Euro wrap-up

Overview

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- Bunds made big losses as the account of the ECB's most recent policy meeting confirmed that some members advocated a 50bps hike, while German factory orders and euro area retail sales declined in August.
- As UK pension funds appeared to continue to unwind positions before the BoE's backstop is removed, Gilts also made big losses as surveys reported a rise in firms' inflation expectations and a pickup in construction activity.
- Friday will bring the results of surveys of euro area consumers and UK job agencies as well as data for German industrial production.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.762	+0.103
OBL 1.3 10/27	1.937	+0.077
DBR 1.7 08/32	2.077	+0.052
UKT 1 04/24	4.022	+0.099
UKT 1¼ 07/27	4.343	+0.135
UKT 4¼ 06/32	4.159	+0.139

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

Euro area

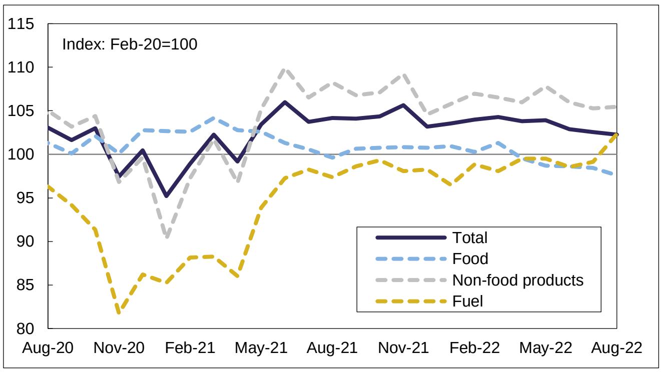
Some ECB Governing Council members advocated a hike of just 50bps last month

Today's account of the ECB's September monetary policy meeting – when the Governing Council tightened by 75bps – offered little new substantive guidance about what to expect in terms of the outlook for policy, which will still be determined on a meeting-by-meeting basis. However, it did provide a window on the debate between the hawks and the doves. Among other things, the account noted that "a very large number of members" backed the proposal for 75bps, as inflation had repeatedly been higher than expected, was becoming increasingly broad-based, and was now expected to remain above-target over the full course of 2024. So, with rates judged still to be far from a neutral setting, a faster pace of monetary policy normalisation was considered to be required to avoid a de-anchoring of inflation expectations. Notably perhaps, the account added that some members of the Governing Council would have preferred a hike of just 50bps, not least given "looming risks of recession", which could be exacerbated by an excessive monetary policy response. However, at the end of the debate on the Council, the doves were ultimately willing to join a consensus for 75bps, as it was made clear that the step "should not signal that the Governing Council intended to agree on interest rate increases of a similar magnitude at future meetings".

Another hike of 75bps most likely this month as hawks' fears of inflation persistence dominate

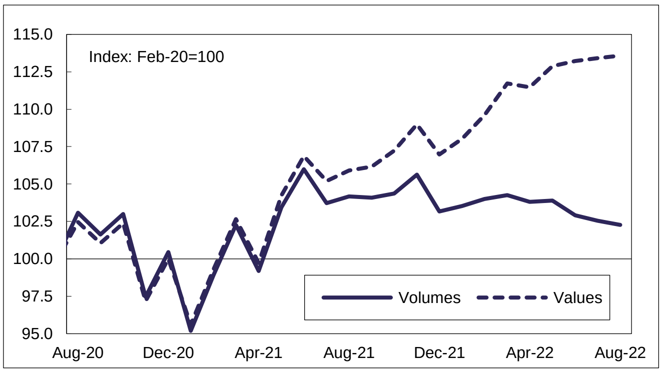
The hawks are evidently not allowing themselves (yet) to be distracted by recession risks. In line with the thrust of a speech by Executive Board member Isabel Schnabel earlier this week, it was argued that the ongoing supply shocks risk significantly reducing euro area potential output. As such, while it was generally agreed that there were so far no convincing signs of second-round effects through wages on inflation, and most measures of market and survey-based inflation expectations were considered still to be broadly anchored, a period of significantly weaker demand might also be required to avoid persistent above-potential demand and keep inflation in check. There are additional concerns that the nature of the inflation process might be changing, with high inflation becoming self-reinforcing, so that even a marked weakening in growth might not be sufficient to bring inflation back to target. Indeed, among the various hawkish concerns expressed, some member states' labour markets were judged to be very tight, the euro's depreciation against the dollar had added to price pressures, poorly targeted fiscal initiatives could add to inflation over the medium term, and – most importantly perhaps – Russia's war in Ukraine risked aggravating the energy and food price shock, particularly if energy rationing proved ultimately to be required. Clearly, the concerns of the hawks continue to dominate the Governing Council, and are likely to continue to do so until the deposit rate is back in neutral territory, which is probably somewhere in the range of 1.50-2.00%. If anything, however, the balance of views reported in the account today would suggest that another hike of 75bps is most likely to come at the next policy meeting on 27-28 October, with the hurdle for an increment of 100bps likely to be very high indeed.

Euro area: Retail sales by store-type



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

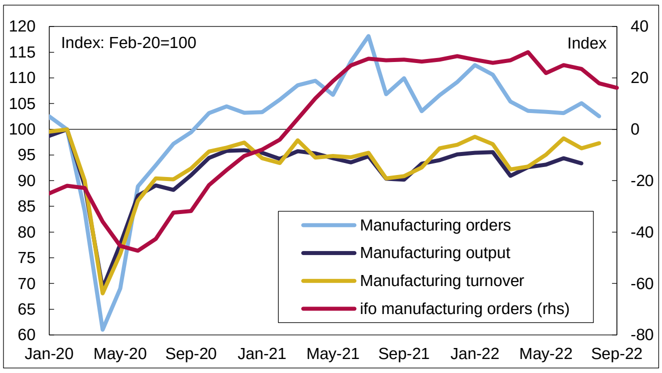
Euro area retail sales maintain downwards trend, despite boost from fuel

With households' purchasing power diminished by record high inflation, and given increased opportunities to spend on services, today's euro area retail figures confirmed an ongoing downtrend in spending on goods over the summer. Sales volumes fell for the third consecutive month in August, with a drop of 0.3%M/M following a downwardly revised print in July (by 0.7ppt to -0.4%M/M). There were heftier declines in Germany (-1.3%M/M) and the Netherlands (-2.2%M/M) in August, while sales in France and Spain eked out modest growth. By store-type, food sales volumes fell (-0.8%M/M) for the sixth month out of the past seven, as price pressures in the sector remained particularly acute, while non-store sales (-3.8%M/M) largely reversed the temporary bounce at the start of the quarter. And although spending at non-food stores rose marginally (0.2%M/M) this was small beer compared with the near-2½% cumulative drop in the previous two months. Admittedly, there was a further rebound in spending on fuel (3.2%M/M) as the price of petrol fell. But overall retail sales volumes were down by more than 1% on the Q2 average and more than 3% lower than the peak late last year. In marked contrast, nominal sales were roughly 1% higher than the Q2 average and more than 4% above last November's level. And with prices having continued to trend sharply higher and confidence remaining at historical lows, we think that the shortfall in sales volumes will only get bigger over coming months.

German factory orders data for August not quite as weak as headline numbers suggest

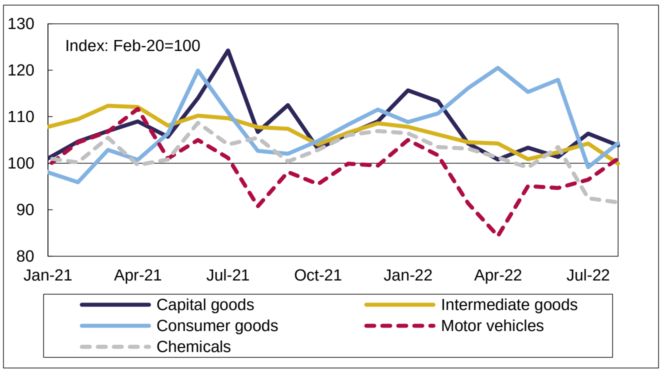
At face value, today's German factory orders data disappointed, with a steeper-than-expected decline in August of 2.4%M/M, the most since Russia invaded Ukraine in March. But this followed a notable upwards revision to new orders in July (with monthly growth boosted by 3ppts to +1.9%M/M) following the late inclusion of a large-scale foreign order from the aerospace sector. Indeed, when excluding bulk contracts, orders rose 0.8%M/M in August. Nevertheless, the overall drop in August reflected declines in domestic orders (-3.4%M/M), as well as those from elsewhere in the euro area (-3.8%M/M), reversing the strength seen previously. And there was a further decline in orders for energy-intensive sector goods such as chemicals (-1.0%M/M, to be down a cumulative 11½% over the past two months). Looking through the monthly volatility, in the first two months of the third quarter total orders were trending some 0.4% higher than the Q2 average, thanks to orders of capital goods (up 2.7% on the same basis). This notwithstanding, orders still remain almost 9% lower than at the start of the year, and more than 13% below last year's peak. Moreover, survey indicators including the PMIs and ifo indices point to a further deterioration in conditions in the manufacturing sector in September as demand responds to the ongoing energy crisis and increasing concerns of global recession, suggesting that this levelling off in Q3 will likely prove temporary.

Germany: Manufacturing orders, turnover & output



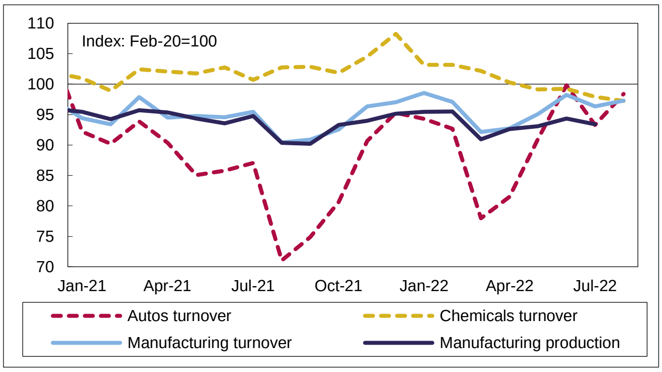
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

Germany: Manufacturing orders



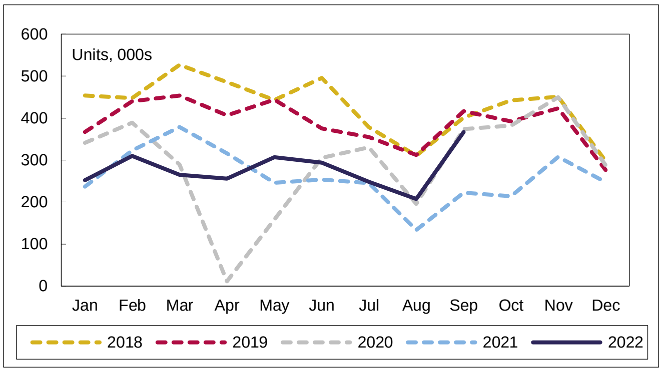
Source: *Refinitiv and Daiwa Capital Markets Europe Ltd.*

Germany: Manufacturing production & turnover



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Autos production



Source: Bloomberg, VDA and Daiwa Capital Markets Europe Ltd.

German manufacturing turnover rises for the fourth month out five, autos output accelerates

Perhaps not least thanks to firms' continued efforts to work off their order backlogs, today's German manufacturing turnover data for August were more encouraging, reporting positive growth (+1.0%M/M) for the fourth month out of the past five. That left turnover trending in the first two months of Q3 around 1½% higher than in Q2. That might add to impressions that an easing of supply-chain problems is facilitating higher output in certain key sub-sectors, but we note that there has been a slight mismatch between turnover and IP over recent months. Nevertheless, today's release suggests that tomorrow's production report could well surprise on the upside – the Bloomberg survey consensus is for a drop of 0.5%M/M. Also on the positive side, today's VDA numbers suggested that German autos production jumped in September, to be up a whopping 65%Y/Y, albeit still almost 12% below the level in the same month in 2019 ahead of the pandemic.

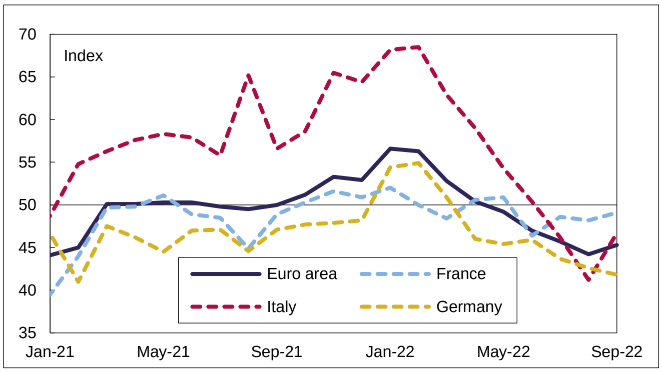
Construction PMIs consistent with ongoing contraction

While Germany's manufacturing sector may well have benefited from some easing in supply bottlenecks, construction remains extremely fragile, at least according to today's PMI survey. In particular, this showed the headline German activity index falling for the third consecutive month in September to 41.8, a nineteen-month low. The housing component was the weakest since April 2020, while the new orders index collapsed, falling 9.1pts to 32.7, its second-lowest since the global financial crisis. In contrast, the French construction activity PMI rose slightly in September to 49.1, while the equivalent Italian index jumped 5.5pts to 46.7. But both were consistent with contraction in the sector, with the Italian index in Q3 some 10pts lower than the Q2 average. Overall, the euro area construction PMI (45.3) was a modest improvement on August's nineteen-month low, but nevertheless still firmly in contractionary territory and the Q3 average almost 4pts lower than in Q2. And with new orders in the sector reportedly contracting at a steeper pace, and input prices having taken a further step up, business expectations for the year ahead were the weakest since April 2020.

The day ahead in the euro area

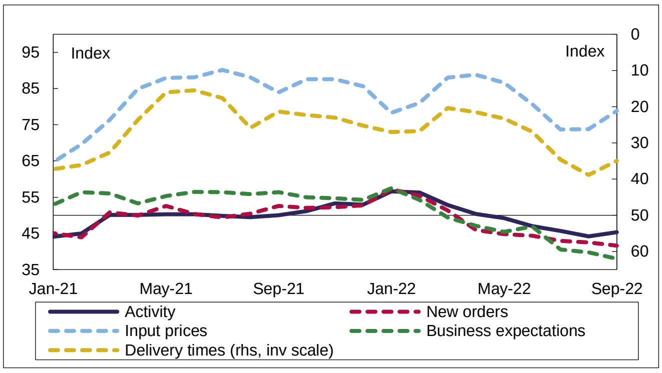
Tomorrow will bring the aforementioned German IP release. Following today's turnover numbers, and upwards surprises to the equivalent French (2.4%M/M) and Spanish (0.4%M/M) figures, we might well see German output reverse the 0.3%M/M decline recorded in July. Friday will also bring German and Italian retail sales data for August, with the former likely to confirm the drop (-1.3%M/M) reported in today's Eurostat release. The ECB will also publish its latest consumer expectation survey results.

Euro area: Construction PMIs by country



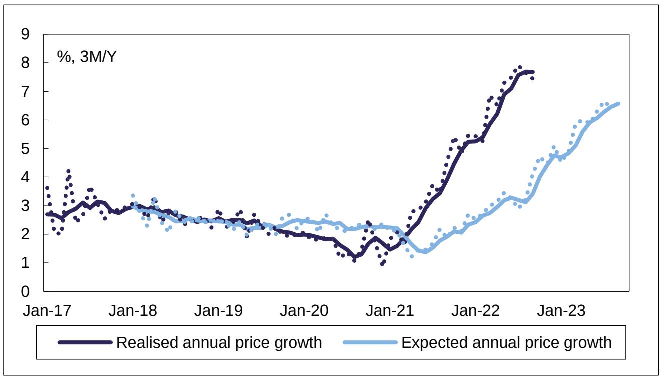
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



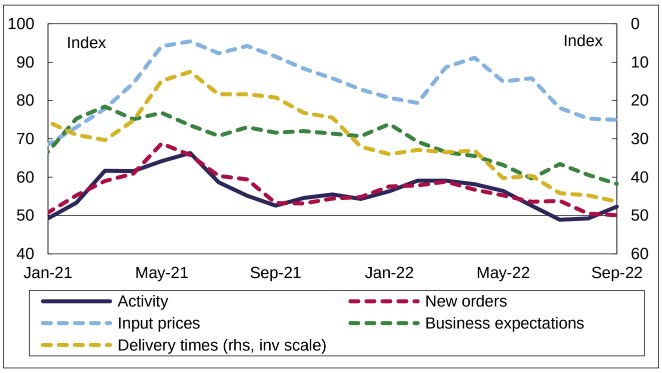
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Firms' price outturns & expectations*



**Dotted lines represent Y/Y%. Source: BoE Decision Maker Panel Survey and Daiwa Capital Markets Europe Ltd.*

UK: Construction PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK

BoE survey reports further rise in firms' price and wage expectations

Given persistently high inflation, concerns about potential second-round effects on price expectations have been one key driver of the BoE's push to tighten monetary policy over recent quarters. And its Decision Maker Panel (DMP) survey of Chief Financial Officers from UK firms has provided one source of information about how business inflation expectations have been evolving. Today's results of the September DMP survey will have provided some cause for concern. Firms surveyed judged that annual private sector output price inflation had remained stable in the three months to September, at 7.7%Y/Y, with the single-month figure moderating 0.3ppt to 7.4%Y/Y. However, their expected year-ahead annual output price inflation in the three months to September rose 0.1ppt to a new series high of 6.6%Y/Y, with the single-month up more than 0.2ppt back to match the series high of 6.65%Y/Y. And despite government initiatives to cap energy bills, DMP members now expect CPI inflation to be 9.5%Y/Y one-year ahead, up from 8.4%Y/Y in the August survey, and well above target at 4.8%Y/Y in three years' time. Respondent firms had also become more concerned about cost pressures. While over the twelve months to September, average cost growth was judged to have been unchanged from the August survey, at 9.8%Y/Y, over the coming twelve months, firms expect unit cost growth to be 9.1%Y/Y, 0.8ppt higher than previously expected. And with average wage growth reported to have edged up to a new high of 6.5%Y/Y in the twelve months to September, it was expected to remain elevated at 5.9%Y/Y over the coming twelve months.

UK construction PMI rises above 50 (for now)

The UK construction PMIs offered a more upbeat assessment of conditions at the end of Q3, with the headline activity index rising 3.1pts to 52.3, with the housing (52.9) and commercial indices (51.0) similarly consistent with growth, perhaps reflecting a further easing in supplier delivery times. But this still represented a marked slowdown since the Spring, with the average PMI in Q3 some 5½ pts lower than Q2 and 8pts below the Q1 level. Moreover, amid increasing concerns about inflation, squeezed budgets and the global economic outlook, demand was at its weakest since the pandemic recovery started in June 2020. And given the prospect of sharply higher borrowing costs for households and corporates from now on, and increases in costs of input materials and labour still vigorous, firms were the most pessimistic about the year ahead since July 2020.

The day ahead in the UK

It should be a relatively quiet end to the week for UK top-tier releases, with the REC/KPMG report on UK jobs to be watched for a further drop in labour demand amid weakening economic conditions, while BoE Deputy Governor Ramsden is due to speak publicly.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Construction PMI	Sep	**45.3**	-	44.2	**-**
		Retail sales M/M% (Y/Y%)	Aug	**-0.3 (-2.0)**	-0.4 (-1.7)	0.3 (-0.9)	**-0.4 (-1.2)**
Germany		Factory orders M/M% (Y/Y%)	Aug	**-2.4 (-4.1)**	-0.7 (-5.5)	-1.1 (-13.6)	**1.9 (-11.0)**
		Construction PMI	Sep	**41.8**	-	42.6	**-**
		Autos production Y/Y%	Sep	**65.0**	-	68.0	**-**
France		Construction PMI	Sep	**49.1**	-	48.2	**-**
Italy		Construction PMI	Sep	**46.7**	-	41.2	**-**
Spain		Industrial production M/M% (Y/Y%)	Aug	**0.4 (5.5)**	-0.3 (4.3)	-1.1 (5.3)	**-1.0 (5.4)**
UK		Construction PMI	Sep	**52.3**	48.0	49.2	**-**

Auctions

Country		Auction
France		sold €5.93bn of 2.00% 2032 bonds at an average yield of 2.59%
		sold €2.88bn of 0.75% 2053 bonds at an average yield of 2.84%
		sold €1.19bn of 1.75% 2066 bonds at an average yield of 2.74%
Spain		sold €1.15bn of 6.00% 2029 bonds at an average yield of 2.632%
		sold €2.18bn of 2.55% 2032 bonds at an average yield of 3.225%
		sold €1.57bn of 1.00% 2050 bonds at an average yield of 3.565%
		sold €505mn of 1.00% 2030 index-linked bonds at an average yield of 0.688%
UK		BoE accepted £154.5mn in its special long-term gilt tender

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Retail sales M/M% (Y/Y%)	Aug	-1.2 (-4.1)	1.9 (-5.1)
		07.00	Industrial production M/M% (Y/Y%)	Aug	-0.5 (2.3)	-0.3 (-1.1)
France		07.45	Trade balance €bn	Aug	-14.4	-14.5
Italy		09.00	Retail sales M/M% (Y/Y%)	Aug	0.0 (-)	1.3 (4.2)

Auctions and events

Country		BST	Event
Euro area		08.00	ECB publishes consumer expectations survey results
UK		00.01	KPMG/REC report on jobs
		11.25	BoE Deputy Governor Ramsden scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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