Euro wrap-up

Overview

- Bunds largely followed USTs lower on a quiet end to the week for economic news from the euro area.
- Gilts made larger losses as a UK construction sector survey beat expectations.
- The coming week brings the latest ECB policy meeting, where an extension to the asset purchase programme is possible. New data include services PMIs, euro area retail sales, and German and UK IP and trade.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.631	-0.008
OBL 0 10/21	-0.499	+0.008
DBR 0 08/26	-0.040	+0.027
UKT 1¼ 07/18	0.135	+0.016
UKT 3¾ 09/21	0.255	+0.038
UKT 1½ 07/26	0.731	+0.062

*Change from close as at 4.30pm BST.
Source: Bloomberg

Euro area

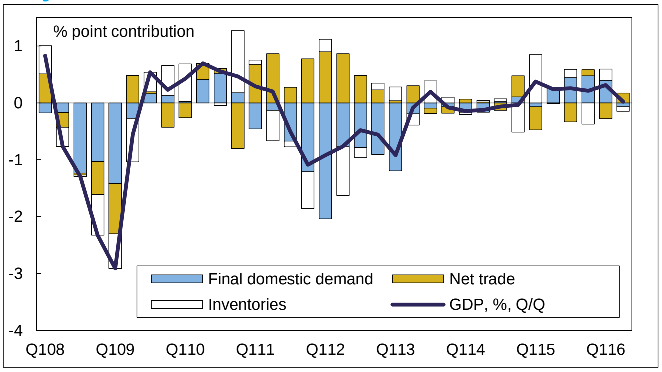
Domestic demand weighed on Italian GDP in Q2

It was an uneventful end to the week for euro area economic data with the most notable new release being the final estimate of Italian GDP in Q2, which confirmed that economic output was disappointingly flat in the second quarter, the first quarter without growth in six. As a result, GDP was up just 0.8%Y/Y, the softest annual rate in a year, albeit still in excess of objective estimates of potential growth. The weakness was driven by domestic demand, as household consumption growth slowed to a five-quarter low of 0.1%Q/Q, while government consumption (-0.3%Q/Q) and business investment (also -0.3%Q/Q) contracted for the first time in a year. Inventories similarly subtracted slightly from GDP growth. In contrast, modest support was provided by net trade, with exports rising close to 2%Q/Q, the most in almost six years and outpacing firm growth in imports. Looking ahead, there appears to be no shortage of reasons to be concerned about the Italian growth outlook. While they do not always provide a reliable guide to GDP growth, surveys suggest that economic conditions in the third quarter have deteriorated, e.g. the manufacturing PMI in August signalled contraction in the sector for the first time since the start of 2015 while the latest ISTAT survey suggested that services sector sentiment is at an eighteen-month low and consumer confidence has also fallen to its lowest level in a year. And with last month's earthquake in central Italy perhaps adding further to pessimism, unease persisting about the health of the banking sector, and political uncertainty rising ahead of the constitutional referendum, the risks to our forecast of GDP growth of 0.1%Q/Q in Q3 appear skewed to the downside.

The week ahead in the euro area and US

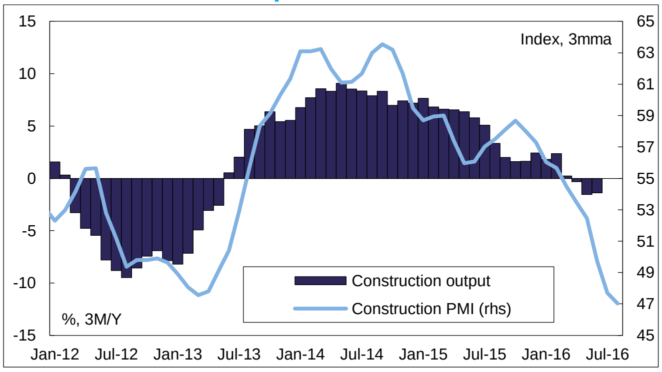
All eyes in the coming week will be on Thursday's conclusion of the latest ECB monetary policy meeting. Since the Governing Council last met in July little has occurred that is likely to change policymakers' assessment of the outlook. The moderation of euro area economic growth in Q2 to 0.3%Q/Q will have been broadly in line with ECB expectations and, with little economic impact visible from the UK's vote to leave the EU, sentiment surveys suggest that growth is likely to be close to that rate in the third quarter too. Meanwhile, with the ECB's corporate bond purchases now well underway and the second TLTROII operation scheduled for later this month, financial conditions have continued to ease further: bank loan interest rates have fallen to record lows, government bond yields on average have taken a further step down over the summer, and major euro area equity markets have risen back close to levels in June. Additionally, while headline and core inflation measures have remained stubbornly low, the ECB will still expect them to pick up gradually over coming months, not least since the oil price is well above levels prevailing at the back end of 2015 and in early 2016. Indeed, while the Governing Council will be presented with updated economic forecasts, we expect these to be little changed from the most recent set published in June, which foresaw GDP growth at 1.6%Y/Y in 2016 and a fraction higher in 2017 and 2018, and average inflation rising from 0.2%Y/Y in 2016 to 1.3%Y/Y and 1.6%Y/Y in the coming two years.

Italy: GDP and contributions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Construction output and construction PMI



Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

With little notable changes to be made to the ECB's baseline economic projections, the Governing Council might well be tempted to leave policy unchanged again this month. However, the persistence of non–negligible downside risks, not least those associated with the near-term path of Fed policy and its possible global repercussions, means that at a minimum we expect Draghi to remain highly dovish, restating the Governing Council's readiness to take further action to ease policy if necessary. Indeed, eventually, if only to avoid a damaging tightening of financial conditions, we expect the ECB to extend the end of the asset purchase programme by a further six months to September 2017 at the earliest, and would not be surprised if an announcement to that effect was made following the coming meeting. By the same token, however, we suspect that the ECB might not want to *pre-commit* to extending those purchases beyond March *at the current pace* just yet. In addition, given that the ECB still appears to face a shortage of bonds that it can buy, as the yields on more than €1.5trn of securities that would otherwise be eligible are currently below the floor of -0.40%, the Governing Council also ought to review the rules governing the asset purchase programme. However, with seemingly no appetite to do that at previous meetings, unless an extension to the programme is announced this time around, agreement on any amendments (such as removal of the yield floor, an increase in the issue limit on purchases, or abandonment of the capital key) might not be required just yet.

On the political front, on Monday morning markets will digest the outcome of this evening's vote to see whether the caretaker PM Rajoy of the right-wing Partido Popular can muster sufficient support to form a new minority government. The result of Wednesday's vote – which saw Rajoy fall short by 6 votes as the PP's traditional foes, the Socialists, teamed up with the far-left populists Podemos – would suggest that Rajoy is set to fail again this evening. If so, political uncertainty will likely persist for some time to come, with the parties having another couple of months to try to find a solution. If a deal then still remains elusive, a new general election – the third in little more than a year – will be held on Christmas Day.

Data-wise, the coming week kicks off on Monday with the final services and composite PMIs for August: the flash euro area services PMI inched up 0.2pt to a three-month high of 53.1 while the flash euro area composite PMI rose 0.1pt to 53.3, the highest since January consistent with continued steady GDP growth. Euro area retail sales figures for July are also due at the start of the week, and following strong German numbers these are expected to show growth of almost ½%M/M taking the annual rate to a five-month high close to 2%Y/Y. Tuesday brings the final estimate of euro area GDP in Q2, which is expected to confirm the initial estimates of growth of 0.3%Q/Q, 1.7%Y/Y. German factory orders figures for July are due the same day ahead of the related industrial production data on Wednesday. While the ECB policy announcement will take centre-stage that day, Thursday will also bring the Bank of France's August business sentiment survey while German goods trade and French and Spanish IP data, all for July, are due on Friday. In the bond markets, Germany will sell index-linked bonds on Tuesday and 10Y Bunds on Wednesday.

In the US, with markets closed on Monday for the Labor Day holiday, the coming week looks set to be much quieter for top-tier releases. The most noteworthy release might be August's non-manufacturing ISM on Tuesday, which is currently expected to show the headline balance little changed from July's reading of 55.5, in line with the average of the past year and consistent with ongoing expansion. Wednesday brings July's JOLTS report as well as the Fed's latest Beige Book, which will be followed on Thursday by consumer credit figures and on Friday by wholesale trade data. Meanwhile, there are no UST bond auctions scheduled.

UK

Construction PMI also stronger than expected

Following the release of the manufacturing PMI yesterday, which showed a sharp increase in sentiment in the sector in August following its collapse in July, today's equivalent construction survey also brought an upward surprise. The headline index rose from 45.9, which was the lowest level since June 2009, to a three-month high of 49.2. Within the detail, the indices for all three major construction activities – housing, commercial and civil engineering – rose by 2½ pts or more, while the new orders and employment indicators both rose by about 2pts. Nevertheless, only the employment index exceeded 50, while all of the others pointed to ongoing contraction. Construction output had already slowed in the run up to the referendum, weighed by a number of factors, including Stamp Duty changes in the Spring, and a sharp recovery in construction seems unlikely. Higher government infrastructure spending, expected to be announced this autumn, may well provide some support to this sector in the medium term. But, for now, the construction sector looks set to remain in the doldrums, weighed down by a number of factors, including the uncertainty resulting from the referendum result.

The week ahead in the UK

In the coming week the testimony of Mark Carney and other MPC members in front of the Treasury Select Committee on Wednesday will certainly be worth watching. It is likely to prove a feisty affair, with the Brexiteer members of the Committee likely to be on the attack following the recent PMI numbers, given that they were all opposed to the most recent easing in policy announced in August. But Carney will stick to his guns – the forecast presented last month did not foresee recession and, indeed, was predicated on a slowdown driven by weaker investment. To the extent that no data on investment have been seen since the referendum vote, the recent volatility in the PMIs will not have materially altered the MPC's overall assessment of the future path for growth.

Data-wise, the focus at start of the week will be firmly on the services PMI on Monday. Not least given that services account for nearly 80% of total economic activity, this survey provides a much better guide to overall activity than the past week's manufacturing and construction PMIs. After Monday attention will be mostly on the releases of hard economic indicators for July – industrial production figures are due on Wednesday, while trade and construction output data are out on Friday. Market consensus expects that industrial output was broadly unchanged in the first month following the referendum, while the trade deficit is expected to have fallen slightly that month. Among other new data in the coming week are August surveys from the RICS, due on Thursday, and the BRC, out on Monday and Tuesday.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
Italy		GDP – second release Q/Q% (Y/Y%)	Q2	**0.0 (0.8)**	0.0 (0.7)	0.3 (1.0)	**-**
Spain		Unemployment M/M '000s	Aug	**14.4**	3.4	-84.0	**-**
UK		Construction PMI	Aug	**49.2**	46.3	45.9	**-**
Auctions							
Country		Auction					
- Nothing to report -							

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Coming week's data calendar

Key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 05 September 2016			
EMU		09:00	Final services PMI (final composite PMI)	Aug	53.1 (53.3)	52.9 (53.2)
		10:00	Retail sales M/M% (Y/Y%)	Jul	0.5 (1.8)	0.0 (1.6)
		14:45	ECB QE net purchases €bn	Weekly	*11.5*	10.3
Germany		08:55	Final services PMI (final composite PMI)	Aug	53.3 (54.4)	54.4 (55.3)
France		08:50	Final services PMI (final composite PMI)	Aug	52.0 (51.6)	50.5 (50.1)
Italy		08:45	Services PMI (composite PMI)	Aug	51.8 (52.0)	52.0 (52.2)
Spain		08:15	Services PMI (composite PMI)	Aug	54.2 (53.8)	54.1 (53.7)
UK		00:01	BRC shop price index Y/Y%	Aug	-	-1.6
		09:30	Services PMI (composite PMI)	Aug	50.0 (50.8)	47.4 (47.5)
			Tuesday 06 September 2016			
EMU		10:00	GDP – second estimate Q/Q% (Y/Y%)	Q2	*0.3 (1.6)*	0.6 (1.7)
Germany		07:00	Factory orders M/M% (Y/Y%)	Jul	0.6 (-0.2)	-0.4 (-3.1)
UK		00:01	BRC Sales like-for-like Y/Y%	Aug	1.4	1.1
		09:00	New car registrations Y/Y%	Aug	-	0.1
			Wednesday 07 September 2016			
Germany		07:00	Industrial production M/M% (Y/Y%)	Jul	0.1 (0.2)	0.8 (0.5)
France		07:45	Trade balance €bn	Jul	-3.6	-3.4
		07:45	Current account balance €bn	Jul	-	-0.6
UK		08:30	Halifax house price index M/M% (3M/Y%)	Aug	-0.1 (7.0)	-1.0 (8.4)
		09:30	Industrial production M/M% (Y/Y%)	Jul	-0.2 (1.9)	0.1 (1.6)
		09:30	Manufacturing production M/M% (Y/Y%)	Jul	-0.3 (1.7)	-0.3 (0.9)
		15:00	NIESR GDP 3M/3M%	Aug	-	0.3
			Thursday 08 September 2016			
EMU		12.45	ECB refinancing rate %	Sep	*0.00*	0.00
		12.45	ECB deposit rate %	Sep	*-0.40*	-0.40
		12:45	ECB asset purchase target €bn	Sep	*80*	80
France		07:30	Bank of France manufacturing sentiment indicator	Aug	98	98
UK		00:01	RICS house price balance %	Aug	2	5
			Friday 09 September 2016			
Germany		07:00	Trade balance €bn	Jul	23.7	24.7
		07.00	Current account balance €bn	Jul	24.5	26.3
		07.00	Imports (exports) M/M%	Jul	0.6 (0.4)	1.1 (0.2)
France		07:45	Industrial production M/M% (Y/Y%)	Jul	0.3 (1.0)	-0.8 (-1.3)
		07:45	Manufacturing production M/M% (Y/Y%)	Jul	0.7 (1.8)	-1.2 (-1.5)
Spain		08:00	Industrial production M/M% (Y/Y%)	Jul	0.1 (0.4)	0.2 (0.8)
UK		09:30	Visible trade balance £bn	Jul	-11.7	-12.4
		09:30	Total trade balance £bn	Jul	-4.3	-5.1
		09:30	Construction output M/M% (Y/Y%)	Jul	-0.7 (-3.4)	-0.9 (-2.2)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's events/auctions calendar

Key events & auctions

Country		BST	Event / Auction
			Monday 05 September 2016
UK		14.50	BoE APF operation: To purchase 3-7Y Gilts
			Tuesday 06 September 2016
Germany		10:30	Auction: To sell 0.1% 2026 index-linked bonds (15-Apr-2026)
UK		10:30	Auction: To sell £2.5bn of 1.5% 2026 bonds (22-Jul-2026)
		14.50	BoE APF operation: To purchase 15Y+ Gilts
			Wednesday 07 September 2016
Germany		10:30	Auction: To sell €5bn of 2026 zero-coupon bonds (15-Aug-2026)
UK		14:15	BoE's Carney, Cunliffe, Forbes and McCafferty are scheduled to speak in London
		14.50	BoE APF operation: To purchase 7-15Y Gilts
			Thursday 08 September 2016
			- Nothing scheduled -
			Friday 09 September 2016
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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