Euro wrap-up

Overview

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- Bunds made significant gains and periphery bonds outperformed as the ECB signalled that its net PEPP purchases are expected to be conducted at a "moderately lower pace" over the coming quarter.
- Gilts made modest gains at the longer end of the curve as surveys pointed to ongoing labour shortages but a slowing of housing market activity.
- Friday will bring UK GDP data for July as well as French, Italian and Spanish IP figures for the same month.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.721	-0.017
OBL 0 10/26	-0.667	-0.031
DBR 0 08/31	-0.366	-0.041
UKT 0⁷/₈ 01/23	0.214	+0.012
UKT 0³/₈ 10/26	0.405	+0.013
UKT 0¼ 07/31	0.731	-0.011

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

Euro area

ECB to slow the pace of PEPP net purchases "moderately"

Broadly in line with expectations, when its latest monetary policy meeting concluded today the ECB announced a slowdown in its net PEPP asset purchases over the coming quarter. The Governing Council, which was unanimous in its decision, was deliberately vague about the precise extent of the slowdown to come, however, stating merely that it expects to conduct its net asset purchases under the PEPP programme at "a moderately lower pace" compared to the past two quarters. The pace will thus be below the average between €75-80bn per month seen over the past two quarters. Whether it will slow as far as, or indeed beyond, the average pace in Q1 (a little below €60bn) was left unclear. A Reuters report in late afternoon citing three anonymous ECB sources subsequently suggested that the monthly target would be between €60-70bn. In practice, however, the extent of the slowdown will depend on market developments, with the aim still to maintain favourable financing conditions, which are similarly ill-defined.

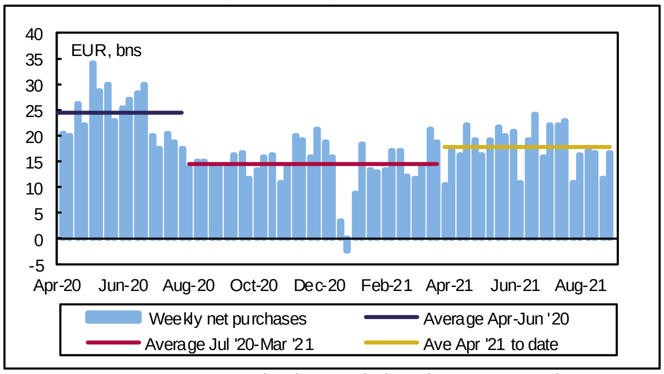
Markets understand that the ECB is not tapering

The ECB will consider this ambiguity in its plans to be constructive. And the narrowing of periphery spreads following today's announcement suggests that markets do not expect the slowdown in purchases relative to new bond supply to be abrupt. Investors also understand that today's move did not represent tapering, with the pace of PEPP purchases merely recalibrated for the coming three months and further large-scale purchases likely to come throughout the coming year, whether under the auspices of the PEPP or a reformed version of the regular asset purchase programme. Indeed, beyond today's decision to slow the PEPP purchases, the ECB predictably left all of its policy parameters and guidance unchanged. In her press conference, Christine Lagarde made clear that there had been no discussion this week of what might come after the coming quarter in terms of asset purchases. Instead, the pace and nature of purchases in the New Year, including perhaps what is likely to come beyond the end of the PEPP, will be discussed at the December Governing Council meeting.

GDP forecast nudged higher to reflect stronger first half of 2021

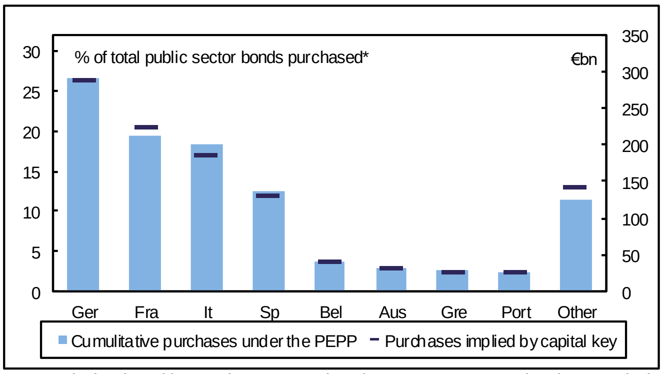
The justification for slowing the pace of net purchases in the coming quarter rests principally on the fact that sovereign yields remain below levels in the second quarter. So, with net issuance to fall, the ECB has scope to slow the pace of buying without risking an unwarranted tightening of conditions. To some extent, the ECB's updated economic outlook also gave cover for the slower pace, with upwards revisions made to the GDP and inflation forecasts for the current year, and an (admittedly very slight) upwards revision to the inflation forecasts for the coming two years. In particular, following stronger-than-expected growth in the first half of the year, and evidence of continued firm momentum over the summer consistent with

Euro area: Weekly PEPP purchases



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Public sector securities under the PEPP



**Excludes bond issues by supranationals. Source: ECB and Daiwa Capital Markets Europe Ltd.*

growth of roughly 2½%Q/Q in Q3, the ECB revised up its forecast for GDP growth in 2021 by 0.4ppt to 5.0%Y/Y. So, it expects economic output to be back above the pre-pandemic peak by end of the year. And also judging it likely that supply bottlenecks will ease over the first half of 2022 and the pandemic will not require the reimposition of restrictions on activity, it left its GDP projections for 2022 and 2023 little changed at 4.6%Y/Y and 2.1%Y/Y respectively.

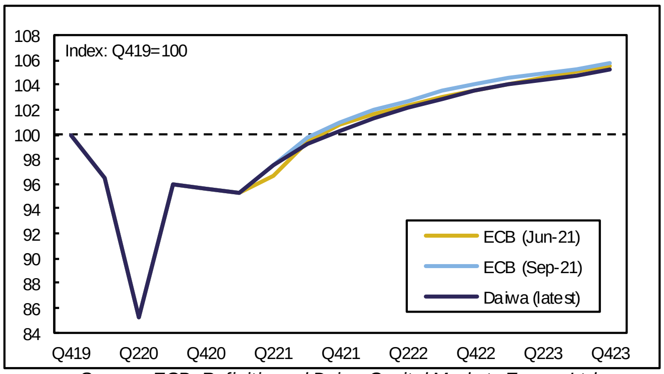
Inflation outlook remains inconsistent with ECB target

In terms of inflation, the recent higher-than-expected outturns meant that the ECB was always going to revise up its forecast for 2021. In the event, it nudged up its expectation for headline inflation this year by 0.3ppt to an above-target 2.2%Y/Y, with the core measure (excluding food and energy) also 0.2ppt higher, albeit at just 1.1%Y/Y. But the higher inflation in 2021 was still judged likely to be temporary, being associated with exceptional developments related to post-pandemic reopening, policy changes (particularly Germany's VAT and carbon-pricing measures) and transitory supply bottlenecks. With the level of GDP judged to be a bit stronger than previously expected, the inflation outlook for the coming couple of years was also nudged higher. But the headline measure is expected to average just 1.7%Y/Y next year and a firmly sub-target 1.5%Y/Y in 2023. And core inflation is expected to rise only gradually, also to 1.5%Y/Y in 2023. With the risks judged to be broadly balanced – with upside risks to prices linked to the possibility of longer-than-expected supply bottlenecks eventually feeding into stronger wage growth – the outlook is thus still inconsistent with the ECB's inflation target. And that continues to beg the question as to why the ECB is not providing more stimulus rather than slowing the pace of QE.

German trade flows weaken at start of Q3 as supply bottlenecks continue to take a toll

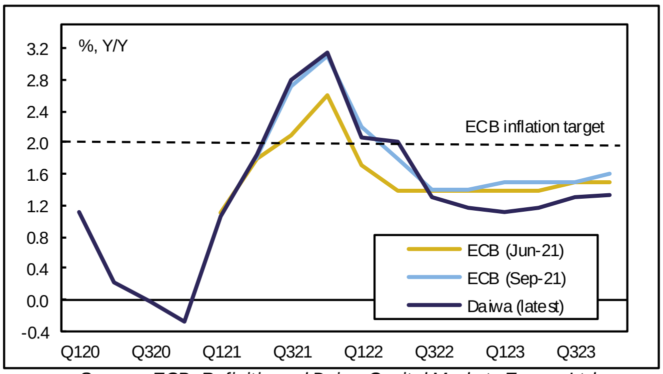
On a quiet day for euro area economic data, Germany's merchandise export and import figures for July pointed to a soft start to Q3 for international trade. Admittedly, the value of goods exports extended its upwards trend, rising for the fourteenth successive month, albeit up just 0.5%M/M following growth of 1.3%M/M in June. That left export values up 12.4%Y/Y and 1.6% above the pre-pandemic level in February 2020. In contrast, German import values fell back in July, dropping a steep 3.8%M/M following growth of 0.7%M/M in June to a three-month low. Given stronger growth earlier in the year, however, imports were still up 16.6%Y/Y and were 5.9% above the pre-pandemic level. And with exports outpacing imports, contrary to expectations of a drop in July, Germany's goods trade surplus rose almost €2bn to €18.1bn, a four-month high and firmly in the top half of the Covid-era range. Adjusted for prices, however, German export volumes dropped for the third month out of the past four in July, down 0.8%M/M to the lowest level since December and 3.1% below the pre-pandemic level. Tallying with the fall in manufacturing production over the course of the second quarter, and in marked contrast to the vigour of new orders from abroad, which rose more than 16% above the pre-pandemic level in July, the data thus suggest a persisting impact on exports from supply bottlenecks. No doubt reflecting continued disruption to supplies of inputs, the drop in import

Euro area: GDP forecasts



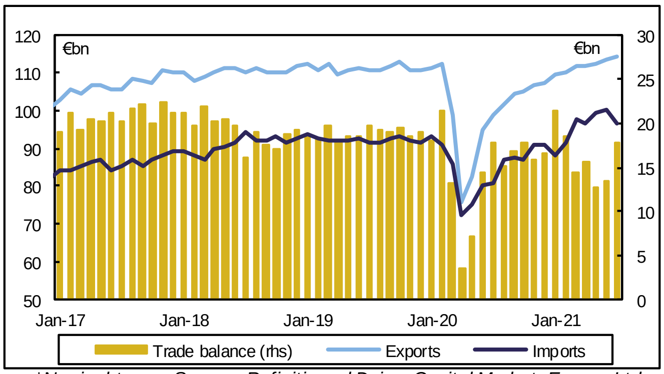
Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



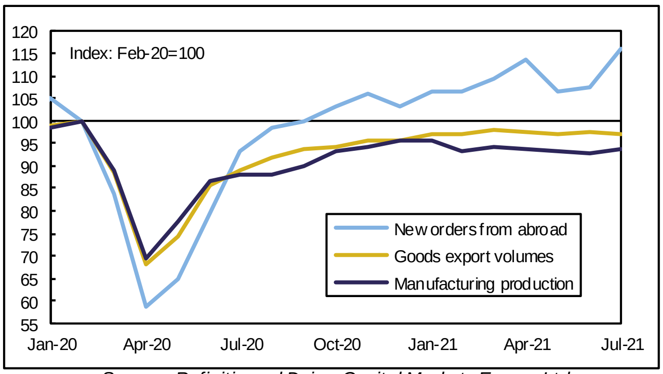
Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Merchandise trade*



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

Germany: Goods output, exports & foreign orders



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

volumes was far more marked, down 6.0%M/M in July to the lowest level in a year. And so, after net trade subtracted from German GDP growth in Q1 and Q2, the weakness of imports already looks set to contribute positively to GDP growth in Q3.

The day ahead in the euro area

The week's euro area data-flow will come to an end tomorrow with French, Italian and Spanish IP figures for July. Like in Germany, France and Spain are expected to register growth in production, albeit somewhat softer at around ½%M/M. In contrast, Italian output is expected to be broadly unchanged. Overall, the data might suggest only a modest easing of supply bottlenecks at the start of Q3. Final German consumer price data, meanwhile, are expected to confirm the flash estimates, which showed that the EU-harmonised measure of inflation rose 0.3ppt in August to 3.4%Y/Y, the highest in thirteen years, with the national CPI measure edging up 0.1ppt to 3.9%Y/Y. Of course, the rise in inflation partly reflects base effects and temporary factors associated with the pandemic, including shifts in energy and commodity prices and VAT changes – and the introduction of Germany's carbon pricing scheme.

UK

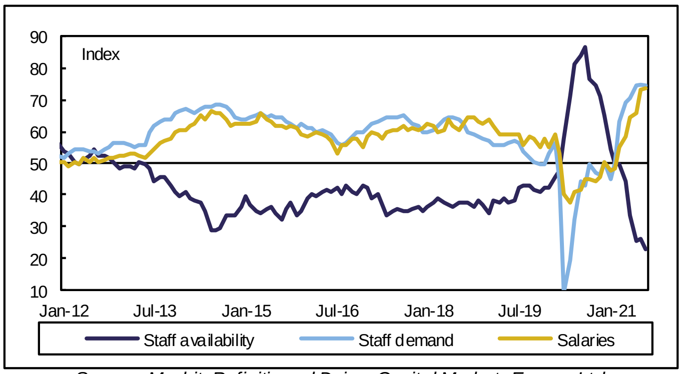
REC survey flags worsening skill shortages

At yesterday's Treasury Select Committee hearing, BoE Governor Bailey acknowledged that the UK economic recovery appeared to have been levelling off over the past month or so, with labour shortages and other pandemic-related factors likely to have been acting as a restraint on activity. Two second-tier surveys released overnight offered some colour on conditions in August. First up, the REC report on jobs – which reflects the views of recruitment and employment consultancies – signalled a further marked pickup in hiring activity last month, with permanent placement growth at a series high and temp billings also up significantly. So, total vacancies reportedly slowed only slightly from July's record pace. But – despite still some 2mn more workers being unemployed, on furlough or inactive compared to before the pandemic – labour and skill shortages were reported to have become even more acute, with candidate availability at a series low. So, the resulting heightened competition for workers reportedly pushed starting salaries for permanent staff up at a record rate, with an accelerated pace of pay growth reported for temps too. Of course, the worsening of labour and skill shortages, which reflects the combination of the Covid and Brexit shocks, has been increasingly evident in the UK for several months. Most prominent in the media has been the shortage HGV drivers – of more than 100k out of a pre-pandemic total of 600k according to the Road Haulage Association – contributing among other things to empty supermarket shelves, shortages of food and drink items in restaurants, and closure of petrol stations. And while the end of the furlough scheme this month should boost labour supply, and the UK government was today set to announce plans to speed up the HGV testing process, it is hard to believe that the shortages in that sector will ease significantly before the end of the year.

RICS survey signals slowing housing market activity

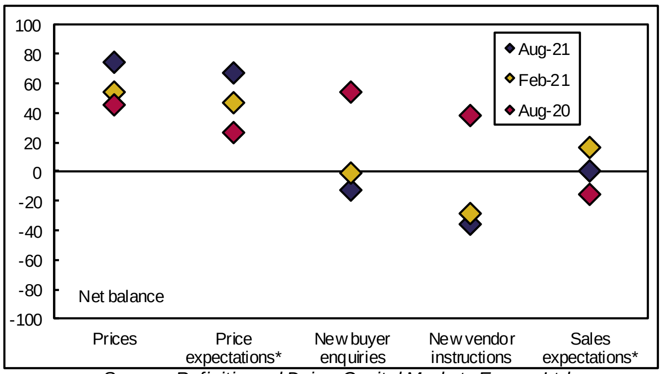
Separately, the RICS residential market survey reported a further slowing of housing market activity in August, reflecting not least the tapering of the government's stamp duty holiday from July, which had brought forward demand to the first half of the year. In particular, according to the respective indices, the number of home sales fell for a second successive month and the pace of house price growth (which reached 11.0%Y/Y on the Nationwide index) eased somewhat too. However, while new buyer enquiries also fell again, new sales instructions and the inventory of homes on the market were also low, and so prices were expected to continue to rise over coming months albeit at a somewhat softer pace than of late. Over the coming three months, the number of sales was expected to stabilise before returning to modest growth over the coming year.

UK: REC report on jobs – selected indicators



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

UK: RICS residential survey – selected indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

The focus in the UK tomorrow will be on the release of July's monthly GDP estimate, along with the production and trade figures for the same month. With most final Covid restrictions having been relaxed on 18 July, we expect to see another month of solid growth in the services sector. And construction output seems likely to rebound following three months of declines. But given persistent supply challenges – as well as the decision by some manufacturers (e.g. in the auto sub-sector) to bring forward their usual summer shutdown maintenance period to alleviate difficulties caused by staff shortages – production in the manufacturing sector is likely to have remained subdued. Overall, we expect GDP growth in July to be marginally softer than the 1.0%M/M increase recorded in June, to leave output about 1½% below the pre-pandemic level.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB refinancing rate %	Sep	**0.00**	*0.00*	0.00	**-**
	Marginal lending facility rate %	Sep	**0.25**	*0.25*	0.25	**-**
	Deposit rate %	Sep	**-0.50**	*-0.50*	-0.50	**-**
Germany	Trade balance €bn	Jul	**18.1**	14.6	16.3	**16.2**
UK	RICS house price balance %	Aug	**73**	75	79	**77**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Trade balance €bn	Jul	**-7.0**	-6.1	-5.8	**-6.1**
Italy	Retail sales M/M% (Y/Y%)	Jul	**-0.4 (6.7)**	-0.2 (4.9)	0.7 (7.7)	**- (7.9)**

Auctions

Country	Auction
Germany	sold €3.2bn of 0% 2031 bonds at an average yield of -0.38%
UK	sold: £1bn of 0.125% 2031 index-linked bonds at an average yield of -3.0%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Germany		07.00	Final CPI (EU-harmonised CPI) Y/Y%	Aug	3.9 (3.4)	3.8 (3.1)
France		07.45	Industrial production M/M% (Y/Y%)	Jul	0.4 (4.2)	0.5 (7.1)
		07.45	Manufacturing production M/M% (Y/Y%)	Jul	-	0.9 (7.5)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jul	-0.2 (5.6)	1.0 (13.9)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jul	0.5 (5.9)	-1.0 (11.1)
UK		07.00	GDP M/M% (3M/3M%)	Jul	*0.5 (3.7)*	1.0 (4.8)
		07.00	Industrial production M/M% (Y/Y%)	Jul	0.4 (3.0)	-0.7 (8.3)
		07.00	Manufacturing production M/M% (Y/Y%)	Jul	0.1 (6.1)	0.2 (13.9)
		07.00	Construction output M/M% (Y/Y%)	Jul	0.4 (10.9)	-1.3 (30.0)
		07.00	Index of services M/M% (3M/3M%)	Jul	0.6 (4.7)	1.5 (5.7)
		07.00	Goods trade balance £bn	Jul	-11.0	-12.0
Auctions and events						
Euro area		-	Euro area Finance Ministers and ECB Governing Council members meet			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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