Euro wrap-up

Overview

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- Bunds made losses as the ZEW survey suggested that investors are a touch less downbeat about the German economic outlook even though they have a highly negative assessment of current conditions.
- Gilts made losses as UK pay growth significantly exceeded expectations despite other evidence of a loosening of labour market conditions.
- Wednesday will bring UK inflation data for July as well as updates on euro area IP in June and GDP and employment in Q2.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.091	+0.032
OBL 2.4 10/28	2.683	+0.039
DBR 2.6 08/33	2.673	+0.041
UKT 0⅝ 06/25	5.093	+0.053
UKT 1⅝ 10/28	4.583	+0.023
UKT 3¼ 01/33	4.582	+0.022

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

Euro area

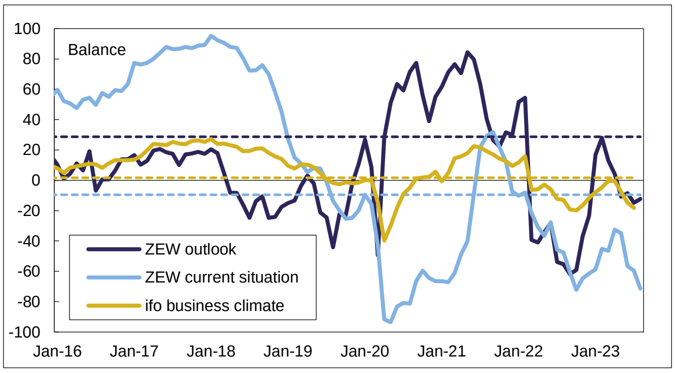
ZEW survey signals deterioration in current conditions but somewhat less downbeat expectations

Today's ZEW survey results suggested that investors take a dim view of current conditions in the German economy. Indeed, the survey's German current conditions index fell for a fourth successive month in August and much further than expected to -71.3, a level that has only once been lower – in October 2022 following the spike in wholesale gas prices – since the first wave of Covid in 2020. That suggests that investors are bracing themselves for a contraction in economic output this quarter. However, like last week's Sentix indices, the ZEW survey suggests that investors are becoming a little less pessimistic about the outlook. Indeed, contrary to the Bloomberg consensus forecast, the index regarding the German economic outlook for the coming six months rose in August. While the increase of 2.4pts on the month left it merely at -12.3, the second-lowest reading so far this year, it was broadly consistent with expectations of stability, rather than recession, in the German economy. Like the improved expectations reported in the Sentix survey, that reflects a large majority view that inflation will continue to subside and that long-term interest rates are close to their peak. And expectations with respect to German stock prices are, on balance, marginally positive, albeit with still significant variation in perceptions between sectors. Judging from the ZEW indices, investors remain upbeat about profits at banks and insurers as well as ICT firms. But they also remain downbeat about the profit outlook for German manufacturers of autos, steel and machinery, and are particularly so with respect to construction firms.

The day ahead in the euro area

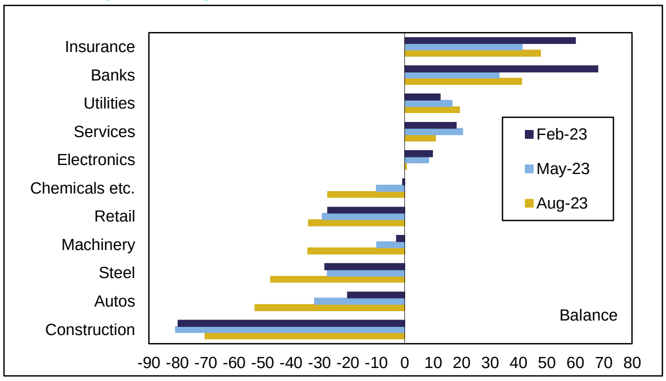
Tomorrow will be the busiest day for euro area data this week, bringing the region's industrial production data for June as well as updates on GDP and employment in Q2. While the figures released so far by the largest member states, including Germany and France, suggested that June would register a drop of ½%M/M or more, the surge of 13.2%M/M in Ireland points to growth of a little less than ½%M/M. But while the May figure is likely to be revised up too, that would still leave IP down around 1½%Q/Q in Q2. Meanwhile, the second estimates of euro area Q2 GDP will likely reaffirm the initial estimates of growth of 0.3%Q/Q and 0.6%Y/Y, which were boosted not least by renewed vigorous growth in Ireland-based multinationals and a surprisingly firm expansion in France. Finally, the preliminary estimate of euro area employment in Q2 should report a ninth successive quarter of job growth to a new high, albeit at a more moderate pace than 0.6%Q/Q, 1.6%Y/Y in Q1.

Germany: ZEW and ifo sentiment indices



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: ZEW profits indices



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK

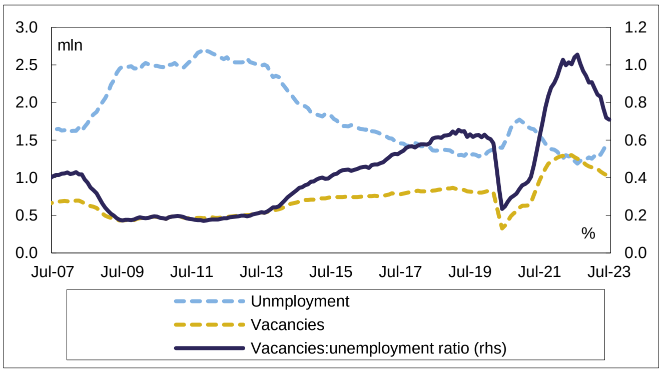
Wage growth accelerates sharply again but labour market is becoming increasingly less tight

Following its August policy meeting, the BoE's MPC flagged the tightness of the labour market and wage growth, as well as services inflation, as the key indicators that would drive its interest rate decisions over coming months. Today's data provided mixed signals. A marked acceleration in private sector wage growth, well ahead of the BoE's forecast, led markets to price in an increased probability of additional tightening to come. But today's figures also suggested strongly that the labour market is softening more rapidly than the MPC had anticipated, which should imply that pay growth is still likely to moderate significantly next year. We maintain our baseline forecast of further rate hikes of 25bps apiece at each of the next two monetary policy meetings before Bank Rate is held at 5.75% into the first half of 2024. But the precise path will be determined by data yet to be released, not least the further labour market report and two sets of inflation reports – starting tomorrow with July's figures – which are due for publication before the September MPC meeting.

Unemployment rises above BoE's expectation while employment and vacancies fall

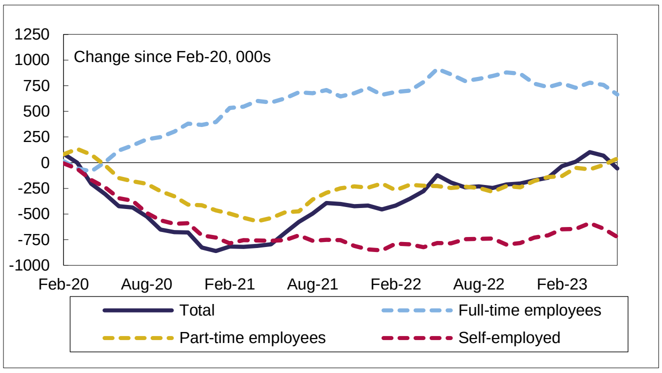
At its August policy meeting, the MPC judged that the labour market remained tight overall, but also saw indications that it was loosening. Judging from today's data, it has been loosening more rapidly than the BoE anticipated. Indeed, contrary to the BoE's assessment that the number of people in work continued to rise, in the three months to June employment fell 66k, the most since August 2022, when the labour market appears to have reached its turning point. And that figure was flattered by a rise in part-time employment. In contrast, the number of full-time employees fell 141k, the most since the first wave of Covid-19, and the number of self-employed was down 75k, the most since the lockdowns of early 2021. In addition, labour force inactivity fell again despite a further rise in long-term sickness to a new record high. So, the unemployment rate unexpectedly rose 0.3ppt on the quarter to 4.2%, up 0.7ppt from the trough in the three months to last August, and up 0.5ppt from the turn of the year. Notably, it was also 0.1ppt above the MPC's expectation for the remainder of the year, and close to the BoE's level of the equilibrium unemployment rate (4.25%) that it did not expect to be reached until Q2 next year. Strikingly too perhaps, the single-month unemployment rate leapt in June to 4.6%, 0.6ppt above its level three months earlier. And the level of vacancies fell in the three months to July for the thirteenth successive month and by 66k to 1.02mn. So, the vacancy-unemployment (VU) ratio – which appears to be the MPC's preferred measure of labour market tightness – fell to 0.72, from the peak of 1.05 in August, with the single-month VU ratio back to its average level in 2019 before the pandemic. With the redundancy rate up to its highest since the three months to April 2021 and the labour force likely to continue to be boosted by net immigration via the government's Skilled Worker visa scheme, the unemployment rate appears likely to continue to rise over the remainder of the year while the VU ratio looks likely to decline further.

UK: Unemployment & vacancies



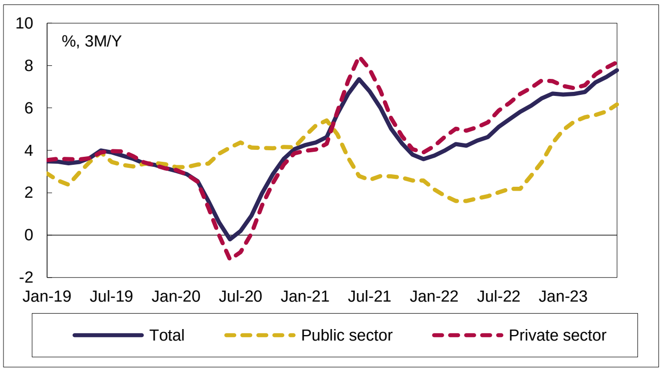
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Change in employment by type



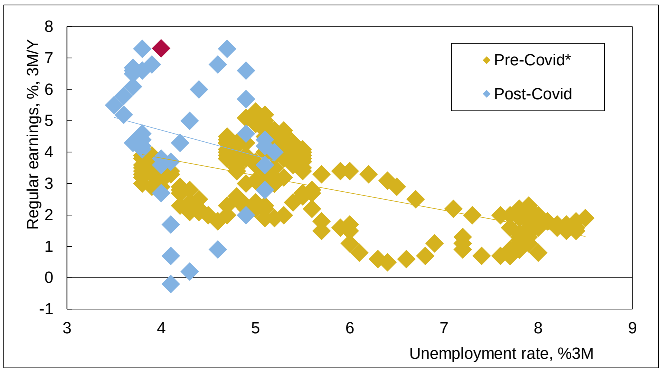
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Regular pay growth



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Phillips curve



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Pay growth hits series high with services wage growth well above BoE forecast

So, the labour market has become steadily less tight over several quarters. And high-frequency data, such as the REC survey indicators, suggest that the cooling of the jobs market has continued into Q3. But the recent shortfall of labour supply relative to demand continues to be reflected in high pay growth well in excess of the BoE's expectations and also significantly above rates that might be considered compatible with achievement of the inflation target over the medium term. In the three months to June, growth in regular pay (excluding bonuses) rose 1.0ppt from the prior quarter to 7.8%3M/Y, the strongest rate on the 22-year series. Boosted in part by one-off payments to National Health Service workers, average total pay including bonuses accelerated even further, up 2.1ppts on the quarter to 8.2%3M/Y. Most important for the MPC, private sector regular pay accelerated 1.1ppt on the quarter, also to 8.2%3M/Y, a series high outside of the pandemic era and a chunky 0.6ppt above the BoE's forecast in its August Monetary Policy Report. Among the various sectors, regular pay in finance and business services rose to 9.5%3M/Y, with the equivalent figures for all services and manufacturing up to 8.0%3M/Y and 8.2%3M/Y respectively.

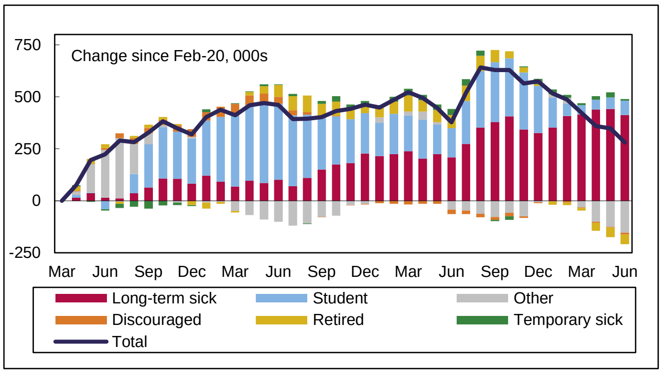
How high will unemployment have to rise to align pay with rates consistent with 2% inflation?

With the annualised 3M/3M rate of growth in private regular wages surging to 11%, momentum in pay intensified in the second quarter. Admittedly, wage growth is a lagging indicator and so the latest data do not reflect the current tightness of the labour market. Some of the recent strength in pay will also reflect temporary compensation for high inflation and so exaggerate the strength of underlying pay growth. But despite evidence of diminished tightness in the labour market over recent quarters, the figures suggest that the unemployment rate is likely to have to rise significantly above the current level, and the BoE's estimate of the equilibrium rate, to return pay growth to levels consistent with the inflation target. Certainly, the BoE's projection for private sector regular pay growth to fall below 7.0%3M/Y over the coming quarter and to 6.2%3M/Y by year-end now looks over-optimistic, perhaps with implications for the near-term path of inflation. More happily, however, with real growth in total pay (deflated by the ONS's preferred CPIH rate) returning to positive territory for the first time in sixteen months (0.5%3M/Y and a vigorous 1.1%3M/3M), and likely to remain positive over the near term, private consumption should also continue to grow throughout the second half of the year even as the labour market continues to cool.

The day ahead in the UK

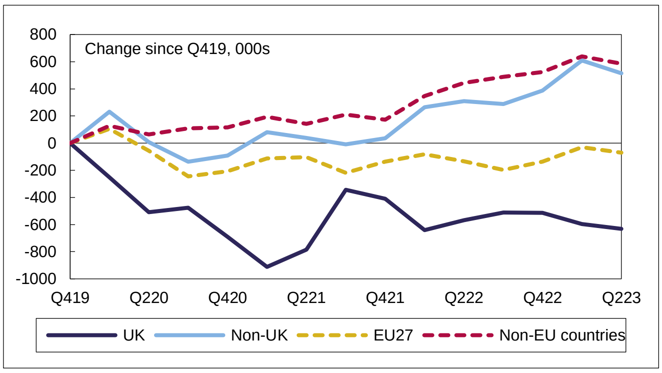
All eyes tomorrow will be on the release of the July inflation figures, which will report a big step down in the headline CPI rate. That will be thanks not least to the drop in the Ofgem price cap, which means that from last month a "typical household" now pays an annual electricity and gas bill of about £2000 compared to £2500 from October to June. As a result, energy inflation looks set to fall more than 10ppts to below -7.0%Y/Y, which would be the weakest since January 2021. Reflecting

UK: Labour force inactivity by reason



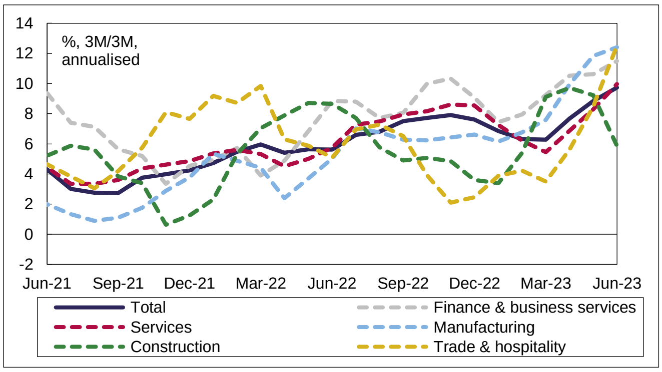
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Change in employment by nationality



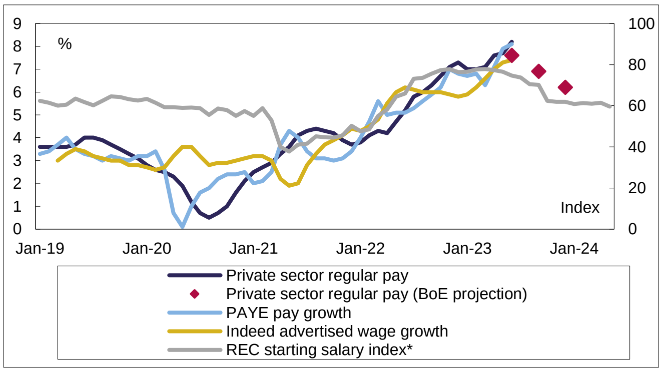
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: Regular pay growth by business subsector



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Regular pay indicators & BoE projection



**New permanent staff, 12M lead. Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

recent trends in wholesale and producer prices, and sterling stronger, food inflation should fall for a third successive month. For similar reasons, and also reflecting significant summer discounting as retailers sought to entice shoppers discouraged by inclement weather, non-energy goods inflation should slow significantly too. But the services component is currently most important for the BoE. And like us, reflecting recent evidence of persistence amid high labour cost growth, the Bank's staff expect services inflation to tick up in July, by 0.1ppt to 7.3%Y/Y. As such, while we (and the Bank) forecast headline inflation to drop 1.2ppts to a 17-month low of 6.8%Y/Y, we expect core inflation to edge down by just 0.1ppt, also to 6.8%Y/Y. Tomorrow's data will also provide an insight into price developments further up the chain, with producer output prices forecast to fall 1.3%Y/Y, which would mark the first decline since January 2021.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	ZEW current situation (expectations) balance	Aug	**-71.3 (-12.3)**	-63.5 (-15.5)	-59.5 (-14.7)	-
UK	Payrolled employees, monthly change '000s	Jul	**97**	-12	-9	-
	Unemployment claimant count rate % (change '000s)	Jul	**4.0 (29.0)**	-	4.0 (25.7)	3.9 (16.2)
	Average weekly earnings (excl. bonuses) 3M/Y%	Jun	**8.2 (7.8)**	7.4 (7.4)	6.9 (7.3)	7.2 (7.5)
	ILO unemployment rate 3M%	Jun	**4.2**	4.0	4.0	-
	Employment change 3M/3M '000s	Jun	**-66**	90	102	-

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	10.00	GDP – second estimate Q/Q% (Y/Y%)	Q2	*0.3 (0.6)*	0.0 (1.1)
	10.00	Preliminary employment Q/Q% (Y/Y%)	Q2	-	0.6 (1.6)
	10.00	Industrial production M/M% (Y/Y%)	Jun	*0.4 (-2.9)*	0.2 (-2.2)
UK	07.00	(Core) CPI Y/Y%	Jul	6.8 (6.8)	7.9 (6.9)
	07.00	PPI output (input) prices Y/Y%	Jul	-1.3 (-2.8)	0.1 (-2.7)
	09.30	House price index Y/Y%	Jun	-	1.9

Auctions and events

Country	BST	Auction
Germany	10.30	Auction: €1.0bn of 0.00% 2050 bonds
	10.30	Auction: €1.5bn of 0.00% 2052 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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