Euro wrap-up

Overview

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- Bunds followed USTs lower despite an extremely downbeat ZEW investor survey.
- Gilts also followed USTs lower as the UK unemployment rate fell due to higher inactivity while regular wage growth accelerated.
- Wednesday will bring data for UK inflation in August and euro area industrial production in July.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.361	+0.073
OBL 1.3 10/27	1.561	+0.077
DBR 1.7 08/32	1.717	+0.070
UKT 1 04/24	3.062	+0.070
UKT 1¼ 07/27	3.059	+0.087
UKT 4¼ 06/32	3.145	+0.069

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

Euro area

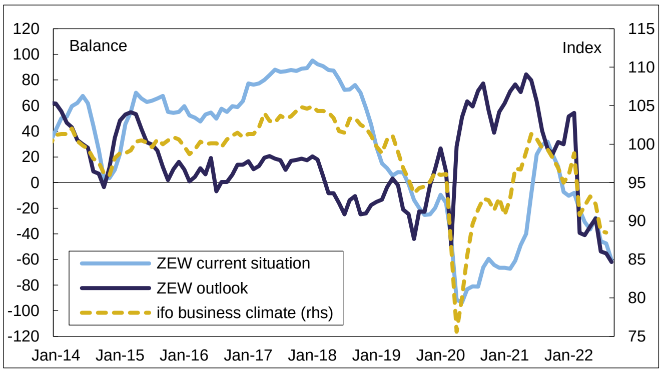
ZEW survey underscores expectations of German recession

Today's results of the August ZEW survey of investors tallied with last week's Sentix indices to highlight rising expectations of German recession. The ZEW index of current conditions dropped further than expected, by almost 13pts to -60.5, the weakest since the lockdowns in Q121. Moreover, the index for economic expectations for the coming six months fell 6.6pts to -61.9, a level that has rarely been lower on the survey. To underscore the downbeat picture, the net balance of expectations for German stock markets for the coming six months shifted into negative territory for the first time since the first wave of Covid-19. Pessimism increased with respect to most sectors, with the profit outlook for steel, chemicals, retail and construction judged to be the worst since the Global Financial Crisis. Despite the recent decline in wholesale natural gas prices, and expectations of EU-wide market interventions to lower electricity bills over coming months, inflation expectations were the least negative for five months, suggesting less confidence that the peak in price pressures is near. Recent weeks have brought recognition within Germany of the increasing likelihood of recession from institutions such as the Bundesbank and ifo institute. And while the ECB's updated economic projections last week suggested that euro area GDP will move broadly sideways between Q322 and Q124, that perhaps reflected the policymakers' hopes more than their expectations.

No surprises from final German inflation data but Spanish figures revised up

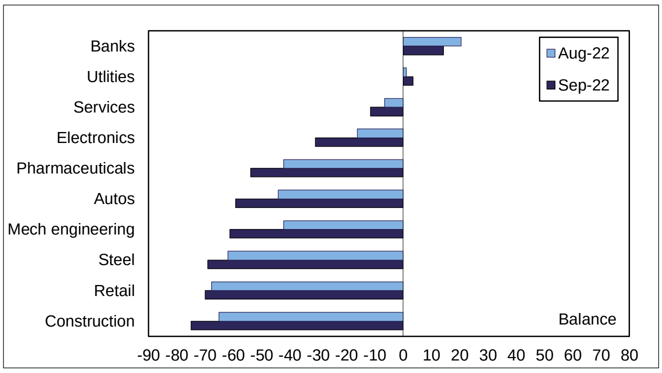
Today's final estimates of German inflation in August provided no surprises as the headline EU-harmonised HICP and national CPI rates were unchanged from the flash estimates. So, the HICP rate rose 0.3ppt to a new series high of 8.8%Y/Y while the CPI rate rose 0.4ppt to match May's post-unification high of 7.9%Y/Y. Key drivers of the latest increase were food and (despite the abolition of an electricity surcharge in July) household energy inflation. But the core CPI rate also rose 0.4ppt to 3.5%Y/Y, with higher inflation of a range of items including clothing, household equipment, hospitality, education and net rents. Looking ahead, core German inflation looks set to surpass 4.0%Y/Y in September due to the end last month of the highly-discounted summer €9 rail pass. And looking further ahead, recent pressures on natural gas and power prices will push German household energy bills significantly higher at the start of 2023 in the absence of more tangible government action to cap prices. In Spain, meanwhile, inflation in August was revised up from the flash estimates, with the HICP rate 0.2ppt higher than previously thought, albeit falling 0.2ppt from July to 10.5%Y/Y, and the CPI measure 0.1ppt higher than previously thought, also at 10.5%Y/Y but down 0.3ppt on the month. The slowing of inflation in Spain in August reflected lower petrol prices, which more than outweighed the impact of higher electricity prices, as well as a new series high in food inflation. But higher components for clothing, furniture, other household equipment and recreation all helped to push core CPI inflation up 0.3ppt to 6.4%Y/Y, the highest since January 1993. The upwards revision to the Spanish data raises the possibility of a modest upwards revision to euro area inflation when the respective final data are published on Friday.

Germany: ZEW & ifo survey indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: ZEW survey – Profit expectations



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

The euro area data focus on Wednesday will be the release of industrial production figures for July. Notwithstanding yesterday's surprise uptick in Italian IP, data published from other member states point to a decline in the euro area aggregate measure – based on figures published, IP is likely to have fallen by around 1%M/M in July. A result in line with our expectations would still leave euro area IP up a little more than ½%Y/Y and almost 2% above the pre-pandemic level. Separately, ECB Chief Economist Lane is due to give opening remarks at a money-market group meeting.

UK

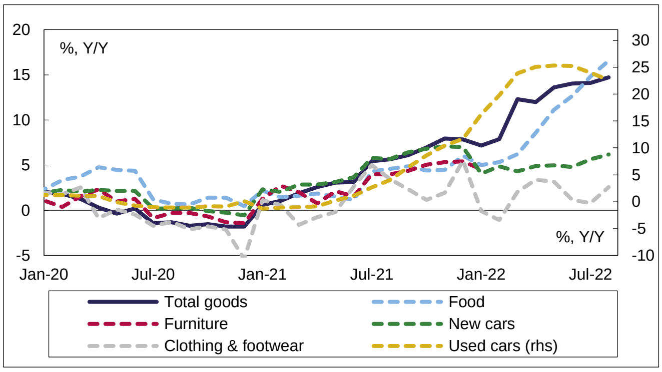
Employment turns for the worse but labour market remains tight as inactivity rises again

Over recent quarters, the BoE has frequently flagged the tightness of the labour market as a source of inflation pressure, compounding the impact of external shocks from energy and food prices and global supply-chain disruption. Indeed, its assessment of conditions in the labour market led the MPC last month to revise up its assessment of excess demand in the UK economy, bolstering the case for further monetary tightening despite the weakness of economic output. And today's data are likely to reinforce that judgement at the Bank, not least as the unemployment rate unexpectedly declined 0.2ppt in the three months to July to 3.6%, a 48-year low. The detail, however, reported a loss of momentum in the market, with the three-month rate of employment growth down 120k from April to just 40k, the lowest since February. Indeed, a turning point appears to have been passed over the summer, with employment on the same basis in July down from the prior two months, to be still 327k below the pre-pandemic level in the three months to February 2020. Total weekly hours worked also fell while the redundancy rate ticked up from a historically low level. So, the source of the drop in the unemployment rate was again a cause for concern rather than a cause for celebration as it reflected a further rise in inactivity, up 194k in the three months to July to be a whopping 642k above the pre-pandemic level. While some of the increase in inactivity was related to the increased number of students, the rise was also again driven by long-term sickness – which now accounts for significantly more than half of all inactive workers – suggesting that severe backlogs in the National Health Service, coupled with failures to address Long Covid, are having serious consequences for the potential level of economic activity in the UK economy.

Level of vacancies falls but remains historically high, so regular wages accelerate again

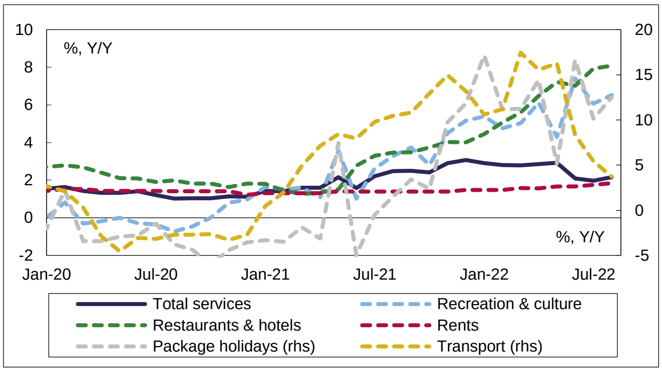
The loss of momentum in the labour market was also reflected in a drop in the number of job vacancies in the three months to August of 34k, marking the sharpest quarterly fall in two years. However, the level of vacancies remained historically high,

Germany: CPI goods inflation components



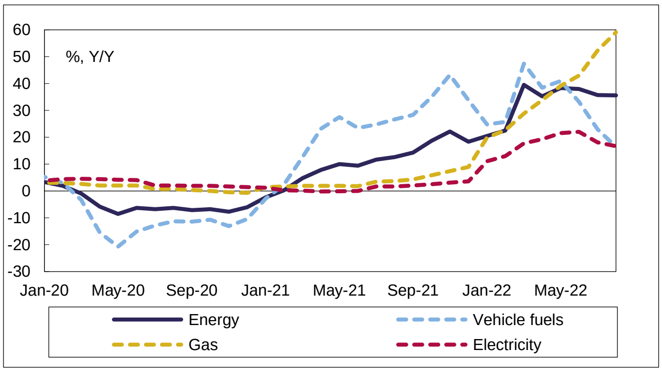
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: CPI services inflation components



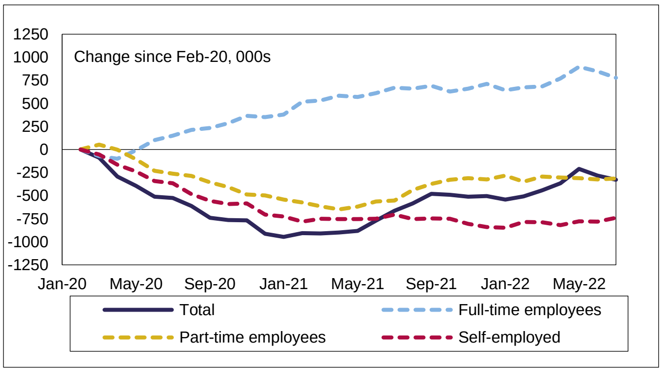
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: CPI energy inflation components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Employment level



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

some 470k (59%) above the pre-pandemic level and broadly in line with the number of workers unemployed, further illustrating the ongoing tightness of the labour market. And that tightness was again reflected in wage growth, the pace of which remained too high for the BoE's comfort. Regular wage growth accelerated a full 1.0ppt in the three months to July to 5.2%3M/Y, the strongest in ten months, narrowing the gap with total pay including bonuses (5.5%3M/Y). Indeed, on an annualised 3M/3M basis, regular pay growth accelerated 0.8ppt between June and July, to 7.0%, pointing to a possible recent pickup in settlement growth that will likely ensure calls from certain MPC members for a rate hike of 75bps at next week's monetary policy meeting. Regular pay growth in hospitality, retail and wholesale sub-sectors, where labour shortages are particularly acute, remained particularly strong (7.0%3M/Y) as did growth in finance and business services (5.9%3M/Y).

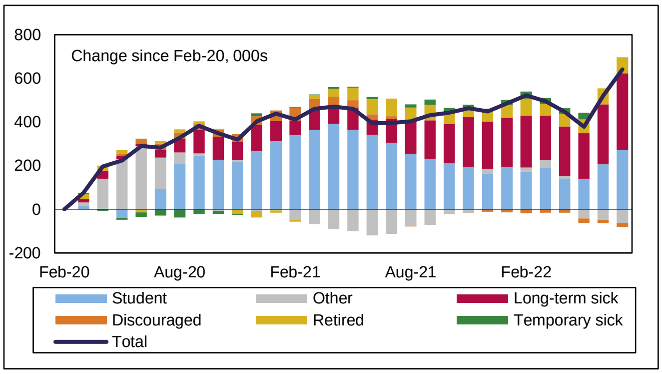
Pay fails badly to keep up with prices so consumption set to remain weak

Nevertheless, nominal pay growth is still failing to keep pace with prices. Deflated by the CPI, real total wages fell 4.6%3M/Y and real regular wages fell 4.4%3M/Y, new record rates of decline on these measures, underscoring the likelihood of a near-term drop in consumer spending. And while inflation is likely to peak in the coming quarter and subsequently fall back gradually, not least thanks to the government's commitment to cap household energy bills from next month on, pay growth will also likely slow in due course in response to the more moderate inflationary environment and weaker economic activity. So, real disposable income growth will likely remain firmly negative next year. Indeed, there are some signs that pay growth is about to slow. For example, firms responding to the BoE's Decision Maker Panel survey in August expected growth in wages to be 0.9ppt lower over the coming twelve months than over the past twelve months, while last week's REC Report on Jobs suggested that pay growth of new permanent staff supplied by job agencies moderated last month to its slowest in fourteen months. But in its August Monetary Policy Report, the BoE expected average weekly wage growth to rise 5¼%Y/Y in both 2022 and 2023, before slowing back to 2¾%Y/Y – a rate more consistent with achievement of the inflation target over the medium term – only in 2024. And while immigration from beyond the EU should provide a boost to labour supply, and the cost-of-living crisis could bring some older workers back into the labour market, unless and until a degree of labour market slack is restored to boost the MPC's confidence that nominal pay growth will fall back to within its tolerance zone, monetary policy will likely continue to be tightened.

The day ahead in the UK

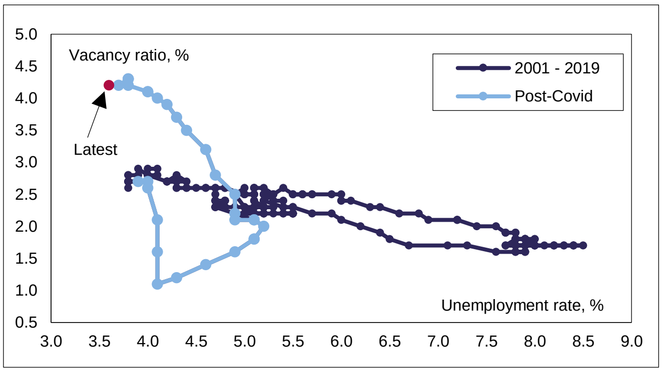
The UK data focus tomorrow will be the August inflation report, which will provide important information ahead of the MPC's monetary policy decision next week. We expect the headline CPI inflation rate to slow 0.2ppt to 9.9%Y/Y, thanks to lower petrol prices. But food price inflation is likely to have trended higher still. And most notably perhaps, we expect the core inflation rate to rise a further 0.1ppt to 6.3%Y/Y. The risks to our forecast also seem skewed significantly to the upside.

UK: Economic inactivity by cause



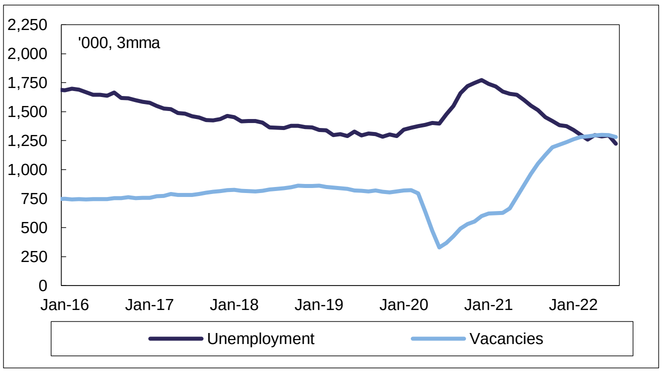
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Vacancy ratio* and unemployment rate



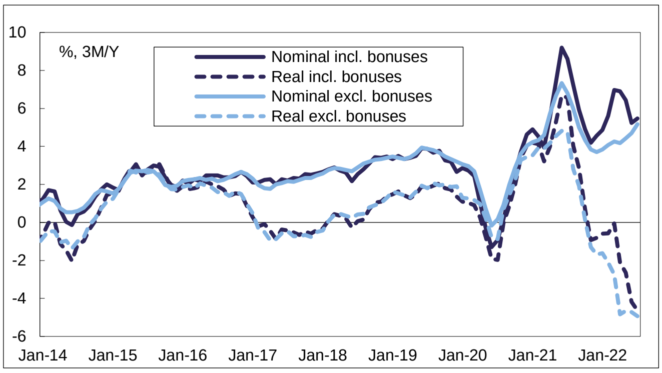
**Vacancy ratio is the number of vacancies for every 100 employee jobs. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Vacancy and unemployment levels*



**Aged 16+. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Average weekly labour earnings*



**Real wages are deflated by CPI inflation. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		Final CPI M/M% (Y/Y%)	Aug	**0.3 (7.9)**	*0.3 (7.9)*	0.9 (7.5)	-
		Final HICP M/M% (Y/Y%)	Aug	**0.4 (8.8)**	*0.4 (8.8)*	0.8 (8.5)	-
		ZEW current assessment (expectations) balance	Sep	**-60.5 (-61.9)**	-52.1 (-59.5)	-47.6 (-55.3)	-
Spain		Final CPI M/M% (Y/Y%)	Aug	**0.3 (10.5)**	*0.1 (10.4)*	-0.3 (10.8)	-
		Final HICP M/M% (Y/Y%)	Aug	**0.3 (10.5)**	*0.1 (10.3)*	-0.6 (10.7)	-
UK		Payrolled employees, change '000s	Aug	**71**	60	73	**77**
		Unemployment claimant count rate % (change '000s)	Aug	**3.9 (6.3)**	-	3.9 (-10.6)	**- (-14.5)**
		ILO unemployment rate 3M%	Jul	**3.6**	3.8	3.8	-
		Employment change 3M'000s	Jul	**40**	125	160	-
		Average earnings including (excluding) bonuses 3M/Y%	Jul	**5.5 (5.2)**	5.4 (5.1)	5.1 (4.7)	**5.2 (-)**

Auctions

Country		Auction
Germany		sold €4.291bn of 0.40% 2024 bonds at an average yield of 1.31%
Italy		sold €2.75bn of 1.20% 2025 bonds at an average yield of 2.77%
		sold €3.25bn of 2.80% 2029 bonds at an average yield of 3.5%
		sold €1.50bn of 3.25% 2046 bonds at an average yield of 4.04%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Industrial production M/M% (Y/Y%)	Jul	*-1.0 (0.7)*	0.4 (2.4)
UK		07.00	CPI M/M% (Y/Y%)	Aug	*0.5 (9.9)*	0.6 (10.1)
		07.00	Core CPI Y/Y%	Aug	*6.3*	6.2
		07.00	PPI output prices M/M% (Y/Y%)	Aug	0.9 (17.6)	1.6 (17.1)
		07.00	PPI input prices M/M% (Y/Y%)	Aug	0.2 (22.9)	0.1 (22.6)
		09.30	House price index Y/Y%	Jul	-	7.8

Auctions and events

Country		BST	Event
Euro area		12.00	ECB Chief Economist Lane to give opening remarks at ECB money market group
Germany		10.30	Auction: €1.0bn of 2.5% 2044 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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