Daiwa Capital Markets

# Euro wrap-up

## Overview

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- Bunds were little changed despite some stronger-than-expected German factory orders data.
- Gilts made losses as the BoE left policy unchanged but suggested that modest tightening over the coming three years is likely to be necessary.
- Friday will bring new data for German, Italian and Spanish industrial production and a UK labour market survey.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0 06/23 | -0.782 | +0.008 |
| OBL 0 10/26 | -0.763 | +0.008 |
| DBR 0 08/31 | -0.496 | +0.007 |
| UKT 0⅛ 01/23 | 0.066 | +0.038 |
| UKT 0⅛ 01/26 | 0.239 | +0.019 |
| UKT 4¾ 12/30 | 0.531 | +0.021 |

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

# Euro area

## German factory orders jump on strong demand

While yesterday's services PMIs implied an acceleration in recovery momentum in the euro area at the start of Q3 with Germany leading the way, today's German factory orders data pointed to firm demand for manufactured items too. In particular, orders rose a much stronger than expected 4.1%M/M in June, more than fully reversing the decline reported in May, to leave them more than 11% higher than their pre-pandemic level. This also left them up almost 4½%Q/Q in Q2. Admittedly, the strength at the end of Q2 in part reflected large one-off orders placed domestically, which were up 9.6%M/M as orders of electronic parts and devices surged 25%M/M. Indeed, when excluding major items, orders were up a more modest 1.7%M/M in June, although this still left them up 2½%Q/Q in Q2, with domestic orders on this measure down 0.2%M/M, while foreign orders were up 3.5%M/M. Within the detail, demand for capital goods (up 6.8%M/M) was driven in part by the aforementioned jump in domestic orders of electronics but also a rebound in overseas orders of motor vehicles (7.0%M/M), although this reversed only half of the drop in May. But while domestic orders of intermediate and consumer goods also rose (5.0%M/M and 1.2%M/M respectively), foreign orders for those goods were down, with the latter more than offsetting the pickup domestically.

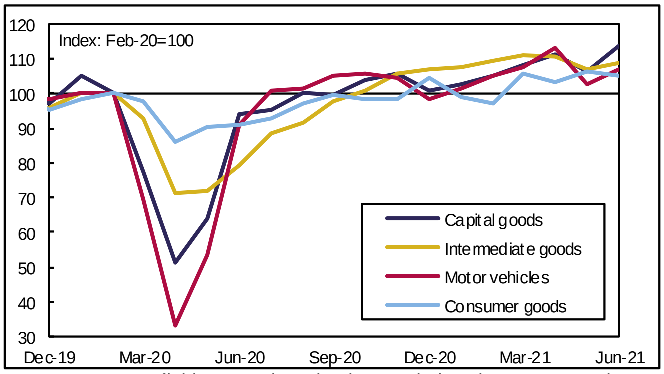
## Manufacturing turnover remains weak

Notwithstanding the ongoing recovery in demand, today's figures again flagged the likelihood that production remained subdued at the end of the second quarter as supply bottlenecks continued to pinch. Certainly, today's turnover figures raise some downside risks to the consensus expectation of an increase of ½%M/M in tomorrow's production numbers. In particular, manufacturing turnover fell 1.4%M/M in June, to leave it 6.7% lower than the pre-pandemic level. This notwithstanding, in the absence of significant weakness in June, manufacturing output likely moved sideways in Q2 compared with Q1. And of course, with recent growth in orders having far outpaced production, and backlogs of work sky-high, German manufacturing output should return to firm growth as soon as supply bottlenecks – particularly in semiconductors – ease.

## French IP gathers momentum at end of Q2

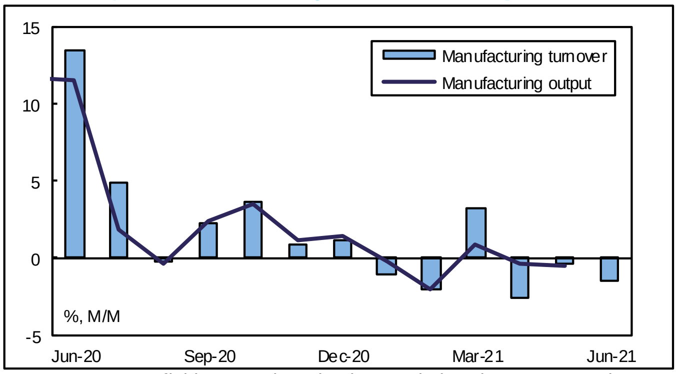
Contrasting with Germany, today's French production figures confirmed that industrial output fell 0.9%Q/Q in Q2, with manufacturing contracting a steeper 1.4%Q/Q as production of autos fell a substantial 16½%Q/Q. But this masked a gradual improvement in the sector towards the end of the quarter, with industrial output rising ½%M/M in June. Manufacturing production rose a stronger 0.9%M/M in June, supported by a pickup in output of transport equipment for the first month in six

**Germany: Manufacturing orders by good-type**




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

**Germany: Manufacturing turnover and production**




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

(2.3%M/M thanks to growth in both autos and other items) and production of coke and refined petroleum products (8.3%M/M). This notwithstanding, the level of output in the transport sub-sector still remained a long way (some 28%) below the pre-pandemic level, with overall manufacturing output still more than 6% lower than the February-2020 peak. And so, like in Germany, with order backlogs still elevated and new orders still growing, as and when supply constraints ease, we see scope for notable strength in manufacturing growth in France. Supply shortages continue to impact the construction sector too, with activity in June declining 2%M/M to leave it down 1.4%Q/Q in Q2 and still 4% lower than the pre-pandemic level.

### Construction PMIs point to contraction as supply constraints bite

As for manufacturing and services, the euro area PMIs suggest that supply bottlenecks are also constraining construction activity. The headline euro area construction activity PMI fell back into contraction territory in July, declining 0.5pt to a five-month low of 49.8. Respondents to the survey cited that shortages of raw materials as well as rising costs of inputs were acting as a restraint on growth. Indeed, the input prices PMI for the sector rose to a new series high for the fourth successive month. House-building activity continued to rise, albeit at the softest pace in three months, while commercial work and civil engineering output declined at a quicker pace than in June. At the country level, once again, only Italy of the three largest member states reported growth in overall construction activity last month, with the respective PMI nevertheless dropping more than two points to a five-month low of 55.8. Looking ahead, Italian construction firms are still very upbeat about the outlook while German respondents to the survey were still, on balance, downbeat.

### The day ahead in the euro area

The end of the week will bring the aforementioned German industrial production figures, as well as equivalent data from Italy and Spain. Given today's turnover numbers, risks to the consensus forecast ½%M/M increase in German production appear skewed the downside. Italian and Spanish industrial output is also expected to have risen between ½-1%M/M in June. French trade numbers for June and wage figures for Q2 are also scheduled for release.

## UK

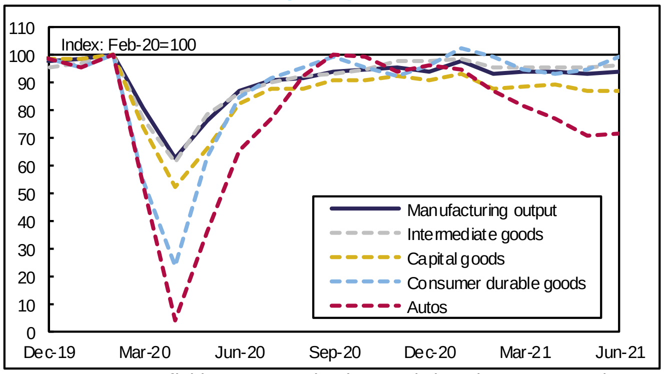
### Policy unchanged, but Gilts weaken on updated guidance, projections and exit strategy

As expected, the BoE left its main policy parameters unchanged today. So, Bank Rate was left at 0.1%, the asset purchase target was unchanged at £895bn, and only one member out of eight (external member Michael Saunders) voted to end the net purchases now rather than concluding the programme just before the end of the year as planned. (Some observers thought that Deputy Governor Dave Ramsden might also have voted for an early end to QE, but he remained loyal to the rest of the Bank staff). There was plenty of news, however, including with respect to forward guidance, the BoE's forecasts, and its exit strategy. And the market's response was to judge the overall presentation to be marginally hawkish, with yields making losses – albeit relatively modest – across the curve.

### Forward guidance simplified, with tightening dependent on medium-term inflation outlook

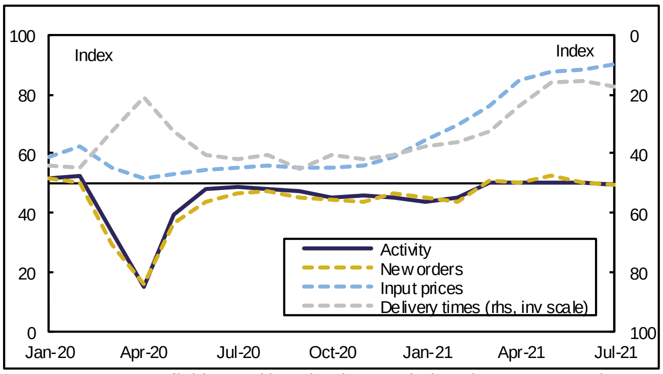
In terms of its forward guidance, the Committee judged that its previous communication on what might determine future policy as unhelpful in the current circumstances. Having previously stated that it did not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably, some MPC members thought that those conditions have now been met. However, the vast majority still didn't think that tightening was required. Instead, they simply argued that the conditions were merely necessary but not sufficient to start tightening. So, the forward guidance was recast. In particular, in judging the appropriate stance of monetary policy (i.e. whether to tighten), the MPC will now – as prior to the pandemic – focus largely on the medium-term inflation outlook. So, rather than worrying about the current inflation spike and supply constraints, it will be more interested in the medium-term drivers of inflation, i.e. the labour market, in particular wages, as well as medium-term inflation

**France: Manufacturing output**




*Source: Refinitiv, INSEE and Daiwa Capital Markets Europe Ltd.*

**Euro area: Construction PMIs**




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

expectations. And the MPC recognised that there are downside as well as upside risks to the medium-term inflation outlook. So, we judge the new guidance to be neither more hawkish nor more dovish than before.

## Inflation expected to be near target in 3 years' time, so only very modest tightening expected

The BoE's updated projections underscore that the MPC thinks that the economic recovery will continue pretty much as it thought three months ago. And, crucially, they make clear that the current spike in inflation will be temporary. While the BoE revised up its forecast for GDP growth in Q2, it revised down its forecast for Q3, and still expects the pre-pandemic level of GDP to be reached just before the end of 2021. It also expects growth to slow significantly in 2022 and 2023, and to level off close to 1¼%Y/Y through 2024. While headline CPI inflation is expected to peak around 4%Y/Y in Q4, it is also expected to fall back steadily thereafter, and return close to 2% in 2023 and 2024. As such, the projections suggest that only limited tightening – if any at all – will be required over the coming three years. Assuming no change in monetary policy, inflation is forecast to be just 2.1%Y/Y – only very marginally above target – at the end of the projection horizon in Q324. And assuming a path for Bank Rate implied by the markets – i.e. up to just 0.2% in a year's time, 0.4% in two years' time, and 0.5% by Q324 – inflation is expected to fall below target to 1.89%Y/Y by the end of the forecast period. So, while the MPC stated that, if the economy evolves in line with its projections some modest tightening over the forecast period is likely to be required, it is quite possible that no hikes will be required at all until 2024 or beyond.

## New exit strategy lowers rate threshold for shrinking balance sheet

While its updated forecasts make clear that only very limited tightening, if any, is expected to be appropriate over the coming three years, the MPC agreed a new approach to its tightening strategy for if and when it is needed. Having previously stated that it would not start to reverse QE until Bank Rate reached 1.5%, the MPC now states that it will start that process of shrinking the balance sheet, by ceasing reinvestment of maturing securities, once Bank Rate reaches just 0.5%. And it will only start to shrink its balance sheet via asset sales once Bank Rate has reached 1.0%. The BoE insisted that Bank Rate would remain the primary tool for changing monetary policy from one meeting to the next, while any shrinkage of the balance sheet would be conducted on a pre-set and hence predictable path, which would not be adjusted from one MPC meeting to the next. In part, the change in strategy reflects the fact that negative rates are now considered part of the tool kit for the future. But it also underscores that Bank Rate simply isn't expected to rise back to that previous threshold of 1.5% for the foreseeable future. Indeed, given the UK's weak potential growth rate as well as the new tightening strategy – which should result in a steeper yield curve other things being equal – Bank Rate looks unlikely to reach the 1.0% threshold that would trigger active BoE Gilts sales before the second half of the current decade.

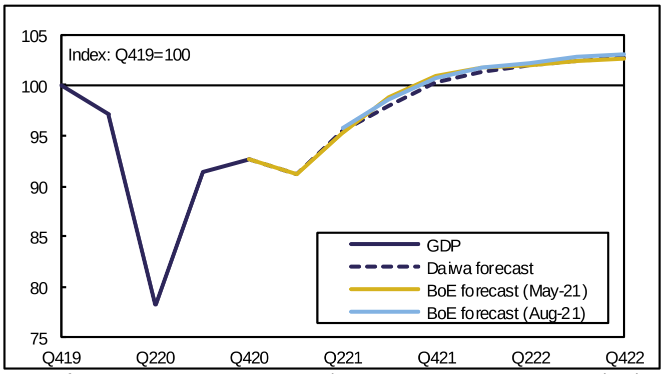
## New car registrations drop to lowest in more than two decades

In terms of today's data, which were very much of secondary importance, UK new car registrations were weak in July at just 123k. That represented declines of about 30%Y/Y and 22% from the same month in 2019, and was the lowest July total in more than two decades. Given disruption from the semi-conductor shortage as well as workers' enforced quarantine, the car manufacturers' trade association SMMT revised down its full-year forecast for a third time to 1.82mn, which would be up a little more than 10% from last year but more than 20% down on 2019.

## Construction PMIs signal moderation in momentum as supply constraints bind

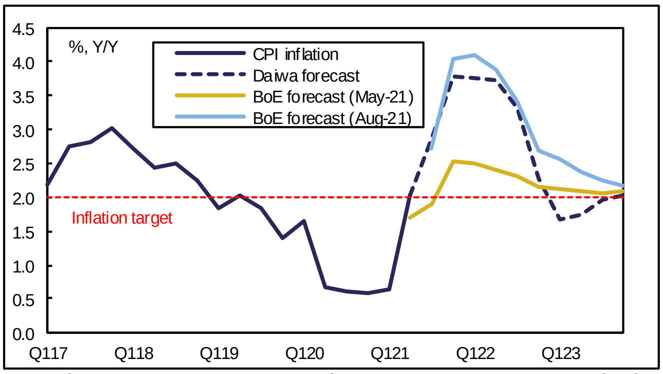
Meanwhile, like the equivalent manufacturing and services PMIs, the construction activity index fell back in July, declining more than 7pts from the 24-year high recorded in June to a five-month low of 58.7. Growth in house-building, commercial work and civil engineering projects all moderated, with survey respondents continuing to cite shortages of materials and sub-contractors as a binding constraint. While not quite as severe as the prior month, input price pressures were judged to remain extremely high, with the respective PMI at 92.3, and supplier delivery times were still very long by historical standards

### UK: BoE GDP forecast*




*BoE forecast assumes constant Bank Rate at 0.1%. Source: BoE and Daiwa Capital Markets Europe Ltd.

### UK: BoE inflation forecast*



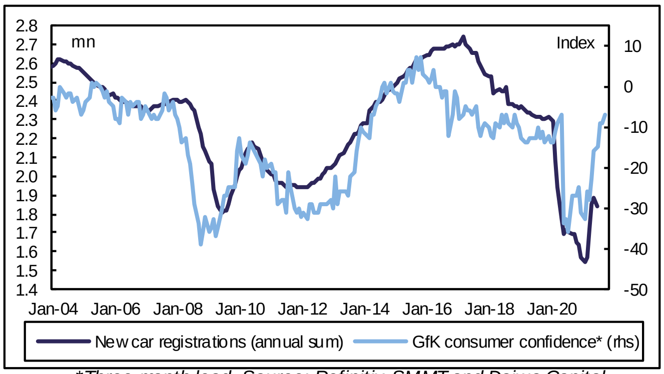

*BoE forecast assumes constant Bank Rate at 0.1%. Source: BoE and Daiwa Capital Markets Europe Ltd.

too. Growth in new orders in the sector reportedly slowed to a four-month low, but the respective index (60.3) and that for business expectations twelve months ahead (70.7) remained consistent with solid growth ahead.

## The day ahead in the UK

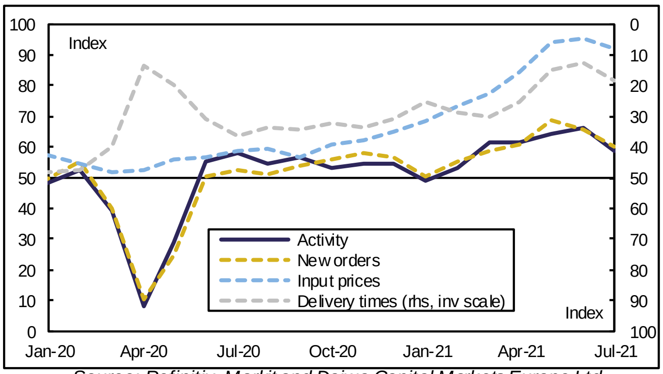
A relatively quiet end to the week brings the REC/KPMG UK jobs report for July, with employment consultancies likely to signal increased vacancies, ongoing recruitment difficulties due to insufficient candidates, and therefore higher starting wages.

### UK: Car registrations and consumer confidence




*Three-month lead. Source: Refinitiv, SMMT and Daiwa Capital Markets Europe Ltd.

### UK: Construction PMIs




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

# European calendar

## Today's results

**Economic data**

| Country | | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | Revised |
|---|---|---|---|---|---|---|---|
| Euro area | | Construction PMI | Jul | **49.8** | - | 50.3 | - |
| Germany | | Factory orders M/M% (Y/Y%) | Jun | **4.1 (26.2)** | 2.0 (22.4) | -3.7 (54.3) | **-3.2 (54.9)** |
| | | Construction PMI | Jul | **47.1** | - | 47.0 | - |
| France | | Industrial production M/M% (Y/Y%) | Jun | **0.5 (7.1)** | 0.5 (7.6) | -0.3 (20.5) | **-0.4 (20.5)** |
| | | Manufacturing production M/M% (Y/Y%) | Jun | **0.9 (7.5)** | - | -0.5 (22.3) | **-0.6 (22.1)** |
| | | Construction PMI | Jul | **48.5** | - | 48.9 | - |
| Italy | | Construction PMI | Jul | **55.8** | - | 57.9 | - |
| UK | | New car registrations Y/Y% | Jul | **-29.5** | - | 28.0 | - |
| | | Construction PMI | Jul | **58.7** | 64.0 | 66..3 | - |
| | | BoE Bank Rate % | Aug | **0.10** | *0.10* | 0.10 | - |
| | | BoE Gilt purchases target £bn | Aug | **875** | *875* | 875 | - |

**Auctions**

| Country | Auction |
|---|---|
| | |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Tomorrow's releases

**Economic data**

| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|---|
| Germany | | 07.00 | Industrial production M/M% (Y/Y%) | Jun | 0.5 (7.9) | -0.3 (17.3) |
| France | | 07.45 | Trade balance €bn | Jun | - | -6.8 |
| | | 07.45 | Private sector payrolls (wages) Q/Q% | Q2 | - | 0.5 (0.6) |
| Italy | | 09.00 | Industrial production M/M% (Y/Y%) | Jun | 0.8 (12.8) | -1.5 (21.1) |
| Spain | | 08.00 | Industrial production M/M% (Y/Y%) | Jun | 0.7 (14.1) | 4.3 (26.0) |

**Auctions and events**

| Country | | BST | Event |
|---|---|---|---|
| UK | | 00.01 | REC/KPMG report on UK jobs for July |
| | | 12.15 | BoE Deputy Governor Broadbent hosts online briefing for businesses |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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