Daiwa Capital Markets

Euro wrap-up

Overview

- Despite an upwards revision to euro area Q2 GDP, Bunds followed USTs higher at the longer end of the curve as German manufacturing output declined at the start of Q3.
- While sterling's downtrend resumed, Gilts rallied, particularly at the short end of the curve, as tomorrow's policy announcement from new PM Liz Truss was expected to reduce inflation significantly over the near term.
- Thursday will likely bring a rate hike of 75bps from the ECB, while Truss will announce her plans to cap UK energy bills.

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Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.056	-0.009
OBL 1.3 10/27	1.355	-0.050
DBR 1.7 08/32	1.568	-0.062
UKT 1 04/24	2.947	-0.193
UKT 1¼ 07/27	2.895	-0.109
UKT 4¼ 06/32	3.027	-0.064

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

Euro area

German factory output falls in July as energy-intensive sectors maintain downtrend

Yesterday's weak factory orders and turnover data strongly pointed to a drop in German manufacturing output in July. And today's figures duly confirmed a decline of 1.0%M/M, the first fall since March, to be down 1.4%Y/Y and 6.6% below the pre-pandemic level in February 2020. The weakness in factory output at the start of Q3 was broad-based, as firms continued to struggle in the face of supply-chain disruption and the fall-out from the war in Ukraine. Capital goods output fell 0.8%M/M as production of machinery dropped 1.5%M/M, while production of motor vehicles fell 4.6%M/M to be still more than 20% below the pre-pandemic level. Output of intermediate items fell 0.6%M/M with consumer goods down 2.4%M/M weighed by a decline of 3.0%M/M in non-durable items (including processed food). Most notably perhaps, production in energy-intensive subsectors dropped 1.9%M/M to be down 6.9% from February when the shock of Russia's invasion of Ukraine triggered efforts by firms to reduce dependence on natural gas. Output of the chemicals subsector – which accounts for more than one third of all natural gas usage in German industry – fell for a fifth successive month and by 1.8%M/M, taking the cumulative decline since the onset of war in Ukraine to more than 21%.

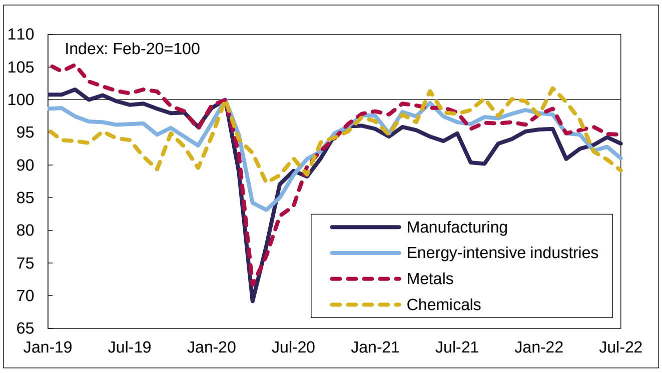
Construction and energy generation soften the blow in July but IP contraction in Q3 highly likely

Despite the non-negligible fall in manufacturing output in July, the decline in overall German industrial production that month was much more modest at just 0.3%M/M. That reflected positive growth in construction for the first time since February (1.4%M/M) and a pickup in energy output (2.8%M/M) likely thanks to a weather-related increase in electricity generated by renewables, which along with coal has helped to offset reduced gas-powered electricity. The small decline in IP in July followed upwardly revised growth of 0.8%M/M in June, and so left the level 0.2% above the Q2 average. Nevertheless, with energy-intensive manufacturing sub-sectors likely to continue to seek to reduce their dependence on gas, the outlook for consumption and investment deteriorating, and construction likely to resume its downtrend too, as suggested by recent surveys, we strongly expect German industrial production to decline over Q3 and Q4.

Euro area GDP revised higher in Q2

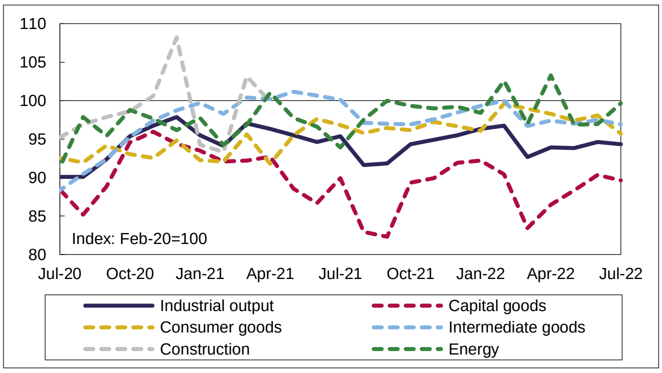
Today's updated euro area GDP figures brought an upwards revision to growth in Q2 by 0.2ppt to 0.8%Q/Q, a non-negligible 0.6ppt stronger than the ECB's baseline forecast published in June. And with growth also revised higher in Q1 by 0.2ppt to 0.5%Q/Q, GDP was up 4.1%Y/Y and 1.8% above the pre-pandemic level in Q419. While growth in Germany was revised slightly higher it was still very subdued at 0.1%Q/Q and merely took output back to the pre-Covid level as ongoing supply-side disruption and, in particular, construction weakness restrained the recovery. Elsewhere, the upwards revision to growth

Germany: Manufacturing output



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

Germany: Industrial output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

in Italy (up 0.1ppt to 1.1%Q/Q) and to a greater extent Austria (up 1ppt to 1.5%Q/Q) more than offset a downwards revision in Portugal (-0.2ppt to -0.2%Q/Q). Meanwhile, Ireland recorded another strong expansion (1.8%Q/Q) albeit at less than one-third of the pace seen in Q1. But the damaging impact of the Ukraine war and double-digit inflation was clearly evident in certain other member states, with GDP in each of the Baltic countries – where inflation is currently highest – having declined in Q2, perhaps giving a foretaste as what to expect in other member states in H222. Indeed, despite the stronger-than-expected growth in the euro area in the first half of the year, the ECB's baseline forecast for GDP in Q3 (0.4%Q/Q), Q4 (0.5%Q/Q) and in 2023 (2.1%Y/Y) will undoubtedly be revised lower, not least reflecting the impact of sharply higher inflation on household spending. Certainly, we wouldn't be surprised to see a recession penciled into the ECB's baseline projection when it is published tomorrow.

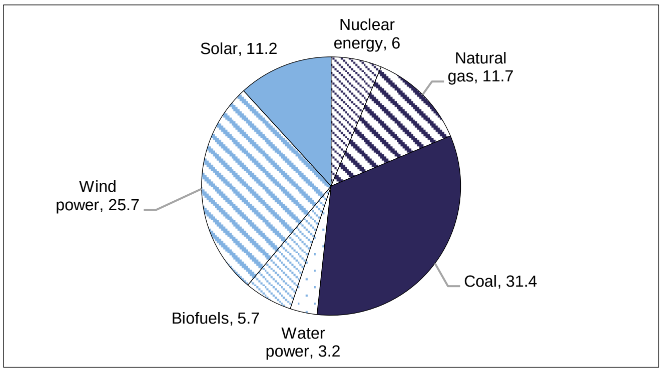
Growth driven by stronger spending on services

Given greater opportunities to spend following the relaxation of pandemic restrictions, euro area growth in Q2 was driven principally by services, for which GVA rose 0.9%Q/Q supported not least by hospitality, transport, entertainment and recreation. Despite ongoing supply strains, value-added in manufacturing rose 0.4%Q/Q, but construction fell 0.7%Q/Q. On the expenditure side, household consumption rose for the first quarter in three in Q2, by 1.3%Q/Q to account for 0.7ppt of GDP growth. Despite falling real wages, consumer spending benefited from another quarter of steady job creation, with employment up more than previously estimated at 0.4%Q/Q (435k). Government consumption also rose for the fifth consecutive quarter (0.6%Q/Q), albeit adding only marginally to GDP growth in Q2. And despite the weakness in residential building, increased spending on equipment, machinery, R&D and intellectual property saw fixed investment rise 0.9%Q/Q to add a further 0.2ppt to GDP growth. This, nevertheless, still left overall capex more than 5½% below the pre-pandemic level. While shipments of goods rose at a similar pace to services exports, total export volumes (1.3%Q/Q) were outpaced by imports (1.8%Q/Q), and so net trade subtracted 0.2ppt from GDP growth.

The day ahead in the euro area

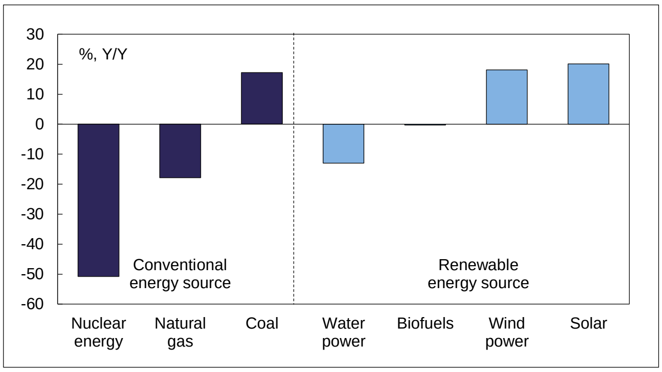
All eyes tomorrow will be on the ECB's policy announcement. After last week's flash euro area HICP estimates in August surprised on the upside – with the headline rate up to 9.1%Y/Y and the core measure up to 4.3%Y/Y – the ECB will have to revise up significantly the profile of its inflation projection. Indeed, the average headline rate in the first two months of Q3 was 9.0%Y/Y, a hefty 1.7ppts above the ECB's baseline forecast for the quarter published in June. There is now a good chance that inflation will reach double-digits in Q4. And with European wholesale natural gas and electricity prices sharply higher and Gazprom currently keeping the Nord Stream 1 pipeline off-stream, and the euro significantly weaker below parity to the dollar, risks to the inflation outlook would seem clearly skewed even further to the upside in the absence of new government

Germany: Share of electricity generation (H122)



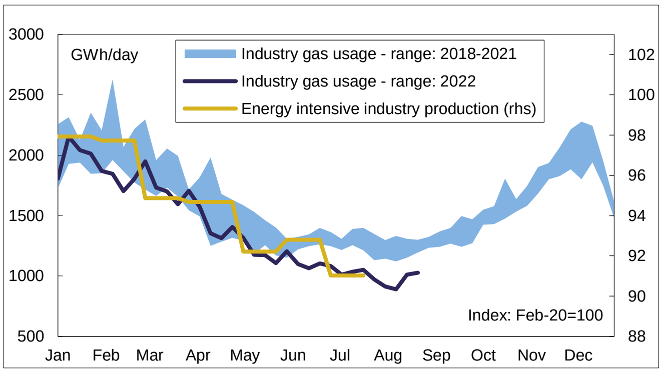
Source: Destatis and Daiwa Capital Markets Europe Ltd.

Germany: Electricity generation (H122)



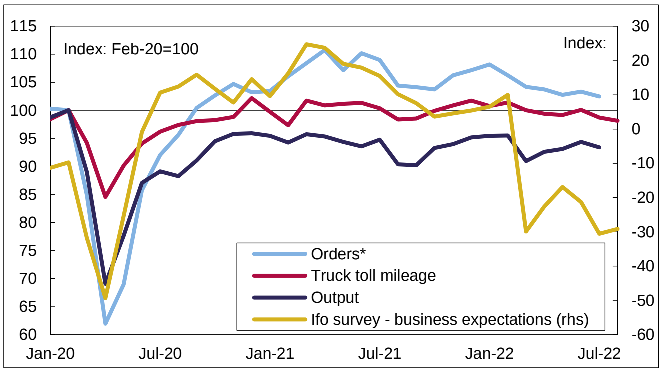
Source: Destatis and Daiwa Capital Markets Europe Ltd.

Germany: Industry gas usage and production



Source: German Federal Network Agency, Destatis and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing indicators



*Excluding bulk orders. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

interventions in energy markets. While the ECB might be reassured somewhat by German Chancellor Scholz's weekend announcement of plans for an extra €65bn of relief measures, funded at least in part by a windfall tax on electricity generators, proposals for a German electricity price brake will not feature in the updated projections.

Of course, the ECB will have to acknowledge the likelihood of a euro area recession over coming quarters. But the ECB's mandate means that it has to prioritise the battle against inflation. And with real short-term interest rates still highly negative and so a long way from neutral let alone a restrictive stance, another big hike seems in order this week. With the hawks having had a majority on the Governing Council for a while, a hike of 75bps – which has been increasingly priced-in since the release of the flash August inflation figures – now looks odds-on. With another hike of at least 50bps then likely for October, and a neutral stance likely to be achieved by year-end, the Governing Council might also this week request advice from the ECB's committees – to be discussed at a future policy meeting – on an appropriate strategy for reducing the stock of bonds purchased under the regular APP programme (i.e. quantitative tightening) for if and when it eventually decides to push policy into restrictive territory.

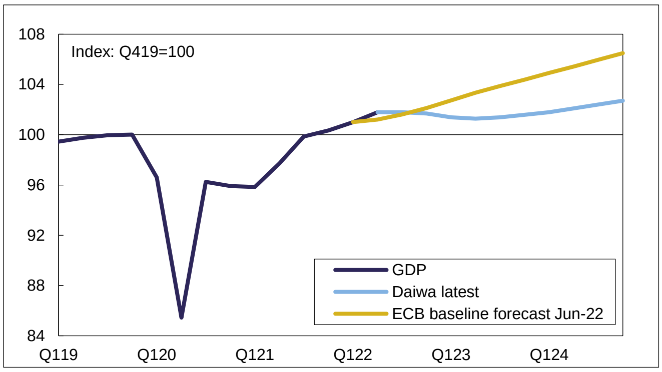
UK

The day ahead in the UK

Politics will remain the key focus in the UK, with Prime Minister Truss set to provide details of her plans to cap energy bills for households and businesses. Despite no shortage of media reports about what she supposedly intends to announce, there remains plenty of uncertainty about the precise modalities, which will help to determine the path of GDP, inflation, public borrowing and interest rates over coming quarters. Certainly, despite criticising such measures during her leadership election campaign, she appears set to announce a cap on energy bills for consumers, which for a typical household are currently scheduled to rise from £1,971 per year to £3,549 in October and higher still in January and April. Reports now suggest such bills might be limited to £2500 per year over the coming eighteen months. But the detail of the mechanism(s) for limiting the price increase, including how it will eventually be paid for, remains unclear.

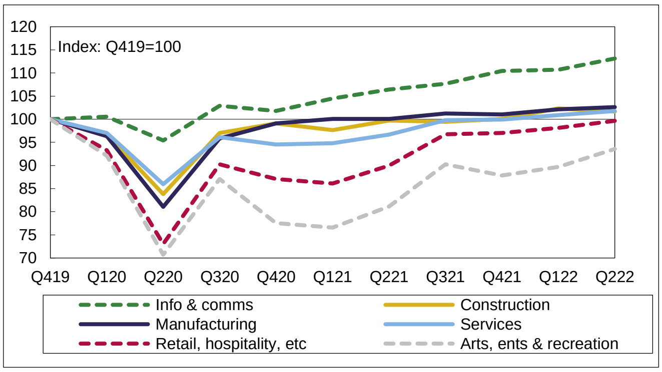
Today, Truss again refused to countenance a new windfall tax on energy companies, and in recent days also backed away from suggestions that households might eventually repay the costs of support via a levy on their bills over future years. The implication, therefore, is simply that government borrowing will take the strain for an extended period. With measures to cap household energy bills set to cost up to £100bn or more (depending on developments in wholesale markets), additional steps to cap bills for small businesses possibly set to cost £40bn or more, and Truss's plans for a cut in National Insurance

Euro area: GDP level and forecasts



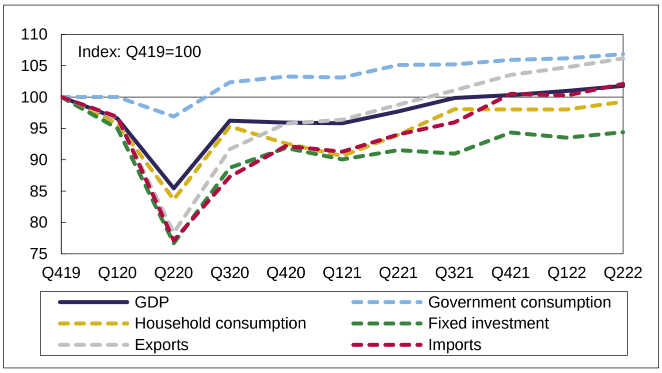
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP by output components



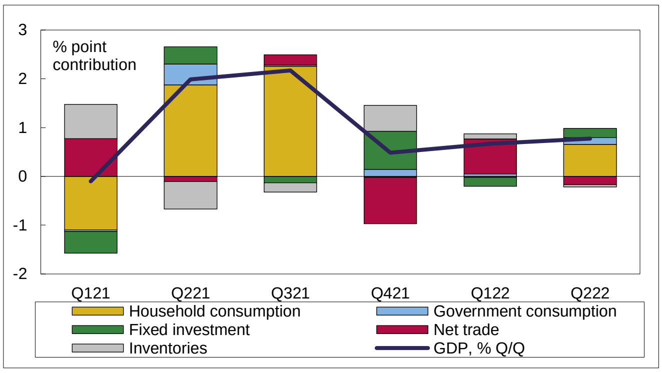
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP by expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to GDP growth



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Contributions, to forego a hike in corporation tax, and other such measures set to cost upwards of £30bn, the public finances could face a shock of up to8% of GDP – an uncomfortable position in light of the increase in the UK's current account deficit to a record high of 8.3% of GDP in Q1. The BoE might ultimately need to scale back its plans for quantitative tightening if the Gilt market responds unfavourably.

Meanwhile, although the government's existing payments to insulate households from some of the increase in household energy bills were judged by the ONS to be transfer payments with no impact on inflation, the new market interventions might now be expected to reduce the profile over coming quarters so that the headline CPI rate peaks in Q4. While Gilts rallied at the short end today given hopes that the MPC might therefore not tighten policy so aggressively over the near term, the BoE will remain focused on inflation two to three years ahead. And given that it would expect GDP and employment to be higher than otherwise would have been the case, and sterling continues to depreciate as the markets balk at the likely deterioration in the public finances and balance of payments to come, it will continue to see the need to tighten monetary policy significantly over coming meetings. Indeed, the terminal rate for the current cycle might now need to be higher than it previously judged would be the case.

Data-wise, Thursday will see the RICS publish its August residential market survey, which is likely to add to evidence of a weakening of house price expectations and concerns about the resilience of the market to higher rates and weaker economic growth. The latest KPMG/REC report on jobs will provide insights into the tightness of the labour market.

Daiwa Capital Markets

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	**0.8 (4.1)**	*0.6 (3.9)*	0.5 (5.4)	**0.7 (5.4)**
	Final employment Q/Q% (Y/Y%)	Q2	**0.4 (2.7)**	*0.3 (2.4)*	0.6 (2.9)	**0.7 (3.1)**
Germany	Industrial production M/M% (Y/Y%)	Jul	**-0.3 (-1.1)**	-0.5 (-2.0)	0.4 (-0.5)	**0.8 (-0.1)**
Italy	Retail sales M/M% (Y/Y%)	Jul	**1.3 (4.2)**	-	-1.1 (1.4)	**- (1.3)**

Auctions

Country	Auction
Germany	sold €1.26bn of 1.00% 2038 bonds at an average yield of 1.74%
UK	sold £2.75bn of 1% 2032 bonds at an average yield of 3.088%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	13.15	ECB refinancing rate %	Sep	*1.25*	0.50
	13.15	ECB deposit rate %	Sep	*0.75*	0.00
France	06.30	Total payrolls Q/Q%	Q2	0.3	0.3
	07.45	Trade balance €bn	Jul	-13.0	-13.1
UK	00.01	RICS house price balance %	Aug	61	63

Auctions and events

Country	BST	Event
Euro area	13.45	ECB President Lagarde's post-meeting press conference
UK	00.01	KPMG/REC report on jobs

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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