Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Ahead of the evening's announcements from the Fed, Bunds were little changed while data reported a further solid pickup in euro area goods exports in July.
- Gilts were also little changed despite a steep drop in UK inflation.
- Thursday will bring the latest announcements from the BoE's MPC, and euro area final inflation figures for August and construction data for July.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.700	-
OBL 0 10/25	-0.683	+0.005
DBR 0 08/30	-0.485	-0.003
UKT 1¾ 09/22	-0.068	+0.005
UKT 0⅝ 06/25	-0.069	+0.003
UKT 4¾ 12/30	0.210	-0.005

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

Euro area

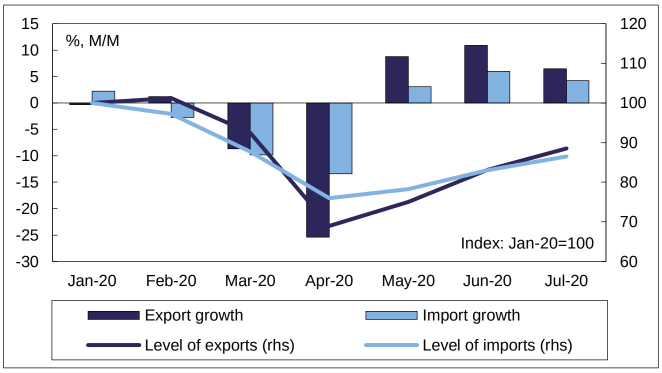
Euro area exports maintain solid recovery

While the outlook for European trade remains uncertain as EU-UK trade negotiations make little progress, today's data signalled an ongoing solid recovery in euro area exports at the start of Q3. In particular, the value of exports rose for the third consecutive month in July and by 6.5%M/M, underpinned by strong growth in shipments to the US (+13.2%M/M) and Latin America (+11.4%M/M). Declines in exports to China, Japan and Korea were offset by solid growth in exports to Hong Kong, India and ASEAN countries, but shipments to Asia rose just 2.6%M/M. And growth in exports to the UK moderated (down 13.6ppts to 5.6%M/M). Having slumped during the lockdown across the region, the value of overall shipments was still 12½% below the pre-pandemic peak and down 10½% compared with a year earlier. And the recent strengthening of the euro – the effective exchange rate yesterday rose to its highest level since mid-2014 to leave it more than 5% higher than at the start of the year – might limit the recovery going forward. Nevertheless, given the recent profile, exports in July were almost 17% higher than the Q2 average. And with imports having risen a softer 4.2%M/M in July to leave them 9½% above the Q2 average, today's report supports the view that net goods trade will provide a sizeable positive contribution to GDP growth in Q3.

The day ahead in the euro area

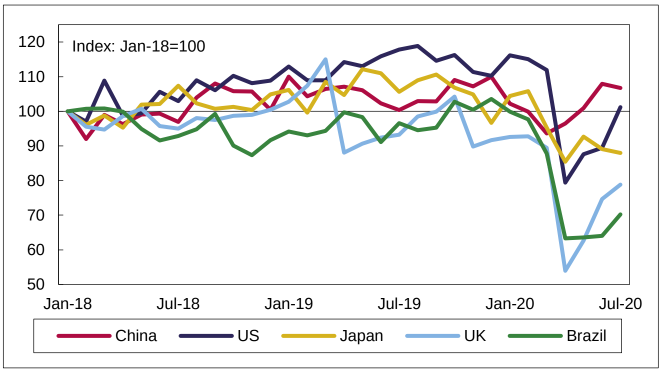
Tomorrow brings final euro area CPI numbers for August. According to the flash estimate, euro area consumer price inflation fell further than expected last month, with the annual rate of CPI plunging 0.6ppt to -0.2%Y/Y, the first negative reading since May 2016. While that partly reflected the timing of the start of the summer sales and Germany's VAT cut, it also underscored the disinflationary effects of the pandemic. And so the core rate also fell to a series low of 0.4%Y/Y. The final figures from each of the four largest member states aligned with their flash estimates and so we expect the same to be the case for the headline euro area numbers. Meanwhile, euro area construction output numbers for July are also due, as well as car registration figures for August. Country data previously released showed construction output falling more than 4%M/M in Germany but rising 5%M/M in France. But the national car registration figures from the four largest member states suggested disappointingly subdued demand. In other news, ECB Vice President Luis De Guindos is scheduled to speak publicly.

Euro area: Export and import values



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Export values by destination



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

Inflation falls sharply in August due principally to hospitality support policies…

UK inflation fell sharply in August, with the headline CPI rate dropping 0.8ppt to 0.2%Y/Y, the lowest since December 2015. The principal driver of the decline was government policy to support the hospitality sector – "Eat out to help out" subsidies to cut prices of restaurant meals from Mondays to Wednesdays, and the 15ppt cut in VAT to 5% on the broader sector, pushed inflation in hotels and restaurants down 4.6ppts to a series low of -2.8%Y/Y, accounting for roughly half of the decline in the CPI rate from July. With inflation of transport dropping due to lower airfares, and healthcare inflation also falling back, services inflation fell 1.5ppts to a series low of 0.6%Y/Y. Goods inflation was also a touch weaker, dropping 0.2ppt back to negative territory at -0.2%Y/Y, partly due to belated summer discounting, which pushed inflation of clothing and footwear down 1.3ppts to -1.4%Y/Y. Food inflation also fell back for a third month, down 0.4ppt to 0.3%Y/Y, and energy inflation was little changed at -6.7%Y/Y. And core inflation plunged 0.9ppt to 0.9%Y/Y, the lowest level since June 2015.

…but is running above the BoE's central projection

Despite the steep drop in the latest month, inflation in both July and August was stronger than BoE staff had expected at the time of the MPC's meeting last month. And with the "Eat out to help out" scheme having concluded at the end of August, inflation is likely to tick a little higher over the near term. Moreover, the hospitality VAT cut will reverse on 12 January, while the negative contribution to inflation from past energy price declines will fade more significantly and, from April, turn positive. So, inflation is highly likely to take a further step up from February, and rise well above 1.0%Y/Y from the start of Q2.

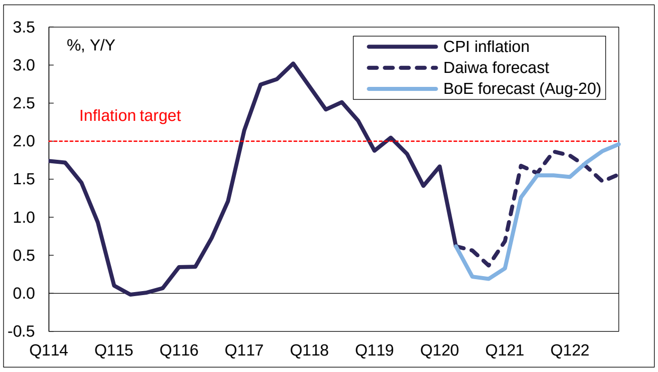
Price outlook dependent on labour market and EU trade relationship

With a major labour market shake-out underway, wage growth is likely to remain extremely weak. And that might normally be expected to ensure that core inflation would remain relatively subdued, despite temporary effects from policy measures and food and energy prices. But much will depend on the outcome of the negotiations between the UK and EU on a new free trade agreement (FTA). In May, the UK Government decided from the start of 2021 to reduce the average UK import tariff from 7.2% to 5.7% for goods imported on 'most favoured nation' (MFN) terms, with a little more than 70% of imports likely to face 0% tariffs compared to 51.5% now. And if an EU-UK FTA is agreed by year-end, the maintenance of 0% tariffs on imports from the EU, as well as those tariff reductions on imports from many third countries and a strengthening of sterling, might help to offset some price pressures that are likely to arise from the new non-tariff barriers that will be erected across the English Channel. But in the event that an FTA is not agreed, only 44% of imports from the EU would be imported tariff-free. And with notably higher tariffs on items imported from the EU such as cars (at a rate of 10%) and food items (at rates often much higher than 10%), as well as a sharp depreciation of sterling, both core and headline inflation would likely be pushed significantly higher and well above 2.0%Y/Y throughout next year, despite the non-negligible hit to GDP that would also likely ensue. Perhaps reassuringly, some media reports suggest that the Government is preparing a climb-down over its internal market bill, whose clauses inconsistent with the Brexit Withdrawal Agreement unsurprisingly inflamed tensions with the EU. Whether such a move would eventually facilitate a deal on a new FTA, however, remains to be seen.

The day ahead in the UK

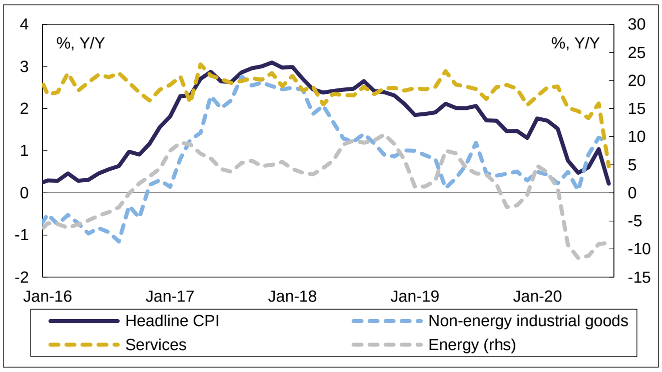
The main event in the UK tomorrow will be the BoE's monetary policy announcement. With no new forecasts to be published, we do not expect any changes to the main policy parameters. So, Bank Rate will remain at 0.1% and the asset purchase target will be kept at £745bn. The following meeting on 5 November – when the Committee will publish its updated projections and there could be greater clarity about the nature of the EU-UK trading relationship from the start of next year – will be the crucial one in determining the next steps for monetary policy. However, tomorrow the MPC might judge that overall economic activity has been, if anything, firmer than expected. And inflation over the past two months has certainly been above its previous forecast. But it will also have to note further recent evidence that a marked deterioration in labour

UK: Inflation forecast*



*Assumes EU FTA is implemented. Source: Refinitiv, BoE and Daiwa Capital Markets Europe Ltd.

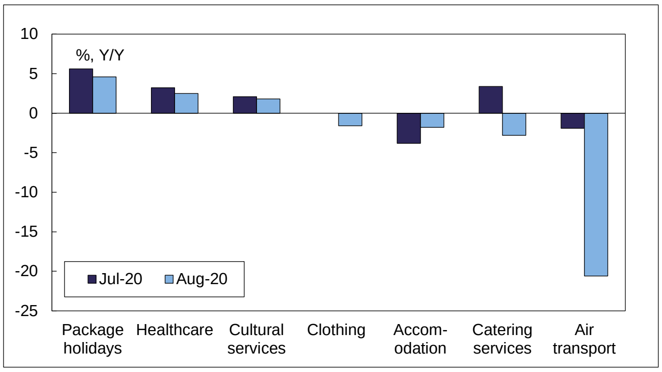
UK: Key inflation components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

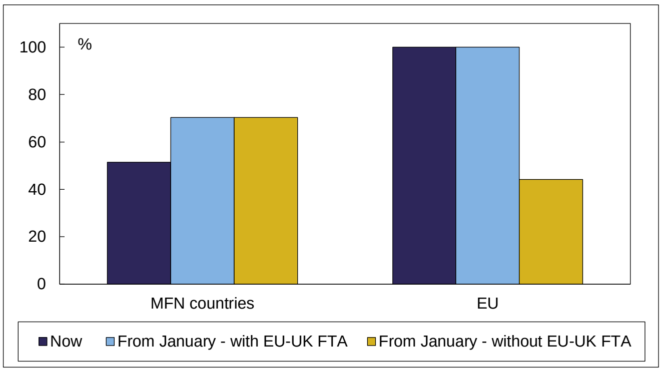
market conditions is underway while uncertainty surrounding the UK's future trading relationship with the EU has increased. Tomorrow will also see the Bank publish its Agents' summary of business conditions in Q3, whose findings will be reflected in the MPC minutes.

UK: Selected inflation sub-components



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Share of imports with zero percent tariffs



Source: UK Trade Policy Observatory

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Trade balance €bn	Jul	**20.3**	19.3	17.1	**16.0**
UK	CPI (core CPI) Y/Y%	Aug	**0.2 (0.9)**	0.0 (0.5)	1.0 (1.8)	**-**
	PPI input prices (output prices) Y/Y%	Aug	**-5.8 (-0.9)**	-5.3 (-0.7)	-5.7 (-0.9)	**-**
	ONS house price index Y/Y%	Jul	**3.4**	-	2.9	**1.1**

Auctions

Country	Auction
Germany	sold €1.5bn of 1.25% 2048 bonds at an average yield of -0.07%
UK	sold £2.5bn of 0.375% 2030 bonds at an average yield of 0.263%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	07.00	EU-27 new car registrations	Aug	-	-22.3
	10.00	Construction output M/M% (Y/Y%)	Jul	-	4.0 (-5.9)
	10.00	Final CPI (core CPI) Y/Y%	Aug	-0.2 (0.4)	0.4 (1.2)
Italy	09.00	Total trade balance €bn	Jul	-	6.2
UK	12.00	BoE Bank Rate %	Sep	*0.10*	0.10
	12.00	BoE gilt and corporate bond purchase target £bn	Sep	*745*	745

Auctions and events

Country	BST	Auction / Event
EMU	09.00	ECB's Vice President de Guindos scheduled to speak
France	09.50	Auction: 0% 2023 bonds
	09.50	Auction: 0.5% 2026 bonds
	09.50	Auction: 0.75% 2028 bonds
	09.50	Auction: 0.1% 2026 index-linked bonds
	09.50	Auction: 0.7% 2030 index-linked bonds
	09.50	Auction: 0.1% 2047 index-linked bonds
UK	12.00	BoE interest rate and asset purchase programme target announcement
	12.00	BoE Agents' summary of business conditions in Q3

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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