Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest gains today while euro area final inflation data for September aligned with the flash estimates.
- Gilts also made gains as UK inflation surprised on the downside.
- Tomorrow brings the conclusion of the EU Council meeting, while UK retail sales figures are due for release.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/20	-0.622	-0.007
OBL 0 04/23	-0.208	-0.023
DBR 0¼ 08/28	0.464	-0.027
UKT 2 07/20	0.798	-0.019
UKT 0¾ 07/23	1.139	-0.029
UKT 1⅝ 10/28	1.570	-0.038

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

Euro area

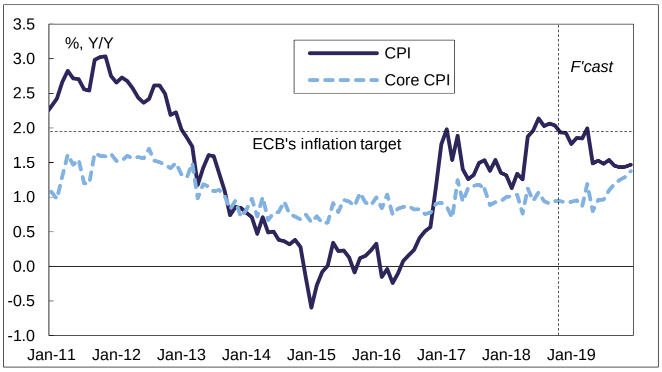
Final euro area inflation confirmed

With only modest tweaks made to the flash estimates from the larger member states – a downward revision to Italian CPI was offset by an upwards revision to the Spanish number – today's release of the euro area's final September inflation figures brought no major surprises. In particular, the headline rate was confirmed at the preliminary estimate of 2.1%Y/Y, up 0.1ppt from August to match the 5½-year high hit in July. While there were modest amendments within the breakdown, the message remained unchanged – i.e. the pickup last month was driven by energy and food prices. The annual rates of energy and unprocessed food inflation both ticked up 0.3ppt to 9.5%Y/Y and 2.7%Y/Y, albeit with the latter revised down from the flash estimate. Meanwhile, the decline in services prices was confirmed at -1.1%M/M, the steepest monthly drop on the series, to leave the annual rate unchanged at 1.3%Y/Y. There was also a slight downward revision to non-energy industrial goods inflation to 0.3%Y/Y. As such, the core CPI rate was confirmed at 0.9%Y/Y in September, marking the tenth month at or below 1.0% out of the past twelve and a level bang in line with the average of the past three years. We still expect core CPI to edge slightly higher over coming quarters, as firmer wage growth feeds through. But as energy price inflation likely heads lower over coming quarters, headline inflation is likely to take a step down, to around 1½%Y/Y by the middle of 2019. And we expect inflation to oscillate around that rate further across the forecast horizon too, thus remaining below the path currently envisaged by the ECB.

Car sales reverse previous surge

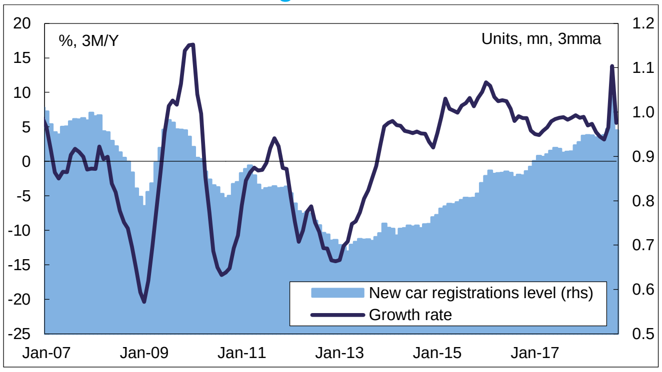
Today's other data were, at face value, disappointing, with euro area car registration numbers reporting a massive 24%Y/Y drop in September. The figures are not, however, alarming, representing payback after the surge of more than 30%Y/Y in the previous month, when car manufacturers had offered particularly attractive deals in order to shift inventory ahead of the introduction of new 'WLTP' (Worldwide Harmonised Light Vehicle Test Procedure) emission-testing standards. Indeed, looking through this distortion, on a year-to-date basis growth was much stronger, at 4.0%YTD/Y, a rate broadly in line with the pace in the first half of the year. Certainly, seasonally adjusted figures suggest that over the third quarter as a whole new car registrations were still up more than 1%Q/Q following growth of just 0.1%Q/Q in Q2, and only marginally softer than average quarterly growth through 2017, suggesting that household consumption is likely to have provided ongoing modest support to euro area GDP growth in Q3.

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.

Construction output declines again

The latest construction output data for August were also on the soft side, with overall output down for the second successive month and by ½%M/M, with building work down 0.3%M/M and civil engineering down by 1.1%M/M. The weakness was principally driven by Germany where output fell 1.8%M/M, while there were modest increases in France and Spain (0.2%M/M and 0.5%M/M respectively). Nevertheless, overall activity in the sector was still 2½% higher than a year earlier, and on average in July and August construction output was 0.3% higher than the average in Q2. Moreover, with confidence among construction firms having risen to a series high, and order books also reportedly at historically high levels, we would expect to see a rebound in activity in September to ensure that the sector once again provided modest support to euro area GDP growth in Q3.

The day ahead in the euro area and US

With no data of note due from the euro area tomorrow, focus will no doubt be on the concluding statements from the EU Council's two-day meeting. Most notably, the Euro Summit will discuss possible future reforms to the policy framework of the euro area, although Italian fiscal policy will cast a pall over deliberations. In the markets, France will sell fixed-rate and index-linked bonds, while Spain will sell bonds with various maturities. In the US, meanwhile, alongside the weekly jobless claims figures tomorrow will bring the Philly Fed Index for October and the Conference Board's Leading Index for September. In the markets, the Treasury will sell 30Y TIPS.

UK

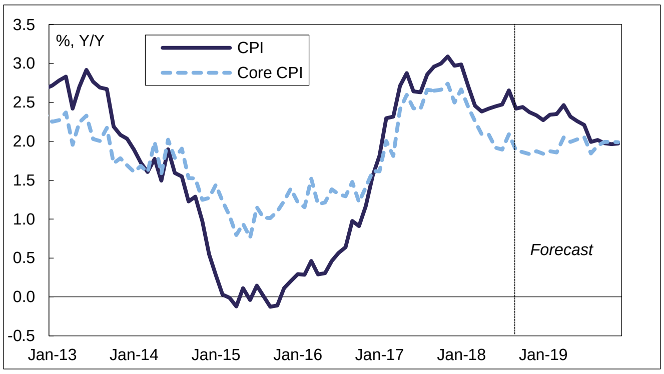
Inflation took a step down in September

While yesterday's stronger-than-expected wage growth figures hinted at strengthening domestically generated inflationary pressures, today's inflation data seem to have brought an entirely different message. After an unexpected surge in UK inflation at the end of summer, when the headline CPI leapt to 2.7%Y/Y, a moderation in September seemed very likely. But today's figures still surprised on the downside, showing a sizeable drop in the headline rate to 2.4%Y/Y, a three-month low. The core rate also fell, reversing the 0.2ppt increase of the previous month to return to 1.9%Y/Y. Among the details, food prices provided the biggest downward contribution, but passenger transport fares, auto fuel (for which prices rose at a slower pace than during the same month a year ago), computer games (which were one of the key factors behind the increase in inflation in August), and clothing and footwear categories also had a negative impact on the headline rate. These were partly offset by higher electricity and gas prices – inflation in this category hit the highest level since mid-2013. With more utility companies increasing their electricity and gas tariffs this month, and the oil price remaining elevated, the upward trend in the energy CPI is set to be maintained in October. However, we expect core inflation to stabilise around current levels in the near term. Thereafter, domestic inflationary pressures – in particular, increases in labour compensation above those justified by productivity growth – as well as any potential shifts in sterling against the backdrop of developments in the Brexit negotiations, will be the main drivers of UK inflation. For now, we expect the headline rate to remain above 2%Y/Y through to next summer before settling close to the BoE's target.

Lethargic housing market

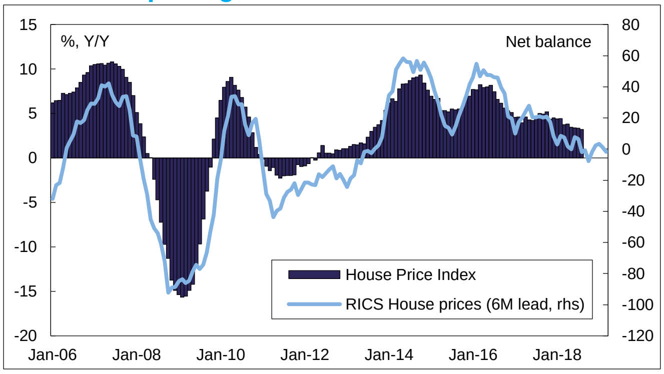
The pace of price growth in the housing market also declined in the latest month, with the UK House Price Index showing a 0.2ppt fall in the headline rate to 3.2%Y/Y, the lowest level in five years. While subdued real wage growth, Brexit uncertainty and the weak overall economic backdrop is keeping the housing market on the back foot, it is worth noting that prices remain on an upward trajectory, with monthly and three-month rises of 0.3%M/M and 1.0%3M/3M respectively in August. London was

UK: CPI inflation



Source: Thompson Reuters and Daiwa Capital Markets Europe Ltd.

UK: House price growth



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

the worst performing region again, with house prices in the capital having moved broadly sideways for the past eighteen months, while annual growth in all other regions remained firmly in positive territory. Looking ahead, a similar trend of gradually moderating house price growth is likely to continue over the near term, not least given that the latest RICS survey suggested no meaningful upward pressure on prices. Down the road, a combination of a smooth Brexit transition and higher wage growth could potentially inject more optimism into the market. On the other hand, a no-deal Brexit would probably tilt the trajectory of prices the other way.

The day ahead in the UK

While investors might respond to news headlines from this evening's EU summit, where leaders are discussing Brexit, we do not expect to see any meaningful breakthrough even if the main protagonists claim incremental progress. The Irish border backstop question is unlikely to get any closer to being resolved, with May simply unable to bring anything substantially new to the table today and maintaining her incompatible negotiating red lines to appease the critics within her own party. On the data front, meanwhile, September figures from the retail sector will take centre-stage. Following a period of particularly rapid growth over the summer, the latest surveys suggested some moderation last month and so a drop in sales of nearly ½%M/M looks on the cards. That would be the lowest reading since March, but would still leave the annual pace of sales growth elevated at around 3½%Y/Y.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	EU27 new car registrations Y/Y%	Sep	**-23.5**	-	31.2	**-**
	Construction output M/M% (Y/Y%)	Aug	**-0.5 (2.5)**	-	0.3 (2.6)	**-0.1 (2.2)**
	Final CPI (core CPI) Y/Y%	Sep	**2.1 (0.9)**	*2.1 (0.9)*	2.0 (0.9)	**-**
UK	CPI (core CPI) Y/Y%	Sep	**2.4 (1.9)**	*2.5 (2.0)*	2.7 (2.1)	**-**
	Input (output) PPI Y/Y%	Sep	**10.3 (3.1)**	9.2 (2.9)	8.7 (2.9)	**9.4 (-)**
	UK House Price Index Y/Y%	Aug	**3.2**	2.8	3.1	**3.4**

Country	Auction
Germany sold	€1.2bn of 2.5% 2044 bonds (04-Jul-2044) at an average yield of 1.04%

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	Retail sales excluding auto fuel M/M% (Y/Y%)	Sep	-0.4 (3.8)	0.3 (3.5)
	09:30	Retail sales including auto fuel M/M% (Y/Y%)	Sep	-0.4 (3.6)	0.3 (3.3)

Auctions and events

Country	BST	Auction / Event
France	09:50	Auction: to sell 0% 2021 bonds (25-Feb-2021)
	09:50	Auction: to sell 0% 2024 bonds (25-Mar-2024)
	09:50	Auction: to sell 1% 2025 bonds (25-Nov-2025)
	10:50	Auction: to sell 0.1% 2021 index-linked bonds (01-Mar-2021)
	10:50	Auction: to sell 0.1% 2047 index-linked bonds (25-Jul-2047)
Spain	09:30	Auction: to sell bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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