

Euro wrap-up

Overview

- Bunds made losses, while French and Belgian spreads widened amid ongoing Budget concerns and a lack of progress in Middle East talks.
- While UK inflation and public sector borrowing rose more than expected, Gilts made gains as central government cash borrowing undershot expectations.
- Thursday will bring the October survey results for euro area consumer confidence, alongside French and UK business sentiment.

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Daily bond market movements

Bond	Yield	Change
BKO 3.0 12/28	3.105	+0.033
OBL 2.9 10/31	3.228	+0.033
DBR 3 08/36	3.418	+0.021
UKT 4 05/29	4.919	-0.035
UKT 4½ 03/31	4.994	-0.036
UKT 4¾ 07/36	5.377	-0.032

*Change from close as of 5.00pm BST.

Source: Bloomberg

UK

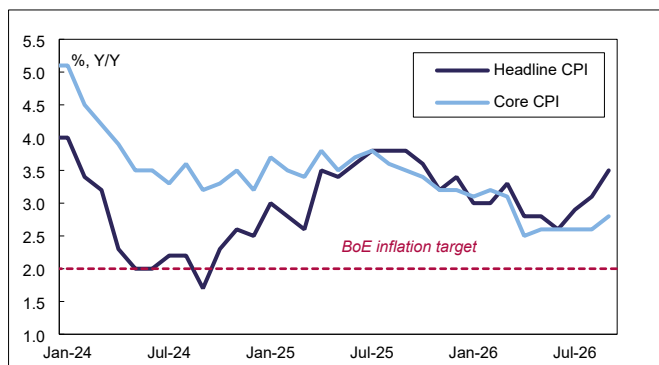
Headline inflation jumps to 11-month high as energy costs accelerate

With [economic growth](#) much stronger than expected, the [labour market](#) showing signs of stabilisation and inflation repeatedly surprising to the upside, it would now be a significant shock if the MPC failed to raise Bank Rate on 5 November, in what would be its first hike since August 2023. Today's inflation figures arguably added to the case for tightening. The headline CPI rate rose for a third successive month in September, and by a stronger-than-expected 0.4ppt to an 11-month high of 3.5%Y/Y. This left it some 0.4ppt above the Bank's central projection published in late July, while the quarterly rate of 3.1%Y/Y matched the Bank's adverse scenario. Once again, however, the upside surprise was largely attributable to energy. Prices of motor fuel jumped a further 5.4%M/M, with the cost of diesel rising to its highest level since July 2022. Together with another double-digit rise in the price of kerosene (22.7%M/M), energy inflation jumped more than 4ppts to a 3½-year high of 17.9%Y/Y, accounting for more than half of the increase in headline inflation.

Uptick in core inflation led by typically volatile goods & services

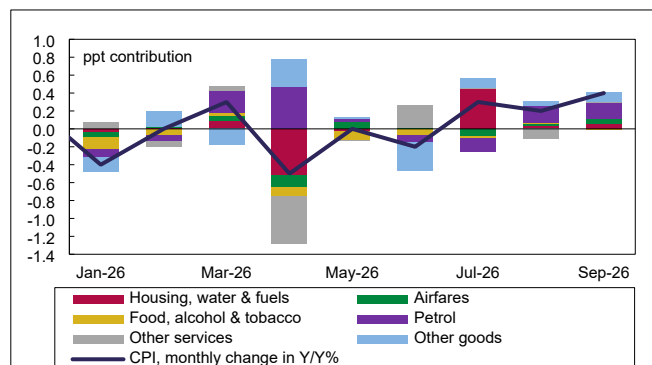
Core inflation also increased in September, rising 0.2ppt to a six-month high of 2.8%Y/Y, broadly in line with expectations. But the details were less concerning than the headline increase implied, with the pickup concentrated in typically volatile components. Certainly, the increase in services inflation, by 0.3ppt to 3.7%Y/Y, largely reflected airfares and live music concert prices. This was partly offset by a moderation in hotel inflation to a six-month low. And when excluding indexed and volatile components, underlying services inflation edged up just 0.1ppt to 4.2%Y/Y, remaining below rates seen at the onset of the US-Iran conflict. Similarly, the uptick in core goods inflation to a still subdued 1.0%Y/Y was related to likely one-off effects associated with the launch of a new computer game and iPhone. While cost pressures remained evident in some ICT products, including memory cards and USB sticks, these continued to have a negligible impact on headline inflation. Meanwhile, food, alcohol and tobacco inflation continued to undershoot the Bank's expectations, moving sideways at 1.6%Y/Y for a third consecutive month. There were, however, tentative signs of pipeline pressures emerging, with higher input costs and the summer drought seemingly beginning to feed through as fresh vegetable prices posted their largest September increase since 2022.

UK: Headline & core CPI inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly change in headline inflation



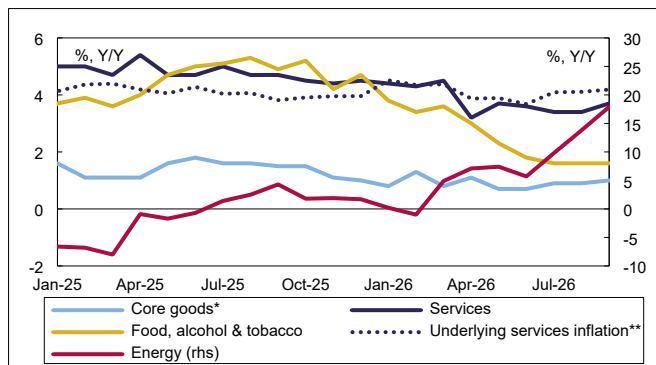
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Headline inflation to peak above 4¼%Y/Y, with core inflation set to remain above target too

Energy will remain the principal driver of inflation over coming months. Indeed, the 4% increase in the Ofgem household energy price cap in October, alongside further rises in petrol and diesel prices, will likely push energy inflation above 20%Y/Y

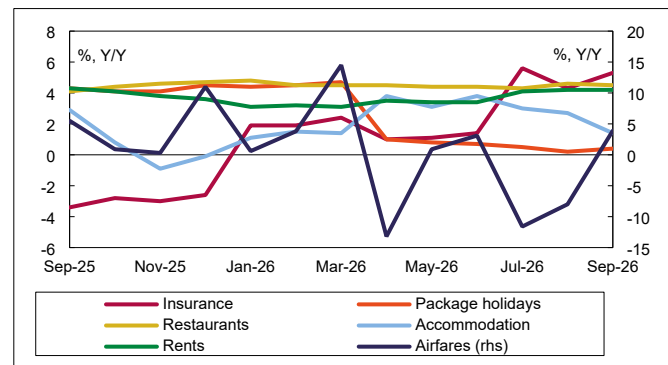
this month. Moreover, recent wholesale gas and oil futures point to the risk of another double-digit increase in household energy tariffs in January too. So far, the indirect effects of the energy shock appear relatively contained. Nevertheless, pipeline cost pressures have continued to build. Manufacturing input prices recorded their largest monthly increase since April in September, lifting the respective PPI inflation rate to 8.3%Y/Y. Producer output price inflation climbed to 4.6%Y/Y, similarly the highest in 3½ years. Refined petroleum products were a key source of pressure at both the input and output stages, while inflation remained elevated across several energy-intensive products. But the picture elsewhere was considerably softer, with producer price inflation for food remaining exceptionally subdued and inflation of other goods including clothing and autos still markedly negative. If sustained, the tightening of financial conditions over recent weeks is likely to weigh on demand over coming quarters. And labour slack and relatively well anchored price and wage expectations should limit the extent to which the energy shock generates sustained second-round inflationary effects. Nevertheless, we continue to expect headline inflation to peak above 4¼%Y/Y in early 2027, before gradually falling from Q2 onwards as long as conditions in the Middle East and energy markets gradually improve. And with core inflation expected to reach 3%Y/Y or more throughout much of 2027 and still be around 2½% at end-2028, one rate hike alone might ultimately prove insufficient to return inflation sustainably to target.

UK: Key CPI inflation components



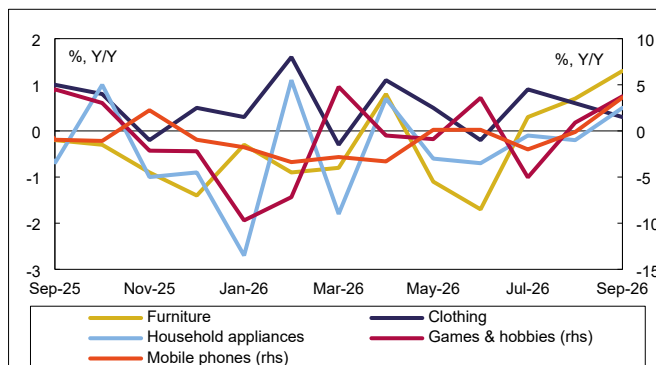
*Non-energy industrial goods. **Excluding indexed and volatile components.
 Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services CPI components



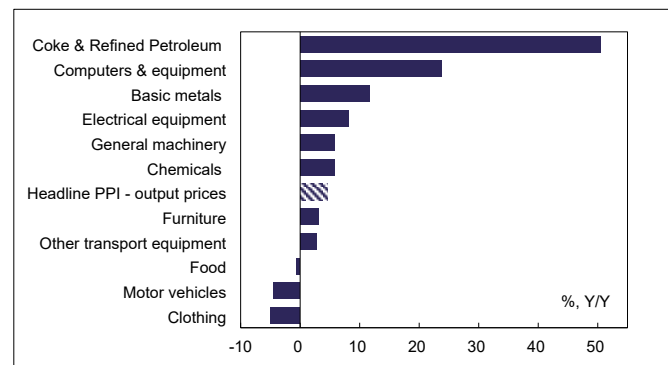
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected goods CPI components



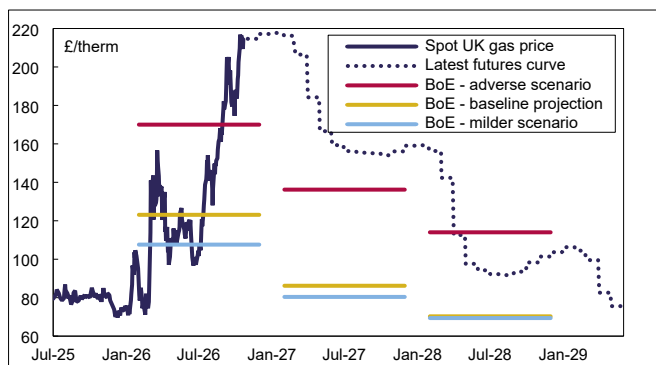
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Producer output price inflation, Sep-26



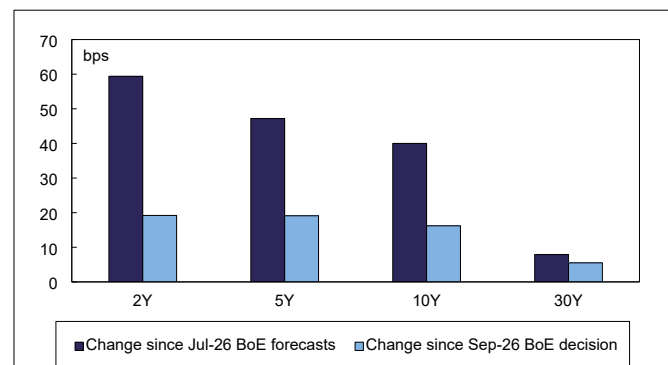
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Natural gas curves & BoE assumptions



Source: BoE July-26 MPR, Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Change in Gilt yields

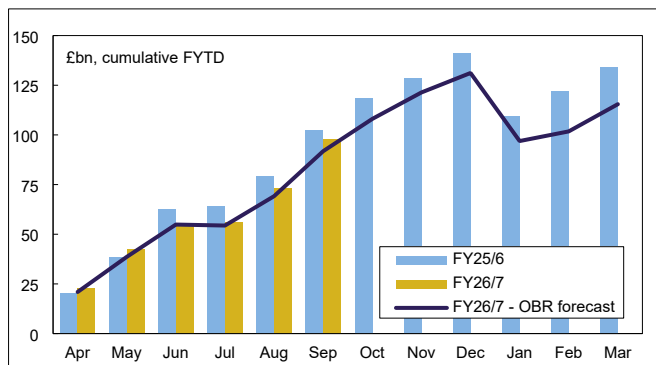


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Public borrowing again exceeded expectations in September to run well above OBR forecast

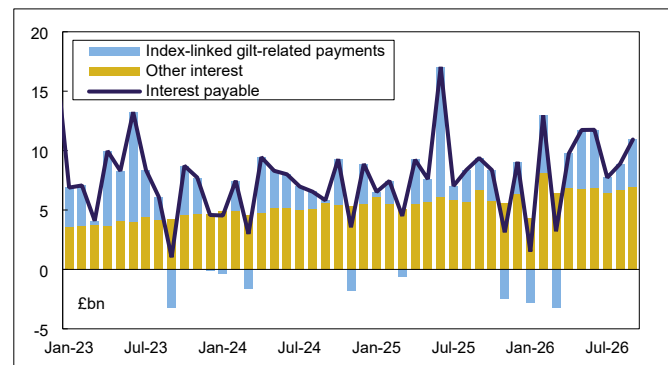
Ahead of next week's UK Budget announcement (28 October), today's public finances data reinforced the limited scope for meaningful fiscal giveaways against the backdrop of the ongoing global energy price shock. Net public sector borrowing in September reached £24.5bn, a touch above both the OBR's forecast and the level a year earlier, owing once again to higher government expenditure on debt interest payments. So, despite the downwards revision to the prior month, cumulative borrowing in the first six months of the fiscal year reached £97.8bn, down just £4.4bn from the same period in FY25/6 and a chunky £6.0bn above the OBR's forecast despite stronger-than-expected economic activity. Of course, together with the cumulative cost of small policies announced by PM Burnham since his appointment, that overshoot implies an erosion of Chancellor Healey's fiscal 'headroom', previously estimated at about £24bn. And while he might be prepared to accept a slightly smaller buffer than his predecessor, he will also be keen not to repeat past mistakes of welcoming speculation over coming months by leaving it too small. With big decisions on spending – including strategic priorities like defence and devolution – likely to be deferred until a review next year, revenues are likely to shoulder most of that shortfall. Indeed, higher taxes on gambling firms and a reversal of cuts to the bank surcharge made in 2023 are amongst the touted options, with the latter to be worth around £2bn in tax revenue. But fundamentally, there is a great deal of uncertainty with respect to the outlook and, moreover, the OBR's various forecast judgements with respect to Gilt yields, inflation, GDP and wage growth and their implications for revenues. Overall, with limited space to manoeuvre policy in either direction, we expect the fiscal stance to be little changed. And since today's data also showed that the central government's net cash requirement significantly undershot the OBR's forecast over the first six months of the fiscal year, the DMO's gilt remit this year should not be revised materially higher.

UK: Public sector net borrowing



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

UK: Central government debt interest payments



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

Thursday will bring a brief lull to the flow of top-tier economic data in the UK. Still, the CBI's industrial trends survey will provide an alternative signal for manufacturing sector activity at the start of Q4 ahead of Friday's flash PMI release. While that survey had an extended period of downcast readings, it improved markedly in recent months to better reflect the modest expansion showcased by the PMIs. Alongside the more familiar indicators concerning manufacturers' order books and price intentions, October's release will feature updates to quarterly indicators on business optimism and investment intentions.

The day ahead in the euro area

The French INSEE business survey – whose larger sample arguably provides a better gauge of economic activity in France than the corresponding PMI survey – will also provide a prelude to Friday's preliminary survey releases. Following a notable recovery in activity over the summer, the headline business climate index eased to a three-month low in September (96), led by weaker sentiment in the services and retail sectors. And, broadly speaking, we see a continuation of that trend as most likely, given the persisting energy shock and not least heightened political and fiscal uncertainty which embodied recent market volatility and social unrest. Indeed, the situation in France poses a material downside risk to the Commission's preliminary consumer confidence reading, pointing towards a second monthly decline in a row and another subdued reading overall.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
UK	 Headline (core) CPI Y/Y%	Sep	3.5 (2.8)	<u>3.4 (2.6)</u>	3.1 (2.6)	-
	 PPI – output (input) prices Y/Y%	Sep	4.6 (8.3)	4.4 (7.6)	3.7 (6.1)	3.8 (6.7)
	 Public sector net borrowing £bn	Sep	24.5	24.0	18.3	17.3
	 House price index Y/Y%	Aug	0.9	-	1.4	1.2

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	 05.00	New car registrations Y/Y%	Sep	-	4.5
	 15.00	Preliminary Commission consumer confidence indicator	Oct	-17.0	-16.5
France	 07.45	INSEE business (manufacturing) confidence indicator	Oct	96 (101)	96 (101)
	 07.45	INSEE production (own-company production) outlook indicator	Oct	-	-9 (15)
UK	 11.00	CBI industrial trends - total orders (selling prices) net % balance	Oct	-	-9 (12)
	 11.00	CBI industrial trends - business optimism % net balance	Q4	-	-36

Auctions and events

UK	 10.00	Auction: to sell £1bn of 0.125% 2031 inflation-linked bonds
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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