Euro wrap-up

Overview

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- Bunds made notable losses as a Reuters report suggested that eight ECB Council members judged the Bank's inflation forecast to be too low, and the euro area flash PMIs suggested a softening of growth momentum amid ongoing supply constraints and rising cost pressures.
- Gilts also made significant losses as the BoE stated that the case has strengthened for some modest tightening of monetary policy over the forecast horizon.
- Friday will bring further economic sentiment survey results from Germany, Italy and the UK.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.701	+0.018
OBL 0 10/26	-0.592	+0.046
DBR 0 08/31	-0.271	+0.055
UKT 0⅛ 01/24	0.365	+0.092
UKT 0⅜ 10/26	0.573	+0.094
UKT 0¼ 07/31	0.894	+0.098

*Change from close as at 4:00pm BST.
Source: Bloomberg

Euro area

Flash PMIs point to a marked slowdown…

Today's flash euro area PMIs for September came in softer than expected, pointing to a further easing of recovery momentum as firms continue to face supply difficulties and price pressures. Judging from the survey, the moderation in growth appears widespread, with, for example, the euro area manufacturing output PMI falling 3.3pts on the month to 55.7, the lowest since January, while the services activity PMI declined 2.7pts to 56.3, a four-month low. As such, the euro area composite PMI fell for the second successive month in September and by 2.9pts to 56.1, the lowest reading since April. Having fallen in five out of the past six months, the manufacturing output PMI in Q3 was therefore on average more than 4pts lower than the Q2 level (albeit at a still-elevated 58.6). In contrast, given the surge in activity in the sector earlier in the summer as restrictions were relaxed, the quarterly services PMI in Q3 (58.4) was 3.7pts above the Q2 figure. And so, the average composite PMI for Q3 rose 1.6pts to 58.4, the highest since Q206, implying another quarter of solid GDP growth and indeed one that has likely been firmer than in Q2.

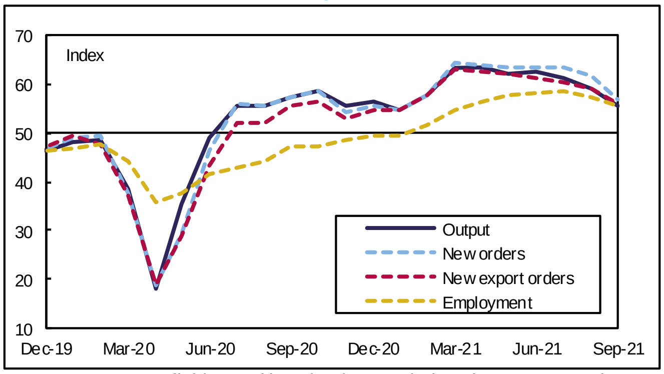
…as supply and price pressures bite

The softness in production highlighted in September's PMIs was again attributed to supply-chain constraints, which were most acute in manufacturing – where increases in supplier delivery times and backlogs of uncompleted work were only marginally less than May's peaks – but also appeared to be creeping into services. Amid persistent production delays and ongoing concerns about the pandemic, growth in new business was also reportedly more moderate in both manufacturing and services at the end of the third quarter, with external demand also waning. And with firms' expectations for future output easing to the lowest since January, jobs growth was also reportedly a touch softer in September. This notwithstanding, a still notable mismatch between supply and demand and rising commodity and energy prices continued to feed into higher input costs, which reportedly rose at the fastest pace for 21 years. And while the output price PMI remained only just off June's record high, today's survey suggested that firms continued to absorb some of these higher costs.

German manufacturers remain most severely impacted

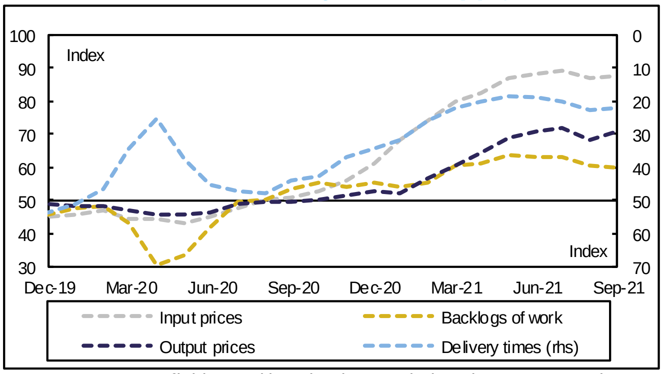
Among the country detail, Germany's flash PMIs recorded a further marked decline, with the composite PMI down 4.7pts in September to 55.3, a three-month low. There were comparable declines in the manufacturing and services PMIs, although the manufacturing output PMI fell to a fifteen-month low (53.8). And there was a more sizeable drop (7.1pts) in the manufacturing new orders PMI, with anecdotal evidence implying lower demand in the autos sector in particular amid supply shortages. Indeed, while backlogs and supplier delivery times were somewhat less severe than earlier in the summer, they

Euro area: Manufacturing PMIs – demand side



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

Euro area: Manufacturing PMIs – supply side



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

remained historically high. Overall, while Germany's average manufacturing output PMI in Q3 was more than 6½pts lower than in Q2, the quarterly composite PMI was still almost 2pts higher than in Q2 and the best since Q111. Like in Germany, the loss of momentum in France's manufacturing recovery has seemingly become more pronounced, with the output PMI falling for the fourth consecutive month in September and by 2.9pts to 51.2, the lowest since January. New orders also slowed markedly, while supplier delivery times lengthened the most on record, with an associated increase in input and output costs, with the price PMIs both at record highs. The PMIs broadly aligned with today's INSEE survey, which suggested that the latest weakness in output was driven by the autos sector. In contrast, the French services recovery appears more robust, with the activity PMI down just 0.3pt in September to 56.0. And so, while the French composite PMI fell for a third consecutive month by 0.8pt, at 55.1 it remained at an elevated level. Moreover, the quarterly average in Q3 (55.9) was marginally firmer than the Q2 average. Markit suggested that growth elsewhere in the euro area outpaced that in Germany and France, although it was still reportedly the softest since April.

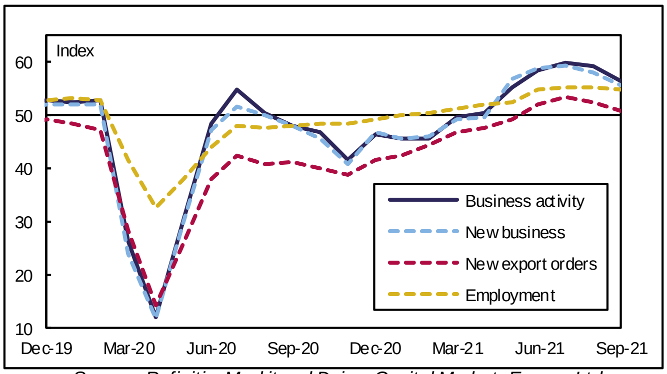
Consumers seemingly more upbeat at the end of Q3

Contrasting with the reported challenges facing euro area businesses, yesterday's European Commission consumer confidence indicator suggested that households were more upbeat about conditions at the end of third quarter. Indeed, the index unexpectedly rose 1.3pts in September to -4.0, reversing the decline reported in August to leave it just 1.3pts below its recent peak and still comfortably above the pre-pandemic level. While we will have to wait until the final publication in the coming week for the detailed breakdown, the improvement in sentiment seems bound to be linked to some extent to the marked reduction in the number of coronavirus cases across the region over the past month. And while several member states now require health passes to enjoy certain activities, this survey suggests that household consumption remained well supported at the end of the third quarter.

Scholz still appears on track to be next German Chancellor unless polls are mistaken

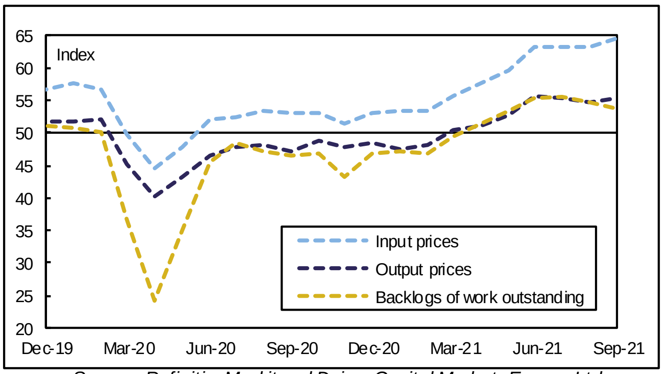
The main event over the coming few days will be Germany's federal election on Sunday, with polling stations set to close at 6pm CET. All surveys since late August, including today's final weekly Kantar poll (see charts), have presented a broadly similar picture, with the centre-left SPD seemingly on track to win the largest share of the vote. Indeed, no poll this month has given the SPD a share of the vote below 25%, with the centre-right CDU/CSU still polling no higher than 22%. On balance, however, the CDU/CSU does appear to have narrowed the gap somewhat in the home straight, with this week's Forsa poll suggesting that the SPD's lead has halved from the previous survey a fortnight ago to 3ppts – within a reasonable margin for error. Of course, the polls also strongly suggest that a three-party coalition will be required to deliver a Bundestag majority after the election.

Euro area: Services PMIs – demand side



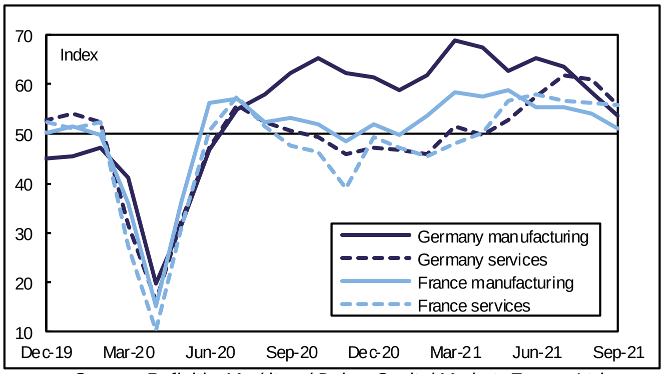
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs – supply side



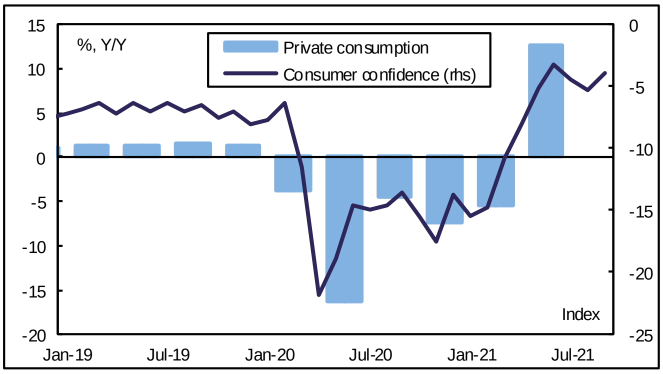
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Germany and France: Output PMIs



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

Euro area: Consumer confidence and consumption



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Don't expect a new German government before the New Year

With several combinations of parties likely to be able to form a government after the election, the initial outcome is bound to be a lengthy period of negotiations, which is unlikely to be concluded before 2022 and thus will require Angela Merkel's government to remain in office into the New Year. Ultimately, however, it seems inconceivable that the CDU/CSU union would be prepared to take a junior position in the next coalition government. And while the arithmetical possibility of a CDU/CSU-led Jamaica coalition with Greens and the FDP exists, the Greens – who look set to near-double their 8.9% of the vote at the previous election in 2017 – would strongly prefer to enter power with the SPD. So, SPD Chancellor-candidate and Finance Minister Olaf Scholz remains best bet to succeed Angela Merkel as German leader. And the SPD and Greens, together with either the far-left Die Linke (currently polling between 6-7% and so likely to enter the next Bundestag as the sixth largest party) or liberal Free Democrats (FDP, currently polling 11-12%, broadly in line with the far-right AfD), will highly likely form the next German government.

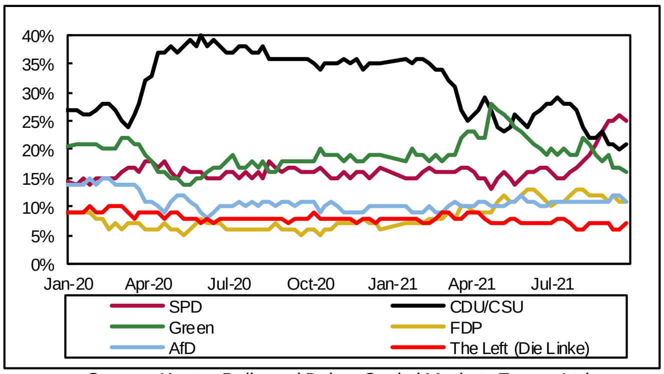
Consensual Traffic-Light coalition more likely than a more radical Red-Red-Green government

The SPD's rank and file might have greater inclination to include Die Linke in government within a Red-Red-Green coalition, which would offer the greatest break from recent policy settings, with scope for increased taxes on the wealthy alongside a more significant increase in public expenditure and probably a looser overall fiscal stance. Die Linke has also signalled its readiness to moderate many of its proposals e.g. on social security and the minimum wage, to participate in a coalition. But Scholz would seem reluctant to do a deal with them, not least given Die Linke's more extreme public profile and anti-NATO, pro-Russia leanings. Instead, consistent with his centrist inclinations, Scholz might well prefer to include the (right-wing) FDP in a Traffic-Light coalition, and maintain a Merkel-style consensual approach to policymaking based on incremental (rather than radical) policy change. The threat of a coalition with Die Linke, however, should ultimately temper the FDP's demands and give it an incentive to make concessions to join government. Importantly, from a fiscal policy perspective, that should provide scope for greater financing off balance sheet of public investment of more than 1% of GDP, not least on green projects, e.g. through the government agencies. But a traffic-light coalition government might still seem most likely to result in a broadly prudent fiscal policy. It also would be unlikely to relax Germany's constitutional debt brake. It might be reluctant to introduce much greater flexibility into the EU's stability and growth pact (e.g. by exempting green public investment from the deficit rules). And it might be unwilling to commit to making permanent, or extending further, the EU's recovery funds.

The day ahead in the euro area

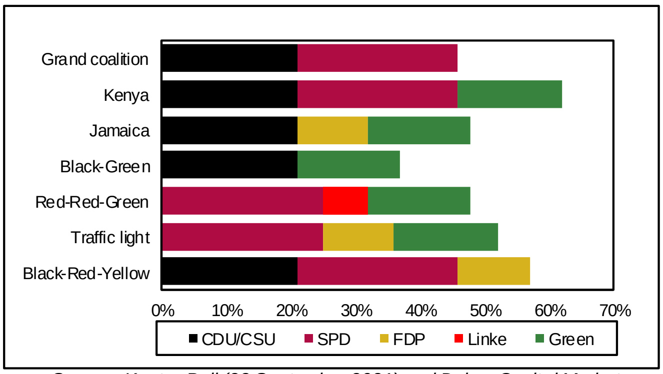
The end of the week will bring several more national sentiment surveys, including most notably the German ifo business climate indicators. Like today's flash PMIS, these are expected to show a deterioration in the headline index in September to

Germany: Latest opinion poll tracker



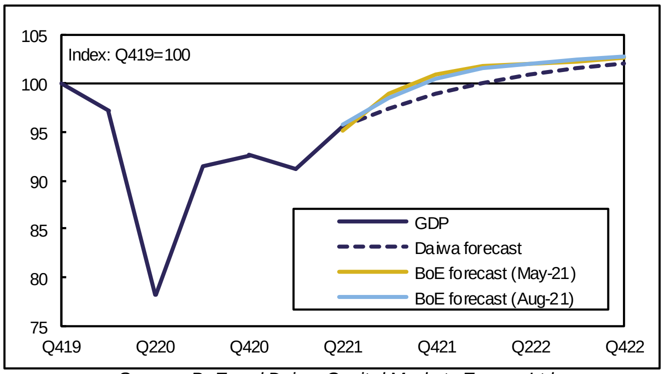
Source: Kantar Polls and Daiwa Capital Markets Europe Ltd.

Germany: Possible coalition outcomes



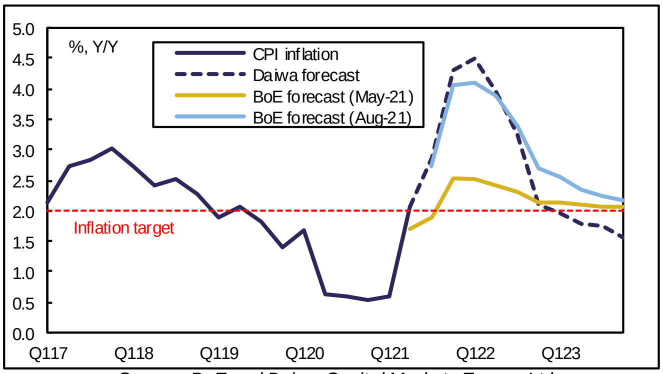
Source: Kantar Poll (23 September 2021) and Daiwa Capital Markets Europe Ltd.

UK: GDP forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Inflation forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

a four-month low as firms' optimism about the near-term outlook is tempered. The Italian ISTAT business and consumer confidence surveys are similarly expected to show a further moderate loss of momentum at the end of Q3.

UK

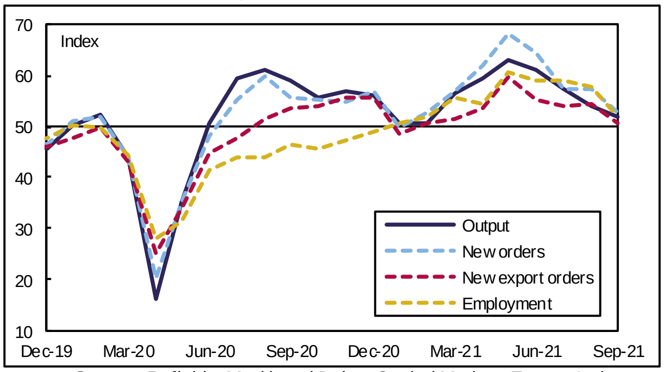
BoE notes "strengthened" case for "some modest tightening" over the horizon

As expected, following its latest MPC meeting, the BoE left all of its monetary policy settings unchanged today. However, two of the nine Committee members voted to reduce the target for the BoE's Gilt purchases by £35bn to £840bn, and by implication voted to curtail the purchases imminently rather than by the end of the year as planned. Deputy Governor Dave Ramsden joined external member Michael Saunders, who had previously been the lone advocate, in voting for that policy, which would have represented a very modest tightening of the monetary stance. Notably perhaps, new Chief Economist Huw Pill, who has previously called for tighter limits on QE, did not join Ramsden and Saunders. More significantly, the MPC stated that some developments since the August meeting have "strengthened" the case for "some modest tightening of monetary policy over the forecast period". And so, the markets responded by bringing forward its expectation for rate hikes, with 15bps of tightening priced in by March and a further 25bps hike in Bank Rate to 0.5% priced in by September 2022, from November 2022 previously.

Inflation expected to rise above BoE's previous forecast

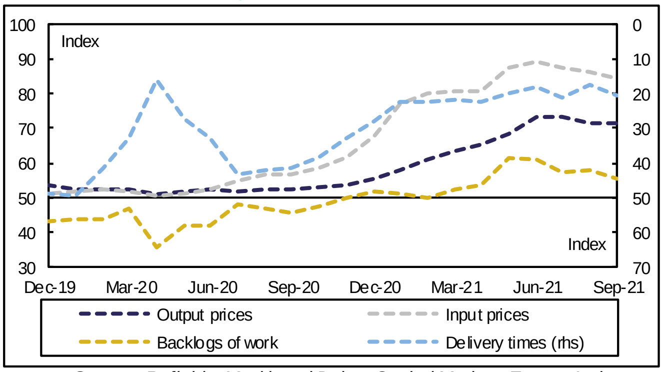
The slightly more hawkish message of the MPC reflected the increase in upside risks to the inflation outlook. Due to recent developments in energy and goods prices, the BoE now expects headline CPI inflation to exceed 4.0% Y/Y in the coming quarter, above the projection in the August Monetary Policy Report. Around half of the increase above target would be due to elevated energy price inflation. Wholesale gas price pressures meant that inflation would remain slightly above 4% until Q222, posing additional upside risks. The MPC judged that most other indicators of cost pressures have remained elevated too. And although it expects global cost pressures to prove transitory, it is not so confident that all domestic cost pressures will do so. Among other things, the Committee noted recent strength in the labour market, with the unemployment rate falling below its projection and payrolls back above the pre-pandemic level. And while it acknowledged that those data were flattered by the higher-than-expected number of workers still on furlough, Bank staff judged that underlying pay growth had now risen above its pre-pandemic rate, in part due to labour shortages in several sectors. Increased indicators of medium-term household inflation expectations also raised unease about second-round effects on inflation from current price pressures.

UK: Manufacturing PMIs – demand side



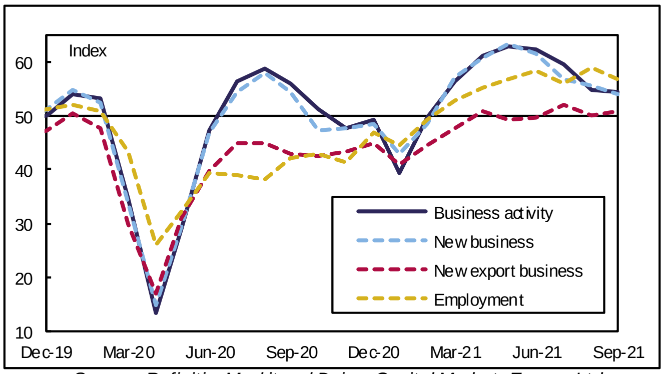
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing PMIs – supply side



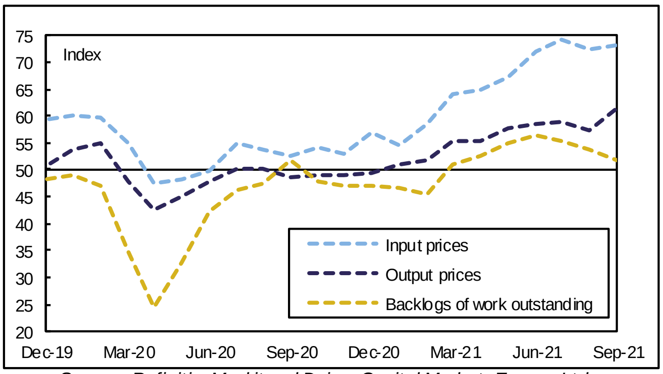
Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs – demand side



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

UK: Services PMIs – supply side



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

Downside risks to GDP outlook should be a deterrent to near-term tightening

Despite upside risks to the near-term profile of inflation, the BoE acknowledged that UK economic activity has been weaker than it had previously anticipated. Indeed, the MPC noted that Bank staff had revised down their expectation for the level of GDP in the current quarter by about 1% since last month. That would leave the level of GDP still around 2½% below the pre-pandemic level in Q3, with the risks that that benchmark might not be surpassed for a number of quarters to come. That downward revision in part reflected the supply constraints that have been evident for some time in economic surveys, and were again illustrated in today's flash September PMIs (see below). And the MPC recognised the significant uncertainty about the near-term labour market outlook, with the impact of the conclusion of the furlough scheme at the end of this month on unemployment and skills mismatches to be closely assessed. Of course, there are plenty further uncertainties too, including the future path of energy prices as well as the fiscal policy decisions to be announced in the Budget and Spending Review announcement on 27 October. Most important in determining the future path of monetary policy will be evidence regarding unemployment and wider measures of slack; underlying pay pressures; the extent to which businesses pass on wage and other cost increases; and medium-term inflation expectations. On balance, recent data in this respect do point to the likelihood of a first rate hike from the BoE in 2022. However, unlike the markets, given the further near-term dampening impact on demand likely to come from energy price rises and certain fiscal decisions, we think take-off for Bank Rate will not occur before the second half of next year.

Flash PMIs point to slowing of recovery momentum amid supply shortages and cost pressures

Today's flash September PMIs added to evidence that the UK economic recovery continues, albeit with diminished vigour. In particular, the composite output PMI fell for a fourth successive month and by 0.7pt to a seven-month low of 54.1, with the respective indicator of growth in new orders similarly falling to the lowest since February (down more than 2pts to 53.8). While activity growth in services also moderated to a seven-month low (55.0), perhaps unsurprisingly the flash PMIs suggested that the slowdown was more marked in manufacturing, where growth in output was reportedly modest (the respective PMI fell more than 2pts to 51.8). The primary cause, of course, was supply-chain disruption, although the survey suggested that growth in work backlogs slowed somewhat and delivery times also lengthened at a slightly slower pace. But there was also evidence of a softening of demand for manufactured items, with growth in new export orders reportedly grinding almost to a halt. And not least given events in energy markets, price pressures remained fierce across the economy. Indeed, with both manufacturing and services feeling the pinch, the composite input cost PMI rose back closer to June's series high, and the output price PMI (63.0) hit a new record. More happily, despite slowing in manufacturing, and amid reports of wage pressures, the survey suggested that job creation remained rapid in services, close to the prior month's series high.

The day ahead in the UK

The flow of sentiment indicators will continue tomorrow, with the GfK consumer confidence and CBI distributive trades surveys set to provide an update on household optimism and spending at the end of the third quarter. With consumer confidence expected to have moved broadly sideways in September, the CBI's survey is likely to report softer retail sales growth compared with a year earlier despite the relatively low base a year ago.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary manufacturing (services) PMI	Sep	**58.7 (56.3)**	60.5 (58.7)	61.4 (59.0)	-
	Preliminary composite PMI	Sep	**56.1**	58.5	59.0	-
Germany	Preliminary manufacturing (services) PMI	Sep	**58.5 (56.0)**	61.5 (60.4)	62.6 (60.8)	-
	Preliminary composite PMI	Sep	**55.3**	59.2	60.0	-
France	INSEE business (manufacturing) confidence	Sep	**111 (106)**	110 (109)	110 (110)	-
	Preliminary manufacturing (services) PMI	Sep	**55.2 (56.0)**	57.0 (56.1)	57.5 (56.3)	-
	Preliminary composite PMI	Sep	**55.1**	55.7	55.9	-
Spain	GDP – final estimate Q/Q% (Y/Y%)	Q2	**1.1 (17.5)**	2.8 (19.8)	-0.4 (-4.2)	**-0.6 (-)**
UK	Preliminary manufacturing (services) PMI	Sep	**56.3 (54.6)**	59.0 (55.0)	60.3 (55.0)	-
	Preliminary composite PMI	Sep	**54.1**	54.6	54.8	-
	BoE Bank Rate %	Sep	**0.10**	*0.10*	0.10	-
	BoE Gilt purchase target £bn	Sep	**875**	*875*	875	-
	BoE Corporate Bond purchase target £bn	Sep	**20**	*20*	20	-

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary consumer confidence	Sep	**-4.0**	-5.3	-5.3	-
Italy	Industrial sales M/M% (Y/Y%)	Jul	**0.9 (19.1)**	-	3.1 (28.4)	**- (28.5)**

Auctions

Country	Auction
Germany	sold €1.86bn of 0% 2036 bonds at an average yield of -0.06%
UK	sold £350mn of 0⅛% 2056 index-linked bonds at an average yield of -2.289%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	09.00	Ifo business climate	Sep	99.0	99.4
	09.00	Ifo current assessment (expectations)	Sep	101.8 (96.5)	101.4 (99.4)
Italy	09.00	ISTAT business (manufacturing) confidence	Sep	- (112.7)	114.2 (113.4)
	09.00	ISTAT consumer confidence	Sep	115.8	116.2
UK	00.01	GfK consumer confidence	Sep	-7	-8
	11.00	CBI distributive trades survey, reported sales	Sep	34	60

Auctions and events

Country	BST	Event
Euro area	14.15	ECB's Chief Economist Lane takes part in annual research seminar organised by the ESM
Italy	10.00	Auction: €2.5bn of 0% 2024 bonds
Italy	10.00	Auction: €1bn of 0.4% 2030 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs