Euro wrap-up

Overview

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- Bunds made modest gains at the long end of the curve, as ECB Governing Council member Stournaras cautioned that it is "too early to declare victory over the pandemic" and so "too early to draw conclusions about the extension or not of the PEPP [purchase programme] beyond March 2022".
- Gilts made modest losses at the short end as a survey of UK manufacturers flagged concerns about the impact of supply-side challenges on prices.
- Ahead of the BoE policy announcement on Thursday lunchtime, the Commission's flash euro area consumer confidence index is due Wednesday with flash PMIs due the following morning.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.724	+0.002
OBL 0 10/26	-0.644	-0.005
DBR 0 08/31	-0.331	-0.009
UKT $0^1/_8$ 01/24	0.261	+0.012
UKT $0^3/_8$ 10/26	0.472	+0.009
UKT 0¼ 07/31	0.722	-

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

Euro area

Natural gas prices push German PPI inflation to new post oil-shock high

So far this week, the most notable new economic data from the euro area have been Germany's August producer price figures, which highlighted the intensifying pressures emanating not least from power markets. Indeed, German PPI inflation surprised significantly on the upside once again, with prices rising 1.5%M/M, matching the second-highest increase this cycle and the fourth successive rise of 1.3%M/M or more. That left the headline PPI rate up 1.6ppts to 12.0%Y/Y, well above the median forecast on the Bloomberg survey of 11.1%Y/Y and the highest since the first OPEC shock in 1974. The main cause of the further jump in producer price inflation was energy, prices of which rose 3.3%M/M to push the annual rate up 3.6ppts to a new series high of 24.0%Y/Y. Given the spike in wholesale markets, pressures in that component were unsurprisingly centred on natural gas, prices of which rose 12.8%M/M to be up more than 226%Y/Y, a series high. In addition, intermediate goods prices rose 1.4%M/M, the eighth successive rise above 1.0%M/M, to push the respective annual rate up 1.5ppts to 17.1%Y/Y. Prices of sawn timber and metallic secondary raw materials were both more than double their levels a year earlier. While still less acute, pressures further along the supply chain appeared to increase slightly. Prices of capital goods rose 0.6%M/M, the most since January 2020, to be up 2.4%Y/Y, the highest annual rate in almost three decades. And prices of durable consumer goods rose 0.6%M/M for the second month to push the respective annual rate up 0.6ppt to 2.8%Y/Y, the highest since 2008. The rate for consumer non-durables rose 0.3ppt to 2.1%Y/Y, merely a sixteen-month high.

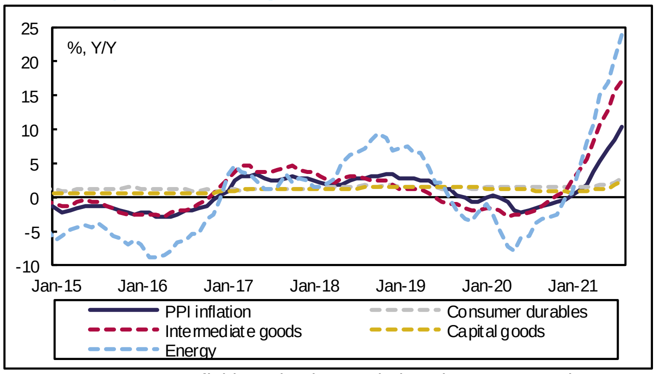
PMIs to be watched on Thursday for signs of intensified pressures in September

The further spike in wholesale natural gas prices over the past couple of weeks suggests that German producer prices remain under upwards pressure. So, while Germany's manufacturing input and output price PMIs fell back last month from the series highs reached in July, the flash September PMIs due Thursday will be watched for renewed upwards inflation momentum. Some additional pass-through to final consumer prices might seem likely over coming months too. However, with pressures still being principally absorbed by margins, those pipeline pressures seem unlikely to be sufficient to offset fully the negative impact on consumer price inflation when VAT base effects fall out of the CPI arithmetic from January on.

The coming two days in the euro area

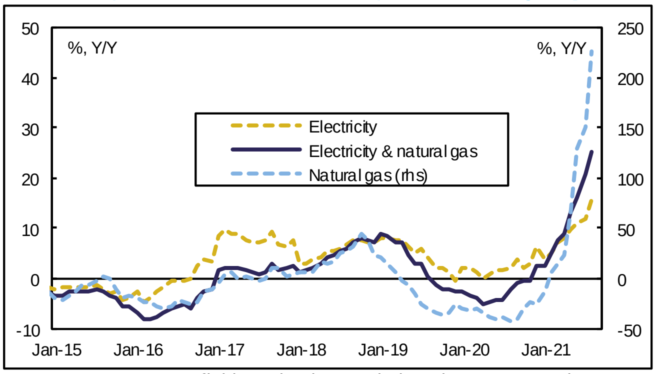
Sentiment surveys will dominate the data flow over the coming two days. First up will be tomorrow's preliminary European Commission consumer confidence indicator, which is expected to move sideways (at -5.3) having fallen in the previous two months. That, however, would still leave it some way above the average since the start of the pandemic (-12.1). Thursday's

Germany: Producer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Producer electricity & natural gas prices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

flash PMIs, meanwhile, are expected to show that, whilst confidence remains relatively high, there has been a further loss of momentum as supply constraints continue to constrain the recovery. Indeed, although the 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 output PMI is expected to fall for a third successive month 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. Flash PMIs from Germany and France, as well as the French INSEE business survey are also due on Thursday.

UK

CBI manufacturing survey flags slowing output and high price pressures

Today's CBI industrial trends survey predictably reported ongoing challenges in the UK's manufacturing sector from persistent supply constraints. Despite close to half of all respondent manufacturers reporting above-normal order books, the survey suggested a further slowdown in output in the three months to September, with growth largely driven by the food, drink and tobacco sub-sector. The output index – that typically reflects the annual rate of growth – remained elevated by historical standards (+18), although this remains distorted by the pandemic-induced low base a year ago. Manufacturers continued to report near-record low adequacy of stocks of raw materials, with skill and labour shortages similarly weighing on activity. And taken together with significantly higher prices of commodities and energy, and limited availability of many components, manufacturers continued to report strong expectations for output price growth over the coming three months. The ongoing spike in natural gas prices – which is more acute than in the euro area and has already hit production in certain sectors (e.g. fertilizer and CO2) with risks of far wider knock-on effects (e.g. to the food and drink sector), and associated potential energy supply outages over the colder months, will remain a big concern for manufacturers. And global supply bottlenecks will continue to limit production capacity too. So, while strong order books remain reassuring, the risks to the near-term manufacturing outlook seem to be clearly skewed to the downside.

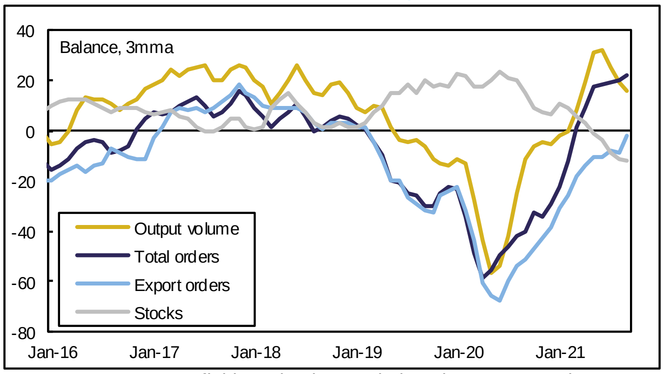
Public borrowing higher than expected in August, but still trending below OBR forecast

Today's UK public sector finance figures suggested that net borrowing in August was larger than had been expected, with the increase of £20.5bn inevitably the second-highest for that month on record, but still £5.5bn less than a year earlier. The ongoing economic recovery again helped to boost central government receipts in August, which were estimated to have risen by £9.6bn compared with August 2020 to £61.2bn, with tax revenues up by £4.1bn to £45bn, supported not least by higher PAYE and self-assessed income tax payments, VAT contributions and business rates. But central government expenditure stood at £79.6bn in August, down just £1bn from August 2020 despite a significantly larger drop in spending on the government's Covid-support schemes (down £5.9bn compared with a year ago) as spending on procurement related to the pandemic, including the vaccination programme, remained higher. Despite the higher borrowing in August, it was still lower than forecast by the OBR. And it followed downward revisions to borrowing in previous months, by a cumulative £4.8bn since the start of the financial year. So, in the first five months of financial year 2021/22, public sector borrowing stood at £93.8bn, less than half the amount borrowed in the equivalent period a year ago. Moreover, cumulative net borrowing is currently £31.8bn lower than had been forecast by the OBR in March. This notwithstanding, given the logging for the first time of expected expenditure (i.e. losses) of almost £21bn under the government's loan guarantee schemes, today's release also saw estimated public sector borrowing in the financial year ending March 2021 revised higher, by £27.1bn to £325.1bn.

But fiscal stance set to tighten

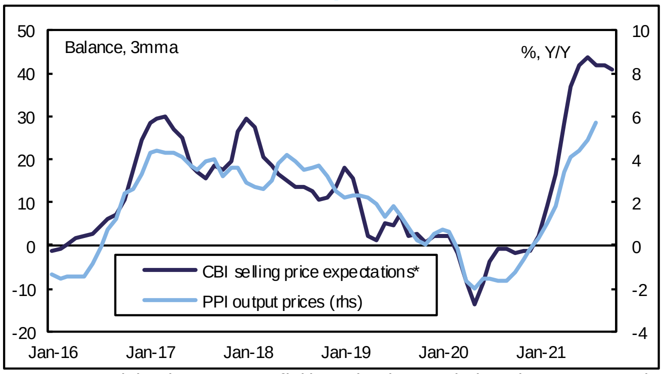
Against this backdrop, earlier this month the government announced £14bn per year of tax increases – principally via the NICS system – and increases in spending on health and social care of the same amount from next April. Overall, that package should be fiscally neutral, although the decision to use the NICS system for funding the package seems likely to be growth-negative (and jobs-negative) at the margin. The government also announced its overall spending envelope for

UK: CBI industrial trends survey indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends price index and PPI



**One-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

government departments for the coming three years, with public service spending set to increase at an average real rate of 3.2% per year. Given the extra funding already committed to health and social care and certain other items, as noted by the IFS, these figures imply near-flat real spending for many 'unprotected' departments, particularly if any extra pandemic-related expenditure is required. At the same time, UK taxes as a share of GDP will reach their highest ever level on a sustained basis. Over the immediate future, the end of the government's Job Retention Scheme and support for the self-employed at the end of this month, as well as the cut to Universal Credit payments for 6mn people early next month, will have a significant dampening impact on demand. And, while the Chancellor is likely to have a little more room for manoeuvre given the recent strong-than-expected performance of the public finances, the Budget and full Spending Review announcement on 27 October is likely to confirm a relatively neutral fiscal stance from next April, and a more significant tightening of the fiscal stance from April 2023 on – one reason why the BoE will avoid tightening monetary policy significantly over the horizon.

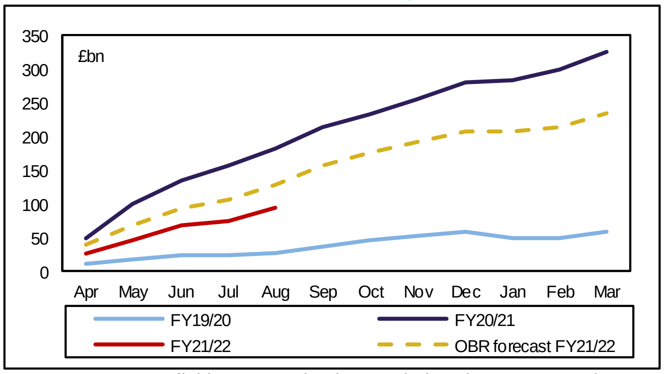
The coming two days in the UK

The main event in the UK over the coming two days will be the BoE's monetary policy announcements on Thursday, which will take place against the backdrop of the recent leap in inflation and expectations of further increases to come. But while both headline and core CPI rates jumped in August to multi-year highs above 3%Y/Y, the BoE should not be surprised. After all, the largest contributor to the rise was the base effect associated with last year's hospitality subsidies and VAT cut. And certain other pressures, not least related to used car prices, seem bound to be transitory. The BoE's most recent projection, which foresaw inflation rising slightly above 4.0%Y/Y in Q421 and Q122, remains broadly credible, although developments in the wholesale power markets now seem highly likely to push that peak higher still. But that projection also suggested that UK inflation was likely to fall back close to the 2.0%Y/Y by the end of the forecast period. And the majority on the MPC will continue to expect inflation to fall back in due course, even if it remains higher for longer than previously expected. At a minimum, however, given those developments in energy markets, and supply shortages widespread causing production difficulties and empty supermarket shelves, vacancies up to a record high, as well as hints of rising wage settlements, the MPC seems highly likely to flag that the risks to the inflation outlook are skewed to the upside.

At the same time, of course, economic recovery momentum appears to have been levelling off over the summer. UK GDP growth slowed to 0.1%M/M, and Friday's August retail sales release reported the longest unbroken losing streak on the series. Over the near term, there are notable additional downside risks to demand too. In particular, the ending of the furlough scheme this month seems likely to trigger a jump in unemployment, while cuts to the main universal benefit payment will significantly reduce incomes for 6 million people from early October. At the same time, pressures on power prices and possible power cuts to come, among other supply challenges, seem likely to weigh heavily on production and spending alike. So, the BoE's near-term GDP forecast now looks overoptimistic and the minutes of this meeting are likely to acknowledge that.

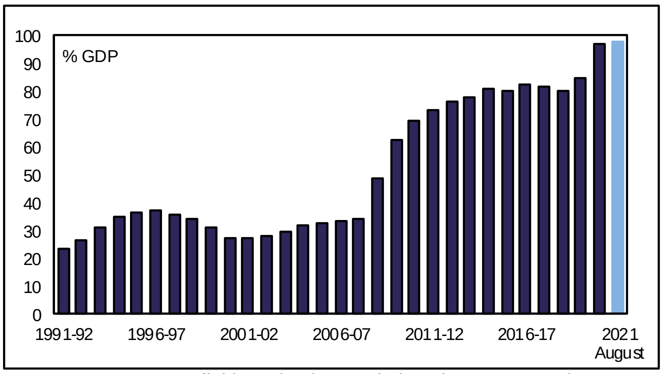
What does that all mean for policy? With growth slowing and downside risks to demand and supply rising, we expect the majority on the MPC to continue to emphasise that there remain two-sided risks around the path for inflation in the medium term. Moreover, with risk management considerations also still 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 it suspects have a good chance of being temporary. But while we still do not expect the BoE to raise rates for several quarters to come, we acknowledge that the decision on QE is more finely balanced. 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 when the stock reaches £850bn. However, beyond providing a signal with respect to an increased probability of a rate hike 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, particularly when the downside risks to GDP have undeniably increased. So, we expect the QE Gilt purchase target to be left at £875bn this week.

UK: Public sector net borrowing



Source: Refinitiv, OBR and Daiwa Capital Markets Europe Ltd.

UK: Public sector net debt



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Predicting the precise voting outcome of this meeting, however, will be a little trickier than usual as it will be the first to feature new external member Catherine Mann and Chief Economist Huw Pill. The reaction function of Mann appears to be dovish. But Pill's reaction function is more difficult to discern. While his 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 not clear.

Data-wise, Thursday will also bring the flash UK PMIs for September. 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 as flagged by today's CBI survey.

The next edition of the Euro wrap-up will be published on 23 September 2021

European calendar

Today's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
UK	Public sector net borrowing, excluding banking groups £bn	Aug	**20.5**	14.9	10.4	**6.9**
	CBI industrial trends survey, total orders (selling prices)	Sep	**22 (41)**	15 (43)	18 (43)	**-**

Country	Auction
Auctions	
Germany	sold €2.469bn of 0% 2028 bonds at an average yield of -0.493%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
Germany	PPI M/M% (Y/Y%)	Aug	**1.5 (12.0)**	0.8 (11.1)	1.9 (10.4)	**-**
UK	Rightmove house prices M/M% (Y/Y%)	Sep	**0.3 (5.8)**	-	-0.3 (5.6)	**-**

Country	Auction
Auctions	
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data					
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)
Auctions and events					
Germany	10.30	Auction: €2.5bn of 0% 2036 bonds			
UK	10.00	Auction: £350mn of 0⅛% 2056 index-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
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
Auctions and events						
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			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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