Euro wrap-up

Overview

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- Bunds made losses as German industrial production, including autos output, returned to growth in July while euro area GDP growth in Q2 was revised up.
- Gilts also followed USTs lower even as the UK government announced tax rises to pay for extra spending on health and social care, and a survey signalled a slowing in retail sales.
- Ahead of Thursday's key ECB announcements, Wednesday will bring French trade and Italian retail sales data while Governor Bailey and other BoE officials will speak publicly on monetary policy.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.705	+0.019
OBL 0 10/26	-0.632	+0.042
DBR 0 08/31	-0.318	+0.051
UKT 0⅛ 01/23	0.198	+0.025
UKT 0⅜ 10/26	0.385	+0.034
UKT 0¼ 07/31	0.747	+0.054

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

Euro area

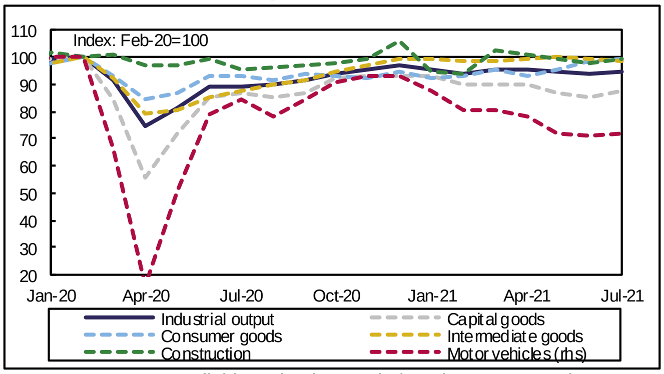
German IP returns to growth in July with first rise in autos output this year

As suggested by yesterday's turnover data, German industrial production returned to growth in July following three successive monthly declines and a contraction of 1.0%Q/Q in Q2. The increase of 1.0%M/M, however, merely reversed the drop in June to suggest only a modest easing of supply bottlenecks at the start of Q3. Indeed, while production rose 5.7% from its level a year earlier it was still almost 3% below the level at the end of last year and 5.5% below the pre-pandemic level in February 2020. Within the detail, output of capital goods rose 3.2%M/M in July, with production of machinery up a vigorous 6.9%M/M and production of motor vehicles up 1.9%M/M to mark its first increase so far this year. While that pushed machinery output to less than 1% below the pre-pandemic level, autos output was still down 28% on the same basis and 23% below the level at the end of 2020. In addition, production of consumer goods rose 0.9%M/M thanks to a surge in output of consumer durables, which rose more than 5% above the pre-pandemic level. But output of intermediate goods dropped for a second successive month, falling 0.5%M/M to be 1.3% below the pre-pandemic level. Beyond manufacturing, energy production fell for a third successive month, dropping 3.2%M/M to the lowest level in a year. But construction output rose for the first time since March, increasing 1.1%M/M albeit remaining 1.1% below the pre-pandemic level. With new factory orders up almost 12% from the end of last year and almost 16% higher than the level in February 2020, the main restraint on manufacturing output remains supply rather than demand. And, as and when bottlenecks ease further, industrial production should accelerate, adding renewed support for the economic recovery.

ZEW survey flags softer expectations for growth and inflation

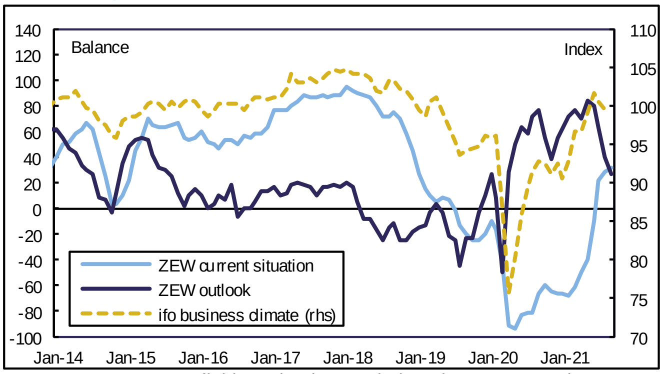
Like yesterday's similar Sentix survey, today's ZEW survey signalled a further easing of investor confidence in the economic outlook, albeit from relatively elevated levels. In particular, the index of expectations in Germany's economic outlook for the coming six months declined for a fourth successive month, dropping almost 14pts in September to 26.5, the lowest since the initial wave of pandemic in March 2020. As a moderation of GDP growth seems inevitable following the initial vigorous rebound in response to the easing of pandemic restrictions, we are not overly concerned. Indeed, in contrast to the softening in expectations, investors' assessment of current conditions picked up for a second successive month, rising 2.6pts to 31.9, the highest level since end-2018. Perhaps most notably within the detail of the survey, the index of inflation expectations dropped significantly for a third successive month, falling almost 25pts to 15.9, the lowest in fourteen months, to suggest that investors (appropriately in our view) expect price pressures to ease significantly over the coming six months. Nevertheless, with the profit outlook for most sectors still positive – and judged to have improved for services, IT and utilities – and

Germany: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Sentiment indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Thursday's news regarding ECB asset purchases in Q4 awaited, the ZEW measure of investor expectations for long-term interest rates rose back close to June's 2½-year high.

Q2 GDP and employment revised up with growth led by private consumption

According to today's updated figures, the rebound in euro area GDP in Q2 was 0.2ppt firmer than previously estimated, at 2.2%Q/Q. Revisions to estimates for earlier quarters meant that the annual rate of growth was revised up by a larger 0.7ppt to 14.3%Y/Y. And following modest declines of 0.3%Q/Q in Q1 and 0.4%Q/Q in Q4, the level of economic output was just 2.2% below the pre-pandemic peak reached in Q419. The expenditure breakdown, published for the first time, confirmed that household consumption was the main driver of growth. But while its rise of 3.7%Q/Q, which contributed 1.9ppt to GDP growth, was stronger than anticipated, it was still hampered by persisting pandemic restrictions and was thus insufficient to return its level to the recent post-pandemic peak in Q320. Fixed investment also added to GDP growth, rising 1.1%Q/Q. But with volumes of exports and imports rising slightly more than 2%Q/Q, net trade made no contribution. With production struggling to meet demand, meanwhile, inventories subtracted 0.2ppt, having contributed positively in each of the previous two quarters. Just as GDP was firmer than previously estimated, so too was job growth, with employment up 0.7%Q/Q (760k) marking an upwards revision of 0.2ppt. And with workers returning from government short-time working schemes, hours worked rose a larger 2.7%Q/Q. Given revisions to previous quarters, however, the annual rate of employment growth was unchanged at 2.0%Y/Y (2.52mn). And the number of people in work was down 1.6% (2.54mn) from the pre-pandemic peak in Q419.

ECB will need to revise up its GDP projection for 2021

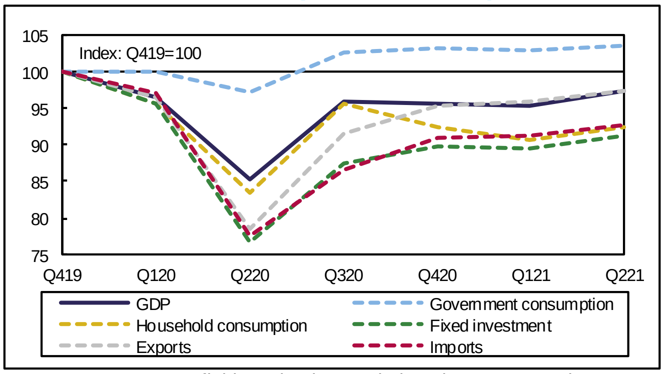
Today's revisions mean that cumulative euro area GDP growth in Q1 and Q2 was 1.1ppts firmer than the ECB forecast in June. While the spread of the delta variant and, more significantly perhaps, supply bottlenecks mean that GDP growth in Q3 is likely to be significantly softer than the 2.8%Q/Q rate it previously projected, any moderation in growth in Q3 should be limited by the further liberalization of pandemic restrictions, recovery in tourism, and a modest rebound in manufacturing output. So, when it presents updated projections on Thursday, the ECB is likely to revise up its full-year growth forecast for 2021 from 4.6%Y/Y to closer to 5%Y/Y. Notwithstanding the risks of a more significant wave of coronavirus in the autumn, it should also expect the pre-pandemic level of GDP to be surpassed in Q4. And with confidence in the growth outlook bolstered by further progress with vaccinations, with more than 70% of adults in the EU now having received two jabs, and the labour market seemingly performing better than expected, its assessment of medium-term scarring might be scaled back further. So, the ECB's GDP forecasts for the coming two years need not be revised down significantly from 4.7%Y/Y and 2.1%Y/Y respectively.

The coming two days in the euro area

The main event in the coming two days will undoubtedly be Thursday's announcements from the ECB following its latest monetary policy meeting. The Governing Council will be presented with updated economic projections. Based on these, coupled with an assessment of financial conditions, it will give an indication of the expected pace of PEPP purchases over the coming quarter. Last month's Reuters interview with ECB Chief Economist Lane suggests, however, that we will not learn anything conclusive about the pace and nature of asset purchases beyond the end of this year.

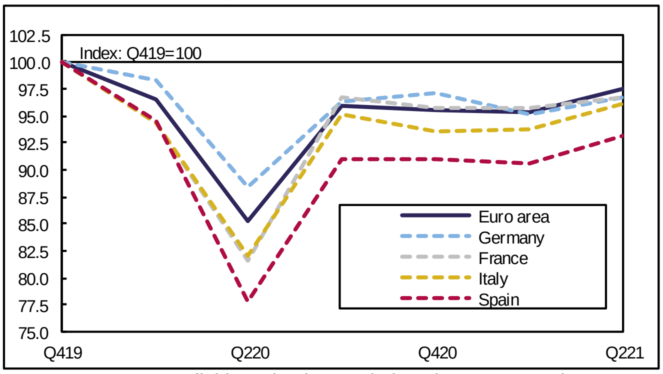
With respect to the ECB's economic projections, upwards revisions to the near-term profiles of GDP and inflation from those forecast in June now look to be in order. As discussed above, the euro area GDP forecast for 2021 of 4.6%Y/Y now looks some ½ppt too soft, while the projections of 4.7%Y/Y and 2.1%Y/Y in 2022 and '23 respectively might be nudged down only slightly. Given recent outturns, including the jump to 3.0%Y/Y in August, the projection for inflation this year (1.9%Y/Y) will be revised up above the ECB's 2.0% target. However, as there remain no significant second-round effects on wages or expectations, the inflation projections for both 2022 and '23 (1.5%Y/Y and 1.4%Y/Y respectively) should be little changed. And so, in light of the ECB's rate guidance, the inflation outlook will still be incompatible with no tightening over the horizon.

Euro area: GDP and expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The aim of the PEPP purchases, however, is to “maintain favourable financing conditions” throughout the pandemic. And with market interest rates currently lower than in June when the pace of purchases for Q3 was agreed, and less sovereign bond issuance to come than over recent quarters, there appears scope for a modest slowing in the pace of PEPP purchases in the coming quarter from the average rate between €75-80bn per month conducted throughout Q2 and so far in Q3. So not to risk a marked correction in periphery bonds, however, the Governing Council might wish also to commit to maintaining net purchases no lower than the rate close to €60bn per month conducted in Q1. So, the extent of any slowing in purchases, if at all, will likely be modest.

Datawise, French (tomorrow) and German (Thursday) merchandise trade numbers for July are due over the coming two days with Italian retail sales for the same month also due tomorrow.

UK

Extra tax on payrolls and dividends provides reminder of less supportive fiscal outlook

Attention in the UK today was focused primarily on the UK government’s long-awaited announcement of reforms to health and social care, which notably saw PM Johnson break a key election pledge not to increase direct taxation on individuals. In particular, to fund an extra £12bn per year of public expenditure aimed initially at meeting pressures on the health service but ultimately absorbing the costs of an ageing population, the PM announced a new 1.25% Health and Social Care Levy – based on National Insurance Contributions, a payroll tax paid by both workers and businesses – as well as an equivalent increase of 1.25ppts in the tax on dividend income. The measures will effectively increase taxation by a little more than ½% of GDP from next April, on top of the increase of 1% already built into the Government’s plans. The funds raised from the new levy will be spent by the public sector, so at face value today’s announcement should be neutral from the perspective of the fiscal policy. However, the tax hike will likely weigh somewhat on household consumption. The government also announced its intention to break a further pledge to index state pensions with wages next year. And given other policies in the baseline, fiscal policy is still set to weigh increasingly on UK GDP growth from next year on, one factor that is likely to reduce the urgency for monetary tightening from the BoE over the horizon.

BRC survey signals moderation in retail sales growth

On a quiet day for UK economic data, meanwhile, the latest BRC survey signalled a slowdown in retail sales in August. In particular, despite stronger spending on clothes as more workers returned to the office, the BRC survey measure of total sales slowed 3.4ppts to 3.0%Y/Y, the softest since February. With greater scope for eating out, food sales slowed more abruptly, to 1.9%Y/Y, while online sales fell 2.5%Y/Y. The survey measure of like-for-like sales growth, meanwhile, slowed 3.2ppts to 1.5%Y/Y, the weakest since the initial pandemic drop in March last year. Of course, as in other major economies, the moderation in UK spending on goods is likely to have been at least matched by increased spending on services.

The coming two days in the UK

Looking ahead, it’s set to be a quiet couple of days in the UK on the economic data front, with just the RICS housing survey for August and REC report on jobs due on Thursday. More interesting perhaps, BoE Governor Bailey and MPC members Broadbent and Ramsden are due to testify before the Treasury Select Committee on the July Financial Stability Report and the August Monetary Policy Report late on Wednesday.

The next edition of the Euro wrap-up will be published on 9th September 2021

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area		Final GDP Q/Q% (Y/Y%)	Q2	**2.2 (14.3)**	_2.0 (13.6)_	-0.3 (-1.3)	**-0.3 (-1.2)**
		Final employment Q/Q% (Y/Y%)	Q2	**0.7 (1.8)**	0.5 (1.8)	-0.2 (-1.8)	-
Germany		Industrial production M/M% (Y/Y%)	Jul	**1.0 (5.7)**	0.9 (5.0)	-1.3 (5.1)	**-1.0 (5.4)**
		ZEW current situation (expectations)	Sep	**31.9 (26.5)**	33.0 (30.0)	29.3 (40.4)	-
UK		BRC retail sales monitor, like-for-like sales Y/Y%	Aug	**1.5**	-	4.7	-

Auctions

Country		Auction
Germany		sold €490mn of 0.5% 2030 index-linked bonds at an average yield of -2.06%
		sold €66mn of 0.1% 2046 index-linked bonds at an average yield of -1.68%
UK		sold £3.25bn of 0.25% 2025 bonds at an average yield of 0.258%
		sold £1.25bn of 1.625% 2071 bonds at an average yield of 0.895%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ _Daiwa forecast_	Previous
France		07.45	Trade balance €bn	Jul	-6.1	-5.8
Italy		09.00	Retail sales M/M% (Y/Y%)	Jul	-0.2 (4.9)	0.7 (7.7)

Auctions and events

Country		BST	Event
Germany		10.30	Auction: €3.5bn of 0% 2031 bonds
UK		10.00	Auction: £1bn of 0.125% 2031 index-linked bonds
		16.00	BoE's Bailey and certain other officials speak at Treasury Select Committee Hearing

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data

Country		BST	Release	Period	Market consensus/ _Daiwa forecast_	Previous
Euro area		12.45	ECB refinancing rate %	Sep	_0.00_	0.00
		12.45	Marginal lending facility rate %	Sep	_0.25_	0.25
		12.45	Deposit rate %	Sep	_-0.50_	-0.50
Germany		07.00	Trade balance €bn	Jul	13.8	16.2
UK		00.01	RICS house price balance %	Aug	75	79

Auctions and events

Country		BST	Event
Euro area		12.45	ECB monetary policy announcement
		13.30	ECB President Lagarde speaks at post-Governing Council press conference
		14.30	ECB publishes staff macroeconomic projections for the euro area
UK		00.01	REC report on jobs
		15.00	BoE's term funding scheme usage and lending data published – Q221

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