Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses as final euro area inflation was unrevised at a near-decade high and risks to the near-term inflation outlook remain skewed to the upside.
- Gilts also made losses despite a downside surprise to UK retail sales in August, which marked the longest unbroken losing streak on the series.
- The main event in the UK in the coming week will be Thursday's BoE policy announcements. Flash September PMIs from the euro area and UK are also due that day.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.711	-0.001
OBL 0 10/26	-0.611	+0.013
DBR 0 08/31	-0.282	+0.022
UKT 0¹/₈ 01/23	0.280	+0.002
UKT 0³/₈ 10/26	0.501	+0.012
UKT 0¼ 07/31	0.842	+0.027

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

Euro area

Final euro area inflation unrevised at a near-decade high

The final euro area inflation figures for August offered no surprises, with the headline rate bang in line with the flash estimate that showed a rise of 0.8ppt to 3.0%Y/Y, the highest since November 2011. While energy inflation continues to provide the largest contribution (up 15.4%Y/Y, to account for 1.44ppts of all inflation), the upwards move last month was principally driven by non-energy industrial goods inflation, which, despite the moderate downwards revision from the flash estimate, jumped 1.9ppts to 2.6%Y/Y, a series high. Services inflation also edged slightly higher (by 0.2ppt to 1.1%Y/Y) to leave core inflation up 0.9ppt to 1.6%Y/Y, the highest since July 2012.

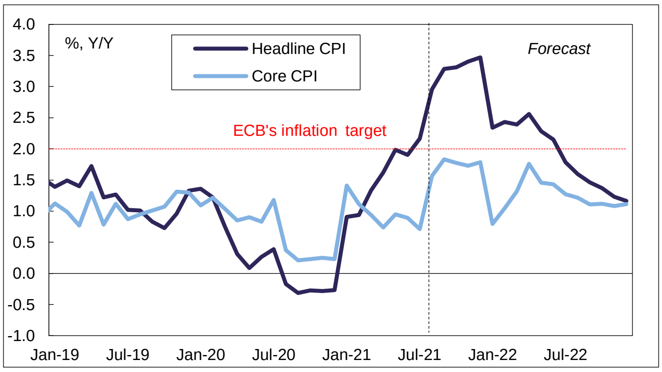
Price pressures remain largely associated with the pandemic

The recent upwards pressures are largely related to the pandemic. For example, clothing price inflation jumped more than 7ppts between July and August due to the different timing of summer discounts. Increased prices of package holidays, restaurants and hotels and accommodation services were also given a boost by base effects from extremely low prices a year earlier and subsequent normalisation, also in part reflecting Germany's temporary VAT cut. While some of these pressures will prove temporary, additional price pressures associated with supply-side constraints might well come to the fore over the near term. Services price inflation also seems bound to move higher over coming months on the back of base effects.

Energy inflation to remain elevated over the near term

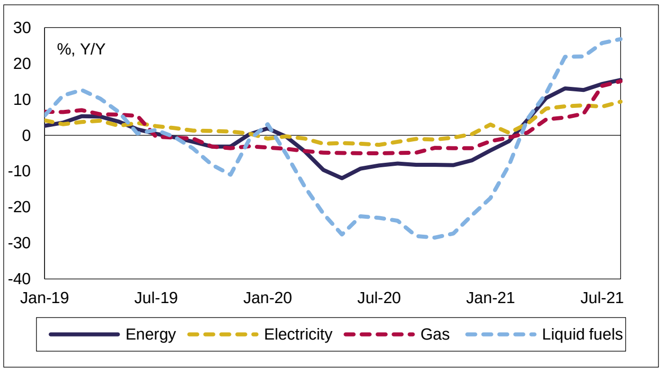
The near-term outlook for energy inflation remains skewed to the upside too, reflecting not least the recent surge in wholesale prices amid insufficient wind and low inventories – e.g. the main natural gas futures contract so far in September is up more than four-fold compared with a year earlier. Indeed, we have already seen an upwards shift in euro area gas and electricity inflation over recent months, to 15.1%Y/Y and 9.4%Y/Y respectively in August. Margins should absorb some pressures on consumer prices from developments in the wholesale market. And various member state governments – including Spain, Greece, Italy and France – plan further measures to protect some consumers from surging bills. But household and producer energy bills seem bound to rise further over the coming three to six months, which might have a broader negative impact on demand and industrial production.

Euro area: Inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Energy price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Price pressures to dissipate over the coming two years

Overall, we continue to expect energy inflation to dissipate over the coming couple of years as base effects work their way through. And we would expect a similar easing of pressures on non-energy goods and services inflation too. Certainly, the past week's labour costs figures – down 0.1%Y/Y in Q2 – suggested no imminent threat to cost pressures with settlements similarly more reflective of the significant amounts of spare capacity in the labour market. The FT yesterday reported that ECB Chief Economist Lane suggested in a private meeting that one of its internal models predicted that the 2% inflation target would be hit in 2025. The ECB subsequently denied this. And we think the ECB's updated projections in December will continue to show inflation below target in 2024, and hence inconsistent with rate hikes before then, with the inflation outlook beyond that point a matter for mere speculation.

The week ahead in the euro area

The euro area's economic data calendar in the coming week focuses on the latest round of sentiment surveys, which are expected to reveal that, whilst confidence remains relatively high in September, there has been a further loss of momentum as supply constraints continue to curb the recovery. This will likely be evident in the preliminary PMIs – to be published on Thursday – from the euro area, Germany and France. While the flash euro area services activity PMI is expected to have moved broadly sideways, benefitting from the decline in the spread of the delta variant, the manufacturing PMI is expected to have fallen further as the sector continues to be impacted by supply bottlenecks. Overall, the euro area composite output PMI is expected to ease back slightly from the still-elevated reading of 59.0 recorded in August. The back end of the week also sees the release of national sentiment indicators from the largest member states, including the French INSEE business survey on Thursday, and Germany's Ifo business survey and Italy's ISTAT manufacturing and consumer confidence indicators on Friday. Ahead of this, the calendar will also bring the European Commission's preliminary consumer confidence indicator (on Wednesday), which is expected to have moved sideways (at -5.3) having fallen in the previous two months, to leave it still some way above the average since the start of the pandemic (-12.1).

UK

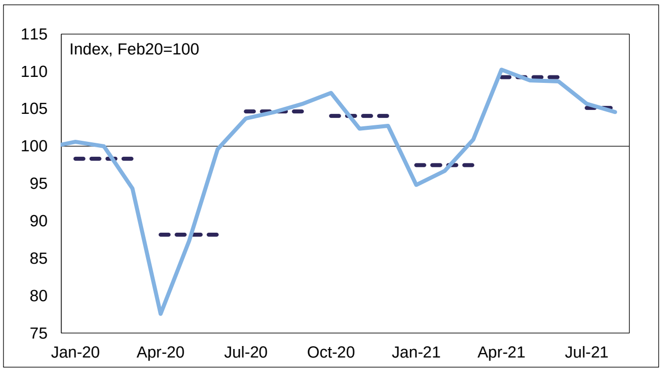
Retail sales decline for the fourth consecutive month

After last week's softer-than-expected UK GDP figures for July, today's retail sales numbers for August provided a big downside surprise too. Contrasting with expectations of a moderate increase, sales fell 0.9%M/M, following a steeper-than-previously-estimated drop in July (now judged to be down 2.8%M/M). This marked the fourth consecutive monthly decline in overall sales, representing the longest unbroken losing streak on the series. It also left sales more than 5% lower than the pandemic peak, albeit still 4.6% higher than the pre-pandemic level. And it left the average level for the first two months of Q3 trending a marked 3.8% lower than the Q2 average. The steady decline in the level of retail sales over recent months will in part represent a normalization of spending patterns in favour of services following the relaxation of pandemic restrictions. But it also reflects impediments to supply, with the ONS BICS survey reporting that, in mid-August, some 6.5% of retail businesses were unable to source the materials, goods or services they required. Of course, as far as the BoE is concerned, the weakness of retail sales also raises significant uncertainty about the strength of GDP growth in Q3 and beyond.

Retailing weakness in August was broad based

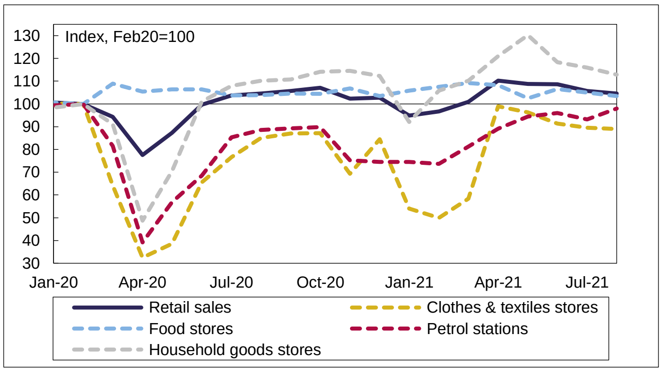
Within the detail, the weakness in retail sales in August in part reflected softer spending at food stores (-1.2%M/M) as the further easing of hospitality restrictions provided greater opportunity for spending at bars and restaurants. However, shortages of many items on supermarket shelves will also likely have been a factor behind the weakness last month. Non-food store sales fell further too (-1.0%M/M), to leave them on average in July and August 5½% lower than the Q2 level, with spending at clothing and household goods stores down 6.6% and 7.1% on an equivalent basis. While the proportion of online retailing remained substantially higher than the pre-pandemic level (27%), non-store sales in August were down by

UK: Retail sales*



*Dashed dark blue line represents quarterly average. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Retail sales by selected component



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

more than 14% from their recent peak and on average so far in Q3 trending 7% lower than in Q2. So, it was only thanks to a pickup in spending on auto fuel in August (+1.5%M/M) to its highest level since the onset of the pandemic – likely supported by an increase in domestic tourism – that the overall drop in sales wasn't steeper.

Economic recovery momentum levelling off

Coming ahead of the BoE's all-important monetary policy announcements on Thursday, the August retail sales data tally with Governor Bailey's recent judgement that economic recovery momentum appears to have been levelling off over the summer. That assessment was also supported by the slowdown in GDP to just 0.1%M/M in July, which would have marked a contraction had it not been for the reopening of a North Sea oil field that month. And over the near term, there appear several additional downside risks to demand. In particular, the ending this month of the furlough scheme, which was still supporting some 6% of employees (more than 1½ million workers) on a part- or full-time basis late last month, seems highly likely to trigger a jump in unemployment. And cuts of £20 per week to universal benefit payments will significantly reduce incomes for 6 million people from early October. At the same time, supply-side problems, including increasing pressures on power prices and possible power cuts to come, seem likely to weigh on production and spending alike. So, the BoE's near-term GDP forecast published last month now looks overoptimistic. At the forthcoming meeting, the MPC should acknowledge that fact, and also note the non-negligible downside risks to the growth outlook.

MPC likely to see risks to the inflation outlook skewed to the upside

Of course, while economic growth has slowed, inflation has jumped sharply, with both headline and core CPI inflation up in August to multi-year highs above 3%Y/Y. The BoE should not, however, be surprised by that move. After all, the largest contributor to the rise was the base effect associated with last year's hospitality subsidies and VAT cut. And many other pressures, not least related to used car prices, seem bound to be transitory. Indeed, the BoE's August projection, which foresaw inflation rising slightly above 4.0%Y/Y in Q421 and Q122, remains credible. That also suggested that inflation was likely to fall back close to the 2.0%Y/Y target by the end of the forecast period. Recent comments from senior BoE officials suggest that the majority on the MPC will also continue to expect inflation to decline in due course, even if it remains higher for longer than previously expected. But with wholesale power prices having spiked, supply shortages widespread, vacancies up to a record high, and hints of rising wage settlements, the MPC seems likely to flag that the risks to the inflation outlook are also skewed to the upside. Indeed, we have now nudged our headline CPI forecast higher this year and next to reflect higher energy inflation.

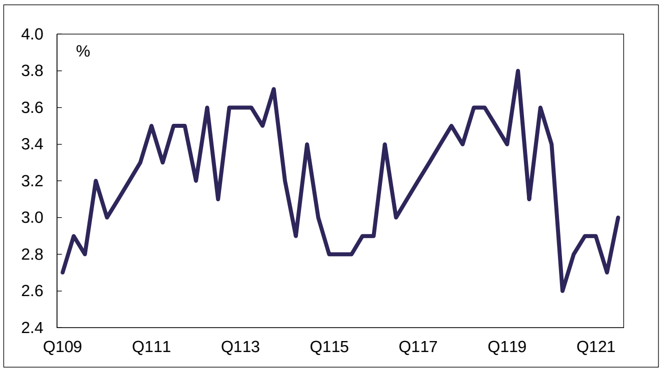
BoE to watch expectations and wages but slowdown reminds of downside risks too

Nevertheless, the loss of GDP growth momentum should help to limit second-round effects emerging from the current price pressures. So, today's retail sales data provide a reminder that there remain two-sided risks around the path for inflation in the medium term. With risk management considerations still pertinent – just as early in the last decade when inflation jumped above 5%Y/Y and remained above target for four years – the MPC will not tighten policy precipitously in response to supply-driven price pressures that have a strong probability of being temporary. Recent market developments, not least shifts in the 5Y5Y inflation swap forward rate, suggest that medium- to long-term investor inflation expectations have picked up, but not alarmingly so. And the BoE's latest inflation attitudes survey, released today, suggested that medium- to long-run consumer inflation expectations have not become de-anchored either. The BoE will also continue to monitor closely the labour market, wider measures of slack and underlying wage pressures. But while the Bank's agents recently flagged a pickup in wage settlements, the impact of the end of the Job Retention Scheme could well have a dampening impact from now on. And the MPC will only vote to hike rates if and when it is confident that second-round effects via wages and inflation expectations mean that inflation is clearly on course to exceed the target over the medium term.

UK: 5Y5Y inflation swap forward rate

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Household inflation expectations, 5 years ahead



Source: BoE inflation attitudes survey and Daiwa Capital Markets Europe Ltd.

Majority still likely against ending QE programme early

While we still do not expect the BoE to raise rates for several quarters to come, we acknowledge that the forthcoming decision on QE is more finely balanced. At the MPC's policy meeting in early August, the Committee voted 7-1 in favour of continuing with its QE programme and maintaining the target stock of Gilts purchases at £875bn – and the target stock of total asset purchases at £895bn – with those purchases to be concluded before year-end. The sole dissenter was external member Michael Saunders. Based on the updated Monetary Policy Report projections, it also judged that "some modest tightening of monetary policy over the forecast period is likely to be necessary". However, its forecasts also suggested that the path of interest rates priced into the market at the time – which envisaged Bank Rate up to just 0.2% in Q322, 0.4% in Q323, and 0.5% by Q324 – would result in slightly sub-target inflation and sub-potential GDP growth at the end of the horizon. At the forthcoming meeting, if the MPC judges that the risks to the inflation have become more significantly skewed to the upside since the August meeting, and that the need for a rate hike next year has increased, we acknowledge that a majority could vote to end the net Gilt purchases next month when the stock reaches £850bn. However, beyond providing a signal with respect to possible tightening next year, the impact of such a modest tightening of policy would likely be negligible. And, on balance, we doubt that a majority in favour of such a move will be found. In particular, we suspect that external MPC members Haskel and Tenreyro as well as Governor Bailey and Deputy Governors Broadbent and Cunliffe would vote against such a move.

Two new faces on the MPC

The September MPC meeting will, however, bring two new faces to the table. The August policy meeting was the last to feature dovish external member Gertjan Vlieghe, while hawkish former Chief Economist Andy Haldane left the Committee after the June meeting, and both replacements will attend the MPC for the first time at the forthcoming meeting. The reaction function of new external member Catherine Mann appears to be dovish, after she recently suggested that big increases in energy prices did not necessarily pose upside risks to future inflation, that heightened competition might mean that firms are less likely to pass on higher costs of inputs to consumer prices, and that the relationship between labour market conditions and inflation has weakened. The reaction function of new Chief Economist Huw Pill is more difficult to discern. While his recent published work has emphasised the need to protect the independence of the BoE from pressures associated with large-scale bond purchases and the risk of fiscal dominance, his views on the appropriate monetary stance at the present juncture are certainly not clear. While we suspect that he will not be as hawkish as his predecessor, we would not be surprised if he was one of a minority of a members to vote to end the QE purchases early.

The week ahead in the UK

The MPC announcements will clearly be the main event in the UK in the coming week. But turning to the data, like in the euro area, the coming week will bring sentiment surveys for September including the preliminary PMIs on Thursday. These should remain consistent with relatively positive economic growth momentum this month, albeit with some further levelling off in business optimism. In particular, the composite PMI is expected to have slipped back from the 54.8 reading in August to a seven-month low, with supply bottlenecks continuing to weigh especially on activity in the manufacturing sector. Ahead of this, the CBI will publish its industrial trends survey on Tuesday. Meanwhile, the CBI's distributive trades and GfK consumer confidence surveys on Friday might point to a further moderation in retail sales growth at the end of the third quarter. Ahead of the Autumn Budget and Spending Review (27 October), Tuesday's release of public sector finance figures for August will be closely watched for any room for near-term fiscal giveaways.

The next edition of the Euro wrap-up will be published on 21st September 2021

Daiwa Capital Markets

Daiwa economic forecasts

	2021				2022		2021	2022	2023
	Q1	Q2	Q3	Q4	Q1	Q2			
Euro area	-0.3	2.2	1.8	1.1	1.0	0.8	5.1	4.4	2.1
UK	-1.6	4.8	1.8	1.6	1.3	0.8	6.5	5.7	1.7
Euro area									
Headline CPI	1.1	1.8	2.8	3.4	2.4	2.3	2.3	1.9	1.2
Core CPI	1.2	0.9	1.4	1.8	1.1	1.5	1.3	1.2	1.1
UK									
Headline CPI	0.6	2.1	2.9	4.3	4.4	4.5	2.5	3.5	2.0
Core CPI	1.2	1.8	2.7	3.4	3.4	3.5	2.3	2.7	2.0
ECB									
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
PEPP envelope* (€bn)	1850	1850	1850	1850	1850	1850	1850	1850	1850
BoE									
Bank Rate %	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25
Bond purchases* (£bn)	895	895	895	895	895	895	895	895	895

**Target end of period. Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final CPI (core CPI) Y/Y%	Aug	**3.0 (1.6)**	3.0 (1.6)	2.2 (0.7)	-
	Construction output M/M% (Y/Y%)	Jul	**0.1 (3.3)**	-	-1.7 (2.8)	**-0.6 (4.1)**
France	Final wages Q/Q%	Q2	**0.3**	0.3	0.6	-
UK	Retail sales including auto fuel M/M% (Y/Y%)	Aug	**-0.9 (0.0)**	0.5 (2.7)	-2.5 (2.4)	**-2.8 (1.9)**
	Retail sales excluding auto fuel M/M% (Y/Y%)	Aug	**-1.2 (-0.9)**	0.8 (2.5)	-2.4 (1.8)	**-3.2 (0.9)**
	BoE inflation expectations survey, next 12 months %	Aug	**2.7**	-	2.4	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
Monday 20 September 2021						
Germany		07.00	PPI M/M% (Y/Y%)	Aug	0.5 (11.1)	1.9 (10.4)
UK		00.01	Rightmove house prices M/M% (Y/Y%)	Sep	-	-0.3 (5.6)
Tuesday 21 September 2021						
UK		07.00	Public sector net borrowing, excluding banking groups £bn	Aug	14.9	10.4
		11.00	CBI industrial trends survey, total orders (selling prices)	Sep	15 (43)	18 (43)
Wednesday 22 September 2021						
Euro area		15.00	Preliminary consumer confidence	Sep	-5.3	-5.3
Italy		10.00	Industrial sales M/M% (Y/Y%)	Jul	-	3.1 (28.4)
Thursday 23 September 2021						
Euro area		09.00	Preliminary manufacturing (services) PMI	Sep	60.5 (58.7)	61.4 (59.0)
		09.00	Preliminary composite PMI	Sep	58.5	59.0
Germany		08.30	Preliminary manufacturing (services) PMI	Sep	61.5 (60.4)	62.6 (60.8)
		08.30	Preliminary composite PMI	Sep	59.6	60.0
France		07.45	INSEE business confidence	Sep	110	110
		07.45	INSEE manufacturing confidence (production outlook)	Sep	109 (-)	110 (16)
		08.15	Preliminary manufacturing (services) PMI	Sep	57.0 (56.1)	57.5 (56.3)
		08.15	Preliminary composite PMI	Sep	55.7	55.9
Spain		08.00	GDP – final estimate Q/Q% (Y/Y%)	Q2	2.8 (19.8)	-0.4 (-4.2)
UK		09.30	Preliminary manufacturing (services) PMI	Sep	59.0 (54.7)	60.3 (55.0)
		09.30	Preliminary composite PMI	Sep	54.5	54.8
		12.00	BoE Bank Rate %	Sep	0.10	0.10
		12.00	BoE Gilt purchase target £bn	Sep	875	875
		12.00	BoE Corporate Bond purchase target £bn	Sep	20	20
Friday 24 September 2021						
Germany		09.00	Ifo business climate	Sep	99.0	99.4
		09.00	Ifo current assessment (expectations)	Sep	102.0 (97.0)	101.4 (97.5)
Italy		09.00	ISTAT business (manufacturing) confidence	Sep	- (112.8)	114.2 (113.4)
		09.00	ISTAT consumer confidence	Sep	-	116.2
UK		00.01	GfK consumer confidence	Sep	-7	-8
		11.00	CBI distributive trades survey, reported sales	Sep	-	60

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 20 September 2021
Euro area		11.35	ECB's Schnabel due to speak – 'Sustainable economy in times of change' and 'Monetary & fiscal policy – interplay or fight'
			Tuesday 21 September 2021
Euro area		08.05	ECB Vice President de Guindos scheduled to speak at Financial Times conference on financial stability
		10.00	OECD publishes its interim Economic Outlook
Germany		10.30	Auction: €3bn of 0% 2028 bonds
			Wednesday 22 September 2021
Germany		10.30	Auction: €2.5bn of 0% 2036 bonds
UK		10.00	Auction: £350mn of 0⅛% 2056 index-linked bonds
			Thursday 23 September 2021
Euro area		09.00	ECB publishes Economic Bulletin
UK		12.00	BoE monetary policy announcement and publication of meeting minutes
		12.00	BoE publishes Agents' summary of business conditions Q321
			Friday 24 September 2021
Euro area		14.15	ECB's Chief Economist Lane takes part in annual research seminar organised by the ESM
Italy		10.00	Auction: Fixed rate and index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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