Euro wrap-up

Overview

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- While Germany services PMIs were revised down to flag recession risks, Bunds made losses after the German government announced plans for a new fiscal relief package and wholesale power prices rose after Russia indefinitely suspended the flow of natural gas via Nord Stream 1.
- While the UK services PMIs were also revised down, Gilts also made losses, particularly at the short end of the curve, as Liz Truss was confirmed to be the next UK PM.
- Tuesday will bring German factory order figures for July and the August construction PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.135	+0.069
OBL 1.3 10/27	1.344	+0.050
DBR 1.7 08/32	1.560	+0.043
UKT 1 04/24	3.159	+0.103
UKT 1¼ 07/27	2.915	+0.068
UKT 4¼ 06/32	2.941	+0.023

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

Euro area

German government relief package timely as Nord Stream 1 remains offline

With Gazprom having announced that it would suspend plans to recommence the flow of natural gas via the Nord Stream 1 pipeline, European wholesale natural gas and power prices rebounded today. For example, having declined by about one third over the course of last week, one-month forward prices of German baseload electricity reversed more than 15% of the drop to be still up about 125% above the Q2 average and about 340%Y/Y. So, yesterday's announcement by German Chancellor Scholz of a new fiscal package worth €65bn (about 2% of GDP) – perhaps two thirds of which will be funded by the federal government to raise questions about consistency with the constitutional debt brake – should lead to some welcome new support to cushion the impact of high energy prices on households and firms, and should also limit somewhat the further increase in inflation over the next couple of quarters.

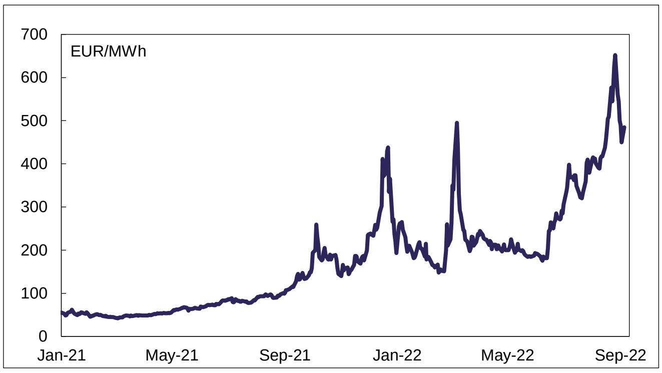
Fiscal support necessary, but probably not sufficient to avoid recession

Measures for consumers include new one-off payments to pensioners and students, increased rent subsidies, child benefits and other welfare payments, as well as increases in income tax thresholds and further public transport subsidies. Measures for businesses include extensions of KfW low-interest loans and federal and state guarantee programmes, the short-time working allowances and catering sales tax cut, as well as suspension of the increase in the carbon price. Initiatives to limit electricity prices (the so-called electricity price brake) are also envisaged, albeit with detail, including timing, still to be worked out and hence the impact on inflation also difficult to predict with any confidence. Measures will in part be funded by a new windfall tax on the profits of generating firms. Overall, the package should limit somewhat the hit to demand from high energy prices. But with the benefits unevenly distributed in favour of higher earners rather than those with the greatest marginal propensity to spend, the measures seem unlikely to boost consumption sufficiently to prevent German recession over coming quarters – particularly should the supply of energy need to be rationed over the winter months.

German services PMI revised lower on weakening domestic and overseas demand

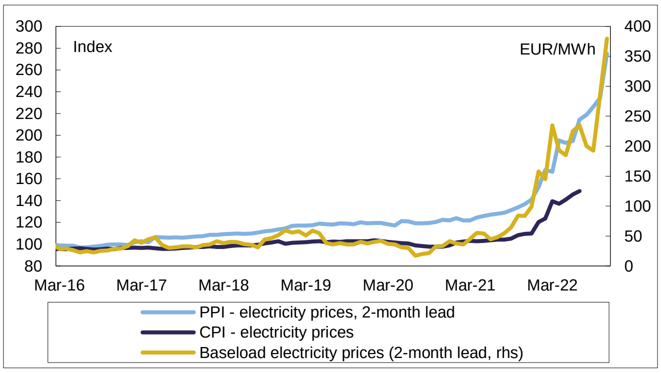
Further evidence of a gradual slide into German recession came from today's final services PMI surveys for August. A downwards revision of 0.5pt to Germany's headline activity index meant that it is now estimated to have fallen for four successive months, and by a substantive 2pts in August to an eighteen-month low of just 47.7. With the manufacturing output PMI last week confirmed at a highly contractionary 46.4, the composite output PMI fell for a fifth successive month, and by a revised 1.2pts to just 46.9. And that left it trending so far in Q3 more than 5½pts below the Q2 average and indicating the steepest pace of contraction since May 2020. While the French services PMI was nudged slightly higher in

Germany: Baseload electricity 1M forward prices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Electricity prices



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

August, at 51.2 it still marked the softest reading since April 2021, while the equivalent Italian index was broadly consistent with stagnation in the sector (up 2.1pts to 50.5). In addition, the Spanish services activity PMI fell a sharp 3.2pts to 50.6, with a fading of the boost from tourism set to restrain near-term growth too.

German Sentix expectations index at series low

Overall, the euro area's services PMI is now estimated to have dropped a steeper 1.4pts in August to 49.8, the first sub-50 reading for seventeen months and almost 8pts below April's peak. Taken together with a very weak manufacturing output PMI (46.5), the euro area's composite output index was left firmly in contractionary territory at 48.9 to be trending some 5pts below the Q2 average. And the survey signalled a worsening of conditions on the horizon too, with the composite new business component down to just 46.9. This tallied with an extremely downbeat Sentix survey of financial investors, with euro area economic conditions index falling 6.6pts to -31.8, the lowest reading since the initial wave of Covid-19 and suggestive of a deepening recession. The weakening reflected both a downturn in the current situation balance, down more than 10pts to -26.5, as well as the expectations balance, down 3.3pts to -37.0, a level that was last lower at the height of the global financial crisis. The Sentix survey also reported a drop in the German expectations balance to an all-time low (-36.0).

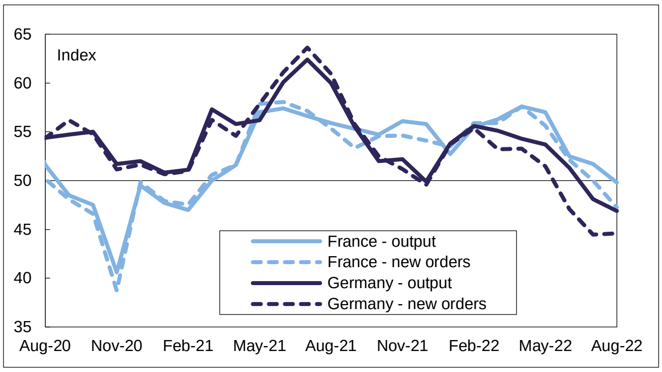
Retail sales post modest rise in July, but spending on core items continues to fall

Admittedly, last week's German retail sales data suggested a surprising rebound in spending on goods (1.9%M/M) at the start of Q3. But not least reflecting declines in France (-0.9%M/M) and Spain (-1.0%M/M), today's aggregate euro area retail sales figures reported merely a modest rise of just 0.3%M/M in July. And this growth reflected a partial rebound in spending on fuel (0.4%M/M) as the price of petrol fell, as well as minimal growth in spending at food stores (0.1%M/M). But despite a rise of more than 4%M/M in online sales, spending on non-core items fell for the fourth month out of the past five in July, by 0.4%M/M, to be almost 1% lower than the Q2 average. Given the weakness seen in previous months, overall retail sales were down slightly on the Q2 average (-0.2%). And with prices having continued to trend sharply higher and confidence remaining at historical lows, we think that this shortfall will only get bigger as the third quarter progresses.

The day ahead in the euro area

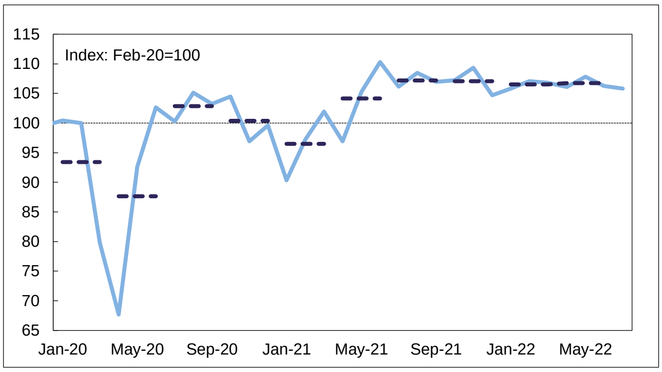
Tomorrow brings the release of German factory orders data for July, which are expected to fall for the sixth successive month, by 0.7%M/M, thus maintaining the downtrend seen since the start of the year. That would leave factory orders down 13.5%Y/Y, albeit still up 2.3% compared with the pre-pandemic level of February 2020. Also to be published tomorrow are

Germany & France: Selected composite PMIs



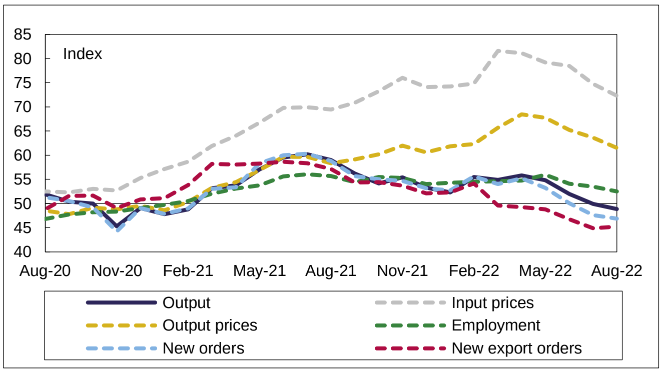
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales*



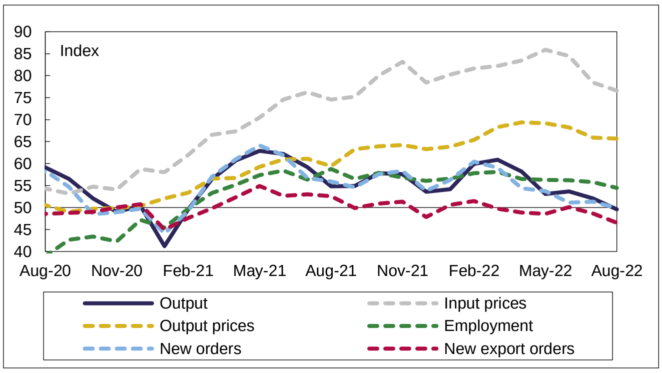
Dashed lines are the quarterly averages. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Composite PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

the construction PMIs for August, which will likely imply a further contraction in activity in the sector, after the headline euro area activity index fell for the sixth consecutive month in July and by 1.3pts to 45.7, the lowest since February 2021.

UK

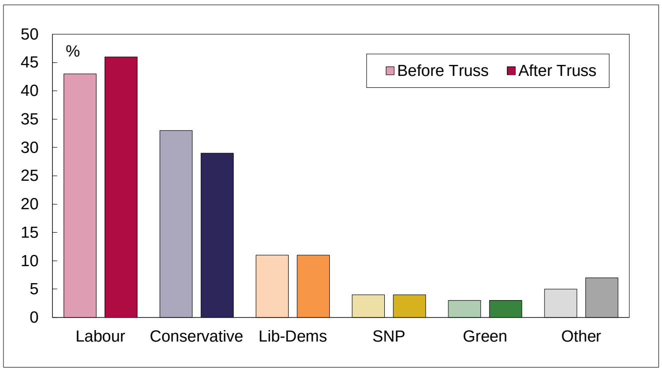
Truss confirmed as next PM with extremely low public ratings

As was widely expected, opportunistic Foreign Secretary Liz Truss was confirmed today as Boris Johnson's successor as Conservative party leader. So, tomorrow she will be confirmed as Johnson's successor as Prime Minister too. While she comfortably won the vote among her party's membership (who are far from representative of the wider UK general public) with cheap libertarian soundbites and a clumsy attempt to imitate Margaret Thatcher, it is hard to remember a Prime Minister taking office with such low public expectations. A YouGov opinion poll published on the weekend suggested that more than half of the public expected her to be a poor or terrible Prime Minister (broadly in line with the share giving that ex post assessment of Johnson's own term in office) with little more than one tenth expecting her to be good or great (even less than the share giving that assessment to Johnson). And a poll published by Survation today suggested that the Conservative party would lose more than 130 seats in the event of a snap general election, while the opposition Labour party would now likely win a majority. Strikingly, the share of the vote taken by the Conservatives would fall by 3ppts in the (now-confirmed) event that Liz Truss became Prime Minister.

Initial Truss fiscal policy steps still unclear with energy price freeze possible

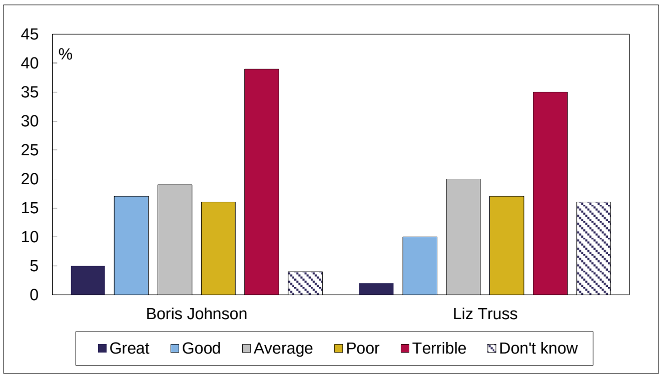
Of course, the financial markets have also already taken a dim view of the forthcoming Truss premiership, not least given her tone of fiscal irresponsibility as well as talk of revisions to the BoE's monetary policy mandate. But given the vagueness of her policy proposals and a seeming lack of clear principle, it is still difficult to know for sure what it set to come next in terms of tangible fiscal measures. Reports today suggested that Truss is now considering adopting the Labour party proposal for a freeze in household energy bills rather than (as previously indicated) proceeding with the roughly 80% hike in the regulated price cap from next month. Such a move could cost somewhere between £70-100bn (3-4% of GDP) but would also reduce the peak in CPI inflation by up to 4ppts. However, unless the recent sharp slide in sterling was reversed, with core inflation (6.2%Y/Y in July) the highest of all major industrialised economies and the labour market still historically tight – whether measured in terms of the ratio of vacancies to unemployed workers, or overall slack – the BoE would seem highly likely to press ahead with an accelerated path of tightening over coming months. Indeed, this afternoon hawkish external MPC member Catherine Mann called for the BoE to act "more forcefully now" suggesting she will vote a 75bps hike this month.

UK: Next general election voting intentions



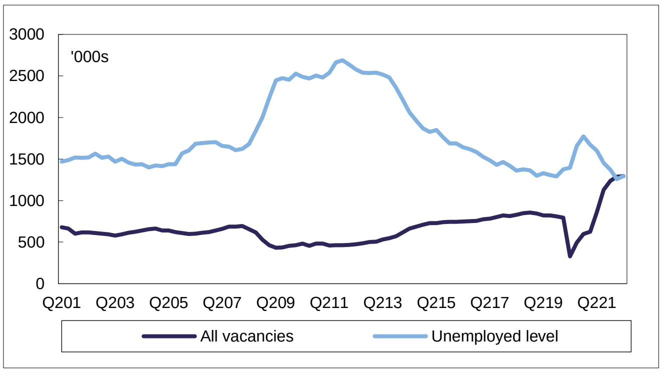
Source: Survation and Daiwa Capital Markets Europe Ltd.

UK poll: Assessments of Johnson & Truss as PM



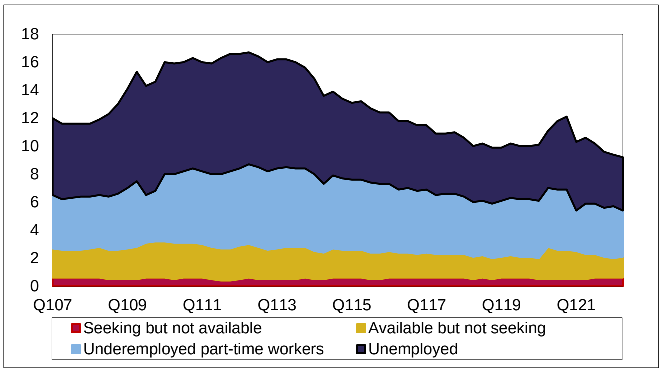
Source: YouGov and Daiwa Capital Markets Europe Ltd.

UK: Unemployment level and vacancies



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Labour market slack



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK services PMI revised lower as cost-of-living crisis weighs on demand

Despite the intensifying cost-of-living crisis, the flash UK services PMIs had suggested that the sector remained relatively resilient in August, with the activity index falling just 0.1pt to 52.5. But today's updated survey suggested that, despite a reported increase in overseas visitors, activity in the sector slowed sharply over the summer as demand for consumer-facing services fell. Indeed, the headline activity PMI was revised down by 1.6pts to 50.9, an eighteen-month low, more than 11½ pts lower than March's peak and consistent with very subdued growth indeed. And given concerns about rising costs and a worsening growth outlook, the survey's new business component (51.0) similarly fell more than initially reported to its lowest level since the lockdowns in February 2021. So, with the manufacturing output index declining at its steepest pace since May 2020, the composite output PMI (49.6) – down for the fourth month out of the past five and by 2.5pts – recorded the first contractionary reading since February 2021, to leave the index trending so far in Q3 more than 4pts below the Q2 average and some 7½pts below the Q1 average. While firms continued to report solid jobs growth in August, the pace was the softest for eighteen months, and expectations for future output remained historically subdued. But despite the weakening in demand, the ongoing squeeze on profit margins from higher input costs related in part to supply-side factors, but also higher wage pressures saw firms – particularly in the services sector – continue to pass on these higher charges to customers. Indeed, at 65.7, the composite output price PMI was some 13½ pts above the pre-pandemic long-run average and a level that will remain a concern for MPC members.

The day ahead in the UK

Looking ahead, tomorrow's economic data calendar brings the release of the BRC retail sales monitor, which will provide a guide to spending on the UK high street in August. Like in the euro area, we will also get the construction PMIs for August, which will likely see the headline activity index fall further below the key 50 expansion/contraction level after dipping to 48.9 in July, the first contractionary level since January 2021.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area	Final services (composite) PMI	Aug	**49.8 (48.9)**	_50.2 (49.2)_	51.2 (49.9)	-
	Sentix investor confidence	Sep	**-31.8**	-26.5	-25.2	-
	Retail sales M/M% (Y/Y%)	Jul	**0.3 (-0.9)**	0.4 (-0.8)	-1.2 (-3.7)	**-1.0 (-3.2)**
Germany	Final services (composite) PMI	Aug	**47.7 (46.9)**	_48.2 (47.6)_	49.7 (48.1)	-
France	Final services (composite) PMI	Aug	**51.2 (50.4)**	_51.0 (49.8)_	53.2 (51.7)	-
Italy	Services (composite) PMI	Aug	**50.5 (49.6)**	48.8 (48.0)	48.4 (47.7)	-
Spain	Services (composite) PMI	Aug	**50.6 (50.5)**	52.4 (52.5)	53.8 (52.7)	-
UK	New car registrations Y/Y%	Aug	**1.2**	-	-9.0	-
	Final services (composite) PMI	Aug	**50.9 (49.6)**	_52.5 (50.9)_	52.6 (52.1)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	08.30	Construction PMI	Aug	-	45.7
Germany	07.00	Factory orders M/M% (Y/Y%)	Jul	-0.7 (-13.5)	-0.4 (-9.0)
	08.30	Construction PMI	Aug	-	43.7
France	08.30	Construction PMI	Aug	-	48.6
Italy	08.30	Construction PMI	Aug	-	46.2
UK	00.01	BRC retail sales like-for-like Y/Y%	Aug	-	1.6
	09.30	Construction PMI	Aug	48.1	48.9
Auctions and events					
Germany	10.30	Auction: €400mn of 0.1% 2046 index-linked bonds			
UK	10.00	Auction: £3.50bn of 0.25% 2025 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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