Euro wrap-up

Overview

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- Bunds made gains as final euro area inflation data for August confirmed weak price pressures while construction and car registration figures also looked underwhelming.
- Gilts made gains as UK inflation data for August significantly undershot expectations.
- Thursday will bring the latest policy announcement from the BoE, the allotment of funds under the ECB's first TLTRO-III operation, and UK retail sales data.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.742	-0.015
OBL 0 10/24	-0.731	-0.016
DBR 0 08/29	-0.513	-0.035
UKT 3¾ 09/21	0.512	-0.013
UKT 1 04/24	0.458	-0.040
UKT 0⅞ 10/29	0.644	-0.051

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

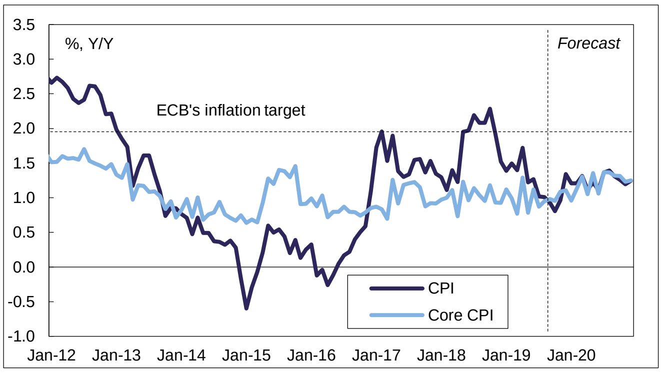
Subdued August inflation unrevised

As expected, the final estimates of euro area headline and core inflation in August were unrevised from the flash figures. Headline inflation was unchanged at 1.0%Y/Y, matching the lowest rate since November 2016. And core inflation was also unchanged from July at 0.9%Y/Y, close to the bottom of the recent range and slightly below the average of the past three years. The main components were unrevised too. Despite rising labour costs, services inflation rose just 0.1ppt from July to remain near the bottom of the recent range at 1.3%Y/Y. Inflation of non-energy industrial goods slipped back 0.1ppt to 0.3%Y/Y. And while food inflation rose to a six-month high of 2.1%Y/Y, energy prices fell 0.6%Y/Y to mark their first annual decline since late 2016. Despite the increase in crude oil prices in the aftermath of the attack on the Saudi production facility, energy inflation will remain in negative territory for a few more months before returning to positive territory in December. And with core inflation set to remain close to recent norms over coming quarters, we expect headline inflation to fall below 1.0%Y/Y next month and remain thereabouts until December. Thereafter, we expect headline inflation to take only a modest step back up, to average 1.2%Y/Y next year, and rise to average a touch below 1.5%Y/Y in 2021. And, notwithstanding significant differences of opinion on the Governing Council, that outlook suggests that ECB policy is likely to remain unchanged for the foreseeable future.

Construction output shrivelled in July heat-wave

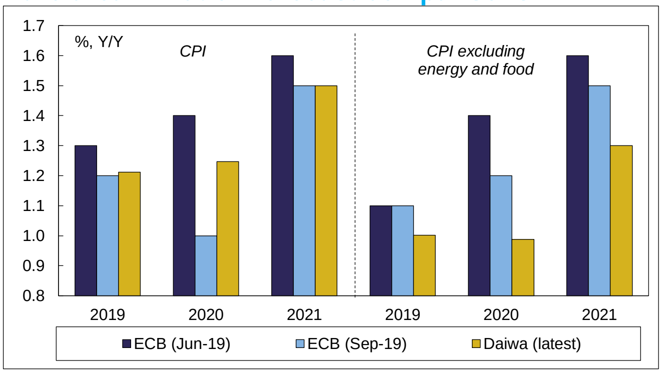
Having reached a series high at the start of the year, sentiment among euro area construction firms has subsequently been on a gradual downward trend. Indeed, according to the European Commission's measure, confidence in the sector in August declined to its lowest level since 2017. And consistent with that softening of sentiment, activity in the sector has been surprisingly subdued so far in 2019. Admittedly, today's data showed that output in June was stronger than previously thought, with the revised increase of 0.6%M/M contrasting with the previous estimate of an underwhelming sideways move. But that growth was more than fully reversed in July, with the drop of 0.7%M/M leaving it up just 1.1%Y/Y, the softest annual rate in six months. Within the detail, both building work and civil engineering output declined in July, with growth in the latter category now very subdued on an annual basis (up just 0.4%Y/Y). However, at the country level, the decline in overall construction output was attributed to France, which recorded a steep drop of 4.2%M/M, while Germany (0.2%M/M) and Spain (0.3%M/M) posted slight increases. With activity in July hit by the extreme heat-wave which saw all-time high temperatures in several member states, we strongly expect to see a rebound in subsequent months, particularly in France. Nevertheless, with the euro area level in July some 0.5% below the Q2 average, the risk of a second successive quarterly contraction in construction output in Q3 is non-negligible.

Euro area: Headline and core CPI forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast comparisons



Source: ECB and Daiwa Capital Markets Europe Ltd.

August car sales difficult to interpret

At face value, the August car registration figures were disappointing, with the 8.4%Y/Y decline in the euro area in August the steepest since December after modest growth on a year-on-year basis in each of the previous three months. There were notable declines in France (-14.1%Y/Y) and Spain (-30.8%Y/Y), while registrations were also lower in Germany (-0.8%Y/Y) and Italy (-3.1%Y/Y). Much of this softness, however, reflected base effects following the surge in registrations this time last year (up 31.2%Y/Y in the euro area in August 2018) ahead of the introduction of new emissions testing standards in the autos sector in September 2018. Indeed, this series is a very volatile one, with seasonal and calendar effects making it difficult to interpret the underlying trend. While registrations dropped about 20%M/M on an unadjusted basis, August is typically the weakest month of the year for car registrations. And, on a seasonally adjusted basis, the ECB estimated growth of 10.7%M/M, the strongest since the surge in the same month a year ago. Nevertheless, looking through the volatility, registrations were still down 3.6%Y/Y over the first eight months of the year, suggesting a clear weakening trend so far in 2019. And with new orders suggesting little sign of life in Germany, we won't hold our breath for an improvement anytime soon.

Southern European politics no cause for (immediate) alarm

Political uncertainty has reared its head again in Southern Europe this week. BTPs sold off yesterday after former PM Matteo Renzi announced his departure from the Democratic Party to form his own new centrist party, albeit maintaining his support for the new M5S/PD coalition for the time being. While the development aims to give him a decisive say in the government's new policies, it also raises uncertainty about its longevity. Nevertheless, we continue to assume that the administration will remain intact for at least a year. Indeed, if it didn't, the parties involved would be on course for a hiding in any new poll, which would almost certainly see Matteo Salvini's League take by some margin the largest share of Parliamentary seats and the leading role in any new Italy government. Given those incentives for the government to remain intact, BTPs fared better today, outperforming Bunds and OATs. Bonos fared even better today even though Spain is now firmly on track for yet another general election on 10 November, after attempts to form a majority-backed government, which have continued since the previous poll in April, finally came to a close yesterday. With the pro-European Socialists of acting Prime Minister Pedro Sanchez set to fare best at the ballot box and probably increase their showing in Parliament, we are certainly not perturbed by the prospect a new elections here. (Of course, the contrary would be the case if Italians were suddenly forced to return to the polls).

The day ahead in the euro area and US

It should be a quieter day for economic news from the euro area tomorrow, with just the ECB's balance of payments for July due for release. In the markets, France and Spain will sell bonds with various maturities. In addition, the ECB will publish the allotment results of its first (of seven) TLTRO-III longer-term refinancing operations. Last week saw the Governing Council make the conditions more attractive, reducing the premium interest rate on the loans by 10bps and increasing the loan maturity to three years (with the option of repayment after two).

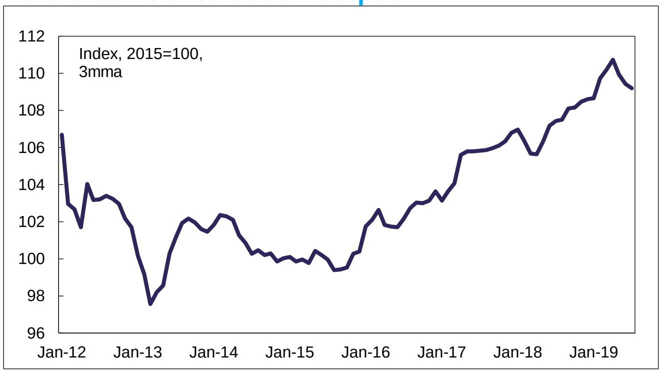
In the US, tomorrow will bring a number of releases including existing home sales figures for August, the Conference Board's leading indicators for the same month, and current account data for Q2, while the usual weekly jobless claims figures are also due. In the markets, the Treasury will sell 10Y TIPS.

UK

Inflation falls more than expected

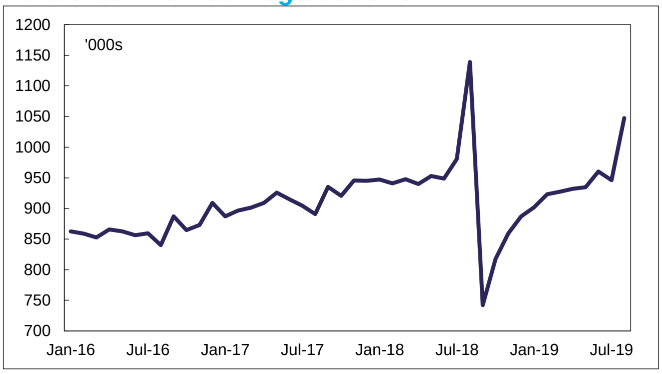
Ahead of tomorrow's BoE monetary policy announcement, today's UK inflation figures for August surprised on the downside. While headline CPI was expected to have fallen back below the BoE's 2%Y/Y target last month, the 0.4ppt drop to 1.7%Y/Y

Euro area: Construction output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations*



**Seasonally adjusted data. Source: ECB, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

was steeper than the median forecast, to leave inflation at its lowest since 2016. The decline in core inflation was also striking, down 0.4ppt to 1.5%Y/Y, the lowest since November 2016. Admittedly, the downwards move was principally driven by a drop in recreation and culture prices last month (down 1.2ppts to 1.1%Y/Y, the lowest since January 2017) as July's jump in computer game prices (which are highly volatile) more than reversed and cultural services inflation fell to its lowest for two years. Perhaps on account of the wet summer weather that deterred sales, clothing prices also provided a modest disinflationary impact, so non-energy industrial goods inflation fell in August by 0.8ppt to 0.4%Y/Y. And services inflation edged lower too, down 0.3ppt to 2.3%Y/Y, a fourteen-month low, as hotel prices were up by less than a year ago. There was also a modest decline in energy inflation, down 0.2ppt to 3.3%Y/Y.

Headline CPI unlikely to exceed BoE's 2% target

While risks to the immediate inflation outlook might well be skewed slightly to the upside, risks to inflation further ahead look to be firmly to the downside. Higher import prices on the back of past sterling depreciation might well see non-energy industrial goods inflation tick slightly higher over the near term. And the jump in the oil price earlier this week on the back of supply concerns related to the weekend's strike on a key Saudi oil facility will limit to some extent the likely downwards shift in energy price inflation too. But given Ofgem's decision to lower the cap on electricity and natural gas prices in October, we still forecast energy prices to provide a temporary drag on inflation in Q4 before shifting higher at the start of 2020. As such, headline CPI is still likely to edge lower in October and November, before shifting back towards 2% in Q120. But with core inflation set to remain subdued through 2020 not least due to weak underlying GDP growth, we still expect headline CPI to edge back below 2.0% from Q220 onwards, therefore leaving the door open for further easing from the Bank of England in due course.

House prices continue to trend lower

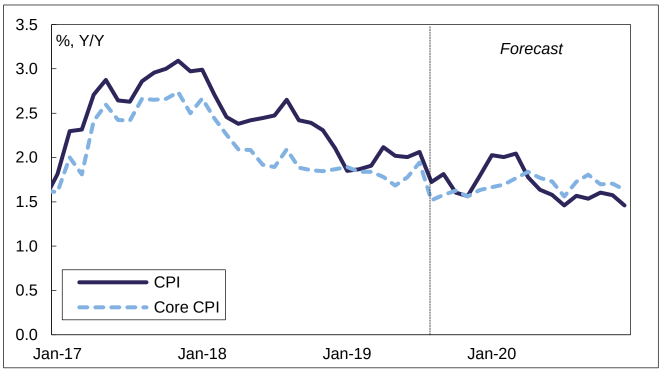
The ONS's official house price figures for July also fell short of expectations today, reporting the first monthly fall in UK house prices in three (-0.3%M/M) and the steepest since March 2018. This left the annual increase down 0.7ppt to 0.7%Y/Y, the lowest such rate since September 2012. The weakness remained dominated by England, where prices were up just 0.3%Y/Y and house prices in Southern England continued to decline (-0.9%Y/Y). But while prices in Northern England continued to rise overall (1.7%Y/Y), there was a notable drop in the North East (-2.2%Y/Y, the steepest for more than four years). Overall, surveys suggest that house price growth will continue to trend lower over the remainder of the year. But while they currently point to some stabilization at the start of 2020, the outlook for the housing market seems bound to depend largely on Brexit.

The day ahead in the UK

It will be a busy day in the UK tomorrow, with the BoE's latest monetary policy decision perhaps most noteworthy despite expectations that Bank Rate will be left unchanged at 0.75%. While GDP in Q2 was weaker than the BoE's expectation, last week's monthly GDP figures for July were firmer and seemed to rule out the chances of another contraction in Q3. And while today's CPI release fell short of expectations, wage growth recently rose to the highest rate in eleven years suggesting a possible increase in domestically generated pressure in the pipeline. This week's jump in the oil price might also add a positive impulse to inflation. Overall, therefore, we expect no substantive change to the MPC's forward guidance that "assuming a smooth Brexit and some recovery in global growth…the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate". That said, Carney will no doubt acknowledge that a smooth Brexit can hardly be taken for granted. Indeed, likely in part reflecting the ongoing uncertainty regarding Brexit, tomorrow's retail sales figures for August are expected to report a decline in spending for the first month in three, in line with the downbeat tone from recent surveys.

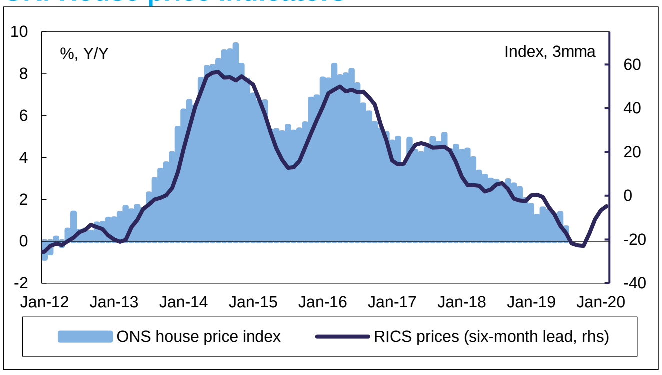
On the political front, Thursday might well bring the outcome from the Supreme Court hearing on whether Boris Johnson's suspension of Parliament was unlawful. Should it rule in favour of the complainants, the UK's political crisis will have become

UK: Headline and core CPI forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

a constitutional one. But even if it prompts a chorus of calls for Johnson's resignation for misleading the Queen, and the recall of MPs back to Parliament, the outcome seems unlikely to change substantially the near-term Brexit outlook. Of course, Johnson is still required by law to request an Article 50 extension should a new deal not be agreed with EU leaders by 19 October. But he is also unwilling to write such a letter. So, a judgement that ruled Johnson's actions unlawful could at least prevent him proroguing Parliament once again if he was tempted to do so next month to try to force through a no-deal Brexit.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	EU27 new car registrations Y/Y%	Aug	**-8.4**	-	-1.4	-
	Final CPI (core CPI) Y/Y%	Aug	**1.0 (0.9)**	1.0 (0.9)	1.0 (0.9)	-
	Construction output M/M% (Y/Y%)	Jul	**-0.7 (1.1)**	-	0.0 (1.0)	0.6 (1.6)
Italy	Total trade balance (EU trade balance) €bn	Jul	**7.6 (3.6)**	-	5.7 (1.9)	-
	Industrial sales (orders) Y/Y%	Jul	**-0.6 (-1.0)**	-	-0.8 (-4.8)	- (-4.9)
UK	CPI (core CPI) Y/Y%	Aug	**1.7 (1.5)**	1.8 (1.8)	2.1 (1.9)	-
	PPI input prices (output prices) Y/Y%	Aug	**-0.8 (1.6)**	-1.0 (1.7)	1.3 (1.8)	0.9 (1.9)
	ONS house price index Y/Y%	Jul	**0.7**	0.7	0.9	1.4

Auctions

Country	Auction
Germany	Auction: sold €0.9bn of 2050 bonds at an average yield of 0.05%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	ZEW current situation (expectations) balance	Sep	**-19.9 (-22.5)**	-15.0 (-38.0)	-13.5 (-44.1)	-
Spain	Labour costs Y/Y%	Q2	**2.4**	-	2.1	-

Monday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Final CPI (EU-harmonised CPI) Y/Y%	Aug	**0.5 (0.5)**	0.5 (0.5)	0.4 (0.3)	-
UK	Rightmove house price index M/M% (Y/Y%)	Sep	**-0.2 (0.2)**	-	-1.0 (1.2)	-

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09.00	Current account balance €bn	Jul	-	18.4
UK	09.30	Retail sales including fuel M/M% (Y/Y%)	Jul	-0.2 (2.7)	0.2 (3.3)
	09.30	Retail sales excluding fuel M/M% (Y/Y%)	Jul	-0.3 (2.3)	0.2 (2.9)
	12.00	BoE Bank Rate %	Sep	0.75	0.75
Auctions					
Country	BST	Auction/Event			
EMU	11.00	ECB's Cœuré speaks in Frankfurt			
France	09.50	Auction: to sell 1.75% 2023 bonds			
	09.50	Auction: to sell 0% 2025 bonds			
	09.50	Auction: to sell 3.5% 2026 bonds			
France	10.50	Auction: to sell 0.1% 2028 index-linked bonds			
	10.50	Auction: to sell 0.1% 2029 index-linked bonds			
	10.50	Auction: to sell 0.1% 2036 index-linked bonds			
Spain	09.45	Auction: to sell 0.05% 2021 bonds			
	09.45	Auction: to sell 0.6% 2029 bonds			
	09.45	Auction: to sell 5.75% 2032 bonds			
	09.45	Auction: to sell 1.85% 2035 bonds			
UK	12.00	BoE MPC policy announcement and meeting minutes published			
	12.00	BoE to publish Agents' summary of business conditions for Q319			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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