Euro wrap-up

Overview

- Bunds made significant losses as wholesale energy prices surged and the ECB's updated macroeconomic projections pointed to the strong likelihood of additional policy tightening to come after today's unanimous rate hike.
- As expectations for a future BoE rate hike increased, Gilts underperformed with 2Y yields at a near-3-year high and 10Y yields reaching the loftiest level since 2007.
- Friday will bring UK monthly GDP figures for July along with the BoE's quarterly consumer inflation expectations survey for Q3.

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Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	3.231	+0.166
OBL 2.9 10/31	3.309	+0.108
DBR 3 08/36	3.497	+0.056
UKT 4 05/29	4.867	+0.174
UKT 4⅛ 03/31	4.946	+0.162
UKT 4⅞ 07/36	5.372	+0.112

*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

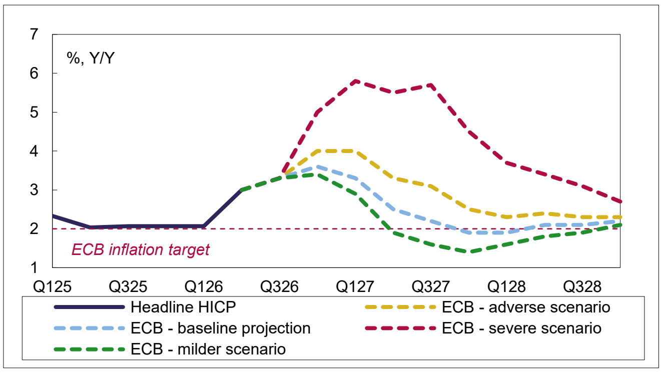
ECB 25bp hike a 'no brainer' as likelihood of further tightening is signalled by updated projections

As was inevitable, the ECB today raised its deposit rate by 25bps to 2.50%. In her press conference, President Lagarde noted that the decision was unanimous and a "no brainer". She added that it was robust under each of the ECB's updated energy price scenarios, whether adverse, severe or benign. And while the Governing Council repeated that future decisions will be data dependent and taken on a meeting-by-meeting basis, with no predetermined path for rates, the description of the inflation outlook and the detail of its updated baseline projections made clear that policy is likely to be tightened again by year end, with scope too for further hikes in 2027. Indeed, with echoes of the language used during the tightening cycle after Russia's invasion of Ukraine, the policy statement asserted that "inflation is set to remain well above target for an extended period" to suggest a material increase in hawkishness from recent meetings. And crucially, while the updated projections incorporated an extra rate hike compared to those published in June – implying two further increases this cycle after today's – the baseline outlook for core inflation was revised up from Q127 onwards and by 0.1ppt to 2.3%Y/Y at the end of the horizon in Q428. Of course, if events in the Middle East take a sudden turn for the better, there would be plenty of time for the inflation outlook to improve. But, for the time being, the tone of today's ECB communications and detail of its updated projections have led us to crystallise our forecast of another rate hike in December, to 2.75%, and the likelihood of further tightening in 2027 if there is no marked decline in energy prices by then. And with energy price curves now well above those used in the ECB's baseline projections, reports today that an October hike is possible are credible.

Near-term baseline inflation outlook looks too soft given rise in energy prices above assumed path

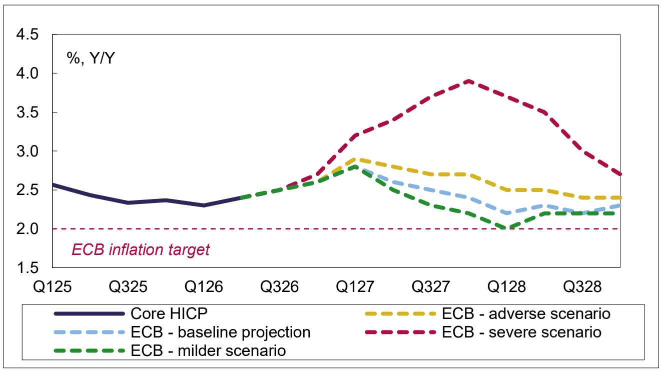
The ECB revised up its inflation outlook despite the recent slight undershooting of its June forecast thanks to lower-than-expected food prices. The baseline assumption used for crude oil prices was also lower than in June. But the assumption for gas prices was revised up. As a result, the baseline profile for energy inflation was shifted significantly higher from the current quarter through to Q327. Reassuringly, the ECB still judges pass-through from the energy cost shock to other prices to be limited. But given greater resilience of economic activity and the labour market than it had previously anticipated, the ECB nudged up its near-term GDP growth outlook to 0.9%Y/Y and 1.4%Y/Y this year and next. And that firmer profile for demand and jobs – which has been bolstered by spending on defence, infrastructure and AI-related activity – called for the upwards revision to the baseline outlooks for core inflation in 2027 and 2028 to 2.6%Y/Y and 2.3%Y/Y respectively. Under that baseline scenario, headline inflation is expected to peak at 3.6%Y/Y next quarter before falling back close to target by Q427. But current energy price curves are closer to the assumptions used in the ECB's adverse scenario, under which GDP growth is expected to slow to 0.2%Q/Q in each of the next two quarters while inflation peaks around 4.0%Y/Y at the turn of the year. And under that adverse scenario, core inflation is expected to remain as high as 2.4%Y/Y by the end of the horizon.

Euro area: Headline inflation projections



Source: ECB Sep-26, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation projections

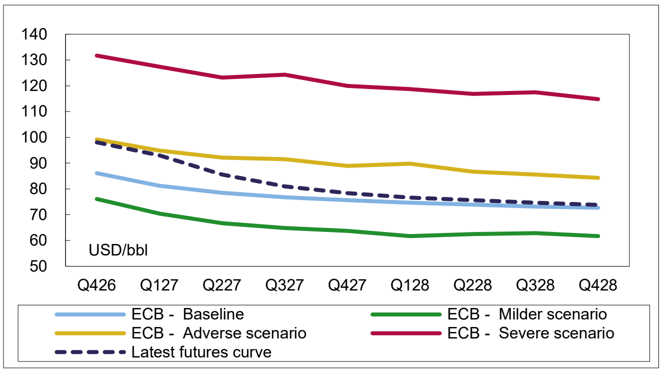


Source: ECB Sep-26, Macrobond and Daiwa Capital Markets Europe Ltd.

German inflation illustrates energy & AI-related pressures, but core CPI relatively stable (for now)

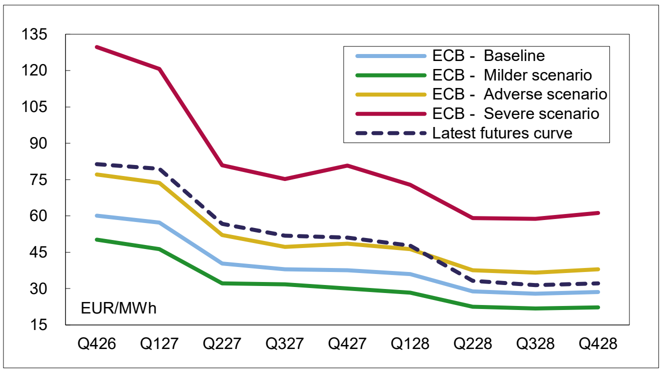
Today's final German inflation readings for August thankfully provided no nasty surprises, matching the flash estimates and so confirming that the headline rates on both the EU-harmonised and national measures rose just 0.1ppt to 2.9%Y/Y. Those figures nevertheless matched the highest levels since winter 2023/24. The detail suggested that the direct effects of this year's energy shock remained the primary source of upward pressure, with underlying inflation appearing relatively contained. Petrol prices rose to post-reunification record levels in August, up around 20% since February, while heating oil prices were the highest since January 2023, almost a third higher over the same period. The detail provided further evidence of AI-related price pressures, with inflation in external hard disks (35%Y/Y) and memory cards (63%Y/Y) remaining exceptionally strong. Several other consumer electronics items, including PCs and tablets, also recorded double-digit annual price growth. In contrast, the pickup in clothing inflation likely related to shifts in the timing of seasonal discounting relative to last year and should therefore prove temporary, while price pressures in household appliances, furniture and new cars remained subdued. Policymakers continue to be pleasantly surprised by the continued absence of meaningful food price pressures, with inflation of this category unchanged at just 0.1%Y/Y despite fears of passthrough from the energy price shock. And at face value, services inflation was more encouraging too, easing to a four-year low (2.8%Y/Y). While this in part reflected further disinflation in cultural services and accommodation, it was flattered by package holiday prices, which are typically highly volatile. Indeed, when excluding the more volatile tourism-related components, there were hints of rising momentum in underlying services inflation.

Euro area: Brent oil futures & ECB assumptions



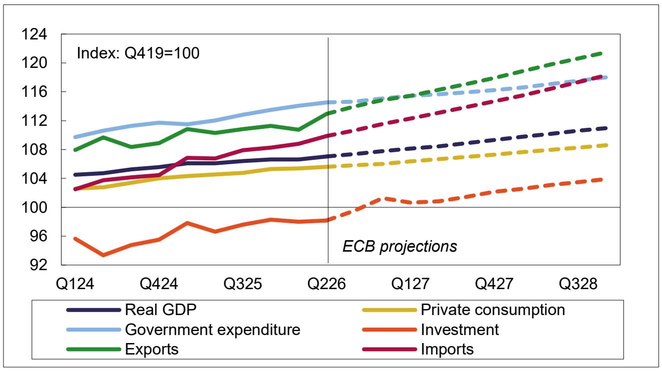
Source: ECB Sep-26, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas futures & ECB assumptions



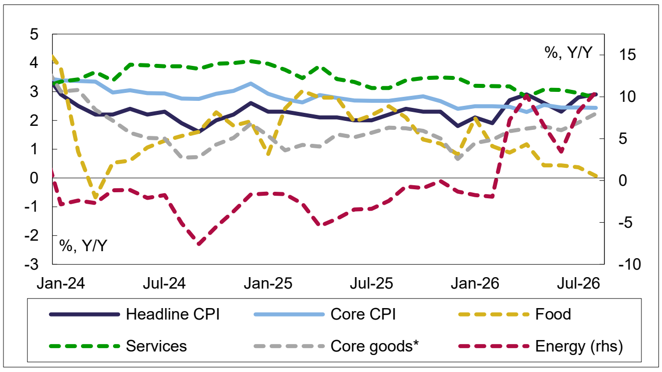
Source: ECB Sep-26, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: GDP & expenditure levels projections



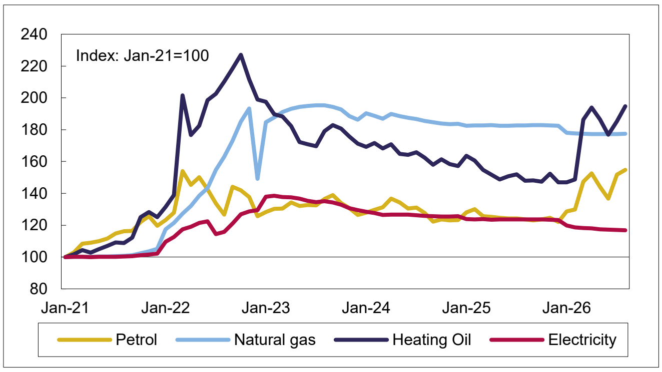
Source: ECB Sep-26, Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: CPI inflation & key components



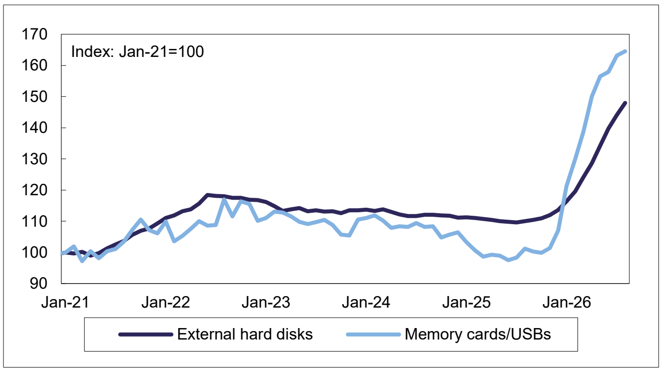
**Non-energy industrial goods.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Petrol & household energy price levels



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: AI-related price levels



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

A speech by ECB Chief Economist Lane in Wexford could provide some additional colour to his staff's updated macroeconomic projections. But with little economic data due besides, it should be a relatively quiet end to the week for economic news from the euro area.

The day ahead in the UK

With the BoE's monetary policy meeting looming into view, the UK data will ramp up over the coming week starting with July's monthly GDP on Friday. Growth only slowed slightly to 0.4%Q/Q in Q2, above the BoE's projection, thanks to a surprisingly strong pickup of 0.3%M/M in June. And the carryover from that month into Q3 alone suggests that the risks to the BoE's forecast for a merely flat quarter are to the upside. That month's strength reflected sustained momentum in the services sector, particularly within ICT, professional, transport and storage services. And there was also evidence of a 'World Cup boost' for some media subsectors, food and beverage producers. Alongside July's record-breaking sunshine, the factors could have sustained their support into July. And while the PMIs weren't a particularly good guide to GDP in Q2, a 'Burnham bounce' and improving geopolitical picture at the start of Q3 pointed to a pickup in momentum. Still, we expect growth to remain subdued, probably no better than 0.1%M/M. Certainly, a further weather-related boost for consumer-facing services isn't guaranteed. Despite lower fuel prices, retail sales fell back quite sharply as relentless heat dampened footfall in stores, and construction activity might also struggle to achieve a material rebound as a result too. Meanwhile, although likely inconsequential to September's rate decision, the BoE/Ipsos' quarterly inflation attitudes survey will also be of particular interest to policymakers. The previous survey – which was conducted in early May when wholesale oil prices were close to their peaks but CPI inflation was tracking below 3%Y/Y thanks to the lag from regulated electricity prices – reported that consumer year-ahead inflation expectations had jumped a steep 0.8ppt to 4%Y/Y, the highest since Q422.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB Deposit (Refinancing) Rate %	Sep	**2.50 (2.65)**	*2.50 (2.65)*	2.25 (2.40)	-
Germany	Final HICP (CPI) Y/Y%	Aug	**2.9 (2.9)**	*2.9 (2.9)*	2.8 (2.8)	-
Italy	Industrial production M/M% (Y/Y%)	Jul	**0.7 (0.0)**	0.3 (-0.6)	-1.0 (-0.6)	-1.1 (-)
Spain	Industrial production M/M% (Y/Y%)	Jul	**0.6 (2.3)**	-	-0.7 (1.1)	-
UK	RICS house price balance %	Aug	**-28**	-30	-30	-29

Auctions

Country	Auction
Italy	sold €3.5bn of 3% 2029 bonds at an average yield of 3.43%
	sold €3.5bn of 3.35% 2033 bonds at an average yield of 3.98%
	sold €750mn of 2.15% 2072 bonds at an average yield of 4.61%
UK	sold £5bn of 4.625% 2030 bonds at an average yield of 4.786%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Industrial production M/M% (Y/Y%)	Jul	**-0.4 (-0.5)**	0.2 (0.4)	0.1 (-0.1)	-0.1 (-)

Auctions

Country	Auction
Germany	sold €4.2bn of 3% 2036 bonds at an average yield of 3.39%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy		09.00	Unemployment rate %	Q2	-	5.3
UK		07.00	Monthly GDP M/M% (3M/3M%)	Jul	*0.1 (0.3)*	0.3 (0.7)
		07.00	Services output M/M% (3M/3M%)	Jul	0.0 (0.5)	0.4 (0.5)
		07.00	Industrial output M/M% (Y/Y%)	Jul	-0.2 (0.2)	-0.2 (-0.2)
		07.00	Construction output M/M% (Y/Y%)	Jul	0.1 (-2.3)	-0.1 (-2.3)
		07.00	Trade (goods trade) balance £bn	Jul	-5.0 (-22.4)	-5.5 (-23.0)
		09.30	BoE/Ipsos inflation attitudes survey - 1Y ahead CPI Y/Y%	Aug	-	4.0

Auctions and events

Euro area		18.00	ECB Chief Economist Lane to give speech in Ireland
UK		09.30	BoE to publish Agents' summary of business conditions for September

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.