Euro wrap-up

Overview

- Bunds made gains at the longer end of the curve as euro area inflation in August was revised down despite matching a three-year high.
- Gilts rallied across the curve as the BoE's MPC left Bank Rate unchanged with the same majority in favour of the decision as in July and agreed a long-term plan for QT, ceasing its sales of its longest-dated Gilts.
- Friday will bring data for UK retail sales, euro area construction output and the ECB's consumer expectations survey.

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Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	3.219	+0.010
OBL 2.9 10/31	3.299	-0.011
DBR 3 08/36	3.474	-0.029
UKT 4 05/29	4.734	-0.022
UKT 4⅛ 03/31	4.808	-0.037
UKT 4⅞ 07/36	5.222	-0.074

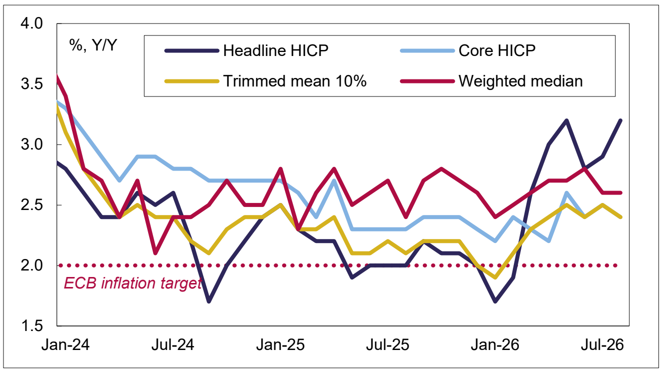
*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

Euro area inflation matches three-year high despite modest downwards revision from flash

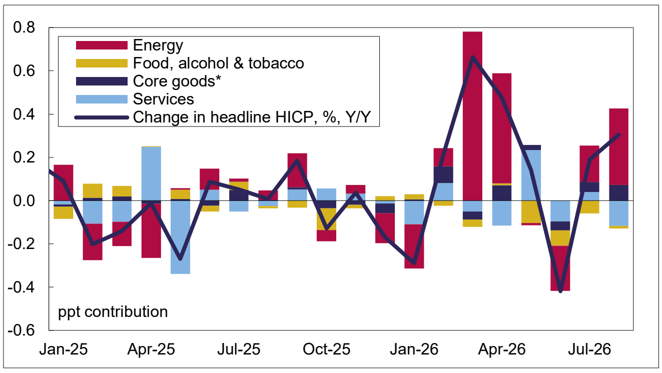
As we expected following modest revisions to several member state estimates, the final euro area inflation data for August brought a very slight downward revision to the headline HICP rate, by 0.1ppt to 3.2%Y/Y (0.01ppt to two decimal places to 3.25%Y/Y). Nevertheless, this matched the highest rate in almost three years and 1.3ppts above the level recorded in February before the escalation of the Middle East conflict. The key driver was again energy inflation, which rose the most since January 2023. That was due principally to rebounding transport fuel inflation to a four-year high (24.5%Y/Y), while household energy inflation accelerated to its strongest rate in more than three years (4.9%Y/Y). Encouragingly, there remained little evidence that higher energy costs are feeding through to the broader inflation basket. Certainly, food and non-alcoholic beverage inflation continued to moderate, to 0.7%Y/Y, less than one third its rate prior to the Iran conflict and the lowest in more than five years. And despite the extended summer heatwave, three-month momentum in fresh food inflation was the weakest in more than two years. In addition, services prices rose the least in any August in six years, pushing the respective inflation rate down to a four-month low (3.0%Y/Y). Despite higher prices of aviation fuel, this in part reflected a larger decline in airfares than a year earlier, to push the annual rate of that component down 3.2ppts to a four-month low. And restaurant and rents inflation was also softer, offsetting a further modest impulse in certain communications services. Meanwhile, the uptick in non-energy industrial goods inflation to a 2½-year high of 1.2%Y/Y largely reflected the timing of summer discounting of clothing and furniture. But ICT equipment inflation was also its highest on the series, again flagging the effects of demand pressure in AI-adjacent sectors. Overall, underlying price pressures remain relatively contained, with core inflation falling 0.1ppt to 2.4%Y/Y, matching its rate before the Iran war.

Euro area: Measures of inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contribution to change in inflation



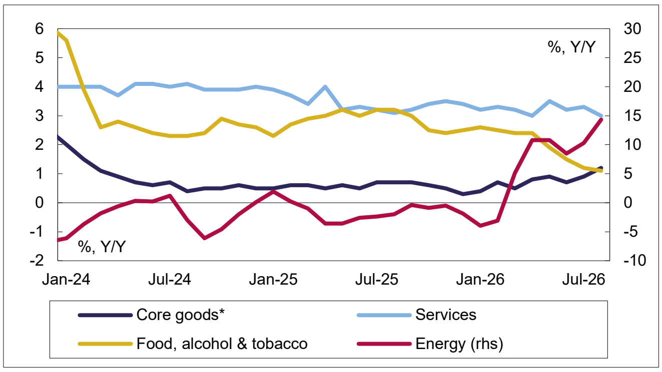
**Non-energy industrial goods.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Risks to inflation outlook tilted to upside, but underlying price pressures still contained

Of course, risks to the near-term inflation outlook remain firmly tilted to the upside due to persistently elevated wholesale energy prices, which continue to track closer to the ECB's adverse scenario presented last week. Indeed, weekly petrol and heating oil prices in the first two weeks of September were around 5% and 16½% higher respectively than at the end of August. As such, we now expect energy inflation to approach 20%Y/Y in the coming months. Food and core goods inflation are also likely to pick up over the next few quarters. So, while services inflation should remain broadly stable in the near term, we have revised up our forecast for headline HICP inflation, expecting it to peak above 4%Y/Y in Q127. For now at least, we expect the peak in core inflation to be more modest, still below 3%Y/Y. And the latest ECB wage tracker, labour costs data and continued easing in labour demand suggest that second-round inflation pressures should remain well-contained. Policymakers may expect the recent acceleration in the prices of frequently purchased items, which rose above

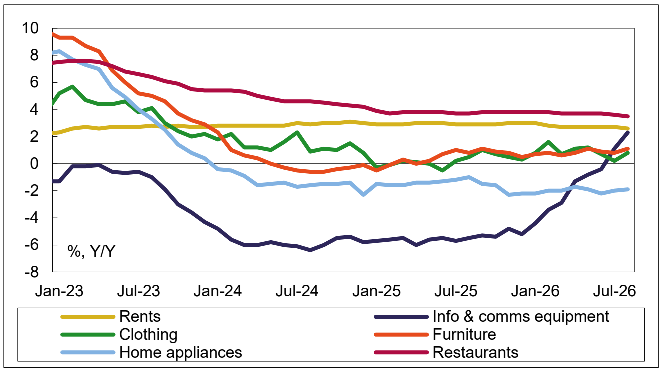
4%Y/Y in August, to weigh more heavily on household demand in the near term. Nevertheless, with core inflation set to remain above target through to the end of the forecast horizon, and the deposit rate considered by many Governing Council members not yet to be restrictive, we expect a majority of policymakers to continue to err on the side of caution. In the absence of an improvement in energy prices, we therefore continue to expect at least one further rate hike before year-end, with both October and December remaining live meetings.

Euro area: Key inflation components



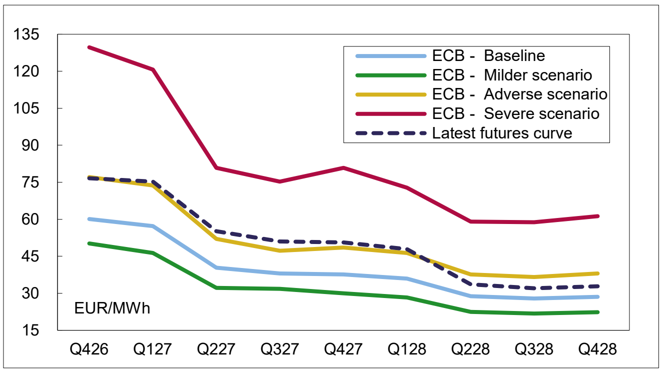
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services & goods components



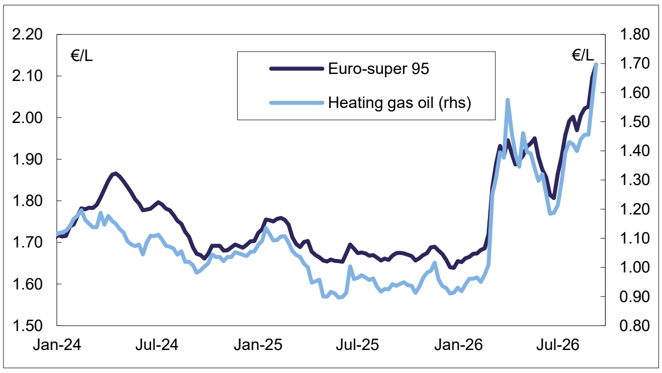
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas futures & ECB assumptions



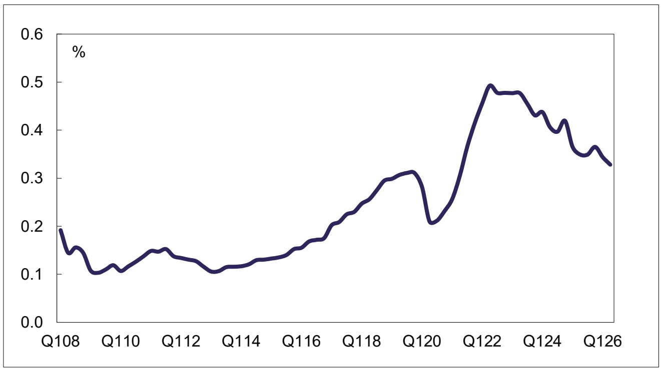
Source: ECB Sep-26, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Weekly petrol & heating oil prices



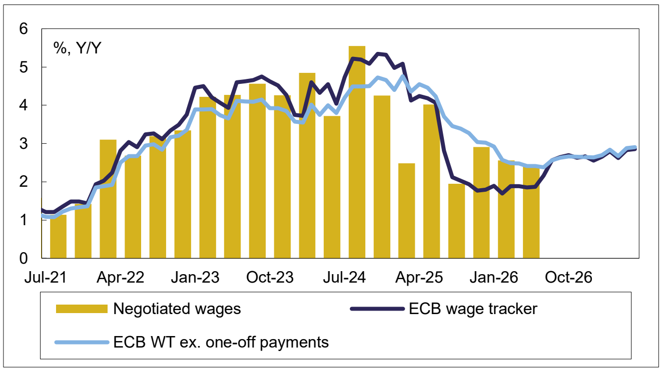
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Vacancy to unemployment ratio



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ECB wage tracker & negotiated wages



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

The day ahead in the euro area

A handful of data releases is slated for release on Friday, including updates on euro area construction output, German producer prices and the ECB's Consumer Expectations Survey. The latter should be of particular interest. Indeed, while the ECB's wage tracker continues to provide reassurance that price increases have not yet fed through into pay settlements, policymakers will be conscious that higher inflation expectations could yet lead workers to seek higher compensation. In July, expectations for inflation in three years' time edged down for a second consecutive month to 2.7%Y/Y, a five-month low, albeit still slightly above its pre-war norm. A return to levels at the onset of the war (3.0%Y/Y) perhaps seems far-fetched but a modest increase would be unsurprising given the latest step-up in inflation and broader reacceleration in energy prices. Those wholesale pressures are also bound to be reflected in the German PPI data, likely pushing the headline rate beyond July's 3-year high and closer to 4%Y/Y on account of unfavourable base effects too. Details beyond those prices directly influenced by energy, such as food, will also be closely watched. Meanwhile, despite weather-related disruption in across many member states including France and Spain, firmer activity in Germany is expected to have led euro area construction output higher in July. But its increase is likely to have been insufficient to offset June's decline and will likely leave construction output trending slightly less than ½% below its level in Q2.

UK

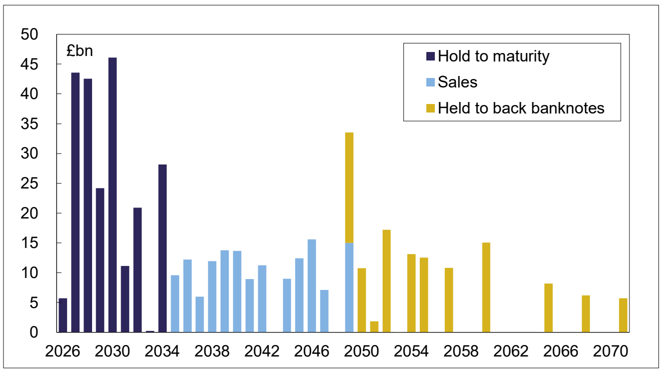
BoE MPC again votes 6-3 to keep Bank Rate unchanged, but clearly moves closer to a hike

As expected, the BoE left Bank Rate unchanged at 3.75%, with the vote on the MPC (6 members in favour, 3 against) unchanged from the previous policy meeting in July. However, the policy statement and members' views expressed in the minutes, suggest that the Committee has moved much closer to raising rates. And unless wholesale energy prices fall significantly from current levels by then, we would continue to expect a large majority of members to vote to hike Bank Rate by 25bps at the next policy meeting in November. Once again, however, today the majority took comfort from the fact that there remains little evidence so far of second-round effects from the energy shock on price- and wage-setting. And they also recognised that the soft labour market and tightening of financial conditions over recent months should weigh on inflation over time. But they additionally know that, with spot energy prices now closer to their previous 'adverse' scenario than their baseline outlook, inflation is set to rise further over the next couple of quarters, perhaps to above 4%Y/Y in Q1. And the longer that energy prices remain high, the greater the risks that second-round effects will sustain high inflation thereafter. Our interpretation of their updated views published today is that up to seven MPC members (all bar Taylor and Dhingra) would vote for a rate hike in November if energy prices remain close to current levels and the autumn wage settlements and/or key surveys point to rising risks of second-round effects. And with economic growth so far this year stronger than the BoE anticipated too, if the Burnham government's first Budget at end-October is stimulative, that would further strengthen the case for a hike.

BoE to cease its sales of long-dated Gilts in new plan to reduce holdings steadily to 2034

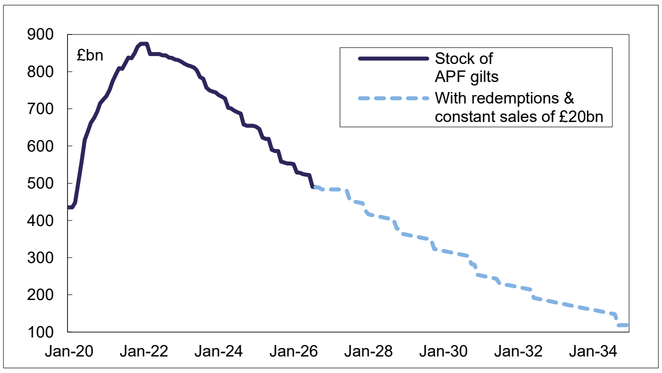
With some market participants evidently positioned for a more hawkish outcome, the MPC's 6-3 vote in favour of unchanged rates gave support to shorter-dated Gilts and weighed on sterling. But it was the longer end of the Gilt curve that rallied hardest thanks to the Bank's updated plan for Quantitative Tightening, which was more radical than expected. Over the past 12 months, the BoE has reduced its stock of Gilts held for monetary purposes by £70bn in purchase proceeds terms, with £21bn of that reduction achieved via sales back to the market. Of its auctions, about 20% were accounted for by bonds with a maturity of 20 years or more. And the sales and redemptions have taken the total stock of its Gilts in its asset purchase facility (APF) to £488bn, more than £400bn below the peak in early 2022. Seemingly mindful of the potential impact on longer-dated yields of its asset sales, but also wary of the continued threat of fiscal dominance posed by its holdings and uncertainty surrounding its annual reviews of the programme, the Bank today announced a plan to return its Gilts held for monetary purposes steadily back to zero by 2034 at an average annual reduction of £46bn per year. Specifically, it will retain to maturity in the APF £222bn of its Gilts with the shortest maturities, i.e. all those scheduled to mature before 2035. At the same time, it will also cease sales altogether of its longest-dating Gilts. Instead, the £120bn of those bonds scheduled to mature in 2049 and beyond will be retained as assets held to match the liabilities of current and future banknote issuance rather than held for monetary purchases. The remaining £146bn of APF Gilts, which are scheduled to mature between 2035 and 2049, will be sold until 2034 at an average of £20bn per year, around the recent pace. But rather than auctioning them back into the market, the BoE intends to sell them back to the Government via the DMO. The modalities are those sales have yet to be finalized but will be announced by April 2027. Until that date, the BoE's asset sales have been suspended.

UK: BoE APF maturity profile & planned treatment



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE Asset Purchase Facility redemptions



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

BoE September 2026: MPC members' views

MPC member	Vote	Selected quotes from the MPC minutes
Governor Bailey	3.75%	"There has been a material increase in energy prices since July… The risk for energy prices, and thus inflation, continues to be on the upside. The geopolitics of the situation makes the upside risk more prominent..." "Domestic inflationary pressures have continued to ease. The labour market continues to be soft … [but] with risks to energy and food prices more to the upside, second-round effects could materialise more strongly." "… if the conflict in the Middle East persists…and the risk of second-round effects emerging increases, it is likely that policy may have to tighten."
Deputy Governor Breeden	3.75%	"What matters is the outlook for [second-round inflation] effects… domestic slack and […] financial conditions should continue to lean against inflationary dynamics becoming embedded. But the scale and likely duration of the energy price shock has increased and there is the potential for more global shocks – related to climate, food prices and AI." "Material uncertainty is likely to continue, but if risks to the outlook for second-round effects crystallise, it becomes increasingly appropriate for Bank Rate to respond."
Deputy Governor Ramsden	3.75%	"[There are] tentative indications of a bottoming out in labour market easing, activity continues to be surprisingly resilient, and external pressures may start to push up on food prices. So there is more risk that domestically generated price pressures could start to emerge in the near future." "…the risks to the inflation outlook have tilted more to the upside. Whilst the policy stance continues to provide restrictiveness, were upside pressures on the inflation outlook to continue to build, there could be a case for increasing Bank Rate."
Deputy Governor Lombardelli	3.75%	"The impact of the conflict to date has been [less] than expected on both sides of the inflation and activity trade-off." "…the longer high and volatile energy prices persist, the more inflationary pressure is building…The balance of risks to inflation has shifted more to the upside since our last policy decision." "The outlook for energy prices is uncertain and could change in the coming weeks, but the case for raising Bank Rate is building the longer the conflict continues without lasting resolution."
Swati Dhingra	3.75%	"My view of the outlook remains largely unchanged… [I still] see value in waiting for a clearer read on the durable scale of the shock over the coming months, including evidence on first-round energy effects and the conditions for 2027 wage and price-setting. This would still allow time to adjust Bank Rate appropriately to mitigate second-round effects..." "With consumption subdued, vacancies below pre-pandemic levels and margins not expanding, the domestic economy appears unlikely to sustain second-round effects that would magnify the initial impulse."
Alan Taylor	3.75%	"The shock is real, and risks are skewed upwards. But policy should respond to evidence of propagation rather than mechanically to volatile ticks in headline energy prices. So far, that evidence is limited." "Clearly, any evidence of emergent second-round effects would build the case for tightening. Equally, if geopolitical tensions abate and inflation pressures ease, an easing of policy should be in sight."
Catherine Mann	4.00%	"[Our short-term forecast projects CPI reaching] over 4% early next year, mechanically driven by energy prices and expected increases in food price inflation. Both of these are salient for households' inflation attentiveness and both will be uncomfortably high ahead of wage negotiations next spring." "Raising Bank Rate is a better risk-management strategy when faced with uncertainty… Doing so avoids a worse outcome whereby inflation becomes embedded, which requires even tighter policy later."
Megan Greene	4.00%	"Previous arguments around a limited risk of second-round effects from the conflict have hinged on economic slack. But resilience in labour demand and activity suggest slack may have already peaked." "Beyond the conflict in Iran, persistent inflationary pressures could come from El Niño, AI-related supply constraints and the reversal of a multi-decade disinflation in global goods. Waiting for definitive evidence of second-round effects before acting would leave policy behind the curve…"
Chief Economist Pill	4.00%	"A 25-basis point increase in Bank Rate now sends a clear signal of the MPC's commitment to achieving its price stability mandate amidst the fog of geopolitical conflict and data noise." "Raising Bank Rate would put the MPC in a better place to address risks to price stability… especially since any resulting second-round effects, once entrenched, are costly to overcome."

Source: BoE (September 2026 Monetary Policy Summary & Minutes) and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

August retail sales figures will provide the highlight of UK dataflow on Friday. Sales volumes fell sharply in July (-0.5%M/M) as high temperatures discouraged shopping in-store and rising electricity bills and fuel prices squeezed household incomes. Indeed, the latest rise in fuel prices is suggestive of weaker fuel sales and the signals from retail surveys such as the BRC's point to broader softness. Of course, those surveys have failed to tally with the recent strength in the official retail sales series, with sales (including fuel) still up 1.1%3M/3M in July. And consumer confidence jumped to a two-year high last month, while major purchase intentions were the least downbeat since December 2021. However, while payback for July's softness and support from cooler temperatures cannot be discounted, we still expect a modest second successive decline in sales in August.

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	**3.2 (2.4)**	*3.3 (2.4)*	2.9 (2.5)	-
UK		BoE Bank Rate %	Sep	**3.75**	*3.75*	3.75	-

Auctions

Country		Auction
France		sold €2.424bn of 2.4% 2029 bonds at an average yield of 3.59%
		sold €2.864bn of 2.7% 2031 bonds at an average yield of 3.78%
		sold €5.669bn of 3.25% 2032 bonds at an average yield of 3.92%
		sold €2.034bn of 2% 2032 bonds at an average yield of 4.01%
		sold €2.5bn of 2.1% 2037 inflation-linked bonds at an average yield of 2.29%
Spain		sold €1.355bn of 0.7% 2032 bonds at an average yield of 3.558%
		sold €1.696bn of 3.45% 2034 bonds at an average yield of 3.796%
		sold €2.689bn of 3.4% 2036 bonds at an average yield of 3.960%

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	ECB consumer expectations survey - 1Y (3Y) ahead CPI Y/Y%	Aug	3.1 (2.8)	2.9 (2.7)
		09.00	ECB current account €bn	Jul	-	35.1
		10.00	Construction output M/M% (Y/Y%)	Jul	-	-1.3 (-0.7)
Germany		07.00	PPI Y/Y%	Aug	3.9	3.0
UK		07.00	Retail sales - incl. auto fuels M/M% (Y/Y%)	Aug	-0.2 (1.9)	-0.5 (1.6)
		07.00	Retail sales - excl. auto fuels M/M% (Y/Y%)	Aug	-0.2 (1.9)	-0.9 (2.3)

Auctions and events

Country		BST	Event
Euro area		10.15	ECB President Lagarde to join press conference following informal ECOFIN meetings in Dublin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.