Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made gains as euro area GDP growth in Q2 was revised down and German industrial production fell for a third successive month.
- Gilts also made gains as UK business inflation expectations moderated.
- While coming days will bring several top-tier data releases including French IP, UK jobs, wages and GDP, the main focus remains Thursday's ECB meeting, where we expect a rate hike, albeit with relatively low conviction.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.076	-0.027
OBL 2.4 10/28	2.617	-0.036
DBR 2.6 08/33	2.616	-0.034
UKT 0⅝ 06/25	5.127	-0.083
UKT 1⅝ 10/28	4.722	-0.074
UKT 3¼ 01/33	4.467	-0.061

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

Euro area

We expect a further 25bps hike in rates on Thursday, but with relatively low conviction

The ECB's monetary policy decision next Thursday remains too close to call with confidence. Following the July Governing Council meeting, ECB President Lagarde opened the door to a pause in the tightening cycle this month, and insisted that the decision would be dependent on the data released between then and now. Given the marked deterioration in recent survey indicators and likelihood that much of the impact of the substantive monetary tightening already implemented has yet to be fully felt, we think that a pause in the rate-tightening cycle would now be prudent. However, the hawks have had a majority on the Governing Council for more than a year. And with most hard macroeconomic data not having deteriorated as far as the survey indicators, headline and core inflation still too high for their comfort, and the inflation outlook still very uncertain, we think that a hawkish majority will still hold. So, we currently expect the ECB to hike rates once again on Thursday, by 25bps, taking the deposit rate to 4.00% and the cumulative tightening since last July to 450bps. But while the Governing Council will also signal that rates are likely to remain at an elevated period for as long as necessary, and additionally state its readiness to tighten policy further if incoming data demand it, that should represent the peak in rates for this cycle.

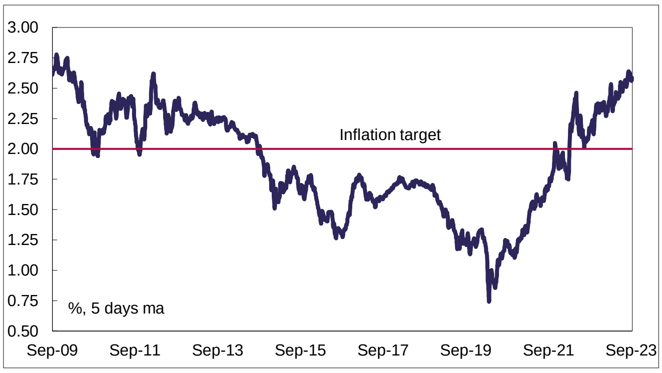
Data compels ECB to revise down GDP outlook

Following the July policy meeting, the Governing Council restated that its rate decisions would be "based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission". So, the ECB's updated macroeconomic projections to be presented in the coming meeting will be an important consideration, albeit not the only one. The account of the July policy meeting reported that the Governing Council already judged that signs of a possible downward surprise in economic activity compared with the ECB's June projections "constituted important news", which ultimately led to the decision to open the door to a pause in rates this month. And, certainly, the ECB's GDP outlook will be revised down next week. Euro area GDP growth in Q2 was today unexpectedly revised down by 0.2ppt to 0.1%Q/Q (see below), below the ECB's forecast of 0.3%Q/Q. And survey indicators such as the PMIs and Commission sentiment indices, as well as falling money supply and tighter credit conditions point to a good chance of contraction in Q3 and perhaps beyond, compared to the ECB's previous projection of growth of 0.3%Q/Q and 0.4%Q/Q this quarter and next.

Updated projections likely to suggest near-term stagnation rather than recession

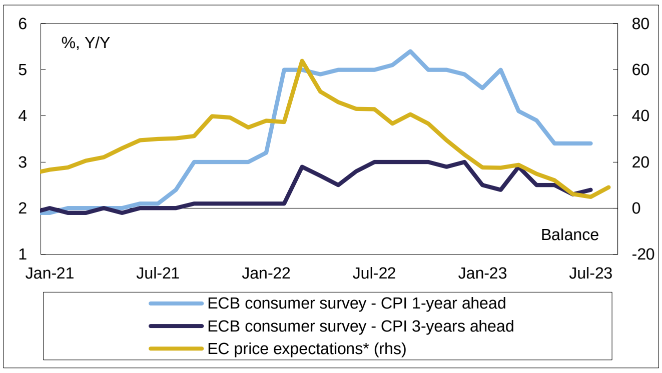
Some recent hard data, including today's German industrial production figures (also see below) are also consistent with a drop in GDP in Q3. But yesterday's euro area retail sales report showed growth of 0.5%3M/3M, the strongest since 2021.

Euro area: 5Y5Y inflation swap forward rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer price expectations



**12 months ahead. Source: EC, ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Record-low unemployment (6.4% in July), continued employment growth (0.2%Q/Q in Q2) and rising pay (hourly growth in compensation per employee rose in Q2 to 5.6%Y/Y, a series high barring the pandemic) all point to a resilient labour market. So, coupled with slowing inflation, real disposable income growth appears to be firming. And having moved sideways in Q2, private consumption appears on track for modest growth in Q3. Therefore, with capex related to NGEU projects and the climate transition still seemingly relatively firm, and some special factors (e.g. the Rugby World Cup, which kicks off in France this week) also set to give temporary support, we suspect that the ECB's updated projections will be consistent with near-term stagnation rather than recession. In particular, we think its full-year growth forecasts will be revised down to about ½% in 2023 (from 0.9% previously) and to 1%Y/Y or below in 2024 (from 1.5% previously) – meaningful downwards revisions but not in their own right a sufficient obstacle to prevent a further rate hike.

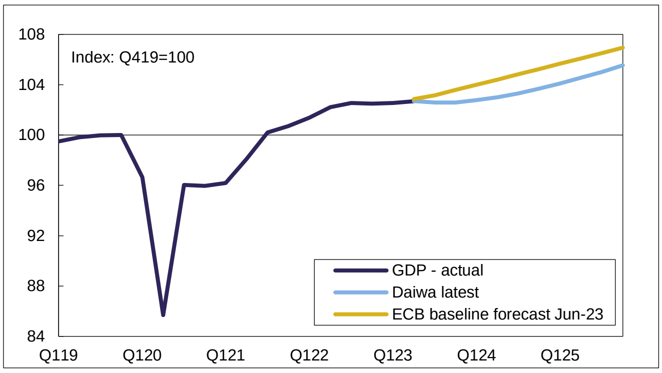
Rising fuel prices require upwards revision to near-term inflation outlook

Regardless of whether the ECB projects near-term stagnation or recession, the lower profile for economic activity than was previously anticipated should normally translate into a softer outlook for inflation. However, not least given higher prices of auto fuel, headline inflation has recently surprised on the upside. Indeed, it will overshoot the ECB's projection of 4.7%Y/Y in Q3, probably coming in at 5.0%Y/Y or more. With the price of Brent crude oil having risen further to $90 per barrel in recent days in response to OPEC+ supply cuts, the forecast of 2.9%Y/Y in Q4 also now looks too low. Admittedly, the ECB's forecast for core inflation of 5.2%Y/Y in Q3 – down 0.3ppt from Q1 and Q2 – still appears on track. And weaker economic activity – including a likely significant cooling in demand for services after the summer tourism season – should limit the ability of firms to boost margins opportunistically. So, the decline in core inflation should accelerate over coming quarters.

Higher inflation expectations limit scope to revise down medium-term price outlook

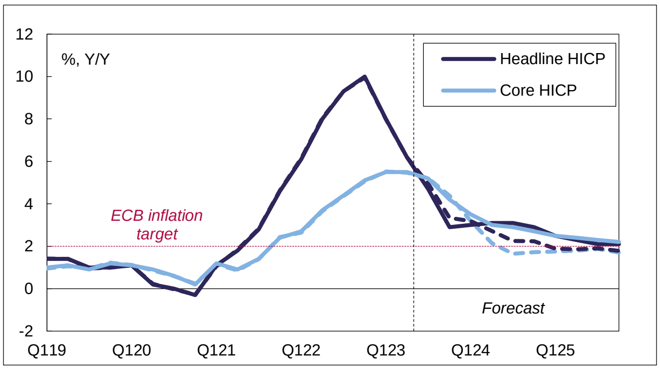
However, while momentum in both core goods and services has slowed significantly over the past quarter, the respective three-month annualised rates remain well above levels consistent with the inflation target. And likely in part reflecting increased oil prices, financial market expectations have risen since the ECB's last projections were published, with the 5Y5Y inflation forward swap rate rising above 2.60% for the first time in more than a decade. Surveys also point to a recent worsening of consumer price expectations for the coming year and three years ahead. And near-term business selling-price expectations picked up in services, industry and construction in August. So, while we see a decent case for the ECB to project inflation back at 2.0%Y/Y by the end of 2025, it might well be disinclined to revise down its full-year forecasts for that year below the current projections of 2.2% and 2.3% for the headline and core measures respectively. And having last year underestimated the upside risks to inflation from energy prices, and given rising oil prices and uncertainty about natural gas prices, the ECB might also judge that the risks to the inflation outlook remain skewed to the upside.

Euro area: GDP forecast



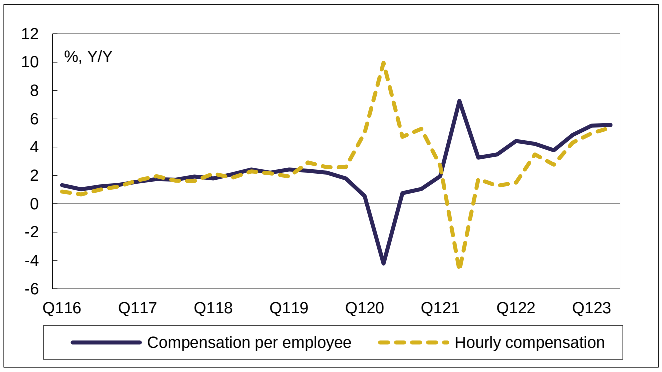
Source: *ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: ECB inflation forecast*



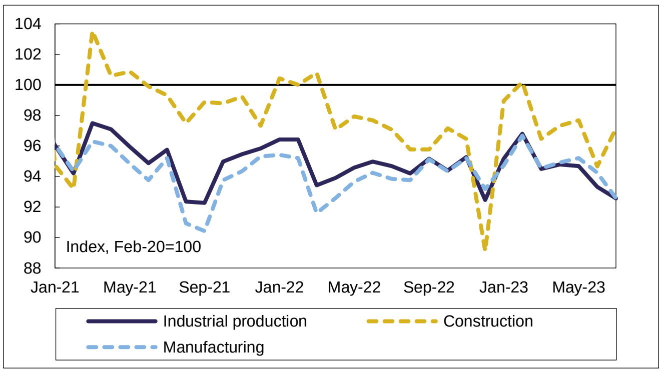
**Dashed lines represent Daiwa forecast. Source: ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Employee compensation



Source: ECB and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

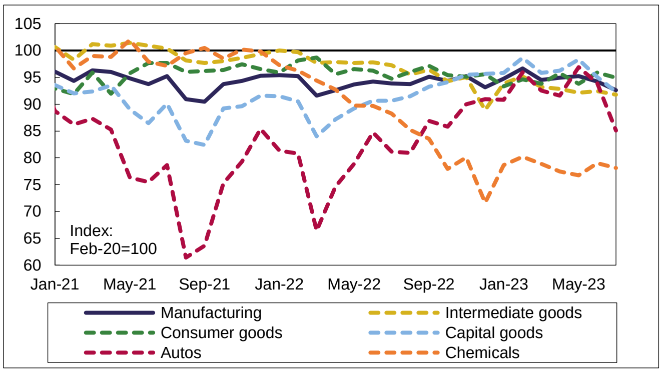
Majority to judge that inflation is still taking too long to return to target, justifying further hike?

In a speech at the end of August, ECB Executive Board member Schnabel, who has best articulated the case for aggressive tightening over the past year, summarized the key judgement to be made at the forthcoming Governing Council meeting. In particular, she stated that should the Governing Council's "assessment of the transmission of monetary policy suggest that the pace of disinflation is proceeding as desired, we may afford to wait until our next meeting to gather more evidence on how the slowdown in aggregate demand will feed through to price and wage-setting over time." However, should it "judge that the policy stance is inconsistent with a timely return of inflation to our 2% target, a further increase in interest rates would be warranted … to insure against the continued elevated risk of inflation remaining above our target for too long." Over recent days, some of the hawks on the Governing Council have intimated how they might prefer to proceed. For example, Dutch Governor Knot considered the market-implied probability of a hike to be underpriced, believing that the "inflation projections won't differ much from the last round in June". And Slovak Governor Kazimir was blunter, judging core inflation still to be too high with persisting upside risks, and thus expressing a preference for a rate hike this month. We suspect that the majority of the Committee will agree with him that the pace of disinflation set out in the updated forecasts remains too slow for comfort, leading them to agree a further rate hike on Thursday. And while the likely drop in core inflation below 5.0%Y/Y in September and steadily lower thereafter means that 4.00% should represent the peak deposit rate for the cycle, the Governing Council will also signal its readiness to tighten further if necessary, restating that its rates will be "set at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the 2% medium-term target".

Larger drop in German manufacturing production driven by auto weakness

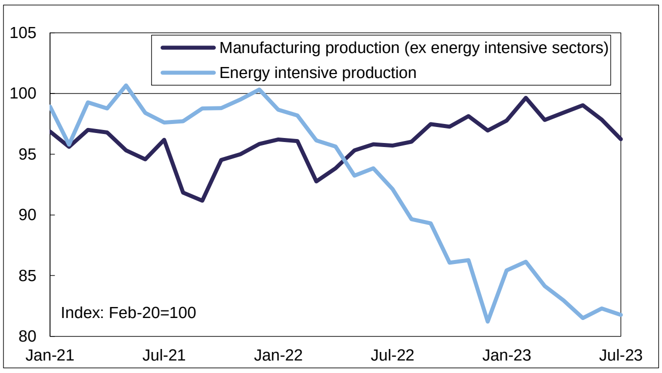
Broadly as expected, and consistent with yesterday's disappointing German orders and turnover figures as well as the steady downtrend in recent surveys, German industrial production fell for a third consecutive month in July, by 0.8%M/M. That left it down 1.9%3M/3M – the steepest drop on a three-month basis since May 2022 – to be more than 4% below the pre-pandemic level in February 2020. And the persisting downtrend in total IP came despite a partial rebound in construction (2.6%M/M) and energy production (2.2%M/M). Indeed, manufacturing output fell 1.8%M/M in July, the most since March, to its lowest level since April 2022 and still more than 5% below the pre-pandemic benchmark. While the weakness was widespread, it was particularly marked in the autos sector, where output fell for fourth month out of the past five and by a steep 9.4%M/M. While that likely reflects shutdowns for summer maintenance, growth on a three-month basis fell into negative territory for the first time in fourteen months. Meanwhile, with business gas usage in July more than 20% below the average level for the month between 2018 and 2021, production in the energy-intensive sector fell further in July (-0.7%M/M) to one of the lowest levels since reunification, to be down 3.0%3M/3M and 11.2%Y/Y. Given the existential threat posed by

Germany: Manufacturing production



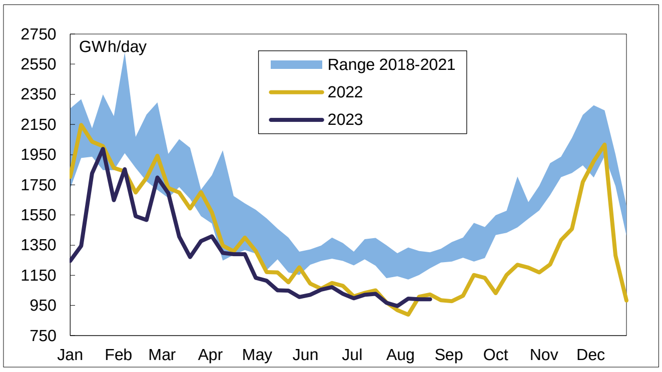
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Energy-intensive industrial production



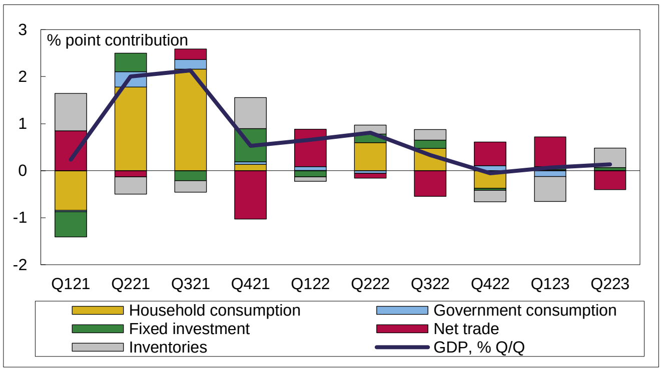
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Industrial gas usage



Source: Bundesnetzagentur and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & expenditure contributions



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

higher energy prices, and the risks to natural gas prices skewed to the upside, we see little chance of a sustained rebound in the energy-intensive subsectors over the near term. The marked deterioration in auto manufacturers' sentiment for the coming six months also bodes ill for that important sector. And with surveys pointing to ongoing weakness in production and new orders, we continue to expect the manufacturing sector to be a drag on German GDP growth in Q3 and possibly Q4 too.

Euro area GDP growth revised lower in Q2 as exports fell & private consumption stagnated

Today's updated euro area national accounts delivered a surprise downwards revision to GDP growth in Q2. Economic output is now assessed to have expanded just 0.1%Q/Q, 0.2ppt below both the previous estimate of growth and the ECB's forecast published in June. With GDP growth nudged slightly higher in Q1 (0.1%Q/Q), the annual rate in Q2 was only a touch softer than previously thought at 0.5%Y/Y, while economic output was still some 2.7% above the pre-pandemic level. Perhaps unsurprisingly given the erratic nature of the Irish figures, which are distorted by activities of a few large multinational corporations, The downwards revision to the euro area figure principally reflected updated figures from Ireland, where growth was revised sharply lower by 2.8ppts to 0.5%Q/Q. In addition, the contractions in Italy (-0.4%Q/Q) and Austria (-0.7%Q/Q) were also steeper than initially estimated. Solid growth in France (0.5%Q/Q) and Spain (0.4%Q/Q) was confirmed, as was the sideways move in German GDP. The expenditure breakdown, which was published for the first time, reported a surprising marked decline in exports in Q2, with the 0.7%Q/Q drop the steepest in three years. With imports up 0.1%Q/Q, net trade subtracted 0.4ppt from GDP growth. But that drag was offset by private sector inventories. Meanwhile, domestic final demand remained relatively lacklustre. Household consumption moved sideways for a second successive quarter to leave it still just below the pre-pandemic level. And while fixed investment posted another modest rise (0.3%Q/Q), it remained more than 4½% below the pre-pandemic benchmark. Notably, within that category, construction spending was down for the third quarter out of the past four, weighed again particularly by the residential sector, a trend that is likely to have continued into Q3.

The data week ahead in the euro area

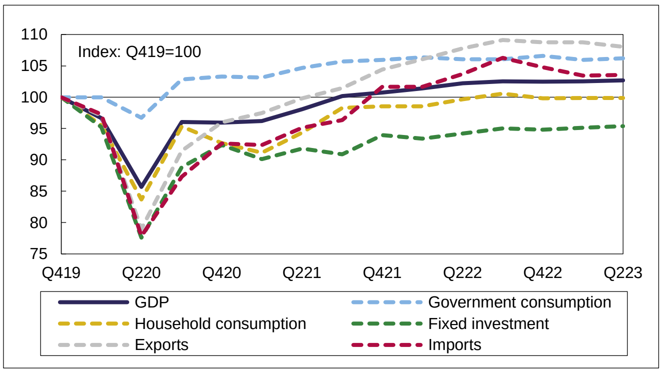
In terms of economic data, the coming week's calendar is relatively thin. Ahead of the ECB decision, euro area industrial production figures for July are due for release on Wednesday. While today's figures showed German manufacturing output fell sharply, data from France, Spain and importantly Ireland will be published tomorrow, followed by equivalent numbers from Italy on Monday. The latest German ZEW investor survey (Tuesday) will offer an update on economic sentiment in September and is likely to echo the deterioration in the Sentix survey published earlier this week. This showed the German current situation balance declining to its lowest reading since the first Covid-19 wave and the global financial crisis before that. Meanwhile, the euro area goods trade report (Friday) is expected to report a narrowing in the trade surplus amid soft external demand. Focus on Friday will also be on the latest euro area labour costs figures for Q2, which are likely to report a slight moderation from growth of 5.0%Y/Y in Q1, but remain too high for some members on the Governing Council.

UK

Business inflation expectations ease in August, wage expectations remain relatively high

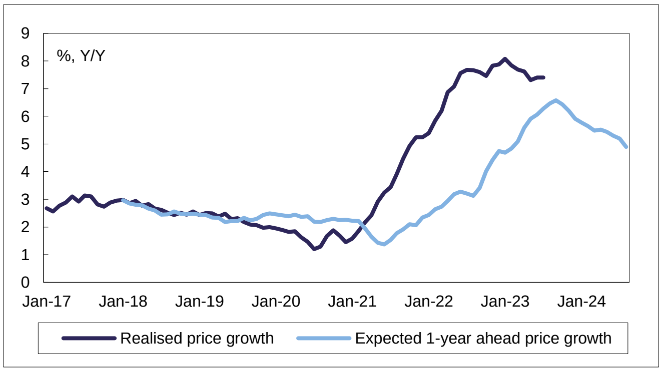
Ahead of the BoE's latest monetary policy setting meeting on 21 September, the results from its latest Decision Maker Panel (DMP) survey were on the whole more encouraging. Despite the recent pickup in energy prices, firms expected a modest disinflationary trend to continue over the coming twelve months. Indeed, as the survey's measure of realised output price inflation eased a further 0.4ppt in August to a fourteen-month low of 7.4%Y/Y, firms' expected growth in their own selling prices over the coming twelve months fell a substantial 1.1ppts to 4.4%Y/Y, the lowest since September 2021. On a three-month basis, expected selling-price growth over the coming twelve months (down 0.3ppt to 4.9%3M/Y) was the softest since February 2022 and 1.6ppts below September's peak. Businesses also moderated their expectations for consumer price inflation in the year ahead, by 0.5ppt to 4.9%Y/Y, with expectations for three years ahead down a touch too, by 0.1ppt to

Euro area: GDP expenditure levels



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

UK: Firms' output price expectations



Source: *BoE DMP survey and Daiwa Capital Markets Europe Ltd.*

3.2%Y/Y, similarly 1.6ppts below the peak. Of course, this remains well above the Bank's 2% target. And policy-makers might well have been disheartened to see that firms' expectation for year-ahead wage growth was unchanged at 5.0%Y/Y – admittedly lower than their current estimate of realised wage growth, but nevertheless perhaps still too high for comfort for many MPC members.

The week ahead in the UK

Following tonight's release of the REC report on jobs – which should signal a further improvement in the balance between labour supply and demand – the coming week will bring several top-tier releases that will feature in the discussion at this month's MPC meeting. Likely of most note will be Tuesday's official labour market figures, which are likely to show that employment in three months to July fell again. Meanwhile, after the unemployment rate unexpectedly rose in the three months to June to 4.2% – and the single-month rate rose to a 25-month high of 4.6% – we might well see a further uptick in the three months to July. Vacancies are likely to have slowed further too. But with wage growth having surged in the three months to June, by 1ppt to 8.2%3M/Y, and private sector regular pay growth also up to series high (8.2%3M/Y) barring the pandemic distortions, the pay data might be most closely watched by MPC members. While private sector wage growth might well have eased slightly in the three months to July, it will still be notably higher than the BoE staff projections in August's Monetary Policy Report and still well above levels that might reasonably be considered consistent with achievement of the Bank's inflation target over the medium term.

Another key focus in the coming week will be Wednesday's release of the July GDP report. Surveys have signalled a weakening in economic momentum at the start of Q3, while wet weather dampened demand on the high street and public sector strikes likely impacted activity too. As such, we expect GDP to have fallen in July, albeit not fully reversing the 0.5%M/M growth recorded in June. We expect output in manufacturing, services and construction all to have declined. Among other releases due, the BoE's household inflation attitudes survey (Friday) will be watched by the MPC – with all of the survey measures of household inflation expectations having dropped over the past two quarters, the key medium-term (5-years ahead) measure could well drop to a two-year low below 3.0%Y/Y. Finally, the latest RICS residential survey (Thursday) is likely to signal ongoing challenges in the housing sector amid high borrowing costs, with surveyors likely to report weak buyer enquiries and expectations of further house price declines over the coming year.

The next edition of the Euro wrap-up will be published on 12 September 2023

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	**0.1 (0.5)**	*0.3 (0.6)*	0.0 (1.1)	0.1 (1.1)
	Final employment Q/Q% (Y/Y%)	Q2	**0.2 (1.5)**	*0.2 (1.5)*	0.5 (1.6)	-
Germany	Industrial production M/M% (Y/Y%)	Jul	**-0.8 (-2.1)**	-0.5 (-2.1)	-1.5 (-1.7)	-1.4 (-1.5)
France	Trade balance €bn	Jul	**-8.1**	-	-6.7	-6.8
Italy	Retail sales M/M% (Y/Y%)	Jul	**0.4 (2.7)**	-	-0.2 (3.6)	- (3.9)
UK	BoE DMP 1 year ahead CPI expectations Y/Y%	Aug	**4.8**	5.0	5.4	-

Auctions

Country	Auction
France	sold €5.79bn of 3% 2033 bonds at an average yield of 3.15%
	sold €2.35bn of 1.25% 2038 bonds at an average yield of 3.42%
	sold €1.90bn of 3% 2054 bonds at an average yield of 3.61%
Spain	sold €1.94bn of 1.3% 2026 bonds at an average yield of 3.304%
	sold €2.60bn of 3.55% 2033 bonds at an average yield of 3.663%
	sold €1.90bn of 1.9% 2052 bonds at an average yield of 4.187%
	sold €483mn of 1% 2030 index-linked bonds at an average yield of 1.025%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		BST	Release	Period	Market consensus/ _Daiwa forecast_	Previous
Germany		07.00	Final HICP (CPI) Y/Y%	Aug	_6.4 (6.2)_	6.5 (6.4)
France		07.45	Industrial production M/M% (Y/Y%)	Jul	0.1 (1.4)	-0.9 (-0.3)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jul	-0.2 (-2.0)	-1.0 (-3.0)
Auctions and events						
UK		00.01	REC/KPMG report on jobs			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases						
Country		BST	Release	Period	Market consensus/ _Daiwa forecast/actual_	Previous
Monday 11 September 2023						
Italy		10.00	Industrial production M/M% (Y/Y%)	Jul	-	0.5 (-0.8)
Tuesday 12 September 2023						
Germany		10.00	ZEW current situation (expectations) balance	Sep	-76.9 (-15.1)	-71.3 (-12.3)
Spain		08.00	Final HICP (CPI) Y/Y%	Aug	_2.4 (2.6)_	2.1 (2.3)
UK		07.00	Average weekly earnings (excluding bonuses) 3M/Y%	Jul	-	8.2 (7.8)
		07.00	Unemployment rate 3M% (employment change 3M/3M 000s)	Jul	-	4.2 (-66)
		07.00	Payrolled employees change M/M 000s	Aug	-	97
		07.00	Claimant count rate % (change 000s)	Aug	-	4.0 (29.0)
Wednesday 13 September 2023						
Euro area		10.00	Industrial production M/M% (Y/Y%)	Jul	-1.0 (-0.4)	0.5 (-1.2)
UK		07.00	GDP M/M% (3M/3M%)	Jul	-	0.5 (0.2)
		07.00	Services activity M/M% (3M/3M%)	Jul	-	0.2 (0.1)
		07.00	Industrial production M/M% (Y/Y%)	Jul	-	1.8 (0.7)
		07.00	Manufacturing production M/M% (Y/Y%)	Jul	-	2.4 (3.1)
		07.00	Construction output M/M% (Y/Y%)	Jul	-	1.6 (4.6)
		07.00	Trade (goods trade) balance £bn	Jul	-	-4.8 (-15.5)
Thursday 14 September 2023						
Euro area		13.15	ECB deposit (refinancing) rate %	Sep	_4.00 (4.50)_	3.75 (4.25)
UK		00.01	RICS house price balance %	Aug	-	-53
Friday 15 September 2023						
Euro area		10.00	Labour costs Y/Y%	Q2	-	5.0
		10.00	Trade balance €bn	Jul	-	12.5
France		07.45	Final HICP (CPI) Y/Y%	Aug	_5.7 (4.8)_	5.1 (4.3)
Italy		10.00	Final HICP (CPI) Y/Y%	Aug	_5.5 (5.5)_	6.3 (5.9)
		10.00	Trade balance €bn	Jul	-	7.7
Spain		08.00	Labour costs Y/Y%	Q2	-	6.2
UK		09.30	BoE inflation attitudes survey, 12 months ahead Y/Y%	Aug	-	3.5

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions			
Country		BST	Event / Auction
Monday 11 September 2023			
UK		09.00	BoE Chief Economist Pill scheduled to speak on a panel
Tuesday 12 September 2023			
Germany		10.30	Auction: €5.5bn of 3.1% 2025 bonds
UK		00.00	BoE's Mann scheduled to give keynote speech: 'Post-pandemic economics: What does the new normal look like?'
		10.30	Auction: £900mn of 0.125% 2051 index-linked bonds
Wednesday 13 September 2023			
Germany		10.30	Auction: €1.0bn of 0.0% 2052 bonds
		10.30	Auction: €1.5bn of 1.8% 2053 bonds
Italy		10.00	Auction: To sell 3Y and 7Y bonds
UK		10.30	Auction: £3.75bn of 3.25% 2033 bonds
Thursday 14 September 2023			
Euro area		13.15	ECB policy announcement
		13.45	ECB President Lagarde speaks at post-meeting press conference
Friday 15 September 2023			
- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs