

Euro wrap-up

Overview

- Bunds made losses while euro area IP rebounded in August as supply bottlenecks eased, but production by energy-intensive manufacturers fell.
- Shorter-dated Gilts made sizeable gains as UK GDP fell more than expected in August to be on track for a non-negligible contraction in Q3; longer-dated Gilts pared back earlier big losses as the BoE stepped up its buying but maintained a threat to exit the market at the end of the week.
- Thursday will bring updated German inflation figures for September, as well as UK housing market and credit conditions survey results.

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Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.845	+0.039
OBL 1.3 10/27	2.078	+0.028
DBR 1.7 08/32	2.338	+0.048
UKT 1 04/24	4.040	-0.188
UKT 1½ 07/27	4.493	-0.080
UKT 4¼ 06/32	4.455	+0.013

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

Euro area

Euro area IP rebounds (temporarily) as supply bottlenecks ease

While sentiment surveys pointed to a marked deterioration in manufacturing conditions over the summer, at face value, today's euro area industrial production numbers suggested renewed strength in August, with output rising 1.5%M/M to be up 2.5%Y/Y. However, this followed a sharper decline in July (-2.5%M/M), to be still trending so far in Q3 some ½% lower than the Q2 average. The weakness in the first two months of Q3 in part reflected a further drop in energy supply in August, down 2.3%M/M, to be more than 2% lower than the second quarter average. In contrast, manufacturing production rose 1.7%M/M, to reverse the drop in July and leave it broadly unchanged from the Q2 average, driven not least by a rebound in output of computer, electronic & optical products (14.9%M/M) and autos (6.5%M/M) as supply bottlenecks eased. Indeed, these sectors underpinned a strong showing from France (2.5%M/M), Italy (2.3%M/M) and Ireland (16.6%M/M) in August, to offset weakness in Germany (-0.5%M/M), Netherlands (-1.5%M/M) and Belgium (-6.1%M/M).

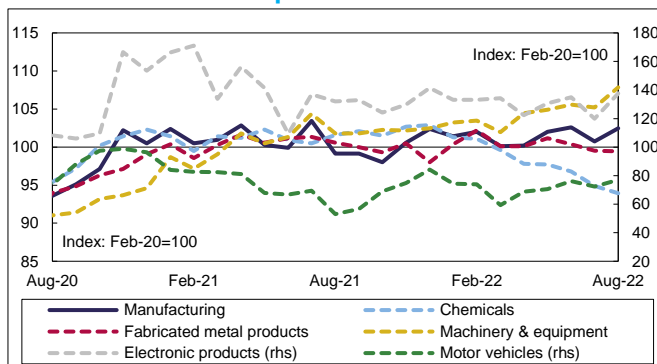
Energy-intensive sectors still struggling

But energy-intensive subsectors continued to struggle over the summer. For example, chemicals production in the euro area fell in August for the eighth consecutive month to be almost 9% lower than at the end of last year, with weakness in Germany likely exacerbated by the low River Rhine water level. Nevertheless, production in energy-intensive sectors in aggregate was down more than ½%M/M in August and roughly 4% below the level ahead of Russia's invasion of Ukraine. And given ongoing concerns about energy supply, production in these subsectors seems likely to have maintained a downtrend at the end of the third quarter, and will also likely retreat further over the winter. Certainly, if recent surveys are to be believed – the manufacturing output PMI (46.3) was firmly in contractionary territory and the Commission's industry balance turned negative for the first time in twenty months – manufacturing output as a whole seems highly likely to be a drag on GDP growth in the second half of 2022 and possibly beyond.

The coming two days ahead in the euro area

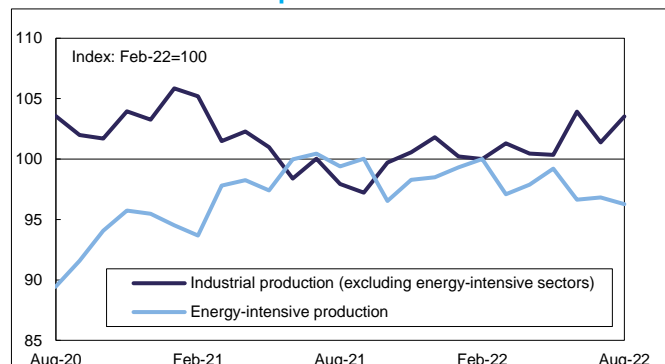
The second half of the week brings updated September inflation figures, including detailed breakdowns for the first time, with data due from Germany (tomorrow), France and Spain (Friday). These are expected to confirm the jump in the headline German HICP rate (up 2.1ppts to 10.9%Y/Y), as well as the drop in the equivalent inflation rates in France (down 0.4ppt to 6.6%Y/Y) and Spain (down 1.2ppts to 9.3%Y/Y). Friday also brings euro area goods trade data for August. With the German trade surplus having narrowed to its smallest since 1992, euro area goods trade figures for August are likely to report a widening in the deficit from July's record high (€40.3bn) due not least to elevated prices of imported energy.

Euro area: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK

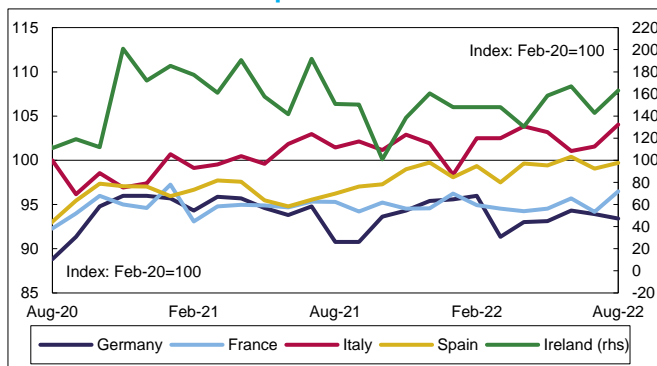
GDP drops in August to be on track for non-negligible contraction in Q3

Economic output in the UK continues to disappoint expectations, dropping 0.3%M/M in August compared to the consensus forecast on the Bloomberg survey of no change. With growth in July revised down 0.1ppt to 0.1%M/M, that meant that GDP in August was down 0.3%3M/3M, the first decline on that basis since March 2021. Not least given the additional disruption to activity following the Queen's death in September, GDP looks firmly on track for a contraction over Q3 as a whole. Indeed, we now think that GDP fell by about ½%Q/Q last quarter. Further illustrating the recent loss of recovery momentum, GDP in August was unchanged from the pre-pandemic level in February 2020 and 0.6% below the pre-pandemic peak. And given the further increase in energy bills this month as well as the injection of significant stress in sterling rates markets and uncertainty caused by the government's ill-considered fiscal policy announcement, we expect GDP to decline further in Q4 and indeed through the first half of 2023 too.

Manufacturing particularly weak in August, but no major sector is likely to have expanded in Q3

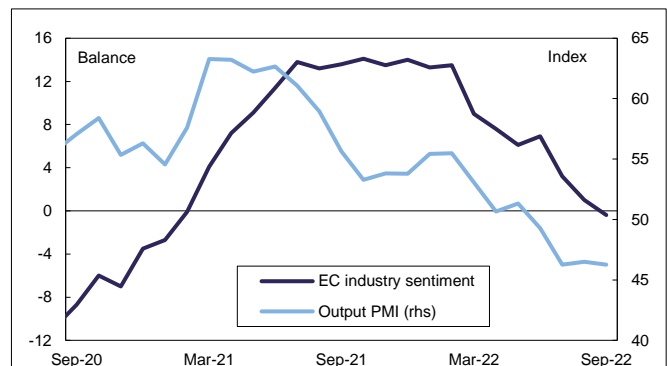
The principal source of weakness in UK economic output in August was industrial production, which fell 1.8%M/M following a revised drop of 1.1%M/M in July. That reflected a sharp fall of 8.2%M/M in mining and quarrying as well as a significant retreat of 1.6%M/M in manufacturing, not least due to falls in production of pharmaceuticals and autos. Indeed, on average over the first two months of Q3, manufacturing output was trending more than 2½% below the Q2 average. Services output also declined in August, but only by 0.1%M/M following downwardly revised growth of 0.3%M/M previously. The small drop was in part due to less Covid-related activity, as well as a decline in entertainment and recreation due to fewer big sporting events (e.g. the European women's football championships concluded at end-July), and lower retail sales. Nevertheless, services output was trending little changed over the first two months of Q3 from the previous quarter. In contrast, construction provided support in August, with growth of 0.4%M/M following a rise of 0.1%M/M in July. However, the average level of construction output in the first two months of Q3 was little changed from the Q2 average. So, overall, the lack of growth momentum appears to have been broad-based, and none of the major sectors is likely to have expanded in Q3.

Euro area: Industrial production



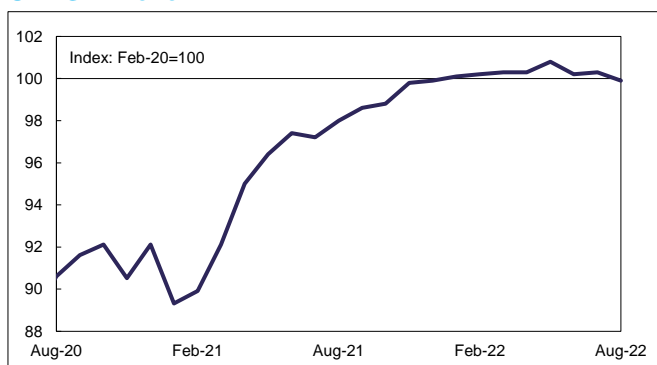
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial sentiment indices



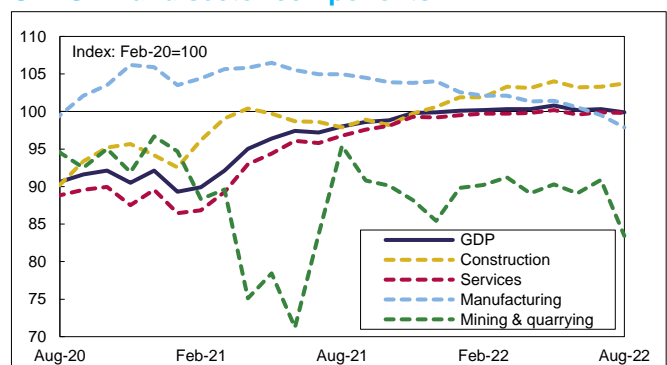
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP level



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP and sector components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Underlying UK goods trade deficit hits new high and set to widen further in Q4

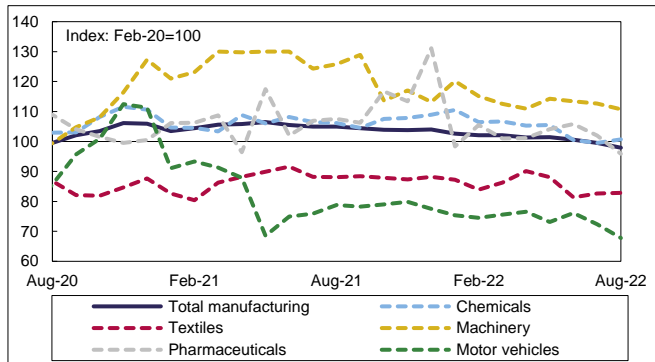
The August trade data were not any more encouraging than the GDP figures, as they flagged a further deterioration in the UK's external balance. Most notably, high natural gas prices meant that the value of goods (up 5.7% M/M excluding precious metals) once again significantly outpaced exports (up just 1.2% M/M on the same basis rose). The deficit in fuels trade rose about £2.7bn to a record high of £9.8bn, more than six times the average in 2021. And the underlying goods trade balance (excluding precious metals) widened more than £2.6bn to a new high of £21.7bn. Including services, the overall trade deficit also widened more than £2.6bn to above £95.5bn, falling just shy of March's record. Looking ahead, sterling's depreciation is likely to magnify import cost pressures over the near term, and – due to a range of structural factors including the import-dependence of exporters, the nature of imports and Brexit-related trade barriers – provide only a modest boost (if any) to net export volumes over coming quarters. Meanwhile, high natural gas prices mean that the overall UK trade deficit is likely to widen significantly further over coming months. So, the trade deficit could rebound in Q4 from 4.2% of GDP in Q2 to perhaps 2ppts above the series high of 5.3% of GDP reached in Q1. And despite support from weak sterling and the strong net international investment position, the current account deficit is likely to exceed the high of 7.2% of GDP reached in Q1 leaving UK asset prices and broader financial conditions vulnerable to sudden shifts in foreign investor appetite.

The coming two days ahead in the UK

The UK data calendar tomorrow will bring the RICS Residential Market Survey for September, which will be watched closely for signs of further slowing in house price growth due to expectations of a sharp increase in borrowing costs. The Bank of England will also publish its latest credit conditions survey results tomorrow. While these are unlikely to reflect recent market developments, lenders are still expected to report a tightening in credit conditions during the three months to October, while the July survey had suggested that supply of secured and unsecured lending was likely to decrease.

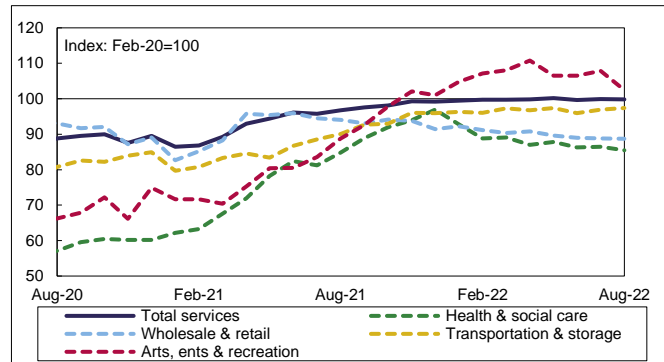
The next edition of the Euro wrap-up will be published on 14 October 2022

UK: Manufacturing production



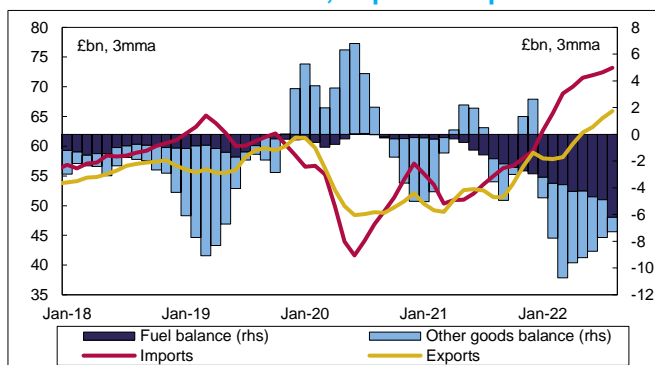
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services activity



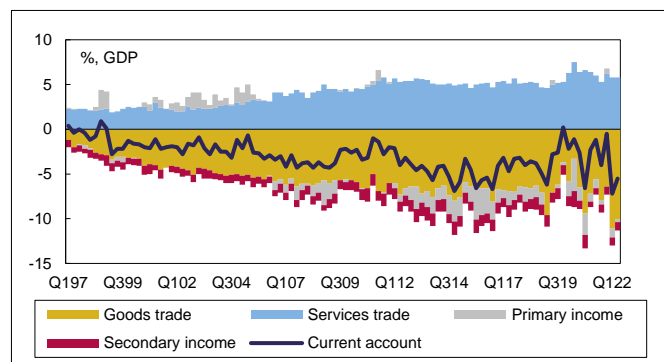
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Goods trade balance, import & export values



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: Current account balance



Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	Industrial production M/M% (Y/Y%)	Aug	1.5 (2.5)	0.6 (1.2)	-2.3 (-2.4)	- (-2.5)
UK	GDP M/M% (3M/3M%)	Aug	-0.3 (-0.3)	0.1 (-0.2)	0.2 (0.0)	0.1 (0.1)
	Industrial production M/M% (Y/Y%)	Aug	-1.8 (-5.2)	-0.3 (-0.1)	-0.3 (1.1)	-1.1 (-3.2)
	Index of services M/M% (3M/3M%)	Aug	-0.1 (-0.1)	0.1 (0.1)	0.4 (-0.2)	0.3 (0.2)
	Construction output M/M% (Y/Y%)	Aug	0.4 (6.1)	0.6 (5.6)	-0.8 (4.3)	0.1 (4.9)
	Goods trade (excluding precious metals) balance £bn	Aug	-19.3 (-21.7)	-20.5 (-)	-19.4 (-19.5)	-17.6 (-19.0)

Auctions

Country	Auction
UK	sold €3.5bn of 2027 bonds at an average yield of 4.8%
	BoE brought £2.375bn of long-dated gilts
	BoE brought £1.98bn of inflation-linked gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany		07.00 Final CPI M/M% (Y/Y%)	Sep	1.9 (10.0)	0.3 (7.9)
		07.00 Final HICP M/M% (Y/Y%)	Sep	2.2 (10.9)	0.4 (8.8)
		- Current account balance* €bn	Aug	-	5.0
UK		00.01 RICS house price balance %	Sep	48	53

Auctions and events

Euro area		08.30 ECB Vice President de Guindos scheduled to speak
Italy		10.00 Auction: €3.75bn of 3.5% 2026 bonds
		10.00 Auction: €2.75bn of 2.8% 2029 bonds
		10.00 Auction: €1.00bn of 3.25% 2038 bonds
		10.00 Auction: €1.25bn of 5.0% 2039 bonds
UK		09.30 BoE publishes Q3 bank liabilities and credit conditions surveys
		12.00 BoE MPC member Mann scheduled to speak in Washington

*Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area		10.00 Trade balance €bn	Aug	-	-40.3
France		07.45 Final CPI M/M% (Y/Y%)	Sep	-0.5 (5.6)	0.5 (5.9)
		07.45 Final HICP M/M% (Y/Y%)	Sep	-0.5 (6.2)	0.5 (6.6)
Spain		08.00 Final CPI M/M% (Y/Y%)	Sep	-0.6 (9.0)	0.3 (10.5)
		08.00 Final HICP M/M% (Y/Y%)	Sep	0.0 (9.3)	0.3 (10.5)

Auctions and events

UK		12.00 BoE publishes its Quarterly Bulletin
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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