Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- While comments from ECB Board member Schnabel were more hawkish than of late, Bunds were little changed today as euro area CPI inflation was unrevised matching the euro-era high, but core inflation was a touch softer.
- Gilts made gains despite a significant upside surprise to UK inflation, with headline and core CPI rates rising to their highest in a decade.
- UK retail sales data will be in focus on Friday, alongside UK consumer confidence and German PPI numbers. ECB Chief Economist Lane will be in action tomorrow with President Lagarde set to speak on Friday.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.741	+0.004
OBL 0 10/26	-0.565	+0.000
DBR 0 08/31	-0.248	-0.002
UKT 0⅛ 01/24	0.553	-0.035
UKT 0⅝ 10/26	0.713	-0.031
UKT 0¼ 07/31	0.967	-0.018

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

Euro area

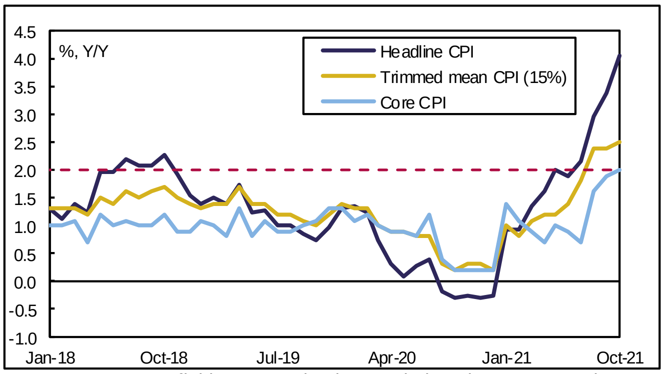
Final headline inflation unrevised at euro-era high, but core inflation a touch softer

Final euro area inflation numbers today confirmed that the headline CPI rate was unrevised from the flash estimate in October, which had jumped 0.7ppt to 4.1%Y/Y to match the euro-era high. The detail of the report showed a marginally stronger surge in energy prices than initially estimated, by 5.6%M/M, with prices of liquid fuels and gas up more than 9½%M/M and 5½%M/M respectively, while electricity prices were up more than 2%M/M too. So, energy inflation rose a further 6.1ppts to 23.7%Y/Y, to account for a little more than half of all inflation. This contribution was in part offset by softer food inflation (down 0.1ppt from September to 1.9%Y/Y), while non-energy industrial goods inflation was also a touch weaker than initially calculated to two decimal places (2.02%Y/Y). This was despite a further rise in inflation of motor vehicles (up 0.5ppt to a series high of 4.3%Y/Y), of which inflation of second-hand autos increased 1ppt to 3.8%Y/Y. In contrast, clothing inflation eased 0.8ppt to 0.9%Y/Y. As such, with services inflation unrevised at 2.1%Y/Y (albeit the strongest rate since 2013 due to pressures on contact-intensive services), the euro area's core CPI rate was also revised lower from the flash reading, by 0.1ppt to 2.0%Y/Y, leaving it just 0.1ppt higher than in September, nevertheless still its strongest rate in nineteen years.

Inflation to fall back next year as base effects ease

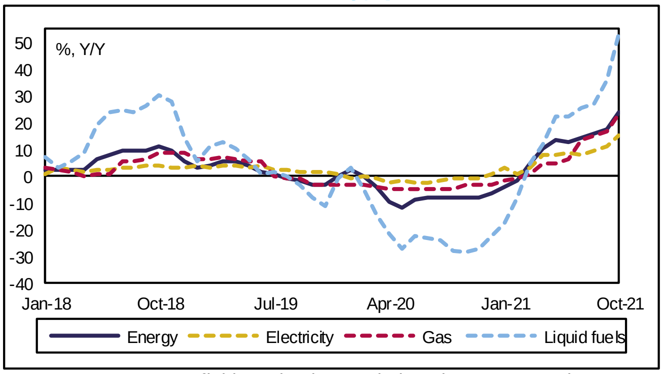
Despite the increase in both headline and core inflation to multi-year highs, most of the pressure still derives from base effects and a normalisation in prices (including those of energy and consumer-facing services) following pandemic-related weakness last year, as well as the impact of supply bottlenecks (e.g. on new and second-hand cars and other durable goods). Indeed, rather than pushing into new territory, the core price index has still just returned to its subdued pre-pandemic trend. And the euro area's trimmed mean CPI – which excludes the top and bottom 7½% price moves – rose just 0.1ppt to a still-moderate 2.5%Y/Y, well below the 4.1%Y/Y rate on the equivalent Cleveland Fed US 16% trimmed mean CPI, and similarly suggesting no significant broadening of price pressures at the start of Q4. While wholesale natural gas prices appear to have passed their peak, we expect energy inflation to maintain an upwards trend into the winter before falling back significantly from the spring onwards. And persisting supply constraints might also for a while continue to exert upward pressures over the near term in certain categories – e.g. in autos. But we continue to expect headline inflation to peak at the end of this year, not least as the impact of Germany's temporary VAT cut in 2020 will fall out of the calculation in January to subtract about ½ppt from inflation – indeed, on a constant tax basis, euro area headline inflation stood at 3.6%Y/Y in October. And with second-round effects on wages from current price pressures still likely to be limited, we expect headline inflation to fall back below the 2% by the end of next year and drop further in 2023, consistent with the assessment that conditions are unlikely to be met to justify an ECB rate hike next year.

Euro area: Headline, core and trimmed mean CPI



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

Euro area: Consumer energy price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Schnabel mindful of risks to the inflation outlook, which might eventually justify tighter policy

The assessment that economic conditions are unlikely to merit an ECB rate hike next year was repeated today by highly influential Executive Board member Isabel Schnabel. But her speech was more hawkish than other recent commentary from Executive Board members. Given recent developments and the significant uncertainty surrounding the inflation outlook, she considered it "not surprising that uncertainty around the future path of short-term interest rates as priced by investors has increased over the past few weeks". And she acknowledged structural changes in the global economy – not least the green transition – that could enable higher inflation to become more persistent and broad-based going forward. Such changes might well in due course merit earlier monetary tightening than suggested by the Governing Council's central projection. So, Schnabel was in no mood to try to shift market pricing, instead simply suggesting that the ECB was pursuing a "risk-management approach" to monetary policy, mindful of the "entire distribution of risks" around the most likely future path of the economy and "keeping sufficient optionality to address all inflation contingencies" which might eventually crystallise.

Construction output ticks higher in September after three monthly falls

The euro area's construction sector had a weak summer, with output declining in each month from June to August, not least weighed by shortages of materials and labour. Some modest relief came in September, however, with production in the sector up 0.9%M/M. But that was insufficient to fully reverse the decline of 1.4%M/M in August. And over Q3 as a whole, construction output fell 1.7%Q/Q, more than offsetting the growth of 1.5%Q/Q in Q2. Similarly, despite a rise in September, building work (-2.3%Q/Q) and infrastructure (-1.0%Q/Q) both fell significantly in the third quarter, with the former more than reversing growth in both Q1 and Q2. Among the large member states, construction output last quarter fell 2.1%Q/Q in Germany and France and a hefty 3.6%Q/Q in Spain, the latter marking a fourth successive quarterly decline. While September figures for Italy are not yet available, its average level of construction output in the first two months of the quarter was trending a much smaller 0.3% below the average in Q2. Reassuringly, perhaps, survey indicators such as those of the European Commission and PMIs point to a pickup in new orders at the start of Q4, with the former signalling the strongest demand since April 2019. Price pressures from materials, energy, labour, and subcontractor rates remain elevated. However, housing activity should respond to still favourable fundamentals including super-low interest rates and firm residential price growth (a fifteen-year high of 6.8%Y/Y in Q2) while civil engineering activity should benefit increasingly from NGEU projects. Some commercial activity should also pickup in line with overall business investment. But projects associated with city-centre retail, entertainment and office development might continue to lag as the impact of Covid-19 on ways of work and recreation continues to resonate.

The coming two days in the euro area

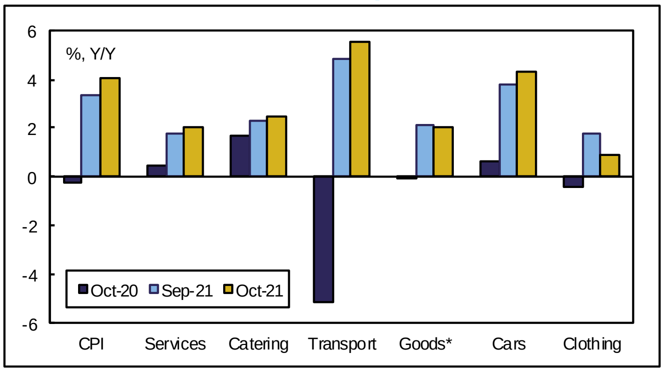
The remainder of the week is set to be relatively quiet on the euro area economic data front, with just the release tomorrow of EU new car registrations data and the Bank of France's retail survey for October, while on Friday German PPI numbers for the same month are likely to register a new post-reunification high. As such, ECB-speak might be of more interest. Chief Economist Lane will take part in a fireside chat tomorrow with New York Fed President John Williams on 'the new Fed and ECB strategies – implications for monetary policy" at a joint conference on transatlantic economic policy responses to the pandemic and the road to recovery, while President Lagarde will give a speech at the European Banking Congress on Friday.

UK

Inflation up to decade high with several drivers

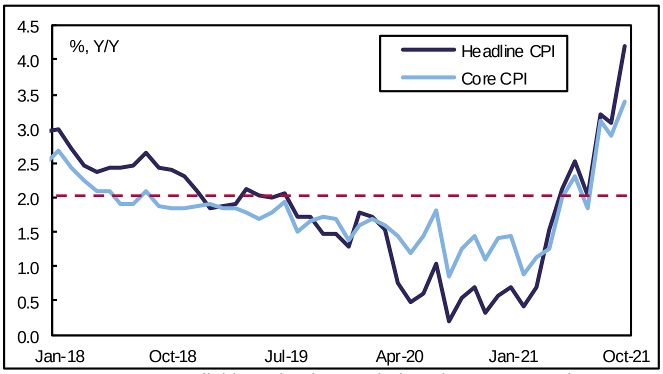
Following yesterday's strong jobs numbers but moderating wage figures, today's UK inflation data surprised on the upside, probably adding at the margin to the likelihood of a BoE rate hike next month. In particular, CPI inflation rose 1.1ppt in October to 4.2%Y/Y, 0.3ppt above the consensus forecast and the BoE's expectation. Inevitably, the principal driver of the rise in inflation was energy prices, in large part due to the increase in Ofgem's regulated price cap, as well as higher prices

Euro area: Selected CPI components



*Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Headline and core CPI



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

of auto fuel. Indeed, inflation of electricity, gas and other household fuels leapt more than 20ppts to 22.9%Y/Y, the highest since 2009. And with petrol prices also up again, energy inflation accounted for about 0.8ppt of the 1.1ppt rise in inflation last month, and contributed about one third of the annual CPI rate. However, several other components added to inflation in October. Services inflation rose 0.6ppt to 3.2%Y/Y, the highest since 2013, with significant increases in a range of items. Inflation of restaurants and hotels accelerated to 6.3%Y/Y as firms passed on to consumers some of the 7.5ppt rise in VAT in the sector. Education fees were also much higher, rising 4.5%Y/Y, seemingly reflecting increased university tuition fees for students from the EU post-Brexit. And inflation of air fares was higher too, up to 16.2%Y/Y. Moreover, non-energy industrial goods inflation rose 0.3ppt to 3.6%Y/Y, in large part reflecting a further rise in prices of used cars (up 22.8%Y/Y) on account of the continued shortage of new vehicles. So, while food inflation was also higher (up 0.4ppt to 1.3%Y/Y), core inflation jumped a larger-than-expected 0.5ppt to 3.4%Y/Y, the highest since 2011.

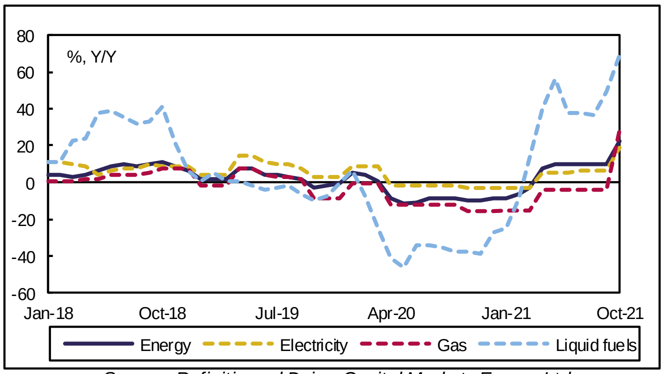
Inflation to rise above 5% before falling back in H222 and into 2023

We expect inflation to jump yet again in November to above 4½%Y/Y, and to peak at around 5.2%Y/Y early in the New Year. And inflation will remain elevated in the spring as Ofgem will increase its energy price cap once again in April, when the hospitality VAT rate will increase once again to 20%. Firms might also be tempted to pass on some of the cost of the increase in employers' National Insurance Contributions to consumers too. And some further pass-through of pressures from factory goods prices (PPI output inflation rose a larger-than-expected 1.0ppt to 8.0%Y/Y), including processed food items, also seems likely. Nevertheless, consumer price inflation should still start to decline steadily from May onwards, as base effects associated with economic reopening become more favourable, prices of used cars normalise, and supply bottlenecks ease pressures on a range of other items too. If yesterday's wage data are any guide, cost pressures from pay should also remain well contained. And as suggested by futures prices, wholesale natural gas prices are widely expected to fall back too, enabling Ofgem to reduce its price cap in October 2022 and again in April 2023. So, we still expect the headline CPI rate to fall back below 2½%Y/Y by the end of next year, and below the BoE's 2% target in 2023. As such, while the MPC might well decide next month that a 15bps hike to 0.25% is hard to resist, we expect Bank Rate to end next year at just 0.5%.

The coming two days in the UK

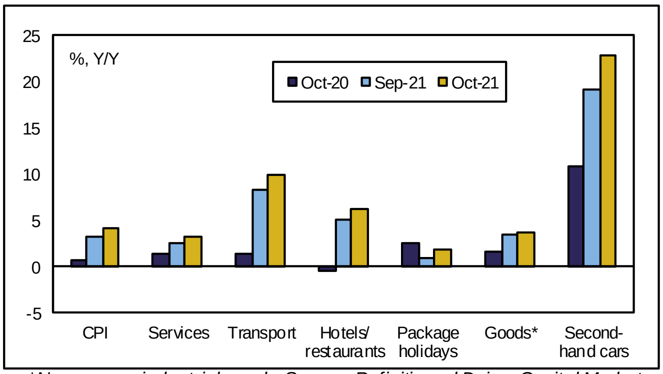
After a quiet day in the UK for data tomorrow, Friday brings some more economic releases that will play a key role in the MPC's December monetary policy decision. In particular, October's retail sales report will provide an update on spending on goods at the start of the fourth quarter, with recent surveys pointing to a pickup in expenditure as consumers started their Christmas shopping early amid fears of ongoing supply shortages throughout the festive season. Excluding fuel, retail sales are expected to have risen 0.6%M/M, to leave them 5.1% higher than February 2020's pre-pandemic level, albeit still 2.8% lower compared to a year earlier. At the same time, the latest GfK consumer confidence survey is expected to reveal that the headline sentiment index fell for the fourth consecutive month in October to a nine-month low of -18. Meanwhile, the latest public finance figures are expected to show that public sector net borrowing (PSNB) excluding banks increased £14bn in October, £6.0bn less than the same month a year ago.

UK: Consumer energy price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected CPI components



**Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

The next edition of the Euro wrap-up will be published on 19 November 2021

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%	Oct	**4.1 (2.0)**	*4.1 (2.0)*	3.4 (1.9)	-
	Construction output M/M% (Y/Y%)	Oct	**0.9 (1.5)**	-	-1.3 (-1.6)	**-1.4 (-2.6)**
UK	CPI (core CPI) Y/Y%	Oct	**4.2 (3.4)**	*3.9 (3.0)*	3.1 (2.9)	-
	PPI input (output) prices Y/Y%	Oct	**13.0 (8.0)**	12.1 (7.3)	11.4 (6.7)	**11.9 (7.0)**
	House price index Y/Y%	Sep	**11.8**	-	10.6	**10.2**

Auctions

Country	Auction
Germany	Sold €693mn of 0% 2052 bonds at an average yield of 0.08%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	07.00	EU-27 new car registrations Y/Y%	Oct	-	-23.1
France	-	Bank of France retail sales* M/M%	Oct	-	2.8

Auctions and events

Country	GMT	Event
Euro area	10.00	ECB's Panetta scheduled speaks before the European Parliament's Committee on Economic and Monetary Affairs
	14.30	ECB's Lane takes part in fireside chat 'The new Federal Reserve and ECB Strategies'
France	09.50	Auction: 0% 2024 bonds
	09.50	Auction: 0% 2027 bonds
	09.50	Auction: 2.75% 2027 bonds
	10.50	Auction: 0.1% 2026 inflation-linked bonds
	10.50	Auction: 0.1% 2028 inflation-linked bonds
	10.50	Auction: 0.7% 2030 inflation-linked bonds
Spain	09.30	Auction: 0% 2027 bonds
	09.30	Auction: 0.6% 2029 bonds
	09.30	Auction: 0.5% 2031 bonds

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

Friday's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	09.00	ECB current account balance €bn	Sep	-	13.4
Germany	07.00	PPI Y/Y%	Oct	16.2	14.2
UK	00.01	GfK consumer confidence	Nov	-18	-17
	07.00	Retail sales including auto fuels M/M% (Y/Y%)	Oct	0.5 (-2.0)	-0.2 (-1.3)
	07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Oct	0.4 (-3.4)	-0.6 (-2.6)
	07.00	Public sector net borrowing, excluding banks, £bn	Oct	14.0	21.8

Auctions and events

Country	GMT	Event
Euro area	08.30	ECB President Lagarde to give a speech at the European Banking Congress
	13.00	ECB's Weidmann scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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