Euro wrap-up

Overview

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- Bunds made modest losses as a German survey signalled that investors are a touch less downbeat about the outlook despite increased expectations of contraction in Q3.
- Despite UK wage growth remaining very high, Gilts made gains as today's labour market data reported the steepest drop in employment since the first wave of the pandemic and, before that, the global financial crisis.
- Wednesday will bring July figures for euro area industrial production and UK GDP.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.113	+0.026
OBL 2.4 10/28	2.645	+0.014
DBR 2.6 08/33	2.637	+0.003
UKT 0⅝ 06/25	5.014	-0.042
UKT 1⅝ 10/28	4.629	-0.054
UKT 3¼ 01/33	4.411	-0.053

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

Euro area

Investors signal expectations of German contraction in Q3, but are less downbeat about outlook

Today's ZEW survey results suggested that investors judge that German economic conditions continue to deteriorate. Indeed, the survey's German current conditions index fell for a fifth successive month in September. Once again, the decline was much steeper than expected, down more than 8pts to -79.4, the lowest level since the first wave of Covid in 2020. That suggests that investors are widely expecting a renewed contraction in German GDP in Q3, after economic output moved sideways in Q2. However, for a second successive month, and in contrast to the deterioration reported in last week's Sentix survey results, the ZEW survey also suggested that investors are becoming marginally 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 September. Admittedly, the increase was minimal, less than 1ppt. And it left the index firmly in negative territory at -11.4, the third-lowest reading so far this year and a long way below the range in the first half of the year. Nevertheless, it was broadly consistent with expectations of stagnation, rather than recession, in the German economy around the turn of the year. And the wide gap between the current conditions and expectations indices might suggest that the worst of the downturn is close to being reached.

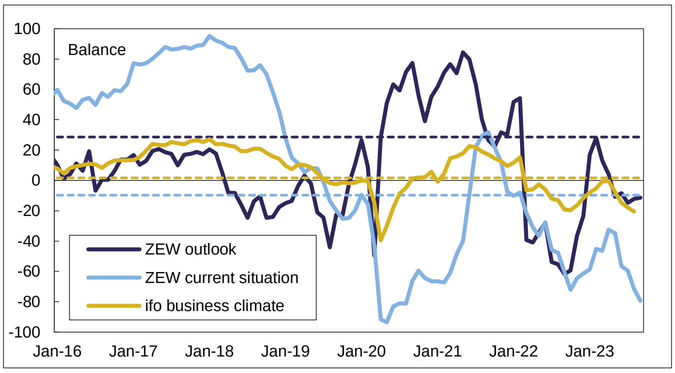
Survey flags major divergence in fortunes between sub-sectors

Within the survey's other findings, despite the recent pickup in oil prices which has been reflected recently in increased consumer and business price expectations, a large majority of survey respondents still expect inflation to continue to subside over the coming year. On balance, investors also believe that long-term interest rates are very close to their peak. And most encouragingly perhaps, expectations with respect to German stock prices were the most positive since January, albeit with still significant variation in perceptions between sectors. Judging from the ZEW indices, investors remain upbeat about profits at ICT firms. And they continue to take a positive view of banks and insurers, albeit not quite as much as over recent months given that interest rates are now judged to be close to their peak. At the same time, pessimism with respect to the profit outlook for German retailers rose in September to the highest since January. Investors also became more downbeat about the outlook for manufacturers of autos, steel and machinery than at any time this year. And they remain most pessimistic with respect to prospects for construction firms.

The day ahead in the euro area

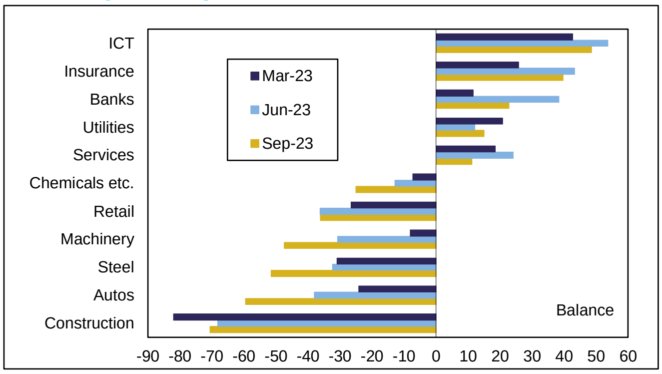
Ahead of Thursday's ECB monetary policy announcement, Wednesday will bring the release of euro area industrial production data for July. Despite growth in France, Spain and the Netherlands, Germany and Italy were weak, and the

Germany: ZEW & 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.

notoriously volatile Irish figure registered a steep drop in (-6.6%M/M). So, we expect euro area production to fall at the start of Q3 by around 1.0%M/M, with the autos sub-sector a principal drag. Meanwhile, following today's German investor survey, the Banque of France are scheduled to publish overnight its monthly business survey for early September, which will include its assessment of GDP growth in August and an updated forecast for Q3 GDP.

UK

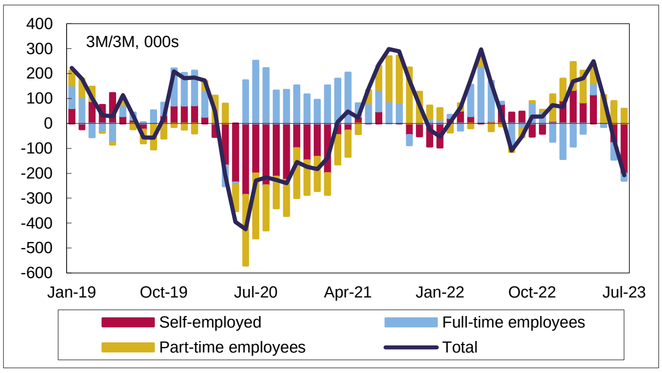
Wage growth remains strong, but labour market is softening more rapidly than expected

Ahead of the BoE's MPC meeting next week, today's labour market report was keenly anticipated given its likely influence on the near-term path for policy. Once again, however, today's figures provided mixed messages, leaving plenty of uncertainty about the rate outlook. Private sector wage growth – an indicator that has played a key role in recent interest rate decisions – edged a touch lower in the latest month. But it remained well above the BoE's forecast in its August Monetary Policy Report (MPR) and thus also significantly in excess of levels that would normally be consistent with achieving the Bank's 2% inflation target over the medium term. At the same time, however, today's figures added to growing evidence that the labour market is softening more rapidly than anticipated, which should help in due course to reduce pay pressures. So, notwithstanding the risks of a nasty upside surprise from next week's July CPI report, taken together with the more dovish commentary from BoE Governor Bailey and Chief Economist Pill, today's data suggest that we might well see just one further rate hike this cycle, with our forecast now for a terminal Bank Rate of 5.50%.

Employment falls at the fastest pace since October 2020, with unemployment ticking higher too

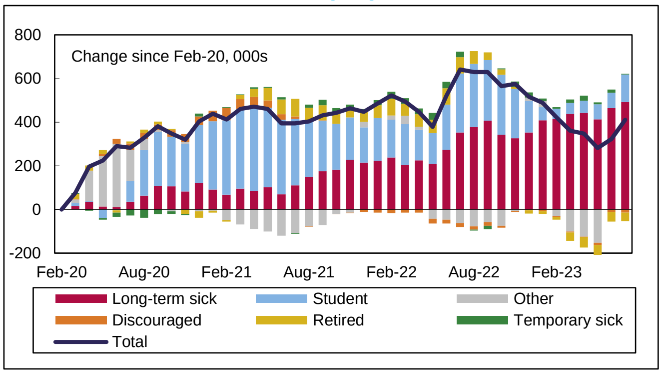
While the UK's labour market remained tight by historical standards, in August the MPC was already flagging signs that it was starting to loosen. And overall today's figures strengthened that trend, and to a greater extent than had been anticipated previously by the BoE. Strikingly, the number of people in work fell in the three months to July by 206k, a rate of decline only exceeded on the series during the first six months of the pandemic and the global financial crisis in 2009 – both, of course, episodes of deep recession. The weakening was led by a further notable decline the number of self-employed (-202k). But while there was a pickup in the number of full-time employees in July (88k), the downwards trend on a three-month basis (-23k) was maintained for a seventh month out of the past eight. So, despite the largest increase in labour force inactivity in twelve months amid a further rise in long-term sickness to a new high and a resurgence in the number of students, the unemployment rate rose 0.5ppt on the quarter to 4.3%, the highest since September 2021 and 0.8ppt above the trough in the three months to August 2022. Admittedly, the single-month figure fell 0.6ppt to 3.9% in July, suggesting that the three-

UK: Employment growth



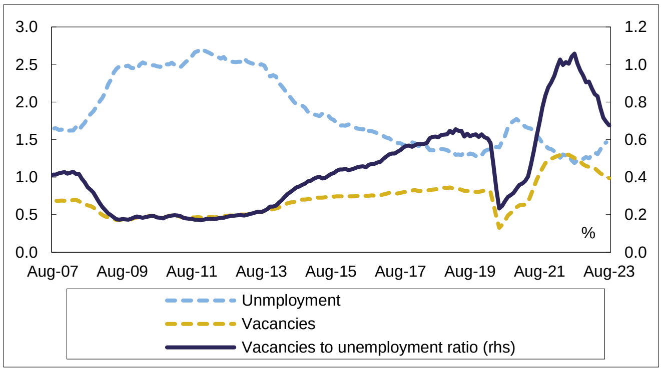
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Labour force inactivity by reason



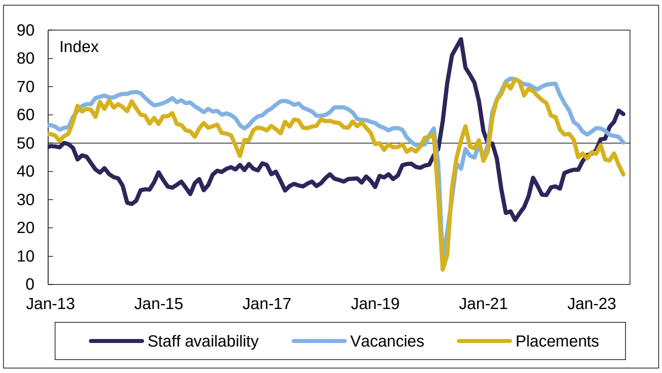
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Unemployment & vacancies



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Selected REC jobs survey indices



Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

month rate might move broadly sideways over the near term. Nevertheless, as it currently stands, the jobless rate was already 0.2ppt above the MPC's expectation for the remainder of the year. And it was also in line with the BoE's estimate of the equilibrium unemployment rate, which the Bank had not expected to be reached until Q2 next year.

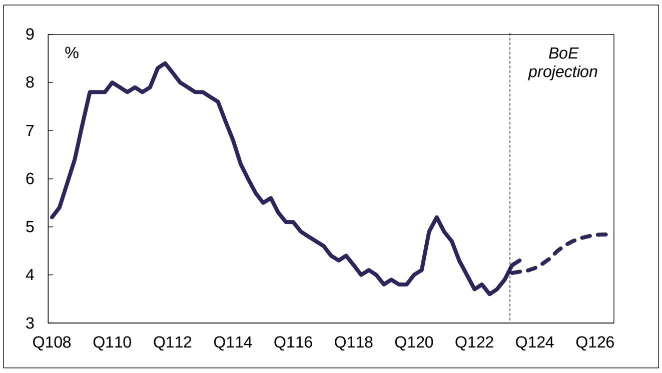
Near-term jobs growth set to weaken further as vacancies fall to lowest in over 2 years

The near-term outlook for the jobs market remains clouded too. Indeed, the level of vacancies fell in the three months to August for the fourteenth successive month back below 1mn for the first time in more than two years. The decline was most acute in hospitality, admin and support services and professional and technical activities, with total services vacancies down around 275k from their peak. So, the vacancy-unemployment (VU) ratio – which appears to be the MPC's preferred measure of labour market tightness – fell to 0.68, well down from the peak of 1.06 thirteen months ago. And while this remained slightly above the average in Q419 ahead of the pandemic (0.63), it was nevertheless the lowest for two years. The drop in vacancies tallies with the findings of the latest REC report on jobs, whereby recruitment consultants reported that growth in their vacancies slowed to the weakest in 2½ years amid softer demand for permanent employees. The REC survey also suggested that permanent placements fell by the most in over three years in August, while temporary billings declined for the first time since the first pandemic wave. So, the VU ratio looks likely to decline further over coming months.

Wage growth remains too high, but signs that momentum in pay growth has now peaked

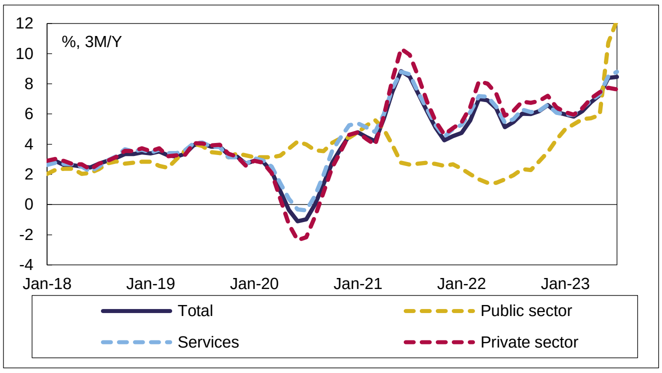
Even though the labour market has become less tight, the imbalance between labour demand and supply over recent quarters continues to be reflected in high pay growth well in excess of the BoE's expectations. Indeed, having been upwardly revised in June, total wage growth rose a further 0.1ppt in the three months to July to 8.5%3M/Y, up 1.7ppts over the quarter and a new series high dating back to 2001 when excluding pandemic-related distortions. Admittedly, this latest increase principally reflected a boost from one-off payments to National Health Service workers (in June) and civil servants (in July), which saw public sector pay growth jump 6.5ppts over the quarter to 12.2%3M/Y. When excluding bonuses, total regular pay growth moved sideways at 7.8%3M/Y, matching the highest rate since comparable records began in 2001. And while private sector regular wage growth edged lower, at 8.1%3M/Y it will need to moderate significantly further to meet the BoE's August MPR projection for Q3 (6.9%3M/Y). Among the various sectors, regular pay in finance and business services (9.5%3M/Y) and wholesaling, retailing and hospitality (6.5%3M/Y) rose further in July, with the former a series high. But manufacturing pay eased slightly (8.1%3M/Y), while construction pay fell to a ten-month low against the backdrop of the housing market downturn. On a three-month annualised basis, momentum in private sector pay appears to have now peaked, easing in July by more than 1ppt to (an admittedly still-high) 9.3%. And wage growth is also a lagging indicator. Indeed, according to the REC report, growth in starting salaries for all permanent placements in August was the softest since March 2021, well below

UK: Unemployment rate*



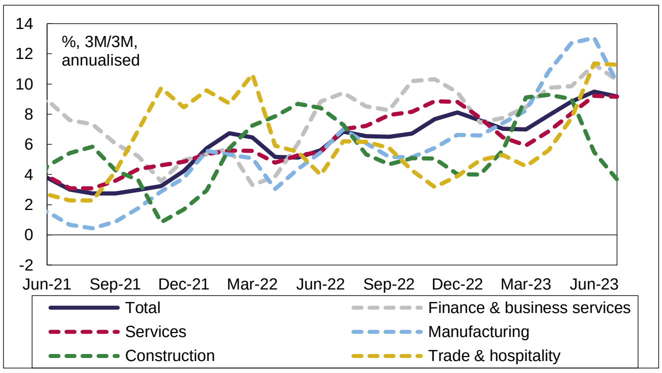
*Q323 figure based on July figures. Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Total wage growth



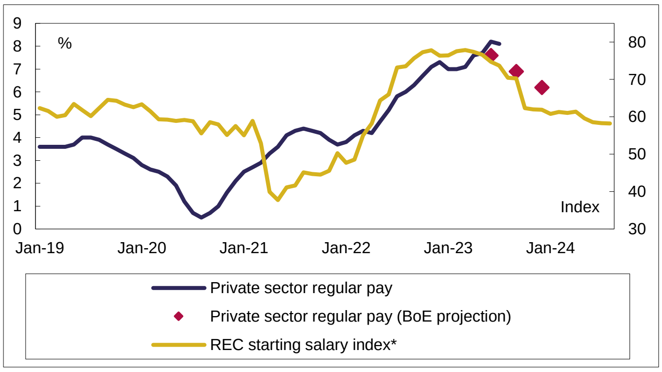
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Private sector regular wage growth



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Private sector regular wages & starting salaries



**New permanent staff, 12-month lead. Source: BoE, Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

the peak in March 2022 and back below the average in the five years before the pandemic. We fully expect underlying wage growth to fall steadily over coming months allowing the BoE to halt its tightening cycle after one last hike next week.

The day ahead in the UK

Wednesday will bring the July GDP report, which is likely to confirm the UK's lacklustre economic performance over the summer. 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, construction and – despite a boost from cinemas – services all to have declined. The latest trade figures might well also report a weakening in export volumes.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Germany		ZEW current situation (expectations) balance	Sep	**-79.4 (-11.4)**	-76.9 (-15.1)	-71.3 (-12.3)	-
Spain		Final HICP (CPI) Y/Y%	Aug	**2.4 (2.6)**	_2.4 (2.6)_	2.1 (2.3)	-
UK		Average weekly earnings (excluding bonuses) 3M/Y%	Jul	**8.5 (7.8)**	8.2 (7.8)	8.2 (7.8)	8.4 (7.8)
		Unemployment rate 3M% (employment change 3M/3M 000s)	Jul	**4.3 (-206)**	4.3 (-175)	4.2 (-66)	-
		Payrolled employees change M/M 000s	Aug	**-1**	29	97	-4
		Claimant count rate % (change 000s)	Aug	**4.0 (0.9)**	-	4.0 (29.0)	- (7.3)

Auctions

Country		Auction
Germany		sold €4.46bn of 3.1% 2025 bonds at an average yield of 3.1%
UK		sold £900mn of 0.125% 2051 index-linked bonds at an average yield of 1.33%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Italy		Industrial production M/M% (Y/Y%)	Jul	**-0.7 (-2.1)**	-0.3 (-1.8)	0.5 (-0.8)	- (-0.7)

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	Industrial production M/M% (Y/Y%)	Jul	-1.0 (-0.4)	0.5 (-1.2)
UK		07.00	GDP M/M% (3M/3M%)	Jul	-0.2 (0.3)	0.5 (0.2)
		07.00	Services activity M/M% (3M/3M%)	Jul	-0.1 (0.2)	0.2 (0.1)
		07.00	Industrial production M/M% (Y/Y%)	Jul	-0.6 (0.4)	1.8 (0.7)
		07.00	Manufacturing production M/M% (Y/Y%)	Jul	-1.0 (2.7)	2.4 (3.1)
		07.00	Construction output M/M% (Y/Y%)	Jul	-0.5 (2.8)	1.6 (4.6)
		07.00	Trade (goods trade) balance £bn	Jul	-4.5 (-15.9)	-4.8 (-15.5)

Auctions and events

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: €3.5bn of 3.85% 2026 bonds
		10.00	Auction: €4.0bn of 4.0% 2030 bonds
		10.00	Auction: €1.0bn of 5.0% 2040 bonds
		10.00	Auction: €1.50bn of 4.5% 2053 bonds
UK		10.30	Auction: £3.75bn of 3.25% 2033 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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