Euro wrap-up

Overview

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- Bunds made gains as the flash August estimate of euro area headline inflation was unchanged from July but the core rate fell back.
- Gilts also made gains as BoE Chief Economist Pill suggested that he didn't see the need for much more monetary tightening.
- Friday will bring the final August manufacturing PMIs, and data on new car registrations in certain euro area member states and house prices in the UK.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	2.966	-0.085
OBL 2.4 10/28	2.476	-0.088
DBR 2.6 08/33	2.467	-0.073
UKT 0⅝ 06/25	5.131	-0.075
UKT 1⅝ 10/28	4.659	-0.064
UKT 3¼ 01/33	4.364	-0.052

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

Euro area

Headline inflation unchanged in August but core rate falls thanks to moderation in goods & services

The ECB's rate decision in September remains finely balanced following today's inflation and unemployment data. The flash estimate of euro area inflation in August exceeded expectations, remaining unchanged at 5.3%Y/Y. However, the stickiness of the headline rate was due to energy prices, which rose for the first time since January due to higher costs of auto fuel, heating oil, and, in some countries including France, electricity. Indeed, the increase in energy prices of 3.2%M/M was the most in ten months and pushed the respective annual rate up 2.8ppts to a three-month high of -3.3%Y/Y. That impact was offset in part by prices of unprocessed food, which fell for a second successive month in August. As a result, the annual rate of inflation in food, alcohol and tobacco fell for the fifth month in a row and by 1.0ppt to a 13-month low of 9.8%Y/Y. More importantly, with the rise in prices below the equivalent rate a year ago for a sixth successive month, inflation of core goods slowed a further 0.2ppt to 4.8%Y/Y, two full percentage points below February's peak. And most encouragingly, with the rise in services prices of 0.2%M/M in line with the long-run norm for the month for the first time this year, the respective annual rate fell back 0.1ppt from July's series high to 5.5%Y/Y. So, in line with the consensus forecast, core inflation also fell, dropping 0.2ppt to a three-month low of 5.3%Y/Y, 0.4ppt below the March peak.

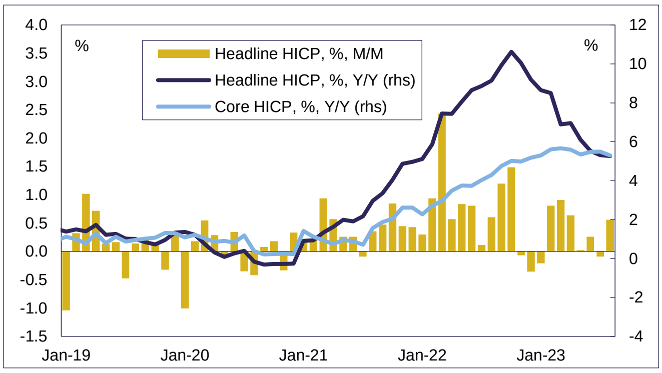
Core inflation to take a significant step down in September and decline further into 2024

The decline in core inflation in August will be followed by a further step down in September, not least as last summer's super-discounted German train fares will fall out of the calculation. However, on top of such base effects, easing momentum in core goods and services should also be increasingly visible in coming months. Indeed, the 3M/3M annualised inflation rate for services fell in August to an 11-month low of 4.3%. And while it picked up for core goods, at 3.2%3M/3M annualised it was still almost 5ppts down from its peak. As a result, we expect core inflation to drop just below 5.0%Y/Y next month and near 4.0%Y/Y by year-end. And despite relatively firm wage growth, with economic activity having weakened significantly, core inflation could be back close to 2.0%Y/Y around the middle of 2024. At the same time, however, while the ECB's June projection of core inflation in the current quarter (5.2%Y/Y) appears on track, its projection of headline inflation (4.7%Y/Y) will be significantly exceeded due to higher energy prices. Nevertheless, large base effects for both food and energy mean that the headline HICP rate could still be back to about 3.0%Y/Y by year-end, and lower still throughout H124.

Euro area unemployment rate remains at series low but German labour market becoming less tight

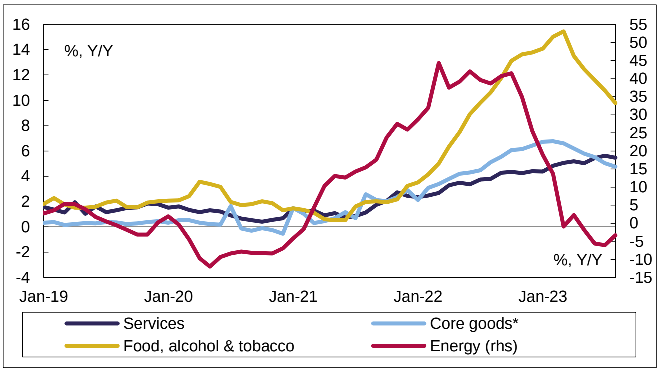
While economic data and surveys point to a marked recent weakening in economic momentum, today's unemployment figures underscored the ongoing resilience in the labour market, with the jobless rate unchanged in July for a fourth month at

Euro area: Consumer price inflation



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price inflation components



**Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

the series low of 6.4%. Admittedly, today's figures did report a slight uptick in the number of people unemployed for the first time in six months, by 73k to 10.94mn. But this followed a cumulative decline of more than 380k from the start of the year, to leave the number of unemployed still roughly 3¼mn below the pandemic peak and more than 1½mn below the pre-pandemic level. The increase in July was due principally to France, where the jobless rate rose 0.1ppt to a thirteen-month high of 7.4%; Italy, where it edged up 0.1ppt to 7.6%; and Austria, where it leapt 0.5ppt to a 21-month high of 5.6%. In contrast, unemployment continued to fall in Spain, down 0.1ppt to 11.6%, the lowest for almost sixteen years. And Germany's rate on the EU measure moved sideways at 2.9% for a fourth consecutive month, while the number of unemployed drifted to the lowest in more than 3½ years. However, the alternative German claimant count measure rose for a seventh successive month in August, by 18k, leaving the equivalent rate at 5.7% for a third month, some 0.7ppt above the level eleven months ago before the incorporation of Ukrainian refugees in the data. And with employment growth also having slowed over the prior three months, the number of German job vacancies fell in August for a seventh successive month, to be almost 6% below the average during the two years ahead of the pandemic. So, with German economic momentum seemingly in reverse once again, German labour market conditions do appear now to be softening.

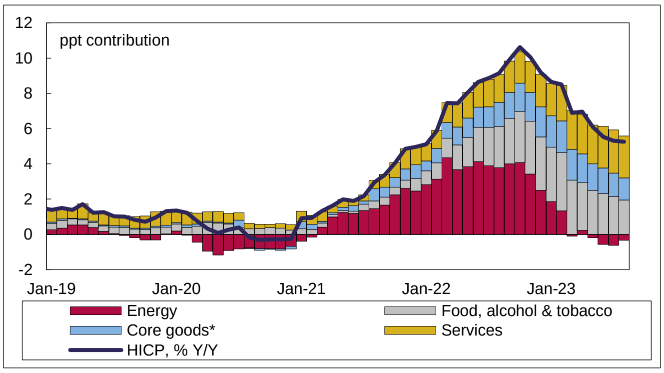
Lower vacancies might be matched with higher unemployment if weakness extends to services

In the euro area as a whole, despite the record unemployment rate, the number of job vacancies has also edged lower over recent quarters to suggest some loss of momentum in the region's labour market. And while the ratio of job vacancies to unemployment remains historically high, it might be expected to move steadily lower as economic activity continues to weaken. The Commission survey suggests that the share of firms in manufacturing and construction reporting worker shortages has fallen over recent quarters. A historically high share of services firms (almost one third) continues to cite a lack of labour as a limiting factor on activity. But given the flexibility of contracts, including a preponderance of temporary and part-time workers, in contact-intensive services, a weakening in demand in this sector – which might occur soon at the end of the tourist season – could translate into both a drop in vacancies and a sudden rise in unemployment. So, the economic slowdown already underway might well become sufficiently potent to shift the vacancy-to-unemployment ratio back in line with levels that would contain any second-round effects on wages and prices, and help underlying inflation to return to target over the projection horizon.

Weaker outlook for GDP would justify notable downwards revision to ECB's inflation projection

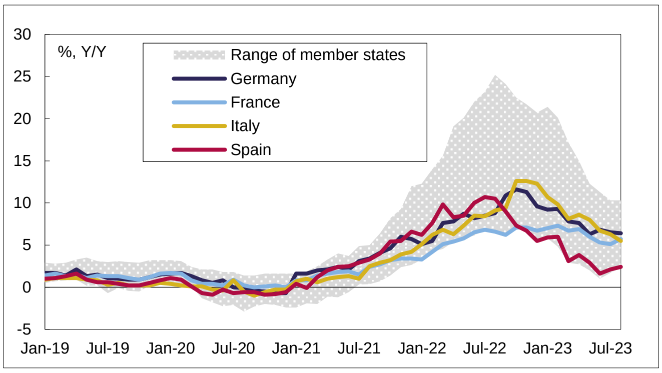
According to today's published account of the July monetary policy meeting, the ECB's Governing Council last month considered the resilience of the labour market to be "puzzling". It also judged that the persistent low level of unemployment and firm pay growth meant that a soft landing for the economy was still possible. But the risks that the labour market might

Euro area: Contributions to consumer price inflation



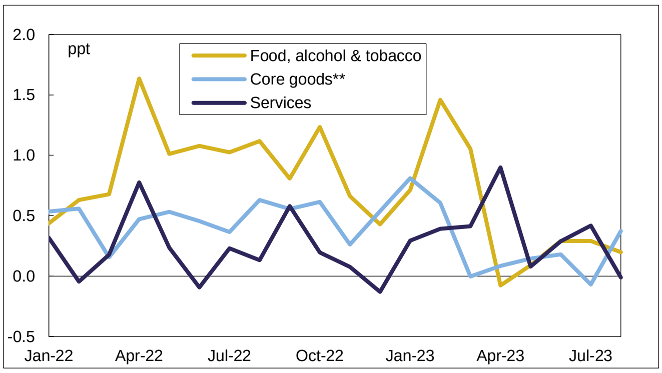
*Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area member states: Consumer price inflation



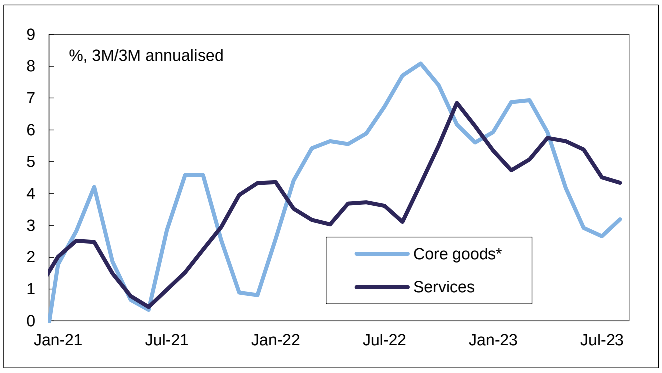
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Deviation from l-r average price change*



*Deviation from long-run average price change. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Services & goods inflation momentum



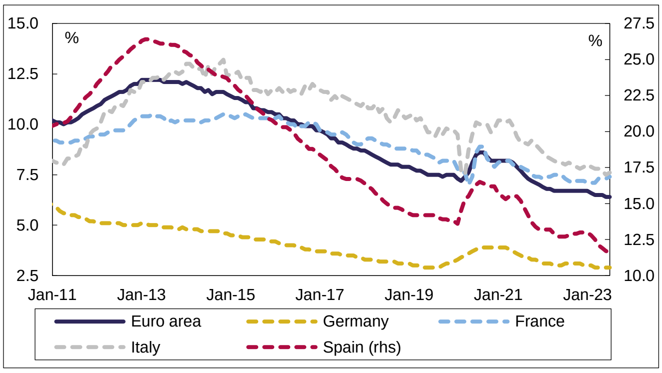
*Non-energy industrial goods. Source: ECB and Daiwa Capital Markets Europe Ltd.

weaken suddenly was also noted. And crucially, the account reported "broad agreement" that signs of a possible downward surprise in economic activity compared with the ECB's June projections "constituted important news". Certainly, that judgement led to the decision to open the door to a pause at the September meeting. The Governing Council debated whether the downturn might be a direct reaction to the ECB's monetary tightening, or simply a response to structural adjustments, such as necessary restructuring to cope with high energy prices. But it was also noted that the negative impact on GDP of most of the recent monetary tightening was probably still in the pipeline and would only materialise over the coming year. So, regardless of the precise causes of the slowdown, the ECB will certainly revise down its expected profile for GDP when it publishes updated projections next month. If it judges that the monetary transmission mechanism is working effectively, it should also therefore revise down its inflation projection to present an expected return to target by mid-2025. That would allow for a decision to keep rates unchanged next month, while also leaving the door open to further tightening in October or beyond if the subsequent data demand it. But many of the hawks are still likely to be more concerned about the risks of tightening too little rather than too much. And they might insist that the persistence of core inflation above 5% in August, and three-month momentum above 2% in both services and core goods, still justifies one last rate hike this cycle. The outcome of the meeting remains too close to call with confidence.

The day ahead in the euro area

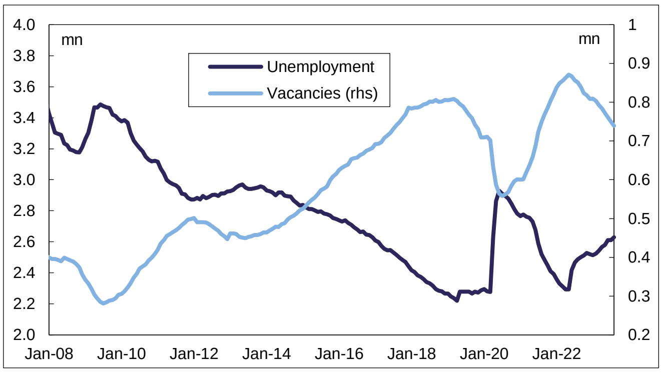
A quieter end to the week will bring the final manufacturing PMIs for August, which will include first readings from Italy and Spain. The flash PMIs suggested that the pace of deterioration in the sector moderated somewhat this month. But while it rose for the first month in five, the euro area manufacturing output index (43.7) remained consistent with relatively sharp contraction as new demand continued to decline. The weakness remained most striking in Germany, where the output index (39.7) fell to its lowest since the first pandemic wave. The French output PMI rose to a five-month high (45.8), albeit still implying contraction. The Italian and Spanish PMIs are also expected to report ongoing weakening in the sector, although at a more moderate pace than in the largest two member states. Strikingly, the flash PMIs also reported that input costs in the manufacturing sector fell at the sharpest pace since the global financial crisis in 2009 with output prices falling at a faster pace too. Friday will also bring new car registration data for August from France, Italy and Spain. Finally, updated Italian Q2 GDP figures are likely to confirm that the economy contracted 0.3%Q/Q, with the first official expenditure breakdown likely to show that the weakness was led by domestic demand.

Euro area member states: Unemployment rates



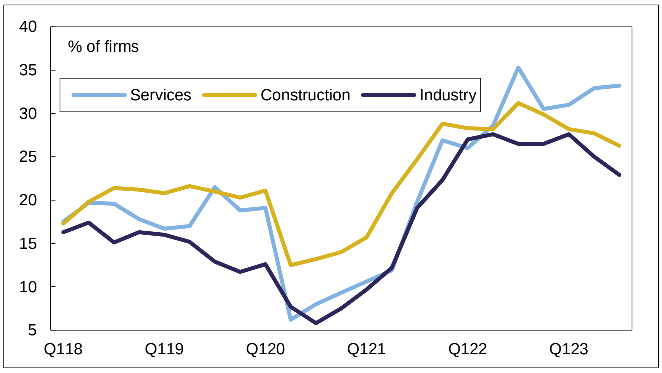
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Unemployment and vacancies



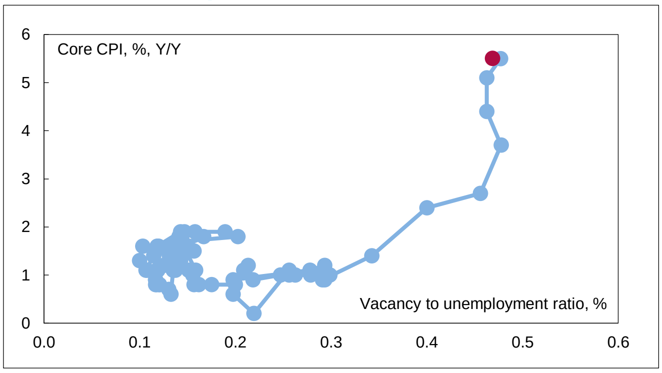
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Labour shortages as a limiting factor*



**Share of firms reporting labour shortages as a limiting factor on activity. Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Phillips curve*



**Red circle represents latest figure for Q223. Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.*

UK

The day ahead in the UK

The week in the UK will end with the release of the Nationwide house price index for August. Amid subdued consumer confidence, stretched affordability and weak mortgage lending, house prices are expected to have fallen for the tenth month out of the past twelve, to leave them down almost 5% compared with a year ago. Friday will also bring the final manufacturing PMIs for August. The flash release showed the output index declining sharply, by 3.9pts to a twelve-month low of 43.3, with the new orders component implying even steeper contraction. The survey detail also suggested that input costs and output prices are falling at the fastest pace since 2016.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Preliminary (core) HICP Y/Y%	Aug	**5.3 (5.3)**	*5.2 (5.4)*	5.3 (5.5)	-
	Unemployment rate %	Jul	**6.4**	6.4	6.4	-
Germany	Retail sales M/M% (Y/Y%)	Jul	**-0.8 (-2.4)**	0.1 (-1.4)	-0.6 (0.4)	-0.2 (0.9)
	Unemployment change '000s (rate %)	Aug	**18.0 (5.7)**	10.0 (5.7)	-4.0 (5.6)	1.0 (5.7)
France	Preliminary HICP (CPI) Y/Y%	Aug	**5.7 (4.8)**	5.3 (4.3)	5.1 (4.3)	-
	Consumer spending M/M% (Y/Y%)	Jul	**0.3 (-1.1)**	-	0.9 (-2.8)	-
	Final GDP Q/Q% (Y/Y%)	Q2	**0.5 (1.0)**	*0.5 (0.9)*	0.1 (0.9)	0.0 (0.8)
Italy	Preliminary HICP (CPI) Y/Y%	Aug	**5.5 (5.5)**	5.3 (5.0)	6.3 (5.9)	-

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	09.00	Final manufacturing PMI	Aug	*43.7*	42.7
Germany	08.55	Final manufacturing PMI	Aug	*39.1*	38.8
France	08.50	Final manufacturing PMI	Aug	*46.4*	45.1
	-	New car registrations* Y/Y%	Aug	-	19.9
Italy	08.45	Manufacturing PMI	Aug	45.7	44.5
	09.00	Final GDP Q/Q% (Y/Y%)	Q2	-0.3 (0.6)	0.6 (2.0)
	17.00	New car registrations Y/Y%	Aug	-	8.8
Spain	08.15	Manufacturing PMI	Aug	48.8	47.8
	-	New car registrations* Y/Y%	Aug	-	10.7
UK	00.01	Nationwide house price index M/M% (Y/Y%)	Aug	-0.4 (-4.9)	-0.2 (-3.8)
	09.30	Final manufacturing PMI	Aug	*42.5*	45.3

Auctions and events

- Nothing scheduled -

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

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