Daiwa Capital Markets

Euro wrap-up

Overview

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- Despite a slight downwards revision to euro area inflation in October, Bunds followed the global trend lower.
- Gilts also made losses as the UK government's fiscal update suggested that the lion's share of its planned fiscal consolidation will be back-loaded to after the next election.
- Friday will bring updates on UK retail sales and consumer confidence, as well as the amount of TLTRO-iii loans to be repaid early by euro area banks next week.

Daily bond market movements

Bond	Yield	Change
BKO 2.2 12/24	2.099	+0.027
OBL 1.3 10/27	1.984	+0.038
DBR 1.7 08/32	2.021	+0.028
UKT 1 04/24	3.126	+0.113
UKT 1¼ 07/27	3.259	+0.076
UKT 4¼ 06/32	3.206	+0.061

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

Euro area

Headline inflation revised down, but record highs in a range of components will remain a concern

As we expected, the final estimate of euro area consumer price inflation in October brought a slight downwards revision from the flash release, of 0.1ppt, to the headline HICP rate. However, that left it up 0.7ppt from September and at a series high of 10.6%Y/Y. The revision reflected a modest downwards adjustment to the estimate of energy inflation, which nevertheless still rose 0.8ppt to 41.5%Y/Y, the third highest reading on the series, despite a further easing in the annual rate of petrol prices to the lowest since March 2021. Indeed, a jump in electricity and gas prices in October saw the respective annual rates rise 6ppts to a new high above 45%Y/Y and by more than 5ppts to 77½%Y/Y. Food inflation was also confirmed at a series high, up 1.4ppts to 13.1%Y/Y. However, price pressures of other core goods prices continued to trend higher too, with inflation of non-energy industrial goods up a stronger-than-initially-estimated 0.6ppt to 6.1%Y/Y, in part reflecting further increases in the components for clothing and furniture. But while new motor car inflation rose to a new record high above 7%Y/Y, prices of second-hand cars moderated for the second successive month to the lowest since May. And although medical costs rose to their highest since 2012 and the package holiday component ticked slightly higher, an easing in accommodation inflation and lower railway transport costs associated with Spain's discounted travel pass left services inflation unchanged from September at 4.3%Y/Y, and down 0.1ppt from the flash release.

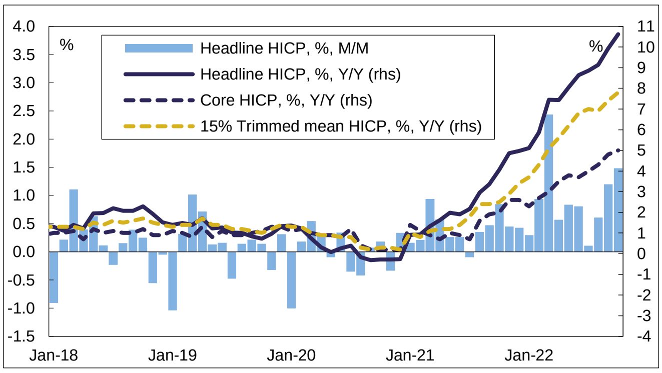
Core and trimmed mean measures up again, but inflation likely now close to its peak

So, today's data left core inflation unrevised from the flash estimate at a new record high 5.0%Y/Y, up 0.2ppt from September. And trimmed mean measures of underlying inflation rose to new highs too, with the 15% rate up 0.4ppt to 7.8%Y/Y, firmly above the equivalent rate in the US (7.0%Y/Y) and underscoring the increasingly broad-based nature of price pressures. While those will remain a concern for many on the ECB's Governing Council, they will in part reflect the pass-through of energy and food price pressures, as well as the impact of other supply-side pressures, to core goods and services prices. And with survey evidence that supply-chain disruption is easing, wholesale prices of energy, food and other commodities much lower, and producer price inflation data suggesting a moderation of pipeline pressures too, inflation should now be close to its peak and fall back steadily next year as recession takes hold.

Construction remained a drag on GDP growth in Q3

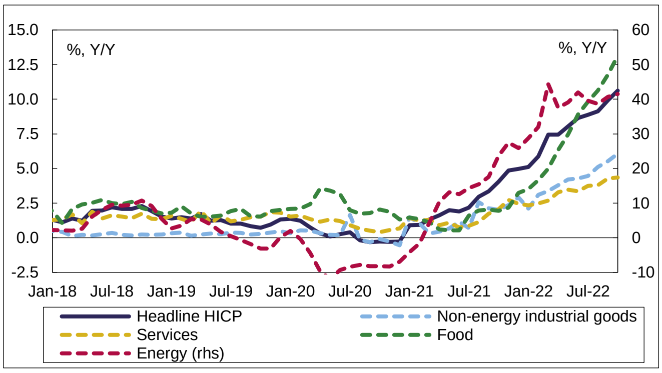
While the manufacturing sector provided modest support to euro area economic growth in the third quarter, today's construction output numbers suggested that the sector continued to struggle in the face of difficulties sourcing raw materials and skilled labour. In particular, activity rose just 0.1%M/M in September, with similarly tepid growth in building work and the

Euro area: HICP inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation – key components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

first modest monthly rise in civil engineering (0.6%M/M) in four. This left output up just 1%Y/Y and down 0.8%Q/Q in Q3, the second successive quarterly contraction. Among the member states, the weakness in Q3 was widespread, including declines in Germany (-0.6%Q/Q), France (-0.2%Q/Q) and Spain (-2.2%Q/Q). And the outlook for the sector is darkening, with activity in certain countries likely to be constrained by ongoing adjustments to past excesses, while the outlook for housing will be impaired by rising borrowing costs. Indeed, the PMIs signalled ongoing contraction in the sector at the start of Q4, with orders declining at the steepest pace since the onset of the pandemic.

The day ahead in the euro area

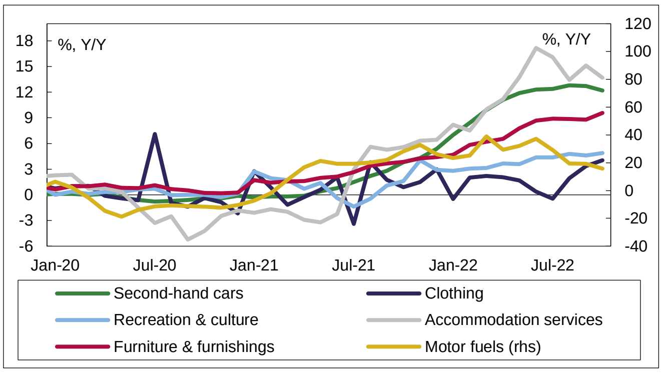
With no key euro area economic data releases scheduled tomorrow, one focus will be on ECB speak, with President Lagarde, hawkish Dutch National Bank President Knot and Bundesbank President Nagel scheduled to speak at a banking conference, while the typically dovish Chief Economist Lane will also speak publicly. In addition, the ECB will publish the amounts of banks' TLTRO-iii loans to be repaid early ahead of the hike in interest rates to be applied from 23 November. The amount of repayments are likely to be relatively high – perhaps in excess of €1.0trn – with financial institutions that focused more on taking advantage of the scheme for arbitrage purposes likely to make use of this new repayment date. Of course, banks with actual funding needs will find that cost of the TLTRO tranches indexed at the deposit rate for the remainder of their duration will still compare favourably to yields demanded in capital markets.

UK

Gilts make losses as fiscal tightening is largely back-loaded to after the next election

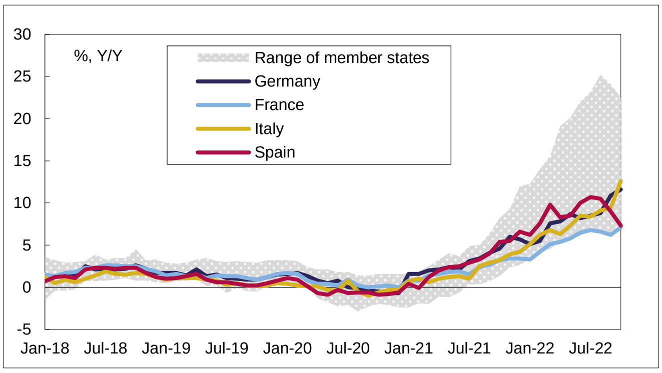
Given the significant worsening in the UK's fiscal outlook, and with the Sunak government desperate to consign the recent Gilt market crisis to history, today's Autumn Budget Statement was predictably the antithesis of September's fateful Truss-Kwarteng fiscal event. Indeed, as he had flagged in advance, Chancellor Hunt announced higher taxes on business and higher-earning individuals, and lower public spending, including cuts to public investment, with the reductions to total expenditure accounting for a little more than half of the total planned fiscal adjustment. Overall, again broadly in line with media reports, the plans announced today aim eventually to reduce public borrowing by £55bn (around 2% of GDP) by 2027/28. However, the lion's share of that fiscal consolidation is planned to take place towards the back end of the forecast horizon, after the next general election (due by January 2025) and hence beyond the end of the monetary policy horizon. Moreover, the detail of the government's energy price guarantee was somewhat more generous than the BoE had assumed in its forecast update earlier this month. So, in response, Gilts trended lower through the afternoon session with losses greatest at the short end of the curve. On balance, today's announcements might suggest than the MPC will need to tighten policy a little more aggressively than it signalled in its (dovish) Monetary Policy Report projections earlier this month. So, overall, we maintain our view that Bank Rate will be hiked by a further 50bps next month, with additional smaller increments in the New Year eventually consistent with a terminal rate of 4.25%.

Euro area: HICP inflation – selected components



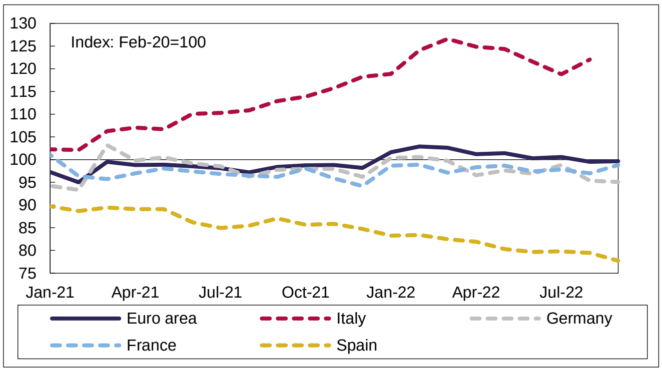
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation by member state



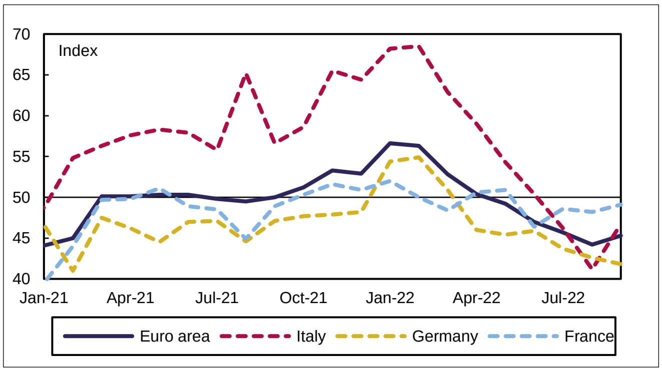
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



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

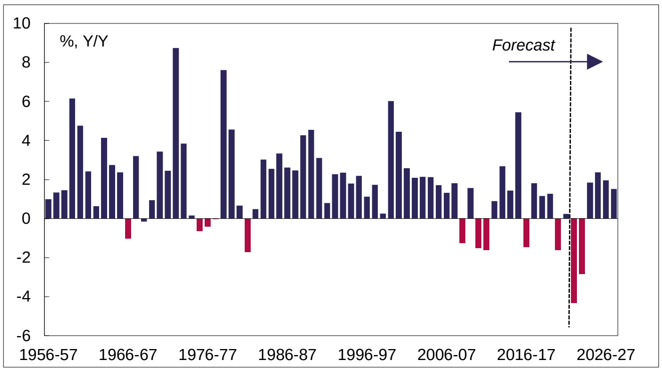
OBR presents bleak economic outlook with a record drop in real disposable incomes

The case for fiscal tightening inevitably reflects the adverse impact of weak economic activity, extremely high inflation and higher interest rates on the outlook for government borrowing. The OBR now forecasts inflation to peak at just above 11%Y/Y this quarter, similar to the BoE's forecast peak of 10.9%Y/Y, and to average close to 7½%Y/Y in 2023, somewhat below the BoE's forecast of a little above 8%Y/Y. One reason for anticipating slightly lower inflation in 2023 than projected by the BoE is the new detail of the government's energy price guarantee. In particular, Hunt announced that a typical household's annual energy bill will rise from £2500 to £3000 from April, somewhat more generous than assumed by the BoE in its projections. Nevertheless, the OBR still forecasts household real disposable income to decline cumulatively by a record 7% over this year and next to fall as far as the level way back in 2013. And so, unsurprisingly, the near-term economic growth outlook remains bleak too. The OBR projects GDP to contract by almost 1½%Y/Y in 2023, with output not expected to return to the pre-pandemic level until the end of 2024.

Forecasts for public borrowing and debt revised sharply higher

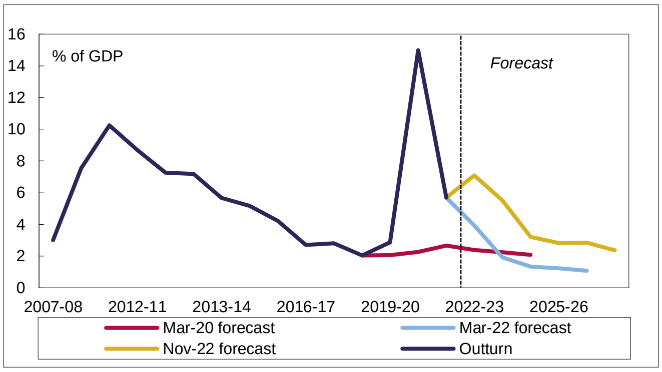
Such a weak economic performance will inevitably take its toll on the public finances. Indeed, the OBR suggested that public sector borrowing will rise to £177bn (7.1% of GDP) in 2022/23, before falling only gradually to £69bn (2.4% of GDP) in 2027/28, to be consistent with one of the government's new fiscal rules that aims to reduce borrowing eventually to below 3% of GDP. So, despite the higher taxes and planned spending cuts, the OBR expects borrowing in five years' time to be almost £50bn higher compared with its previous forecast in March. Roughly three-quarters of this increase reflects higher debt interest payments, up by more than £100bn since March, and expected to reach be a whopping 12% of revenues and 4.8% of GDP in the coming year before easing gradually to 8½% of revenues and 3.4% of GDP by 2027/28. Overall, the OBR forecasts public sector net debt to remain above 100% of GDP through to 2026/27 and underlying debt to rise sharply from 84.3% of GDP last year to almost 98% of GDP in 2025/26, a 63-year high. Given the back-loaded nature of both the cuts to public spending and anticipated economic recovery, the OBR expects public debt eventually to start falling in five years' time to be consistent with the Chancellor's other revised fiscal rule. But the level of public debt will be roughly £400bn higher in 2026/27 than the OBR had forecast in March. Of course, with most of the spending cuts pencilled in for after the election, there must be great doubts that they will ever be implemented. And so, the risks to government borrowing debt over the medium term seem skewed significantly to the upside.

UK: Real household disposable income*



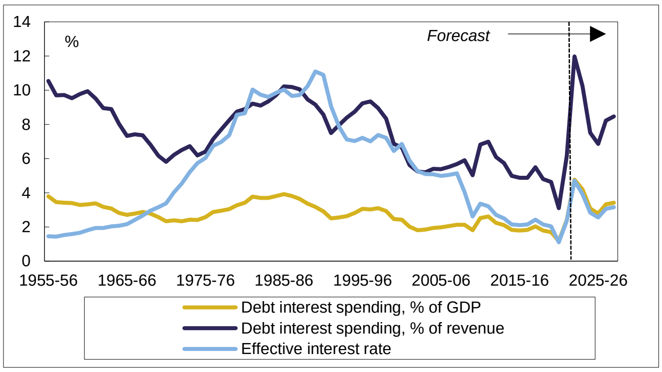
*Per person. Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



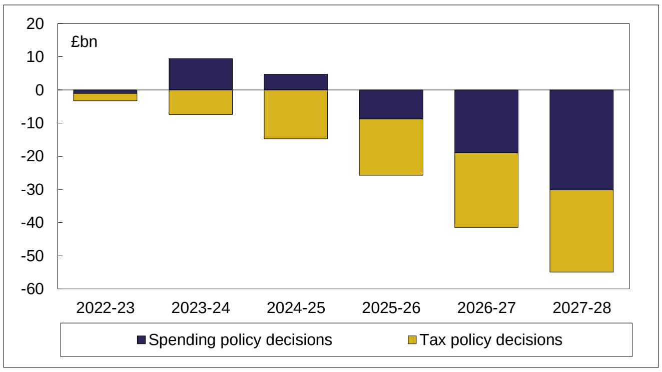
Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Net public debt interest payments



Source: OBR and Daiwa Capital Markets Europe Ltd.

UK: Autumn Statement policy decisions*



*Excludes energy. Impact on net public sector borrowing. Source: HMT and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

After last week's GDP release reported a marked decline in private consumption in Q3, tomorrow's retail sales data will provide an update on spending at the start of Q4. While retail surveys have provided mixed messages, sales in October might well report a modest bounce following September's Bank Holiday-dampened demand for goods. But these data are also likely to illustrate the deterioration in households' purchasing power, with limited spending on non-essentials and big-ticket items: the Bloomberg survey consensus is for an increase of a little more than ½%M/M at the start of Q4, following September's drop of 1.5%M/M, to leave sales down 6½% compared to a year earlier. And the latest GfK consumer confidence survey, also due tomorrow, seems bound to suggest a gloomy outlook for near-term spending prospects too.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	EU27 new car registrations Y/Y%	Oct	**12.2**	-	9.6	-
	Final HICP M/M% (Y/Y%)	Oct	**1.5 (10.6)**	*1.5 (10.6)*	1.2 (9.9)	-
	Final core HICP Y/Y%	Oct	**5.0**	*5.0*	4.8	-
	Construction output M/M% (Y/Y%)	Sep	**0.1 (1.0)**	-	-0.6 (2.3)	**-1.0 (2.0)**
Italy	Trade balance €bn	Sep	**-6.5**	-	-9.6	**-9.5**

Auctions

Country	Auction
France	sold €2.29bn of 0.75% 2028 bonds at an average yield of 2.21%
	sold €1.63bn of 0.50% 2029 bonds at an average yield of 2.20%
	sold €837mn of 0.10% 2031 index-linked bonds at an average yield of -0.10%
	sold €462mn of 3.15% 2032 index-linked bonds at an average yield of -0.05%
	sold €199mn of 0.10% 2047 index-linked bonds at an average yield of 0.33%
Spain	sold €1.75bn of 0.00% 2025 bonds at an average yield of 2.35%
	sold €1.66bn of 0.70% 2032 bonds at an average yield of 2.90%
	sold €873mn of 5.15% 2044 bonds at an average yield of 3.30%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK	00.01	GfK consumer confidence	Nov	-46	-47
	07.00	Retail sales including auto fuel M/M% (Y/Y%)	Oct	0.4 (-6.5)	-1.4 (-6.9)
	07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Oct	0.6 (-6.8)	-1.5 (-6.2)

Auctions and events

Country	GMT	Event
Euro area	08.30	ECB President Lagarde scheduled to speak
	13.15	ECB's Knot and BoE's Mann scheduled to speak at ECB event
	-	ECB publishes TLTRO III repayment amounts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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