Euro wrap-up

Overview

- Bunds made modest losses as the ECB left its policy guidance unchanged but Draghi was upbeat about the euro area inflation outlook.
- Gilts also made losses as the BoE signalled its greater optimism regarding the UK's near-term economic growth outlook.
- Friday will bring euro area goods trade and labour cost data as well as a speech by BoE Governor Carney.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/20	-0.561	+0.001
OBL 0 04/23	-0.221	+0.008
DBR 0¼ 08/28	0.423	+0.013
UKT 2 07/20	0.805	+0.012
UKT 0¾ 07/23	1.101	+0.019
UKT 1⅝ 10/28	1.505	+0.021

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

Euro area

Draghi leaves policy powder dry…

To some extent, today's ECB policy announcement was something of a non-event, with the key planks of policy, which were initially set out in June, simply restated. So, as expected, the Governing Council confirmed the reduction in the rate of net asset purchases from €30bn per month to €15bn per month from the start of next month. It also repeated its intention to cease net asset purchases by the end of the year, as well as its plan to reinvest the principal of maturing securities 'for as long as necessary'. And in line with the expected timescale, Draghi noted that options to introduce greater flexibility into the reinvestment policy would be agreed by the end of the year. In terms of interest rates, meanwhile, the Governing Council simply stated again that it expects them 'to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary'.

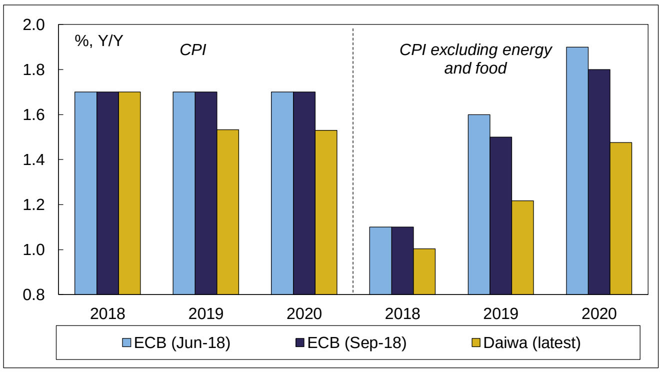
…despite downgrade to the growth outlook

With the inertia in policy having been predictable, the ECB's updated economic forecasts were bound to attract attention. GDP in Q2 had been weaker than the Governing Council previously anticipated. And with recent data pointing to no pickup in Q3, the ECB's growth forecasts were nudged lower, down 0.1ppt in both 2018 and 2019 to 2.0%Y/Y and 1.8%Y/Y respectively. But the GDP growth forecast for 2020 was left unchanged at 1.7%Y/Y. And while Draghi acknowledged that downside risks posed by protectionism, emerging market vulnerabilities and financial market volatility 'have gained more prominence recently', the Governing Council concluded that the risks to the growth outlook were still broadly balanced. That sanguine view was justified by recent strength in the labour market – particularly continued vigorous job creation and accelerating wages – which Draghi stated should support consumer spending even if external demand deteriorates further. Stronger growth in labour costs was also expected to boost underlying inflation. And so, despite the downgrade to the near-term GDP growth forecast, the ECB left unchanged its outlook for headline CPI, projecting average annual rates of 1.7%Y/Y in 2018, 2019 and 2020 – a projection that Draghi judged to be consistent with meeting the ECB's inflation objective. However, with core CPI having remained stubbornly weak over the summer, the ECB revised down by 0.1ppt its forecasts for core inflation in 2019 and 2020, to 1.5%Y/Y and 1.8%Y/Y respectively.

A limited and short-lived monetary tightening ahead

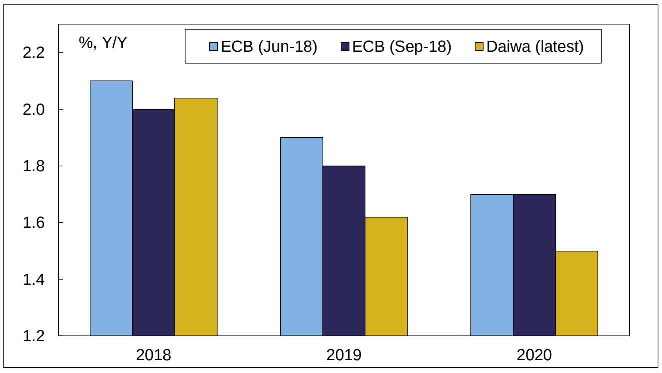
In our view, the forecasts for GDP growth and – in particular – core inflation remain overoptimistic, not least since we think the euro area economy will lack resilience to the slowdown in the US (and rest of the global economy) that we anticipate in 2020.

Euro area: Inflation forecasts



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

Euro area: GDP forecasts



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

As such, we anticipate a monetary tightening cycle that is both limited and short-lived. While we still expect the ECB to raise rates for the first time this cycle before the end of 2019, we currently think it will only manage one further rate hike in 2020 before having to pause for an extended period.

No surprises from national inflation data

Beyond the ECB meeting, it was a relatively uneventful day for new economic data from the euro area. The most notable new releases were the final estimates of August inflation in Germany and France, which – like the Spanish figures released yesterday – aligned with the respective flash estimates. So, in Germany, the headline rate of CPI on the EU-harmonised measure fell to 1.9%Y/Y, down 0.2ppt from July. The detail published on the national measure confirmed that the drop principally reflected softer services inflation, which, excluding rents, fell sharply to 1.2%Y/Y, the weakest rate in ten months. Food inflation was also weaker, but energy inflation rose to an eighteen-month high. In France, meanwhile, headline inflation on the same basis remained unchanged from July at 2.6%Y/Y, with the detail on the national measure also largely stable, e.g. with services inflation unchanged at 1.3%Y/Y and core inflation on this basis unchanged at 0.9%Y/Y. Overall, today's data suggest that the final euro area CPI data, due on Monday, will confirm the flash rates of 2.0%Y/Y headline and 1.0%Y/Y core, with both rates down 0.1ppt from July. However, given the proximity of the flash estimates, to two decimal places, to the rounding ranges, revisions to 2.1%Y/Y and 0.9%Y/Y respectively would not come as a major surprise. The final Italian figures, also due Monday, will be key in that respect.

The day ahead in the euro area and US

Friday in the euro area will bring July merchandise trade data and Q2 labour cost figures. So far in 2018, goods export growth has been subdued, and so net trade subtracted from GDP growth in both Q1 and Q2. Given the downtrend in new export order growth, and in light of the weak German figures already released, we do not anticipate a much stronger performance in July. Meanwhile, the labour cost data will be watched to see whether stronger pay growth is starting to add pressures in the price pipeline.

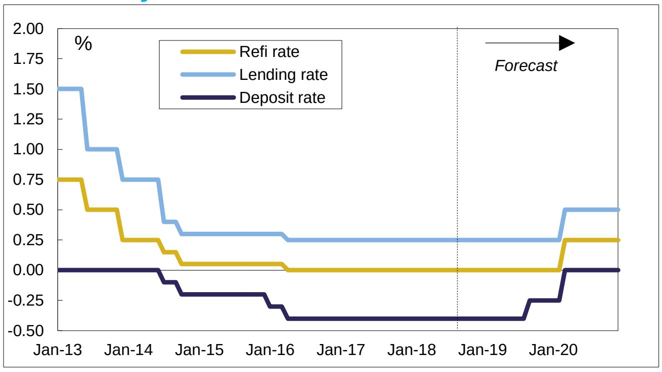
In the US, Friday will be a busy day for new releases, with the retail sales report for August the highlight. While fundamental drivers of consumption remain strong, a slow month for vehicle sales and payback for unusually firm readings in July in certain other key categories could weigh on sales in August. The preliminary University of Michigan consumer survey results for September and industrial production and import price reports for August are also due tomorrow, alongside full business inventory data for July.

UK

BoE more upbeat about near-term growth

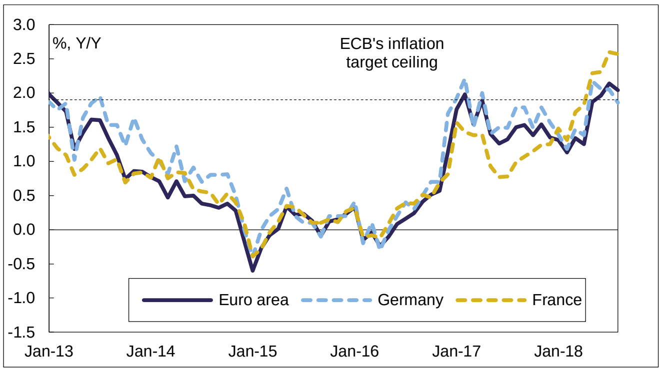
Like the ECB, today's policy announcement from the BoE was largely uneventful. Having raised Bank Rate to 0.75% in August, this time all nine MPC members, including newly appointed external member Jonathan Haskel, voted to keep policy unchanged. The minutes of the meeting highlighted that the economy is evolving broadly in line with the August BoE forecasts. However, the policy makers acknowledged that some developments – for example, household spending growth might be growing at a stronger pace than expected in August – appear to be more positive than previously judged. Indeed, with July's GDP figures having come in above the BoE's expectations, its forecast for Q3 was revised up to 0.5%Q/Q, 0.1ppt above our own expectation. On the downside, the BoE noted that survey measures of new export orders have fallen, seemingly related to a pick-up in uncertainty about Brexit. The Decision Maker Panel survey, which was released alongside the BoE Agents scores today, suggested that firms on average put the probability that Brexit will hinder foreign sales at 40%, while they see only a 14% chance that it will provide a boost. Against this backdrop, the BoE Agents' Business Conditions survey itself showed some weakening in companies' investment intentions, albeit the relevant indicators remained broadly in line with their averages since the start of 2017. Meanwhile, like the ECB, the BoE recognised that downside risks around global growth

ECB: Policy interest rates forecast



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

Euro area: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

have become more prominent too, given the tightening in financial conditions in emerging markets and ongoing US-China trade dispute. Most importantly in the view of the MPC, however, the labour market continued to tighten, with some evidence that pay growth is picking up.

No imminent tightening from the BoE in the pipeline

Overall, the BoE continued to expect that domestically generated inflation will rise over the coming months and beyond as the economy grows above its potential pace. Consistent with that judgment, the MPC maintained its guidance of further gradual policy tightening over the forecast horizon, provided that the economy does not deviate from the August Inflation Report projections. In our opinion, the BoE will refrain from any further policy action at least until Brexit uncertainty recedes and possibly beyond, particularly if productivity growth recovers to offset higher labour cost growth.

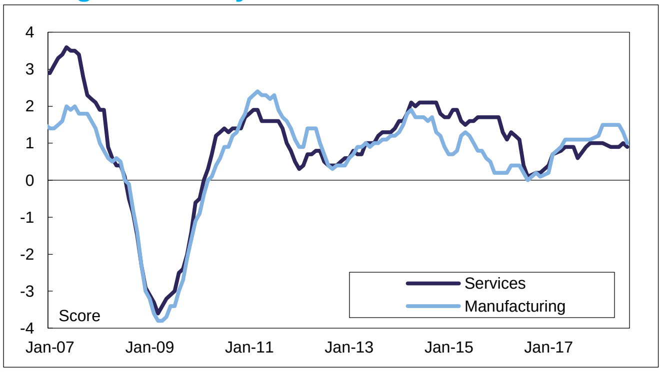
Housing market sentiment remains subdued

One pocket of weakness in the UK economy is the housing market, for which today's RICS Residential Market Survey once again highlighted the absence of momentum. The survey's headline price indicator eased from 4% to 2% signalling that prices continued to move broadly sideways in August. The figure, however, masked very significant regional variation – for example, the prices indicators for London, the South East and the East remained firmly in negative territory, while Scotland, Northern Ireland and the West Midlands reported sizeable increases. Regarding activity in the market, a small increase in new buyer enquiries in London was a brighter spot in the figures. However, at the national level, having been more stable in the previous few months, demand seems to have resumed a gradual downward trend, perhaps reflecting higher borrowing costs after the BoE's decision to tighten monetary policy. Alongside the renewed weakness on the supply side – the new vendor instructions indicator was down from -3% to -15% – that left the level of transactions falling at the steepest pace in five months. Looking ahead, sentiment about future price changes remained subdued, with survey respondents expecting a decline in price growth in the near term and a relatively modest rise over the coming twelve months. We broadly share that view and expect that, against the backdrop of Brexit risks, official annual house price growth to ease further towards the end of the year.

The day ahead in the UK

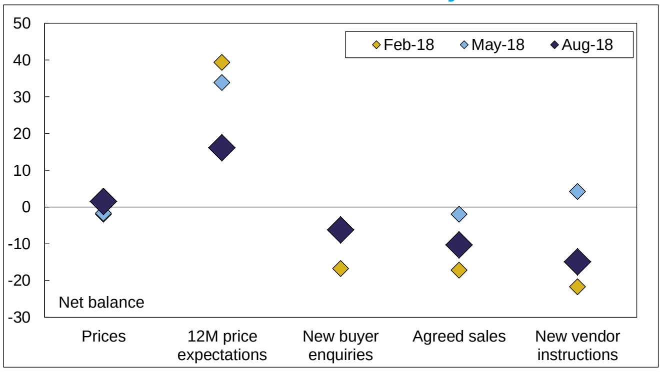
A quiet end of the week brings no new economic data releases. BoE Governor Carney is scheduled to speak in Dublin, so we might hear some additional insights into monetary policy considerations.

UK: Agents' Survey of Business Conditions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: RICS Residential Market Survey



Source: 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	ECB Main Refinancing rate %	Sep	**0.00**	*0.00*	0.00	-
	ECB Marginal Lending Facility rate %	Sep	**0.25**	*0.25*	0.25	-
	ECB Main Deposit rate %	Sep	**-0.40**	*-0.40*	-0.40	-
Germany	Final EU-harmonised CPI Y/Y%	Aug	**1.9**	*1.9*	2.1	-
France	Final EU-harmonised CPI Y/Y%	Aug	**2.6**	*2.6*	2.6	-
UK	RICS house price balance %	Aug	**2**	2	4	-
	BoE Bank Rate %	Sep	**0.75**	*0.75*	0.75	-

Country	Auction
Italy sold	€2.5bn of 0.05% 2021 bonds (15-Apr-2021) at an average yield of 1.2%
	€3.75bn of 2.5% 2025 bonds (15-Nov-2025) at an average yield of 2.55%
	€1.5bn of 3.45% 2048 bonds (01-Mar-2048) at an average yield of 3.55%

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	Trade balance €bn	Jul	16.2	16.7
	10:00	Labour costs Y/Y%	Q2	-	2.0
Italy	09:00	Final EU-harmonised CPI Y/Y%	Aug	*1.7*	1.9

Auctions and events

Country	BST	Auction / Event
UK	11:00	BoE's Carney scheduled to speak in Dublin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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