Europe | Economic Research | 13 September 2023

Daiwa Capital Markets

Euro wrap-up

Overview

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- As a report suggested that the ECB would revise up its 2024 inflation projection tomorrow, Bunds made losses despite a larger-than-expected fall in euro area industrial production in July.
- Gilts rallied as UK GDP fell further than expected in July.
- On balance, due to inflation persistence, we expect the ECB to raise rates again tomorrow, but the decision is too close to call with confidence.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.163	+0.050
OBL 2.4 10/28	2.678	+0.038
DBR 2.6 08/33	2.651	+0.013
UKT 3½ 10/25	4.961	-0.054
UKT 4½ 01/33	4.552	-0.077
UKT 3¼ 01/33	4.341	-0.067

*Change from close as at 4:45pm BST.
Source: Bloomberg

Euro area

Industrial production starts Q3 firmly in reverse due to decline in autos and other capital goods

Euro area industrial production fell for the first time in four months in July and by a larger-than-expected 1.1%M/M. That left it down 2.2%Y/Y, and some 0.8% below the Q2 average, which was down 1.0%Q/Q from Q1. Production was supported by strong growth in energy generation (1.6%M/M), likely related to the weather. In contrast, manufacturing output fell 2.0%M/M, the most since March. The weakness was most acute for autos, production of which dropped for the second successive month and by 11.1%M/M, the most since March 2022 when output was impacted by supply-chain challenges. That took it to an eleven-month low and more than 20% below the pre-pandemic level in February 2020. While new orders have dropped in the subsector and sentiment is low, weakness in auto production in July is likely in part to be related to summer maintenance and we look for a rebound over the remainder of the quarter. Nevertheless, many other subsectors also registered substantive declines in July. For example, production of computers and electronic goods dropped a steep 5.7%M/M to a five-month low. Production of machinery and equipment fell 1.5%M/M to a sixteen-month low. And so, overall output of capital goods fell 2.7%M/M pointing to weakness in business investment.

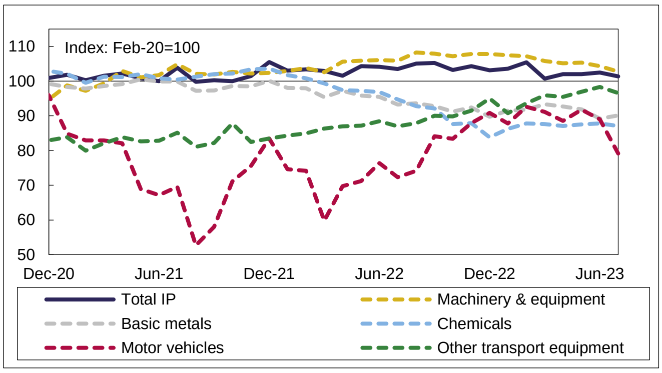
Energy-intensive production remains well down on level before Russian invasion of Ukraine

Elsewhere within the detail, following two months of positive growth, chemicals output declined 0.8%M/M to take it back to the lowest level in six months, roughly 13% below the pre-pandemic level. But with metals output firmer, overall production of energy-intensive goods dropped just 0.1%M/M. That, however, marked the fifth successive monthly decline in such output, and left it 12.9% below the level ahead of Russia's invasion of Ukraine and associated shock to energy prices, which triggered an existential crisis in the relevant sub-sectors.

Industrial production on track for fourth successive quarterly decline in Q4

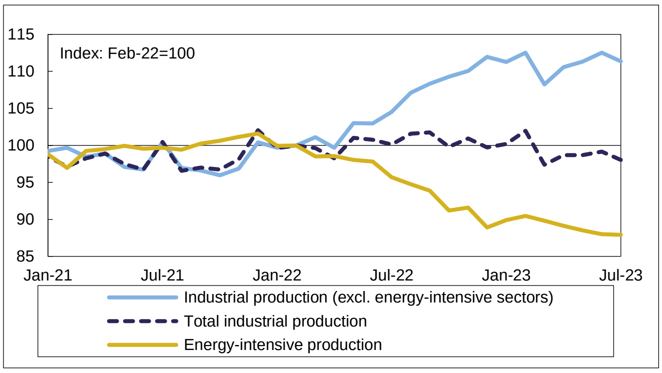
Looking ahead, we expect a rebound in autos output to support a return to growth in overall euro area IP in August. However, survey indicators for the sector are undoubtedly weak. While it edged up last month to give hope that a bottom might be near, the manufacturing output PMI remained historically low at just 43.5. The new orders PMI fell further to a level that has rarely been lower (39.0). And the Commission survey flagged expectations that the production trend will remain negative amid falling orders, from both at home and abroad, declining work backlogs and rising inventories. So, we expect industrial production to drop for a fourth successive quarter in Q3, raising the probability that GDP will decline this quarter too.

Euro area: Industrial production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Energy-intensive industrial production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

The main focus tomorrow will be the ECB's monetary policy announcement, although the outcome 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 inflation on track to exceed the ECB's forecast this quarter, core inflation still too high for their comfort, and the inflation outlook still very uncertain amid higher oil prices, we think that a hawkish majority will still hold. So, we currently expect the ECB to hike rates once again, 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 restrictive 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.

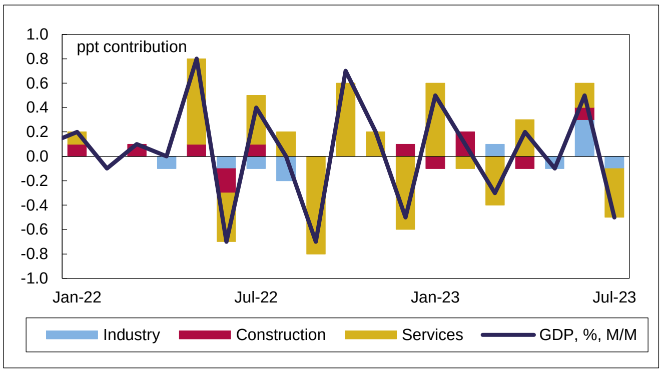
Given the deterioration in economic momentum, the ECB's updated macroeconomic projections will see its near-term GDP outlook revised down, from its previous expectation of growth of 0.3%Q/Q in Q3 and 0.4% in Q4. But we think the ECB's updated projections will be consistent with near-term stagnation rather than recession, with its full-year growth forecasts revised down to about ½% in 2023 (from 0.9% previously) and to 1%Y/Y or below in 2024 (from 1.5% previously). This might normally translate into a softer profile for inflation. 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 the downtrend should accelerate soon too. But with the price of Brent oil having risen more than expected we would expect to see the projection for headline inflation in Q4 (2.9%Y/Y) revised higher. A Reuters report today suggested that the inflation projection would also be revised up from 3.0%. And with various measures of price expectations having recently ticked higher too, the ECB might well be disinclined to revise down its full-year forecasts for 2025 below the current projections of 2.2% and 2.3% for the headline and core measures respectively.

UK

GDP falls further than expected in July as strikes and bad weather weighed

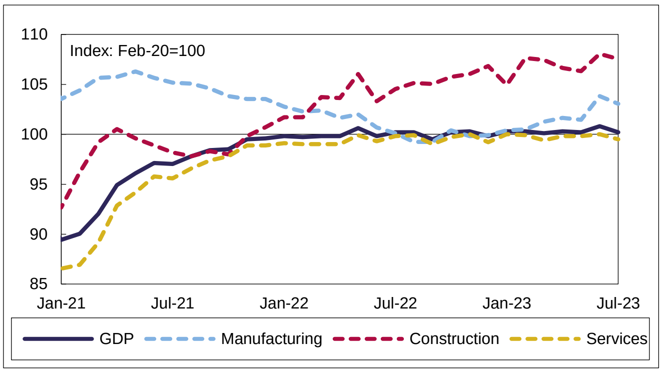
As inclement weather and strike action in the public sector weighed on activity, GDP fell in July by a larger-than-expected 0.5%M/M, the steepest decline since December. That was enough to reverse in full the increase of the same rate in June, and left the level of economic output in July marginally below the Q2 average and unchanged from a year earlier. However,

UK: GDP growth and sector components



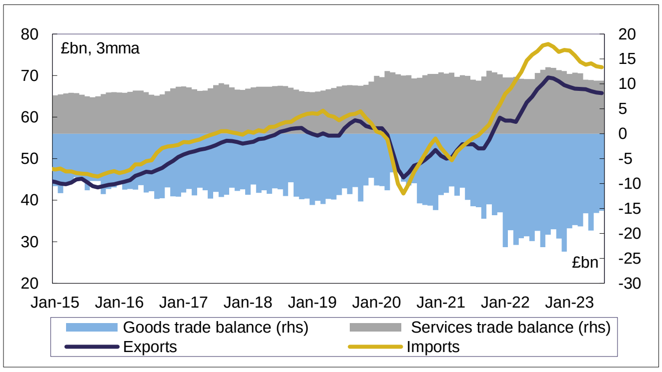
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: GDP level and sector components



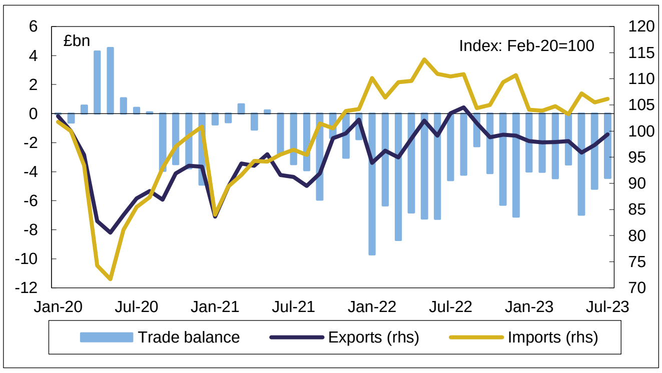
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Nominal trade balance and components



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Real trade balance, export & import volumes



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

the underlying trend was unchanged, with GDP still up 0.2%3M/3M. The weakness at the start of Q3 was broad-based, with declines in output in services (-0.5%M/M), industrial production (-0.7%M/M) and construction (-0.5%M/M). In services, lower activity in health care and education, principally reflecting strikes by doctors, radiographers and teachers, was enough to account for half of the decline in GDP. Retail, hospitality and tourism also contracted, in part as this was the wettest July since 2009. And ICT services fell too, likely as payback for firm growth over the prior three months. In contrast, sports, arts and other recreational activities provided some offset. And on a three-month basis, services output was still up 0.1%3M/3M.

Manufacturing output down in most subsectors while construction momentum fades

In the industrial sector, manufacturing output fell 0.8%M/M in July. Nine out of the thirteen main manufacturing subsectors reported declines, with the sharpest occurring in rubber, plastics, ICT and electronics. Growth in July was firmest in machinery and equipment. Given the strong rise in June, manufacturing output was still up 1.7%3M/3M, incongruously vigorous in light of recent deterioration in survey indicators from the sector, and the main source of GDP growth on a three-month basis. Meanwhile, production of energy (-1.5%M/M) was also weaker in July, but increased extraction of oil and natural gas gave a boost to mineral extraction (+1.9%M/M). And following strong growth in June, construction output fell 0.5%M/M in July as repair and maintenance – which has seen significant expansion over recent quarters – took a step back while new work was broadly flat. Once again, the bad weather explains some of the weakness in July. And construction output was up a marginal 0.1%3M/3M, the softest rate in eleven months.

Services and construction should rebound in August but BoE GDP forecast probably too strong

Looking ahead, surveys suggest that the weakness in manufacturing intensified in August with the current month likely offering little relief too. So, we expect the sector to subtract from growth over Q3 as a whole. With the services activity PMI having dropped below the key 50 threshold last month for the first time since January, there are downside risks to growth in the largest sector too. However, with the main teaching unions having accepted the government's pay offer, output in education is set to recover. And the improvement in the weather in August and so far in September has likely given support to consumer-facing services, such as retail and hospitality, as well as construction. Rising real wages might also give a boost to consumption. However, the marked drop in employment and accompanying rise in unemployment in the three months to July tallies with an economy that is struggling to grow. And while, on balance, we still expect GDP to rise over Q3 as a whole, today's data and recent surveys suggest that the BoE's forecast for growth this quarter of 0.4%Q/Q is too strong. Indeed, GDP growth of at most half that rate looks more realistic in our view, with a contraction not to be ruled out either.

Trade deficit narrows in July but trend in net exports remains unfavourable

After net trade subtracted from GDP growth in each of the past three quarters, and by 1.0ppt or more in Q1 and Q2, it might be expected to make a positive contribution in Q3. And figures today reported a larger-than-expected decline in the overall trade deficit in July, by £1.34bn to £3.45bn. That represented the second-lowest deficit this year, to be more than £2bn below the level a year earlier, and well down from the average of more than £10bn during the first six months following Russia's invasion of Ukraine. The improvement in July reflected modest growth in the value of goods exports (0.8%M/M, excluding the impact of precious metals, which tend to distort the picture), as an increase in shipments of chemicals more than offset a fall in exports of machinery and transport equipment. Imports of both goods and services, meanwhile, edged down 0.4%M/M on the same basis. Nevertheless, looking through the month-to-month volatility, the deficit (excluding precious metals) widened by £1.2bn in the three months to July to £18.8bn as exports fell more than imports. Likewise, adjusting for shifts in relative prices, growth in export volumes (2.1%M/M) outpaced that of imports (0.6%M/M) in July to indicate support to economic growth from net trade at the start of Q3. But on a three-month basis, as exports fell while imports rose, and the services surplus narrowed more than the goods deficit over that period, the real-terms trade deficit widened by £4.6bn to £16.6bn, suggesting that net exports remain an underlying source of economic weakness.

The day ahead in the UK

Focus in the UK tomorrow turns to the housing market, with the overnight release of the RICS residential survey. This 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. Indeed, the Bloomberg survey consensus for the headline price balance is for a further 2ppts drop to -55% in August, which would mark its lowest reading the global financial crisis.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Industrial production M/M% (Y/Y%)	Jul	**-1.1 (-2.2)**	-1.0 (-0.4)	0.5 (-1.2)	0.4 (-1.1)
UK		GDP M/M% (3M/3M%)	Jul	**-.5 (0.2)**	-0.2 (0.3)	0.5 (0.2)	-
		Services activity M/M% (3M/3M%)	Jul	**-0.5 (0.1)**	-0.1 (0.2)	0.2 (0.1)	-
		Industrial production M/M% (Y/Y%)	Jul	**-0.7 (0.4)**	-0.6 (0.4)	1.8 (0.7)	-
		Manufacturing production M/M% (Y/Y%)	Jul	**-0.8 (3.0)**	-1.0 (2.7)	2.4 (3.1)	-
		Construction output M/M% (Y/Y%)	Jul	**-0.5 (2.8)**	-0.5 (2.8)	1.6 (4.6)	-
		Trade (goods trade) balance £bn	Jul	**-3.4 (-14.1)**	-4.5 (-15.9)	-4.8 (-15.5)	-

Auctions

Country		Auction
Germany		sold €809mn of 0.0% 2052 bonds at an average yield of 2.73%
		sold €1.20bn of 1.8% 2053 bonds at an average yield of 2.79%
Italy		sold €4.00bn of 4.0% 2030 bonds at an average yield of 4.21%
		sold €1.00bn of 5.0% 2040 bonds at an average yield of 4.74%
		sold €1.50bn of 4.5% 2053 bonds at an average yield of 4.89%
UK		sold £3.75bn of 3.25% 2033 bonds at an average yield of 4.40%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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	-55	-53

Auctions and events

Country		BST	Event
Euro area		13.15	ECB policy announcement
		13.45	ECB President Lagarde speaks at post-meeting press conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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