intensify in the future, lower real income growth should eventually affect the High Street, and therefore, retail sales growth is likely to ease.

The day ahead in the UK

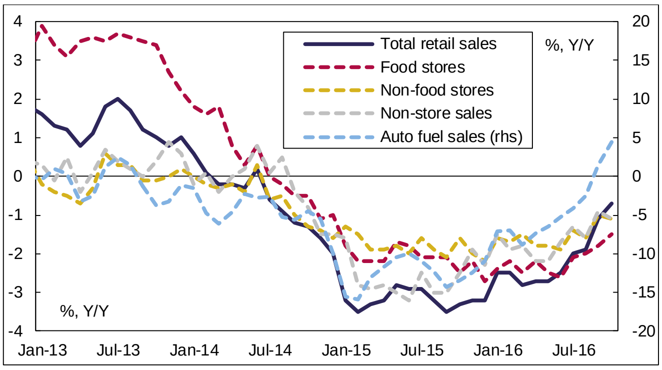
A quiet end to the week brings no new economic data in the UK tomorrow.

UK: Retail sales



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

UK: Retail sales deflators



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	Oct	**0.0**	-	7.2	**-**
		Construction output M/M% (Y/Y%)	Sep	**-0.9 (1.8)**	-	-0.9 (0.9)	**0.1 (2.1)**
		Final CPI (core CPI) Y/Y%	Oct	**0.5 (0.8)**	*0.5 (0.8)*	0.4 (0.8)	**-**
France		Unemployment rate %	Q3	**10.0**	9.9	9.9	**-**
Italy		Trade balance total €bn	Sep	**3.7**	-	2.5	**-**
UK		Retail sales excluding petrol M/M% (Y/Y%)	Oct	**2.0 (7.6)**	0.4 (5.4)	0.0 (4.0)	**0.1 (-)**
		Retail sales including petrol M/M% (Y/Y%)	Oct	**1.9 (7.4)**	0.5 (5.3)	0.0 (4.1)	**0.1 (4.2)**
		BoE corporate bond purchases £mn	Weekly	**3070**	-	2690	**-**
Country		Auction					
France sold		€1.3bn of 3.75% 2021 bonds (25-Apr-2021) at an average yield of -0.21%					
		€4.2bn of 0% 2022 bonds (25-May-2022) at an average yield of -0.03%					
		€635mn of 2.1% 2023 index-linked bonds (25-Jul-2023) at an average yield of -0.84%					
		€363mn of 0.7% 2030 index-linked bonds (25-Jul-2030) at an average yield of -0.36%					
		€481mn of 0.1% 2047 index-linked bonds (25-Jul-2047) at an average yield of 0.02%					
Spain sold		€965mn of 0.25% 2019 bonds (31-Jan-2019) at an average yield of -0.008%					
		€920mn of 0.75% 2021 bonds (30-Jul-2021) at an average yield of 0.408%					
		€2bn of 1.3% 2026 bonds (31-Oct-2026) at an average yield 1.498%					
UK sold		£1.1bn of 0.125% 2026 index-linked bonds (22-Mar-2026) at an average yield of -1.789%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09:00	Current account balance €bn	Sep	-	29.7
Italy	09:30	Current account balance €bn	Sep	-	3.4

Auctions and events		
Country	GMT	Auction / Event
EMU	08:15	ECB's Draghi scheduled to speak in Frankfurt

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope