Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Despite a modest downwards revision to euro area headline inflation, Bunds were little changed as core inflation continued to flatline above target.
- Gilts were also little changed as UK inflation moved sideways at almost double the 2% target but a drop in core inflation left the door open to a November rate cut.
- On Thursday, the BoE will leave Bank Rate on hold but should announce a slowdown in the pace of QT over the coming 12 months.

Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	1.999	+0.001
OBL 2.2 10/30	2.278	-0.004
DBR 2.6 08/35	2.674	-0.017
UKT 3¾ 03/27	3.950	-0.007
UKT 4⅜ 03/30	4.071	-0.004
UKT 4½ 03/35	4.623	-0.014

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

Euro area

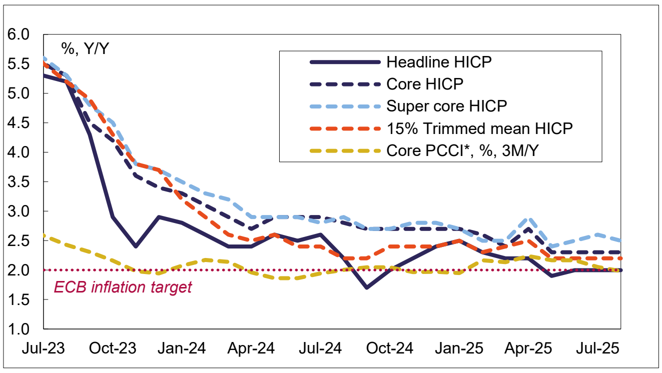
Headline inflation revised down to 2.0%Y/Y for third month, but core rate still stuck above-target

Headline euro area HICP inflation was revised down 0.1ppt from the flash estimate to 2.0%Y/Y, bang in line with the ECB's target for the third successive month. The downwards revision principally reflected the slightly lower estimate in Italy (down 0.1ppt to 1.6%Y/Y) published yesterday. And it will have no impact whatsoever on the ECB's assessment of the inflation outlook. Indeed, the downwards revision was a minimal 0.8bp, with inflation now estimated at 2.044%Y/Y to three decimal places. And it merely reflected the energy component, which was revised down 0.1ppt to -2.0%Y/Y, still a five-month high due to an unfavourable base effect. All other major components were unchanged from the flash estimate. So, inflation of food, alcohol and tobacco moderated very slightly to 3.2%Y/Y. And while inflation of unprocessed food rose to a 19-month high of 5.5%Y/Y, that reflected a base effect as prices of such items declined for a third successive month. Most importantly, services inflation eased 0.1ppt to 3.1%Y/Y, the lowest since March 2022. However, that reflected a softening in vacation-related items including airfares, which are typically volatile and had contributed positively in July, and hotels. And with inflation of non-energy goods low and steady at 0.8%Y/Y, core inflation moved sideways at 2.3%Y/Y for a fourth successive month, also in line with the flash estimate.

Inflation to fall back below target from January in part thanks to German energy policy support

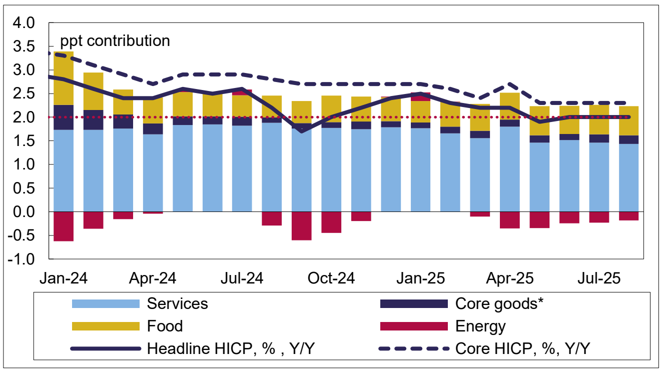
The flatlining of core inflation above target tallies with the assertion of ECB President Lagarde at her previous policy meeting that 'the disinflationary process is over'. Alternative indicators of underlying inflation, including trimmed-mean, super-core and weighted-median rates, also suggest the disinflation process has petered out. And core inflation momentum, whether measured on a three- or six-month annualised basis, edged up in August to around 2½%. We expect core inflation to continue to trend sideways around 2.3%Y/Y into the New Year. And given another unfavourable energy base effect, headline inflation will likely pick up back above target in September, and average above 2.0%Y/Y in Q4. But energy inflation will take a step down in January in part due to German government policies aimed at cutting electricity prices. So, headline inflation should also fall below 2.0%Y/Y from the start of 2026 and remain sub-target throughout next year. Indeed, the ECB expects it to drop to just 1.4%Y/Y in Q126 before moving gradually higher over the following four quarters. We do not think that inflation will fall at the start of next year quite as far as the ECB anticipates. But we do expect it to touch 1½%Y/Y by mid-2026 as labour cost growth moderation and services disinflation eventually resumes in response to softer labour demand. So, we expect core inflation to fall below 2.0%Y/Y from Q226 too, and in the absence of new shocks the headline and core rates should remain sub-target into 2027. But, like the ECB, we expect a fiscal policy-driven pickup in economic growth and higher policy-related energy costs eventually to push inflation back near target by the end of the monetary policy horizon, a baseline outlook that justifies Lagarde's judgement that rates remain in a 'good place' with no urgency to change policy.

Euro area: HICP inflation & underlying measures



*Persistent and common component measure of inflation, excluding food and energy. Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation & contributions



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

The day ahead in the euro area

Thursday's dataflow will bring a further update on economic momentum in the euro area at the start of Q3, with July construction activity figures. Despite modest growth in Germany and France, a further downwards adjustment in Spain (-4.5%M/M) for a third successive month following an extreme surge in April suggests that aggregate euro area output offered no support to GDP growth at the start of Q3. Thursday will also bring euro area balance of payments figures for July, which will include an update of portfolio flows to and from the region over the past twelve months.

UK

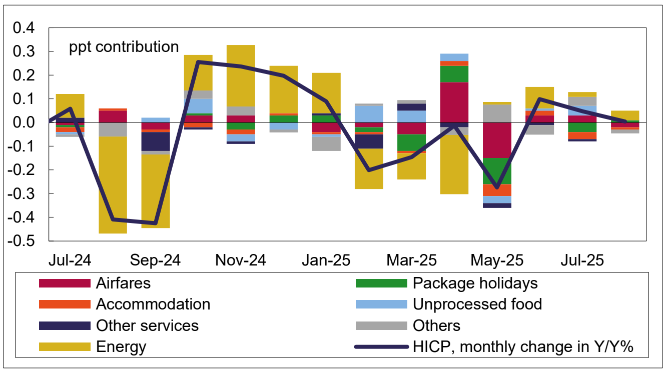
Headline inflation remains sticky, but in line with the BoE's projection

Today's UK inflation data provided no major surprises, with the headline CPI rate unchanged in August at 3.8%Y/Y, the joint-highest rate since January 2024 and still the most elevated in all of the G7 countries. But this was nevertheless bang in line with the BoE's projection for that month. And while a rate cut at tomorrow's meeting is off the table, the detail in today's report neither definitively supported nor ruled out a cut in November when the MPC will be presented with updated macroeconomic projections and the current inflationary uptrend will hopefully have peaked. Despite the sideways move in the headline rate in August, energy again provided an upwards impulse, with the respective annual rate rising to a more than two-year high due to a pickup in auto fuel prices which contrasted the sizeable decline a year earlier. And the MPC members most concerned about potential second-round effects from rising food prices might be most disappointed to see a further pickup in inflation of food, alcohol and tobacco to a 17-month high (5.3%Y/Y). This notwithstanding, food inflation was a touch softer than Bank staff had forecast in August.

Core inflation eases to leave door open to November rate cut

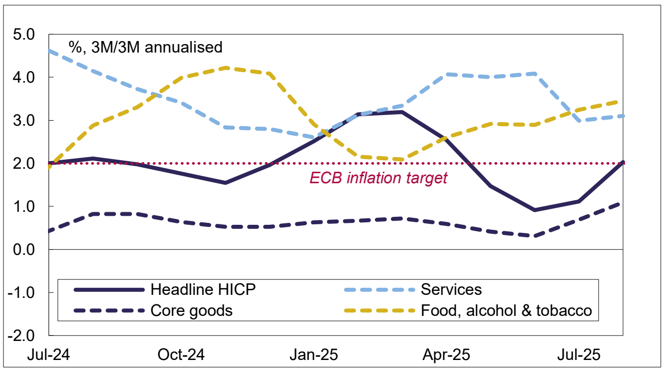
Encouragingly, core inflation fell 0.2ppt in August to 3.6%Y/Y, a three-month low. Most notably, services inflation fell 0.3ppt to 4.7%Y/Y, reversing the increase recorded in July to match the second-softest reading since spring 2022. Admittedly, like in July, the change on the month related to the timing of seasonal pricing in travel-related components, with inflation of airfares dropping a huge 19ppts to -3.5%Y/Y and package holidays moderating more than 1ppt to a five-month low. Together this knocked almost 0.4ppt off services inflation and 0.2ppt off the headline CPI rate. This was in part countered by a jump in accommodation inflation to a seven-month high. But this too might have been impacted by temporary factors. Indeed, a measure of underlying services inflation closely watched by the BoE – which excludes indexed and volatile components, rents and foreign holidays – edged up just 0.1ppt to 4.1%Y/Y in August, still 0.3ppt below the average of the past 12 months,

Euro area: Contributions to change in HICP inflation



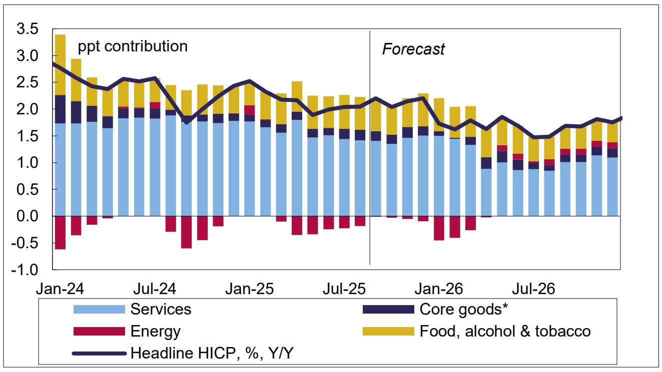
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation momentum



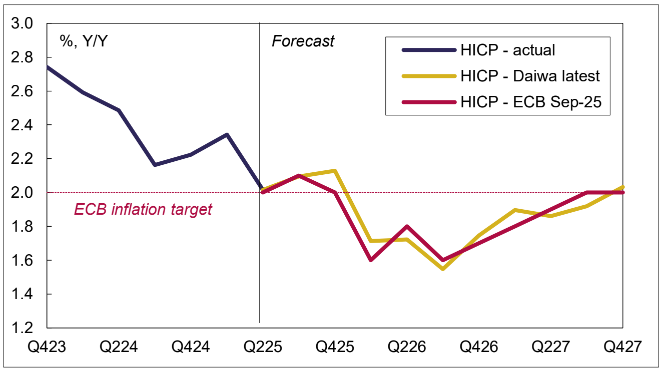
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation contributions & projection



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

Euro area: Inflation projections compared



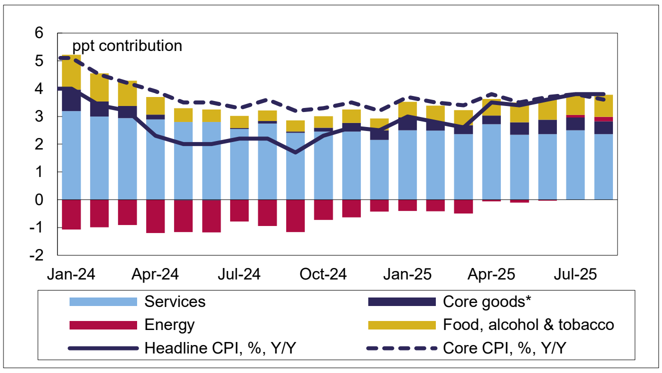
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

almost 3½ppts below the 2023 peak and still one of the softest readings since October 2021. Core goods pricing was also seemingly better behaved, with the change in prices weaker than the norm for the month for just the second time this year. Admittedly, the weakness reflected more significant discounting of garden furniture than usual. And it still left non-energy industrial goods inflation unchanged at 1.6%Y/Y. But not least due to the disinflationary impact of past sterling appreciation, as well as the prospect of increased volumes of cheap imports diverted away from the US, we expect this to be close to the peak for the foreseeable future.

Inflation likely to resume gradual downtrend in Q4, but MPC members to remain split on risks

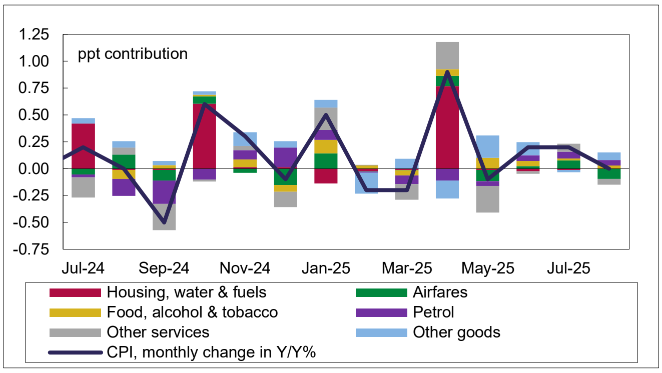
Due principally to unfavourable base effects in the energy component this month – with prices down almost 2%M/M a year ago – we expect headline inflation to rise marginally further in September, by 0.1ppt to 3.9%Y/Y, a touch below the Bank staff expectation (4.0%Y/Y). Thankfully, this should mark the peak. Despite the 2% hike in household energy tariffs in October, the energy component will take a step down that month and maintain a downtrend through to the spring. Signs of normalisation in pricing elsewhere in Europe also supports our expectation that food inflation has perhaps reached the top of the current cycle. And while services inflation is likely to move broadly sideways over the coming six months, we continue to expect a step down next April, and a gradual moderation thereafter supported by softer wage growth. Like the BoE, we continue to expect inflation to move gradually back to the 2% target by spring 2027, particularly as we also expect non-negligible fiscal tightening to be announced in the government's autumn Budget. As such, on balance, in the absence of significant upside surprises in the inflation and wage data to be published next month, we continue to expect a slim majority on the MPC to support a further rate cut in November. But the MPC's large minority of hawks will likely remain concerned about the impact of recent high inflation outturns on price expectations and wage demands and will therefore continue to vote to keep Bank Rate unchanged for the remainder of the year and possibly in early 2026 too.

UK: Contributions to CPI inflation



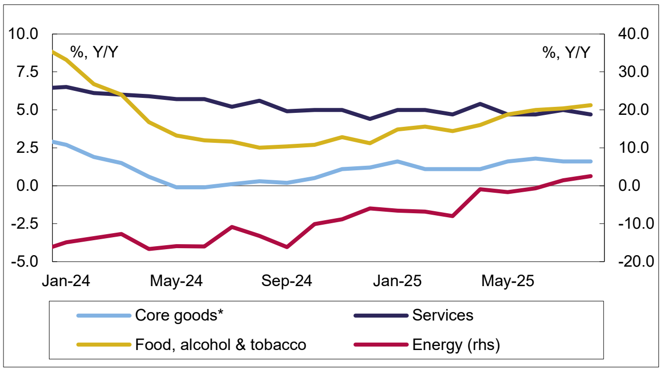
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to monthly change in CPI inflation



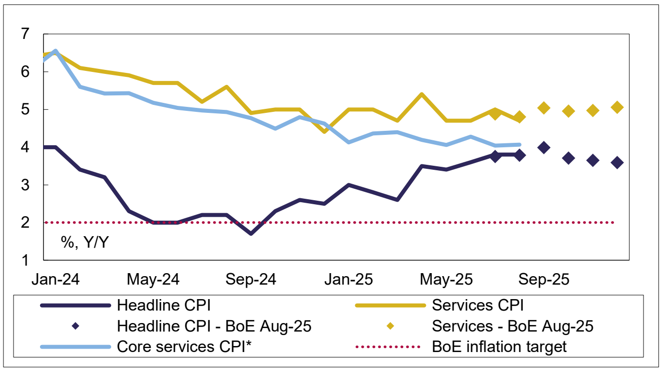
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key CPI inflation components



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

UK: Headline & services CPI inflation

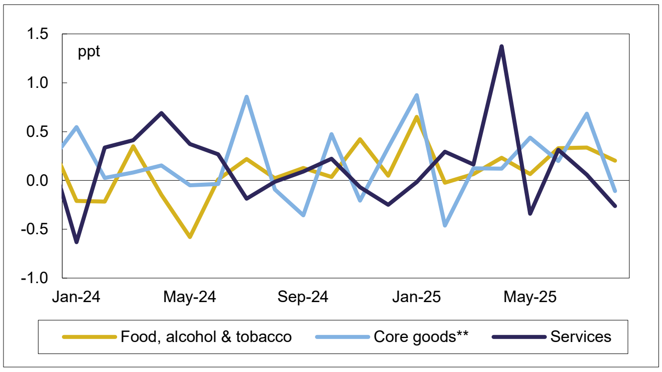


*Excluding volatile and indexed items, foreign holidays and rents.
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

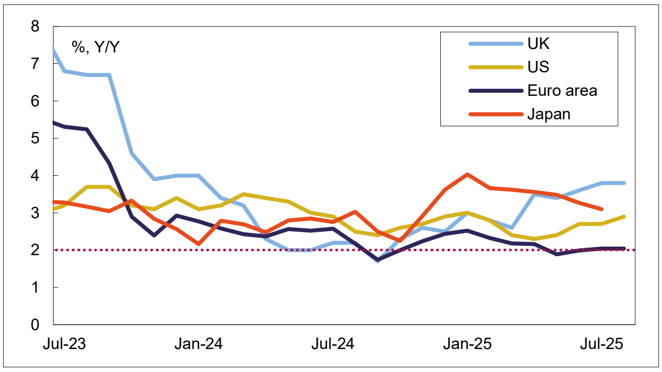
The main focus in the UK tomorrow will be the BoE's monetary policy decision. Of course, the MPC seems bound to keep Bank Rate unchanged this month. But the latest economic data – including yesterday's labour market report and today's inflation figures – suggest that the Committee will maintain its forward guidance that a 'gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate'. Contrasting the three-way split in August, we expect at least seven of the nine rate-setters to favour holding Bank Rate at 4.00%, with external members Taylor and Dhingra perhaps favouring less restrictive policy. With no change expected in Bank Rate, of most interest tomorrow will be the MPC's decision with regards to Quantitative Tightening (QT). Since reserve balances peaked at £975bn in January 2022, the BoE has markedly reduced the size of its balance sheet through a combination of roll-off and, unlike its central bank peers, active sales of bonds. The BoE is widely expected to announce a slower pace of QT for the coming 12 months from £100bn over the past 12 months, not least due to a significant reduction in redemptions, from £87bn to just £49bn over the coming 12 months. Indeed, we doubt that the BoE will seek to compensate for that shortfall by ramping up active sales. As such, our expectation is that the BoE will announce a reduction in the pace of QT to around £60bn, maintaining a similar pace of active Gilt sales as conducted over the past 12 months. But given the uncertain impact of its Gilts sales on yields, we also see a strong case for ending them altogether and allowing QT to proceed from now on merely in a passive way via roll-off, in line with policy at the Fed, ECB and BoJ, at a rate of £49bn over the coming 12 months.

UK: Deviations from long-run monthly price change*



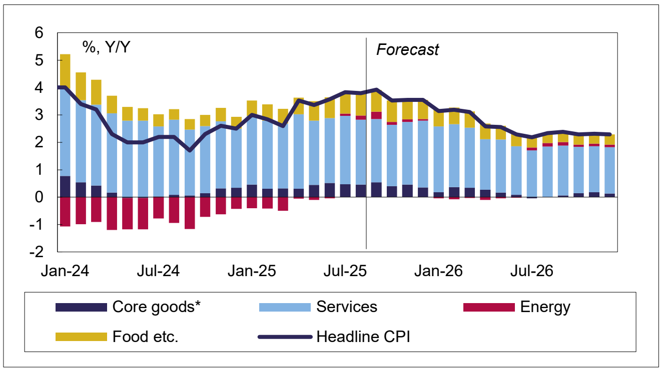
*Monthly change in prices compared with average for the month in the decade before the pandemic. **Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Headline CPI inflation in the major economies



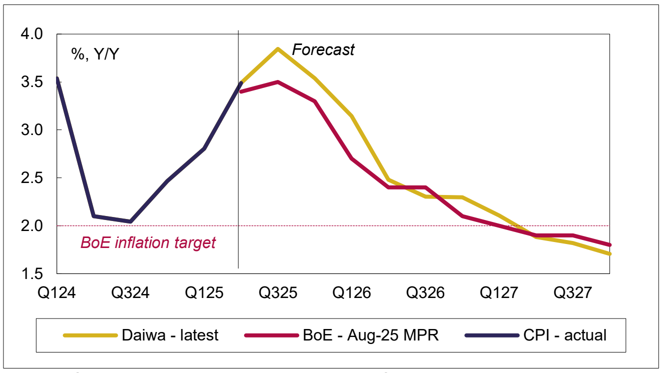
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Inflation contributions & projection



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

UK: Inflation projections compared



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final headline (core) HICP Y/Y%	Aug	**2.0 (2.3)**	*2.1 (2.3)*	2.0 (2.3)	-
UK		Headline (core) CPI Y/Y%	Aug	**3.8 (3.6)**	*3.9 (3.8)*	3.8 (3.8)	-
		House price index Y/Y%	Jul	**2.8**	-	3.7	3.6

Auctions

Country		Auction
Germany		sold €756m of 1.25% 2048 bonds at an average yield of 3.18%
		sold €1.13bn of 2.9% 2056 bonds at an average yield of 3.25%

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	Current account €bn	Jul	-	35.8
		10.00	Construction output M/M% (Y/Y%)	Jul	-	-0.8 (1.7)
UK		12.00	BoE Bank Rate %	Sep	*4.00*	4.00

Auctions and events

Country		BST	Event
Euro area		09.00	ECB Vice-President de Guindos to speak at an MNI event on the 'euro area growth & inflation outlook'
France		09.50	Auction: to sell up to €11.5bn of 0.75% 2028, 2.4% 2028, 2.7% 2031 & 3.5% 2035 bonds
		10.50	Auction: to sell up to €1.5bn of 0.6% 2034, 0.1% 2038 & 0.55% 2039 inflation-linked bonds
Spain		09.30	Auction: to sell 2.4% 2028, 3.2% 2035 & 4% 2054 bonds
UK		12.00	BoE monetary policy announcement and minutes to be published
		12.00	BoE to publish quarterly Agents' summary of business conditions (Q325)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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