Euro wrap-up

Overview

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- Bunds made significant gains as the ECB's bank lending survey reported a notable tightening of credit standards and weaker loan demand, and the ifo business survey remained consistent with German economic recession.
- Gilts also made gains as new PM Rishi Sunak retained Jeremy Hunt as his Chancellor to maintain expectations of fiscal tightening ahead, and a survey reported a sharp deterioration in UK industrial sector sentiment.
- Ahead of the ECB's monetary policy announcement on Thursday, tomorrow will bring euro area bank lending data for September and the INSEE French consumer confidence survey results for October.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.931	-0.044
OBL 1.3 10/27	2.017	-0.121
DBR 1.7 08/32	2.161	-0.163
UKT 1 04/24	3.248	-0.065
UKT 1¼ 07/27	3.708	-0.065
UKT 4¼ 06/32	3.627	-0.102

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

Euro area

Banks report sharpest tightening of standards on business loans since the euro crisis

Ahead of Thursday's monetary policy announcement, the ECB's latest bank lending survey provided a welcome reminder to the Governing Council of the dangers of tightening too fast against the backdrop of a rapidly deteriorating economic outlook. In particular, the survey reported a marked tightening of credit standards, and overall terms and conditions on bank loans, for both households and firms over the past quarter. The survey also reported a larger share of rejected loan applications on all types of credit. Within the detail, a net share of more than 19% of banks surveyed reported a tightening of standards on loans to firms, which was the largest such share since the euro crisis in 2012. And a significantly larger net share (29%) expect to tighten credit standards on such loans in Q4. Firms cited intensifying recession fears, economic uncertainty, industry- or firm-specific issues and overall declining risk tolerance among the causes of the tightening of credit standards. However, they also reported that their cost of funds and balance sheet situation contributed to the tightening, and by the most since the euro crisis in 2012. A larger share of banks in each of the large member states, with the exception of France, reported a net tightening of credit standards last quarter, with Italy and Spain most significantly affected.

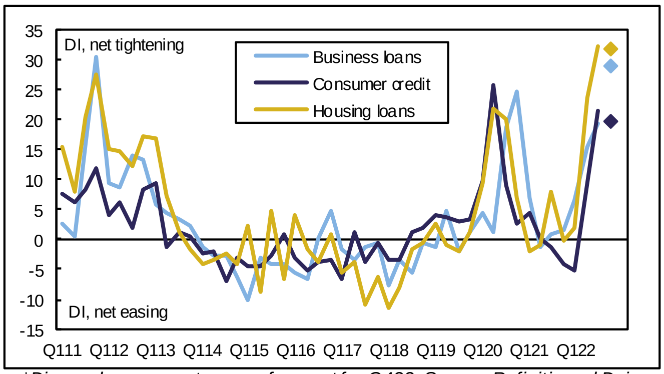
An even bigger tightening of credit standards for households

An even larger net share of banks – the most since 2008 and a bigger share than had been anticipated the prior quarter – reported a net tightening of credit standards for housing loans (32%) in Q3, with a notable net tightening also reported for consumer credit and other lending to households (21%). As for lending to firms, a significant net share of banks expects to keep tightening their standards on credit to households in the current quarter. Despite a net tightening of terms and conditions on such credit, margins reportedly narrowed on both house purchase loans and consumer credit, as market reference rates rose at a faster rate than the interest rates applied to such loans.

A sharp drop in demand for loans for house purchases

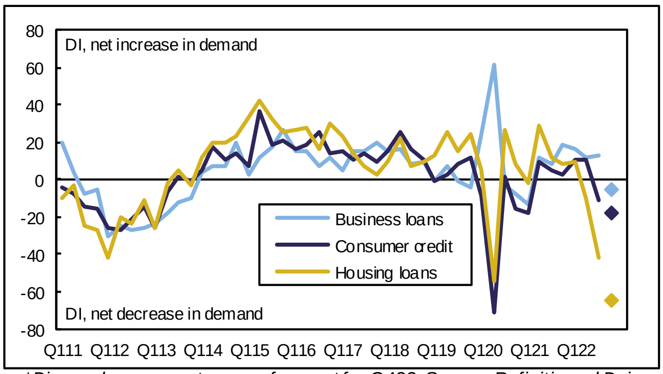
Contrary to expectations the prior quarter, banks reported an increase in firms' net demand for loans in Q3 (+13%). However, the cause for the increased demand was not overly encouraging, being related to firms' financing needs for working capital and inventories, given increased cost pressures, lower-than-expected demand and precautionary activity related to supply bottlenecks. In contrast, for the second consecutive quarter, banks reported that lower fixed investment plans had a dampening impact on firms' net demand for loans, with higher interest rates also playing a role. Given the nature

Euro area: Net tightening of credit standards*



*Diamonds represent survey forecast for Q422. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Net demand for bank credit*



*Diamonds represent survey forecast for Q422. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

of the borrowing needs, demand for short-term loans had increased but net demand for long-term loans was broadly unchanged. Bank also reported a sharp drop in net demand for loans to households for house purchase, with the respective index of -42% the weakest since the euro crisis bar the worst moments of the pandemic. Demand for consumer credit also decreased moderately in net terms, with banks citing higher interest rates and low consumer confidence as key drivers of the decline in household loan demand. In the current quarter, banks expect a net decline in demand for loans to firms and households alike, with the magnitude in the drop in demand for housing loans (-64%) expected slightly to exceed that experienced in the midst of the global financial crisis in H208.

German ifo business climate remains gloomy with a difficult winter ahead

Contrasting with expectations and the further deterioration recorded in yesterday's German flash PMIs, today's ifo business survey suggested that the steady downtrend in economic expectations seen since the start of the year had perhaps paused at the start of the fourth quarter. Admittedly, the slight uptick in the ifo expectations index – by just 0.3pt to 75.6 – still left it at the third-lowest level since the series began in 2005, some 21pts below the long-run average and more than 3pts below the Q3 average. Moreover, it was offset by a further deterioration in firms' assessments of current conditions, for which the survey measure fell 0.4pt to a twenty-month low of 94.1. So, the overall business climate index slipped 0.1pt to 84.3, the lowest since the onset of the pandemic and the weakest since the global financial crisis outside periods of lockdown, with the ifo institute appropriately warning of a challenging winter ahead. And, like yesterday's PMIs, today's survey was still consistent with a gloomy economic backdrop and the strong likelihood of recession.

Retailers remain the most downbeat, but pessimism widespread

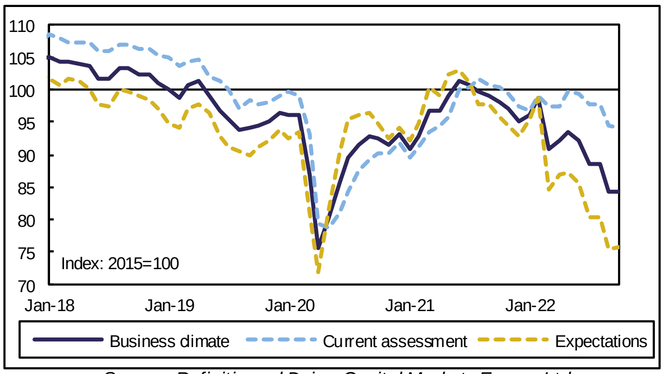
Within the detail of the survey, with consumer confidence at a record low and household budgets being squeezed, retailers were the most negative about the outlook on the series. And as the summer rebound in services activity continued to fade, firms in the sector assessed that conditions had worsened further at the start of Q4, with expectations little improved from September's slump. Despite a modest improvement in the balance of current conditions, manufacturers were the most pessimistic about the coming six months since April 2020, reflecting not least ongoing concerns about the global outlook and energy supply, with the ifo institute considering energy-intensive and autos subsectors to be in 'crisis'. The weakening in sentiment in construction was also noticeable, with firms' assessment of current conditions the worst since January 2016, and expectations continuing to deteriorate amid falling new orders.

The coming two days in the euro area

The main focus over the coming two days will be Thursday's ECB policy announcements, when we expect the Governing Council to raise each of its three main policy rates by 75bps, most notably taking the deposit rate to 1.50%. With euro area inflation in September having again exceeded the ECB's forecast, and the euro having depreciated significantly below parity against the dollar since the last monetary policy meeting, all members of the Governing Council will agree that real short-term rates are still far from the neutral stance that they hope to achieve by year-end. So, while a dovish minority will be mindful of rising recession risks and tightening financial conditions, another hike of 75bps this month is likely to be uncontroversial. While the post-meeting statement will likely repeat that future policy decisions will continue to be data-dependent and made on a meeting-by-meeting basis, it will also likely make clear that rates will likely rise again before year-end. And President Lagarde might make clear that the ECB will consider reducing its bond holdings (i.e. quantitative tightening) once interest rate normalisation has been completed.

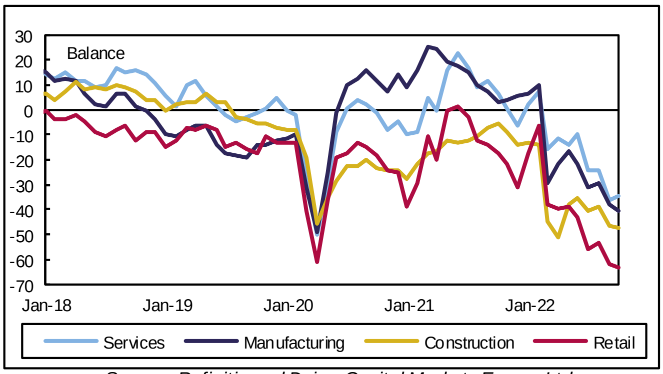
The ECB might well also announce technical adjustments in order to address issues related to the huge amount of excess liquidity in an environment of positive an interest rates, which offers banks significant risk-free income while also representing a big cost to the ECB. Several policy options appear to have been under consideration. In particular, to sharpen banks' incentives to repay their TLTRO loans without undue delay, it is possible that the Governing Council might decide retrospectively to amend the terms of that long-term liquidity. That, however, might have a reputational cost for the ECB.

Germany: ifo business sentiment indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: ifo business expectations indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Alternatively, the ECB might simply introduce a 'reverse-tiering' system to reduce interest paid on deposits above a certain threshold. Whatever precise measure is agreed upon, it will likely reduce total net income for euro area banks by tens of billions of euros in the coming year.

Data-wise, tomorrow will bring the ECB's latest monthly bank lending numbers for September, which among other things are likely to report continued subdued demand for consumer credit, and perhaps also a slowing in mortgages, amid a pickup in interest rates to the highest since 2015. Against this backdrop, high inflation and the uncertain economic outlook, the latest French INSEE consumer confidence survey seems unlikely to report a meaningful improvement at the start of the fourth quarter. This will be followed on Thursday by the German GfK consumer survey, which is expected to see headline sentiment remain close to a post-reunification low, with the equivalent Italian ISTAT business and consumer indicators due that day too.

UK

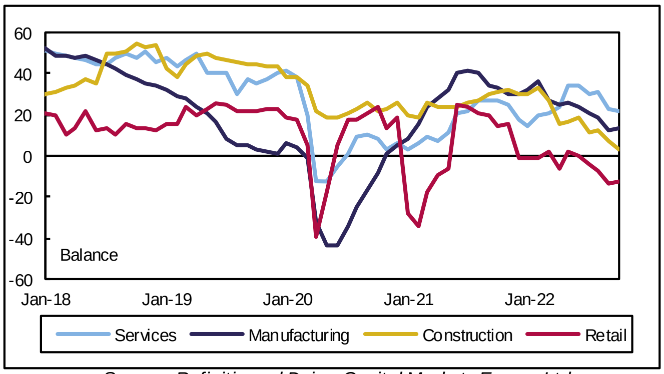
CBI industrial sentiment falls at steepest pace since April 2020

While today's CBI industrial trends survey exceeded expectations with respect to its gauge of UK manufacturing output, the survey was still consistent with a contraction in the three months to October and a reminder that conditions remain exceptionally challenging in the sector at the start of Q4. Overall, the survey suggested that output fell in 11 out of 17 subsectors, led by paper, printing & recorded media and metal manufacturing. While firms were a touch more optimistic about near-term production prospects, the survey's measure of new orders fell back in October, with the balance for new export orders declining at the steepest pace since July 2020. Moreover, the stock of finished orders was the highest since February 2021 suggesting good recent progress working through backlogs. Furthermore, while the share of firms reporting material shortages as a constraining factor on production remained elevated at 54%, that represented an improvement from 63% in the three months to July and 71% in the three months to April. The tight labour market remained a cause for concern too, with the net balance of those citing worker shortages as a restraint on output (49%) the highest since October 1973. So, taken with still extremely elevated cost burdens – the respective survey balance was unchanged over the quarter at 82% – the index of overall business sentiment worsened for a fourth successive quarter and at the steepest pace since April 2020, falling 27ppts to -48%. So, manufacturers were unsurprisingly less upbeat about their investment intentions over the coming year too.

The coming two days in the UK

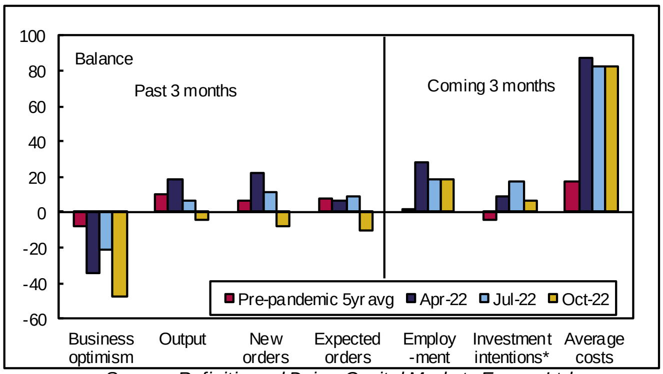
After a day bereft of UK releases tomorrow, Thursday will bring the CBI distributive trades survey for October. Amid the further rise in household energy bills this month, surge in secured and unsecured interest rates and double-digit inflation, this survey is likely to signal ongoing weakness in retail sales at the start of Q4.

Germany: ifo business current conditions indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 27 October 2022

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		Ifo business climate	Oct	**84.3**	83.8	84.3	**84.4**
		Ifo current assessment (expectations) balance	Oct	**94.1 (75.6)**	92.7 (75.0)	94.5 (75.2)	**- (75.3)**
UK		CBI industrial trends survey, total orders (selling prices)	Oct	**-4 (46)**	-	-2 (59)	**-**
		CBI industrial trends survey, business optimism	Oct	**-48**		-21	**-**

Auctions

Country		Auction
Germany		sold €3.25bn of 1.3% 2027 bonds at an average yield of 2.11%
UK		sold £800mn of 0.125% 2039 index-linked bonds at an average yield of 0.07%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	M3 money supply Y/Y%	Sep	6.1	6.1
France		07.45	INSEE consumer confidence	Oct	78	79
		11.00	Total jobseekers, '000s	Q3	-	2945

Auctions and events

Country		BST	Event
Italy		10.00	Auction: €2.5bn of 1.75% 2024 bonds
		10.00	Auction: €750mn of 0.65% 2025 index-linked bonds
		10.00	Auction: €750mn of 0.1% 2033 index-linked bonds
UK		10.00	Auction: £3.5bn of 0.50% 2029 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		13.15	ECB deposit (refinancing) rate %	Sep	*1.50 (2.00)*	0.75 (1.25)
Germany		07.00	GfK consumer confidence	Nov	-41.5	-42.5
Italy		09.00	ISTAT business (manufacturing) sentiment indicator	Oct	- (100.0)	105.2 (101.3)
		09.00	ISTAT consumer confidence	Oct	93.0	94.8
UK		11.00	CBI distributive trades survey, reported sales	Oct	-	-26

Auctions and events

Country		BST	Event
Euro area		13:15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds press conference following the Governing Council meeting
		16.55	ECB's Villeroy speaks at climate finance conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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