

Euro wrap-up

Overview

- Bunds made gains even as German factory orders data significantly beat expectations.
- Gilts made losses at the short end but gains at the longer end of the curve, as the BoE suggested that it was less inclined to ease policy further over the near term but similarly was in no rush to raise rates.
- Friday will bring new data for German and French industrial production and German goods trade.

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.714	-0.005
OBL 0 10/25	-0.725	-0.022
DBR 0 08/30	-0.538	-0.029
UKT 0½ 07/22	-0.050	+0.014
UKT 0% 06/25	-0.092	+0.011
UKT 4% 12/30	0.100	-0.028

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

German factory orders significantly beat expectations

While last week's German Q2 GDP estimate came in weaker than expected, today's factory orders data for June suggest that the country's economic recovery will be far more V-shaped than many of its peers. Certainly, the 27.9%M/M surge in orders that month came in well ahead of expectations and followed an increase of almost 10½%M/M in May, likely reflecting an anticipated boost to domestic demand prompted by the VAT cut last month. Of course, this came on the back of a significant plunge in the spring as lockdowns were introduced – indeed, manufacturing orders in June were still 11½% below February's pre-pandemic level and down more than 10½% compared with a year earlier.

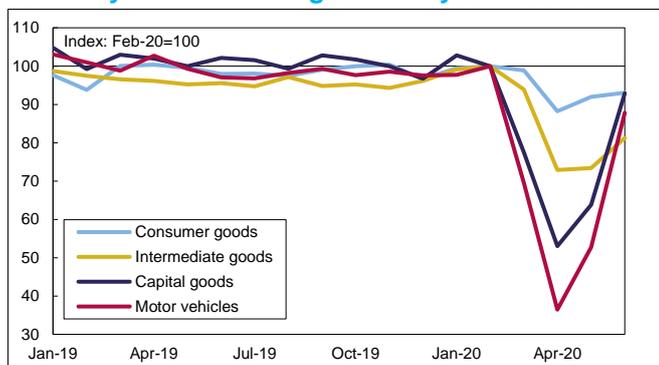
Domestic orders likely boosted by government stimulus

Within the detail – consistent with the view that the government's stimulus measures have been key to restoring momentum – growth in domestic orders continued to drive the recovery, up more than 35%M/M, to take them back above the pre-pandemic level. But while orders from overseas – both within the euro area and elsewhere – were also more dynamic in June, up around 22%M/M, they were still down by more than a fifth compared with February's level. Among the sectors, the strongest growth in orders was again registered in motor vehicles (66½%M/M), with strong demand from at home and overseas. Indeed, the level of domestic motor vehicle orders in June returned back to the pre-pandemic level. Growth in other sectors was somewhat more modest – orders of metals were up 17.8%M/M, electronic items up 13.3%M/M and chemicals up 4.9%M/M. When excluding major items, the improvement was slightly less pronounced, with the near-24%M/M increase leaving the level of orders still 15% below the pre-pandemic peak.

Manufacturing output remains below pre-Covid levels

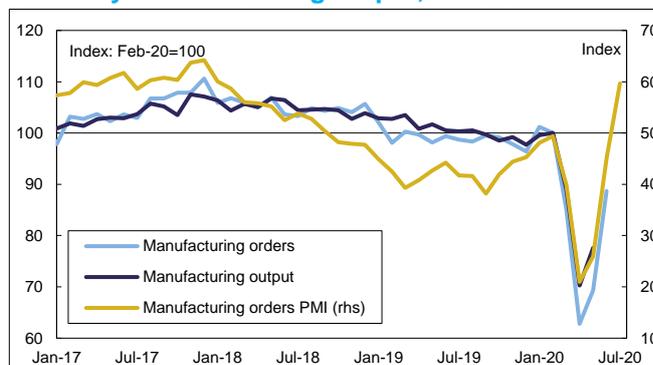
German manufacturing turnover rose a more modest 12.6%M/M in June to be still down 15.6% from February's pre-pandemic level. And so, while tomorrow's manufacturing production figures will likely see another solid increase in June, the level would still seem bound to remain well down on February's level. This was also true of today's Italian IP data. Despite a further rise of 8.2%M/M in June on top of the 41½%M/M increase in May, Italian industrial output was still more than 13½% below January's peak. Production of consumer durables again saw the strongest growth (39.6%M/M) but remained 8½%M/M lower than the pre-lockdown peak. And capital and intermediate goods output was still down by 14½% and 17½% respectively compared with January.

Germany: Manufacturing orders by sub-sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output, orders and PMI



Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.



Construction activity remains subdued

While the manufacturing and services PMIs pointed to ongoing expansion at the start of Q3, today's construction PMIs were consistent with a sector that continues to struggle. Indeed, the euro area's headline activity index rose just 0.6pt to 48.9. Commercial building construction continued to fall across the region, but there was an improvement in home building, underpinned by an upturn in Germany. This notwithstanding, Germany's headline construction PMI (47.1) still signalled declining activity, despite rising 5.8pts on the month, while the French PMI fell 4.4pts to 49.4. And Italy's PMI (51.0) implied only modest expansion. Orders continued to decline across the euro area as a whole reflecting subdued demand and increased competition. But while German construction firms remained pessimistic about the outlook over the coming twelve months, French firms were marginally more positive and Italian firms were reportedly their most upbeat in more than nine years, boosted by the government's ecobonus scheme where it will offer a tax reduction of 110% of the expenses homeowners incur for energy efficiency and earthquake resilience renovations until the end of 2021.

The day ahead in the euro area

Tomorrow brings June industrial production releases from Germany, France and Spain. Like today's results from Italy, we expect to see strong gains across the region as manufacturers continued to play catch up after lockdown measures were eased in May. However, this would still leave manufacturing output some way below pre-pandemic levels. Friday will also bring June trade figures from Germany, France and Italy, as well as Q2 wage data from France.

UK

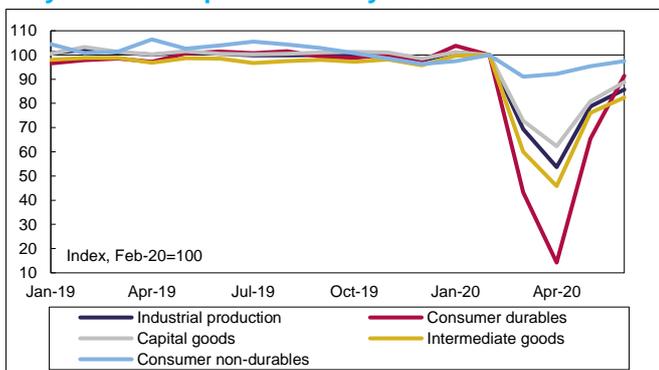
BoE less dovish, but won't get carried away

The BoE's MPC inevitably voted unanimously to leave Bank Rate unchanged at 0.1% and maintain its asset purchase target at £745bn. But it has become less dovish, and accordingly rewrote its guidance on the likely direction of future policy. Having previously signalled a clear easing bias, the MPC now appears equivocal about the most likely direction of the next move in policy. That message was reinforced by the BoE's updated economic outlook – according to the central projection, in two years' time inflation will return to target and be rising, with economic activity back above its potential level too. So, while the MPC acknowledged that the risks to the growth outlook remain hugely skewed to the downside, for the time being it sees no need for additional stimulus. At the same time, the MPC underscored that any moves to reverse recent policy stimulus remain some way off, stating that it "does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably". Such a point is, at best, a long way off. So, the MPC appears now to be in "steady-as-she-goes" mode.

GDP still on track for worst year since 1921

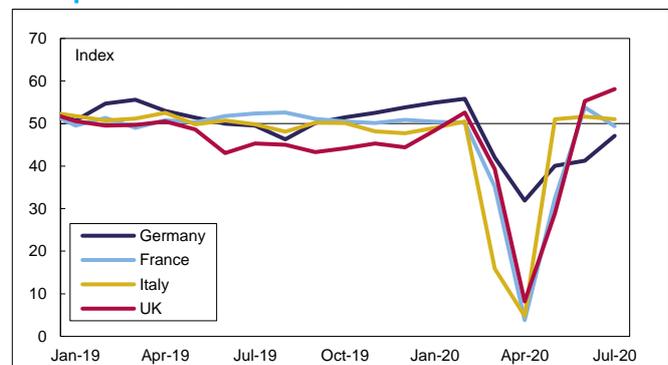
In terms of economic conditions, the BoE judges that UK GDP dropped to a level more than 20% below the pre-Covid peak in Q2. That might represent the worst of all major economies, reflecting the UK's later and longer lockdown, and larger share of spending in GDP involving high degrees of social interaction. But it also takes comfort from higher-frequency indicators, which imply that spending has recovered significantly since April's trough. Indeed, it now expects GDP in Q420 to be down a little less than 5½%Y/Y, to leave it over 2020 as a whole down "just" 9.5%, far less than the drop of 14% presented as the central scenario in the May Monetary Policy Report. That, however, would still represent the worst year for UK GDP since 1921. And the BoE expects conditions in the labour market to continue to deteriorate over the near term, although its projected peak in the unemployment rate at around 7½% at year-end is more optimistic than the peak expectation of the OBR (11.9%). Meanwhile, the BoE forecasts CPI inflation to fall further to around ¼%Y/Y towards the end of 2020 reflecting the impact of spare capacity, lower energy prices and the recent cut of VAT on hospitality.

Italy: Industrial production by sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Europe: Construction PMIs in selected countries



Source: Refinitiv, Markit and Daiwa Capital Markets Europe Ltd.

Excess demand unlikely to generate significant price pressures

Further ahead, assuming no major second wave of pandemic and an orderly move to a comprehensive free trade agreement with the EU at the start of 2021, the BoE expects recovery to be sustained and unemployment to start to decline next year, so that the Q419 level of activity is reached by end-2021. Due to an extremely dim view of the UK's supply potential reflecting the scarring from the Covid shock, it estimates that activity will then move above its trend level and inflation will return to the 2% target in two years' time. With excess demand unlikely to generate significant price pressures, however, even assuming that output continues to rise further above its level potential and the unemployment rate falls back down to 4% or below in 2023, the BoE would expect inflation only to move slightly above target – to about 2.2%Y/Y – in three years' time, suggesting little need to tighten policy even in such an optimistic scenario.

Extra asset purchases likely if recovery falters

Certainly, Bank Rate is highly unlikely to be adjusted in either direction for some time to come. Indeed, while the MPC stated that it would continue to review their appropriateness, the Monetary Policy Report made clear that, even if more stimulus was required, in the present circumstances negative rates could be undesirable given their impact on the banking sector. So, they would not be considered for the time being. Similarly, in an interview following the announcement, Governor Bailey made clear that yield curve control was also not a policy that would be considered at the current juncture. In terms of QE, with market conditions now far more orderly than at the peak of the Covid crisis, from next week until mid-December the BoE's asset purchases (including reinvestments) will slow to £4.4bn per week from an average of £6.9bn over the past five weeks. And the MPC's statement implies that, if the recovery in economic activity continues in line with the BoE's projection, net purchases would likely not be extended into next year. But if recovery momentum peters out, unemployment jumps more than the BoE expects, and/or underlying inflation weakens further so that extra stimulus is required, additional asset purchases and/or strengthened forward guidance might be expected to be the MPC's preferred policy tools. And due to concerns about the path of the pandemic when the weather turns for the worse in the autumn, uncertainty surrounding the path of fiscal policy and the government's targeted support measures, as well as the damaging impact on business investment of Brexit-related non-tariff barriers to trade, our view on GDP and unemployment is more downbeat than that of the BoE. So, we see a significant risk that a further slug of asset purchases in 2021 will be required, with an announcement as early as the November MPC meeting feasible.

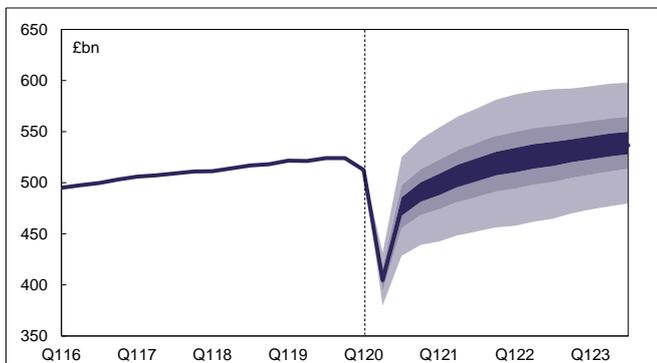
Construction PMI jumps to highest since 2015

Contrasting with the euro area survey, but similar to the services and manufacturing indices, the UK's construction PMI signalled a further acceleration in activity in July, rising 2.8pts to 58.1, the strongest reading since October 2015. This was underpinned by housing activity – the relevant PMI rose to its highest since September 2014 – while commercial and civil engineering work expanded at a slightly faster pace than in June too, with growth partly attributed to the restart of projects delayed by the lockdown. While new orders continued to recover, their growth remained softer than that for overall output in the sector. And while 43% of respondents anticipated a rise in output over the coming twelve months, almost one third were still expecting a contraction. Similarly, around a third of construction firms reported a further fall in employment last month.

The day ahead in the UK

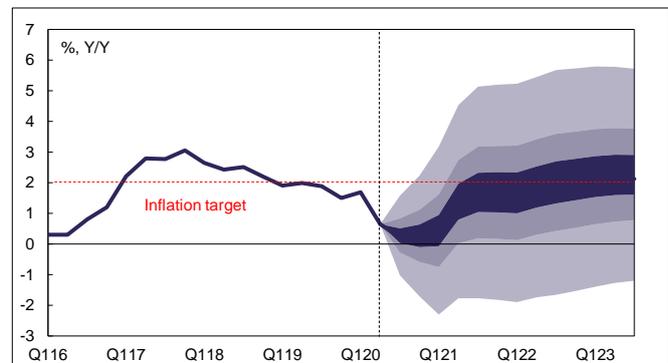
The week's economic calendar ends quietly in the UK, with no key data or events scheduled tomorrow.

UK: BoE's GDP forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE's CPI inflation forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ Daiwa forecast	Previous	Revised
EMU	 Construction PMI	Jul	48.9	-	48.3	-
Germany	 Factory orders M/M% (Y/Y%)	Jun	27.9 (-11.3)	10.1 (-18.5)	10.4 (-29.3)	-
	 Construction PMI	Jul	49.7	-	41.3	-
Italy	 Industrial production M/M% (Y/Y%)	Jun	8.2 (-13.7)	5.0 (-16.0)	42.1 (-20.3)	41.6 (-20.5)
UK	 BoE Bank Rate %	Aug	0.10	0.10	0.10	-
	 BoE gilt and corporate purchase bond target £bn	Aug	745	745	745	-
	 Construction PMI	Jul	58.1	57.0	55.3	-

Auctions

Country	Auction
France	 sold €1.74bn of 5.5% 2029 bonds at an average yield of -0.36%
	 sold €1.73bn of 2.5% 2030 bonds at an average yield of 0.41%
	 sold €3.02bn of 2.5% 2030 bonds at an average yield of -0.27%
	 sold €2.52bn of 1.5% 2031 bonds at an average yield of -0.21%
Spain	 sold €979mn of 0% 2023 bonds at an average yield of -0.392%
	 sold €598mn of 0.65% 2027 index-linked bonds at an average yield of -0.784%
	 sold €1.98bn of 0.8% 2027 bonds at an average yield of -0.021%
	 sold €1.02bn of 1.25% 2030 bonds at an average yield of 0.263%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ Daiwa forecast	Previous
Germany		07.00 Trade balance €bn	Jun	11.3	7.0
		07.00 Industrial production M/M% (Y/Y%)	Jun	8.0 (-11.4)	7.8 (-19.3)
France		07.45 Industrial production M/M% (Y/Y%)	Jun	8.4 (-12.9)	19.6 (-23.4)
		07.45 Manufacturing production M/M% (Y/Y%)	Jun	13.0 (-13.3)	22.0 (-25.2)
		07.45 Trade balance €bn	Jun	-	-7.1
		07.45 Preliminary wages Q/Q%	Q2	-	0.2*
Italy		09.00 Trade balance €bn	Jun	-	5.6
Spain		08.00 Industrial output M/M% (Y/Y%)	Jun	10.0 (-15.2)	14.7 (-24.5)

Auctions and events

Country	BST	Auction / Event
- Nothing scheduled -		

*Previous figure for Q419. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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