# Euro wrap-up

## Overview

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- While UK inflation data surprised on the downside, Gilts were volatile but ended the day little changed as investors awaited the conclusion of the ongoing Brexit negotiations.
- Bunds made losses despite a downwards revision to euro area inflation while trade and car registration data provided mixed messages.
- On Thursday, investors will respond to the outturn of the Brexit negotiations while UK retail sales and euro area construction output will provide the data focus.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0 09/21 | -0.691 | +0.012 |
| OBL 0 10/24 | -0.646 | +0.017 |
| DBR 0 08/29 | -0.393 | +0.028 |
| UKT 3¾ 09/21 | 0.541 | +0.011 |
| UKT 1 04/24 | 0.481 | -0.008 |
| UKT 0⅞ 10/29 | 0.694 | +0.001 |

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

## Euro area

### Headline inflation in September revised down

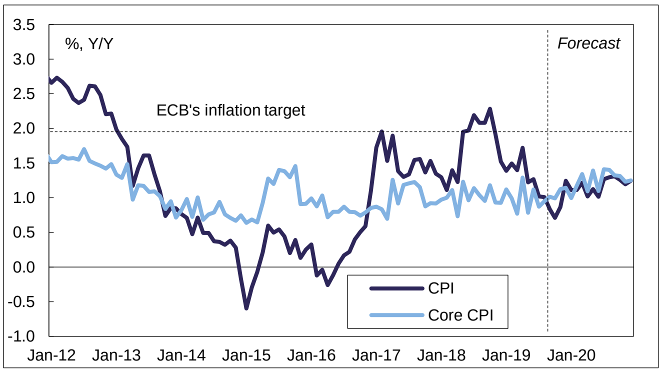
Today's final estimates of euro area inflation in September brought a downwards revision to the headline CPI rate of 0.1ppt to 0.8%Y/Y, representing a drop of 0.2ppt from August and the lowest rate since November 2016. To two decimal places, however, the revision from the flash estimate was minimal at just -0.02ppt. Indeed, the revisions to the various components were largely negligible, with the cause of the drop in inflation over the past month confirmed to be non-core items. In particular, as suggested by the preliminary data, lower food prices saw the respective inflation rate drop 0.5ppt to a three-month low of 1.6%Y/Y. And while, on average, energy prices were little changed from August, base effects saw the inflation rate drop 1.2ppts to -1.8%Y/Y, the sharpest annual pace of decline in three years. In contrast, inflation of non-energy industrial goods was very slightly weaker than previously thought at 0.2%Y/Y, while services inflation rose 0.2ppt, in line with the initial estimate, to a three-month high of 1.5%Y/Y. As a result, today's data confirmed the rise in core inflation of 0.1ppt to 1.0%Y/Y, in line with the average of the past two years.

Not least due to energy price base effects, we expect headline inflation to remain below 1.0%Y/Y in October and November before rising to about 1¼%Y/Y in December. Thereafter, continued sub-potential growth is likely to restrain any rise in core inflation associated with a weaker euro and somewhat stronger wage growth. So, we expect euro area headline CPI inflation to oscillate in a range between 1.0-1.3%Y/Y next year justifying the ECB's decision to ease monetary policy last month.

### Euro area trade surplus widens on weaker imports

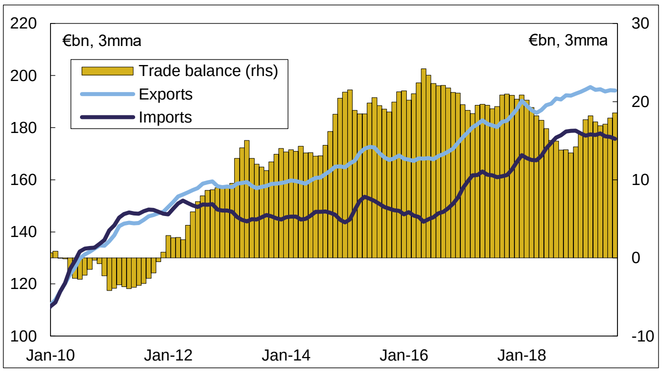
Net trade subtracted 0.1ppt from euro area GDP growth in Q2 as exports stagnated but import volumes ticked higher. However, today's goods trade figures for August suggested that the opposite might have been the case in Q3. The goods trade surplus rose €2.8bn on a seasonally adjusted basis in August to €20.3bn, the biggest since December 2017. The value of goods exports rose for the second successive month, albeit by just 0.4%M/M following downwardly revised growth of 0.2%M/M the prior month to be up just 1.0%Y/Y. But, following a modest rise in July, the value of imports fell 1.2%M/M, the most in six months, to be down 1.4%Y/Y. As a result, while exports in the first two months of Q3 were on average 0.3% above the Q2 monthly equivalent, imports were 0.7% lower on the same basis. Of course, looking through recent noise, the trends for both components remained weak, with exports down compared to a year earlier in August to several destinations, including China, South Korea, India, OPEC countries and Latin America, and still very subdued to the UK. And with shifts in relative prices unclear, we would hesitate to suggest that net trade provided meaningful support to economic growth last quarter.

**Euro area: Inflation**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

**Euro area: Goods trade**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

## Car registration data flattered by base effects

On an annual basis, new car registrations posted exceptionally strong growth of 19.4%Y/Y in September with similar double-digit rates in Germany (22.2%Y/Y), France (16.6%Y/Y) and Italy (13.4%Y/Y). However, these figures were flattered by the low base as new emissions testing came into effect that month last year. Indeed, registrations in the euro area were still down 1.5%Y/Y on a year-to-date basis. And while they were up 2.5%YTD/Y in Germany, they fell 1.3%YTD/Y in France and 1.6%YTD/Y in Italy. Of course, these data are highly volatile on a month-to-month basis, and seasonal adjustment is far from straightforward given the distorting influence of regulatory changes. Nevertheless, adjusting for the time of year, sales appear to have fallen sharply in September (down 18.7%M/M on the ECB's data) following a stronger August (up 10.7%M/M). And that left them up just 0.7%Q/Q on a seasonally adjusted basis in Q3, the softest quarterly rate so far this year.

## The day ahead in the euro area and US

Thursday should be relatively uneventful for economic news from the euro area with August construction output data the sole new release of note. Not least given the 1½%M/M drop in Germany, these are likely to show a fifth decline in production in the sector in six months. In addition, the Presidents of the National Banks of France (Villeroy), Italy (Visco), Spain (De Cos) and the Netherlands (Knot) will speak publicly in Washington DC. In the markets, France and Spain will sell a range of bonds. In the US, the dataflow will bring industrial production, housing starts and building permits data for September, as well as the October Philly Fed survey results and usual weekly jobless claims numbers. FOCM members Williams, Bowman and Evans will speak publicly. In addition, the Treasury will sell 5Y TIPS.

# UK

## Brexit negotiations enter Extra Time

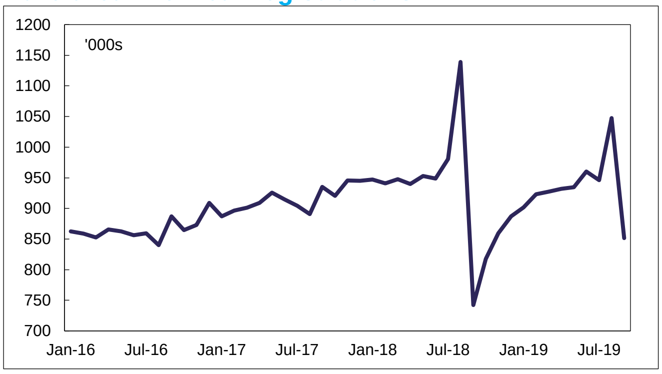
All eyes in the UK remained on Brussels today as negotiators went into Extra Time in an attempt to seal a Brexit deal ahead of tomorrow's EU Summit. At the time of writing, amid rumour and counter-rumour, there had still been no breakthrough, with EU President Juncker suggesting that it could be midnight CET or even Thursday morning before things were resolved one way or the other. Much appeared to depend on the willingness of the Northern Irish DUP – whose votes will be needed by Johnson in the House of Commons if a Withdrawal Agreement is ever to be adopted into UK law – to back any proposals agreed with the EU. So, perhaps inevitably, there were reports of public funds being offered from the UK Government and EU to Northern Ireland to persuade the DUP to drop its long-held opposition to the customs and regulatory borders that would need to be erected down the Irish Sea in the event of an agreement.

Certainly, both the UK and EU sides want to avoid Theresa May's experience of agreeing to a deal that is subsequently rejected in the House of Commons. But even beyond the DUP there likely remain pockets of resistance among hardline Conservative MPs to Johnson's proposals. And Labour MPs would effectively be handing the Conservative Party a landslide victory in the next general election if they vote in favour of Johnson's Brexit deal. So, even if an agreement is reached tonight, the risk of its rejection in a 'meaningful vote' in the House of Commons on Saturday would remain. And even if that hurdle was passed, given the slow progress of recent days, an Article 50 extension beyond the end of the month would still likely be required to give time for the necessary legislation to be adopted. Of course, if a deal is not reached tonight, Boris Johnson will still write a letter to request an Article 50 extension, to provide yet more time to try to reach deal, or an alternative way forward such as a general election or second referendum.

## Headline inflation unchanged in September

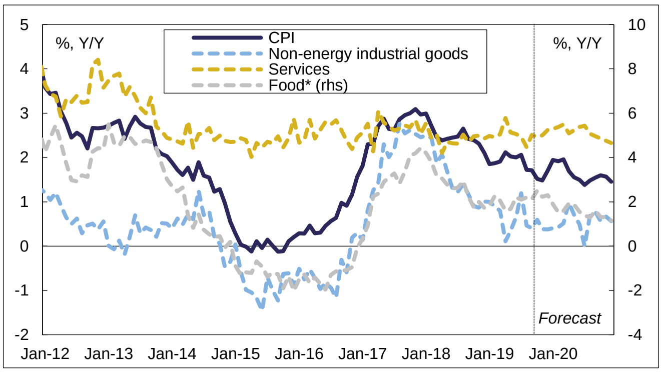
Contrary to expectations of an increase, UK headline CPI inflation was unchanged in September at 1.7%Y/Y, matching the

### Euro area: New car registrations*




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

### UK: Inflation




Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

lowest rate since December 2016. Within the detail, notable downward pressure came from energy inflation, which fell 1.8ppts to a seven-month low of 1.5%Y/Y on lower household prices of electricity and gas as well as lower prices of motor fuels. However, services inflation reversed the 0.3ppt dip of the previous month, returning to 2.5%Y/Y, due not least to higher prices in the hospitality and recreation sectors. And so, while inflation of non-energy goods was unchanged at 0.4%Y/Y, core inflation rose a bigger-than-expected 0.2ppt to 1.7%Y/Y, still matching the average rate of the prior four months and close to the bottom of the range of the past three years.

### Inflation to remain below target over the forecast horizon

Looking ahead, Ofgem's decision to lower the cap on household electricity and gas prices in October should push energy inflation into negative territory over the near term. As such, assuming core inflation remains close to the recent average, headline CPI should fall to about 1.5%Y/Y in October and November before moving briefly higher at the turn of the year. And given the weak economic environment, including the recent softening of the labour market and decent likelihood of a negative print for GDP growth in Q4, we expect core inflation to remain relatively subdued through 2020. As such, we expect headline inflation to remain below target over the forecast horizon opening the door for a rate cut from the Bank of England whether or not the UK leaves the EU.

### The day ahead in the UK

While investors will respond to the outcome of the Brexit negotiations and any further related information that emerges in the EU Summit, Thursday will also bring September's UK retail sales data. Surveys point to a second successive weak month for sales with a modest decline in the headline monthly rate likely. That, however, would still leave sales up over the third quarter as a whole. Separately, BoE Governor Carney will speak publicly in Washington DC.

# 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 | **14.5** | - | -8.4 | - |
| | Trade balance €bn | Aug | **20.3** | 18.0 | 19.0 | 17.5 |
| | Final CPI (core CPI) Y/Y% | Sep | **0.8 (1.0)** | 1.0 (1.0) | 1.0 (0.9) | - |
| Italy | Industrial sales (orders) Y/Y% | Aug | **-2.2 (-10.0)** | - | -0.6 (-1.0) | -0.7 (-0.8) |
| | Final EU-harmonised CPI Y/Y% | Sep | **0.2** | 0.3 | 0.5 | - |
| UK | CPI (core CPI) Y/Y% | Sep | **1.7 (1.7)** | 1.8 (1.7) | 1.7 (1.5) | - |
| | PPI input prices (output prices) Y/Y% | Sep | **-2.8 (1.2)** | -1.7 (1.3) | -0.8 (1.6) | -0.9 (1.7) |
| | House price index Y/Y% | Aug | **1.3** | 0.6 | 0.7 | 0.8 |

**Auctions**

| Country | Auction |
|---|---|
| Germany | Auction: sold €0.8bn of 1.25% 2048 bonds at an average yield of 0.07% |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Tomorrow's releases

| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|---|
| EMU | | 10.00 | Construction output M/M% (Y/Y%) | Aug | - | -0.7 (1.1) |
| Italy | | 09.00 | Total trade balance (EU balance) €bn | Aug | - | 7.6 (3.6) |
| UK | | 09.30 | Retail sales including fuel M/M% (Y/Y%) | Sep | -0.2 (3.1) | -0.2 (2.7) |
| | | 09.30 | Retail sales excluding fuel M/M% (Y/Y%) | Sep | -0.1 (2.9) | -0.3 (2.2) |

**Events & Auctions**

| Country | | BST | Auction/Event |
|---|---|---|---|
| EMU | | 18.30 | ECB's Villeroy De Galhau, Visco, Knot, Hernandez de Cos all speak in Washington |
| France | | 09.50 | Auction: up to €750mn of 0% 2022 bonds |
| | | 09.50 | Auction: 0% 2025 bonds |
| | | 09.50 | Auction: 0.5% 2026 bonds |
| | | 10.50 | Auction: 0.25% 2024 index-linked bonds |
| | | 10.50 | Auction: 0.1% 2025 index-linked bonds |
| | | 10.50 | Auction: 3.4% 2029 index-linked bonds |
| Spain | | 09.45 | Auction: 0.05% 2021 bonds |
| | | 09.45 | Auction: 0.25% 2024 bonds |
| | | 09.45 | Auction: 0.6% 2029 bonds |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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