The Bad Economic Hits Keep Coming in Europe

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The US dollar is trading broadly higher as the divergence thesis gains ground with the latest batch of disappointing euro area data. Soft UK BRC sales and price indices suggest that Britain is being pulled closer to the euro area than the US. Separately, for the second time this month, the People's Bank of China has cut its 14-day repo rate. These global headwinds are seen a potentially delaying the beginning of the normalization of US monetary policy, and are spurring a leg up in the bond market rally, with 10-year Treasury yields dropping to 2.20%.

Poor euro zone data came three times today. First, inflation data from France, Spain and Italy were softer than expected. French September CPI fell 0.4% for a 0.3% year-over-year pace. The consensus called for 0.3% decline and a 0.4% year-over-year pace. Italy recorded outright deflation for the second consecutive month (-0.2% year-over-year against expectations for a -0.1% pace). On the month, Italy's CPI fell 0.4%, which was a little more than expected. Despite a mostly seasonal 1% rise in September prices, Spain's year-over-year rate was unchanged at -0.3%.

Second, euro area industrial output was weaker than anticipated. It was undermined by the whopping 4% decline in German output that had already been reported. However, at -1.8% the aggregate reading was weaker than expected (-1.6%), and the July series was revised lower to 0.9% from 1.0%. This was enough to bring the year-over-year rate to -1.9%, which was more than twice the decline expected and the July pace was cut to 1.6% from 2.2%.

Third, the German ZEW survey disappointed. Economists and investors are well aware the sentiment in Germany had deteriorated alongside the economy and that stock market. However, sentiment is collapsing, not just softening. The current assessment fell to 3.2 from 25.4. The consensus expected a 15 reading. The expectations component fell to -3.6 from 6.9. The consensus expected a flat report. It is the first negative reading since 2012.

The UK is not escaping the pall that hangs over Europe, not just the eurozone. The BRC reported sharp decline in sales. After a 1.3% increase in August, the consensus expected a 1% increase in September. Instead, the market learned of a 2.1% decline, the largest since last April, and the third decline in the past four months.

The disappointing news did not stop there. Headline CPI was expected to slip from 1.5% to 1.4% in September. Instead, UK consumer prices fell to 1.2%, the lowest since 2009. Core prices eased to 1.5% from 1.9%. PPI input prices were also weaker than expected (-7.4% vs consensus -6.6%), suggesting no so-called pipeline inflation.

We had already been identifying the shift in rate hike expectations as a major weight on sterling. With today's report, the pendulum of expectations is swinging further out into H2 2015. The market is now discounting a dovish Quarterly Inflation Report (out next month), and forcing the hawks (Weale and McCafferty) to retreat.

Sweden is also getting pulled into the deflationary impulses from the euro area. Consumer prices rose 0.2% in September. The consensus had called for a 0.5% increase. This put the year-over-year rate deeper into deflationary territory, -0.4% from -0.2% in August. The underlying rate of 0.3% is half of what the consensus expected, and down from 0.5% in August.

The Swedish krona has been hit harder than the euro, and Swedish bonds have rallied the most in Europe, with 10-year yields dropping 8 bp to slip below 1.29%. Core bonds have rallied, but peripheral bonds are lagging. Greek bonds continue to see this year's dramatic gains unwind. The 10-year yield is up 36 bp to almost 7%. Greek PM Samaras want to exit the assistance program at the end of this year. The main advantage is political in nature as Samaras is hoping to avoid elections next year. However, EU officials are pushing back and are not convinced Greece is ready to do without close supervision by the Troika.

In China, the 14-day repo rate stands at 3.4%, down from 3.5% earlier this month and 3.7% in September. China is expected to report tame inflation reports as early as tomorrow. Headline CPI is expected to slip to 1.7% from 2.0% in August. For its part, the yuan edged higher and continues to be one of the few currencies to keep up with the dollar over the past month. It has risen by almost 0.3% since September 1.

The US and Canadian calendars are devoid of market-moving data and central bank talk. Investors will be watching the equity market performance. The Dow Jones Industrials have given back all this year's gain. The euro remains well above the $1.25 area seen earlier this month. However, sterling is testing its recent low near $1.5945. Technically a break opens up scope for another 1-2 cent decline. Dollar support is fraying near JPY106.80. A break can spur a further short squeeze that could see the dollar tumble toward JPY105.60-80.

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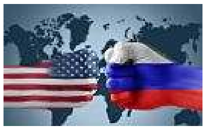

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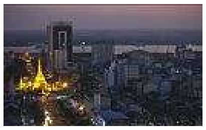

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