Euro wrap-up

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Overview

- Bunds made modest gains as German industrial production contracted for a fifth consecutive month, while the drop in euro area GDP in Q3 was confirmed despite a pickup in final domestic demand.
- Gilts followed USTs lower on a quiet day for UK economic news.
- Friday will bring final German inflation estimates for November, along with survey results for the UK labour market and inflation expectations.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 12/25	2.580	-0.013
OBL 2.4 10/28	2.129	-0.024
DBR 2.6 08/33	2.189	-0.006
UKT 3½ 10/25	4.491	+0.031
UKT 4½ 06/28	4.021	+0.043
UKT 3¼ 01/33	3.970	+0.033

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

Euro area

Confirmation of modest drop in GDP in Q3 despite pickup in final domestic demand

Despite the downside revisions made last week to the respective figures for France, Portugal and Ireland, the initially estimated 0.1%Q/Q drop in euro area GDP in Q3 was today confirmed. Growth in Q2, however, was revised down by 0.1ppt to 0.1%Q/Q. And the net result of all prior revisions was to nudge down the estimate of annual GDP growth by 0.1ppt to zero, underscoring that the euro area economy has effectively stagnated over the past year. Moreover, quarterly GDP growth in Q2 and Q3 was respectively 0.2ppt and 0.1ppt softer than projected by the ECB in September, reinforcing the case for it to revise down its profile for economic activity when it publishes updated Eurosystem projections next week. However, the expenditure breakdown was relatively encouraging, most notably reporting a welcome pickup in final domestic demand in Q3. In the absence of new shocks, that should provide the platform for a gradual recovery over coming quarters, albeit from a weaker starting point than initially hoped.

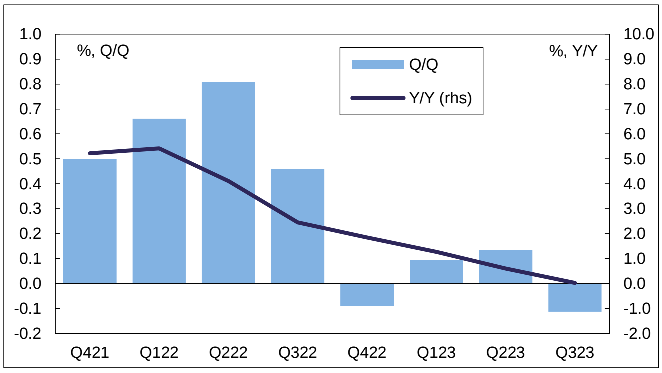
Consumption & most capex components grew, but home-building & inventories subtracted

Most notably within the expenditure detail, private consumption rose 0.3%Q/Q in Q3 to mark the first increase in four quarters. That reflected the first annual real-terms rise in compensation per employee in two years (admittedly just 0.2%Y/Y reflecting quarterly growth of 0.5%Q/Q) thanks to firm wage growth and moderating inflation, as well as increasing employment (0.2%Q/Q and 1.3%Y/Y). As long as the labour market remains resilient to allow for ongoing growth in real incomes, household consumption should continue to support growth over coming quarters. Government consumption also rose in Q3, by 0.3%Q/Q. And fixed investment was unchanged from Q2, as increased spending on machinery, equipment, and R&D offset a second successive decline in construction due to a drop in expenditure on dwellings for the fifth quarter in the past six. While final domestic demand therefore contributed 0.2ppt to GDP growth, net trade was neutral as export volumes fell for a fourth successive quarter (-1.1%Q/Q) and imports declined at a similar pace (-1.2%Q/Q). So, it was only due to a significant adjustment to inventories, which subtracted 0.3ppt from GDP growth, that overall economic output contracted in Q3.

Unit labour costs rose at a record pace as productivity fell further

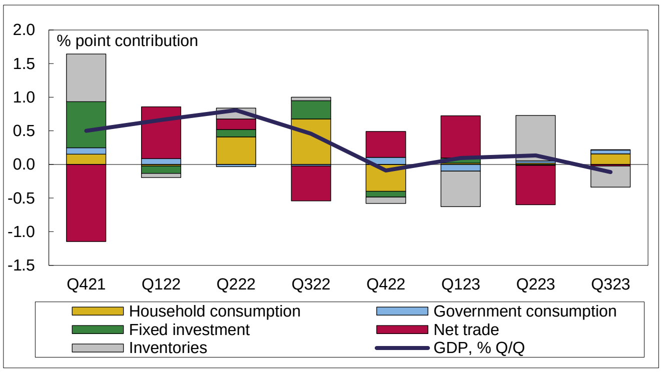
Hard data, such as today's German industrial production figures, and survey indicators such as the PMIs and Commission indices, all suggest that overall economic output in Q4 is continuing to stagnate at best. However, the return to growth of household consumption, as well as the resilience of the labour market and non-construction capex to tight monetary policy, will bolster confidence at the ECB that economic activity should pick up in the New Year once the negative inventory

Euro area: GDP growth



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & expenditure contributions



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

adjustment has played out. Nevertheless, with GDP down but employment still rising, labour productivity continued to weaken in Q3. Indeed, output per employee fell 1.2%Y/Y while productivity based on hours worked fell at the same rate. So, while nominal employee compensation growth moderated slightly, the hawks on the Governing Council will note that growth of unit labour costs on a per hour basis rose to 6.7%Y/Y, the highest on the series. With the GDP deflator easing 0.3ppt in Q3 to 5.8%Y/Y from the record high registered in the prior two quarters, unit profits took the strain. But if and when GDP growth picks up, the hawks will be wary that firms will want to restore margins once again, sustaining above-target inflation if pay growth remains firm and/or productivity fails significantly to recover.

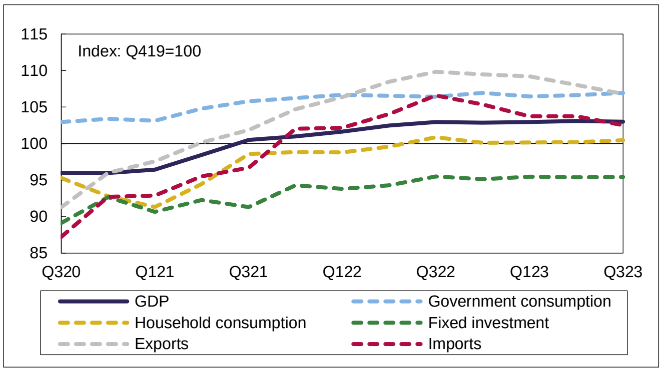
German manufacturing and construction activity start Q4 on the backfoot

Consistent with yesterday's downbeat manufacturing turnover data, today's German industrial production figures reported a fifth consecutive decline in output at the start of Q4, highlighting the ongoing economic adjustments underway in the euro area's largest member state. In particular, IP fell 0.4%M/M in October to its weakest level in more than three years, to be some 1.3% below the Q3 average and almost 9% below the pre-pandemic benchmark in February 2020. The drop would have been even steeper without a jump in energy production, which rose the most in 18 months (7.1%M/M), albeit reversing only a fraction of the cumulative decline of 20% recorded in the first nine months of the year. Indeed, consistent with the worsening in the business climate suggested by various surveys, construction activity fell a steeper 2.2%M/M in October to a ten-month low, with the steady downwards trend in building permits over recent quarters suggesting that the downturn still has further to play out. Meanwhile, manufacturing output contracted for the fourth month out of the past five (-0.5%M/M), to leave it almost 1½% below the Q3 average and therefore suggestive of a third consecutive quarterly contraction in Q4.

Broad-based weakness in production led by machinery and equipment

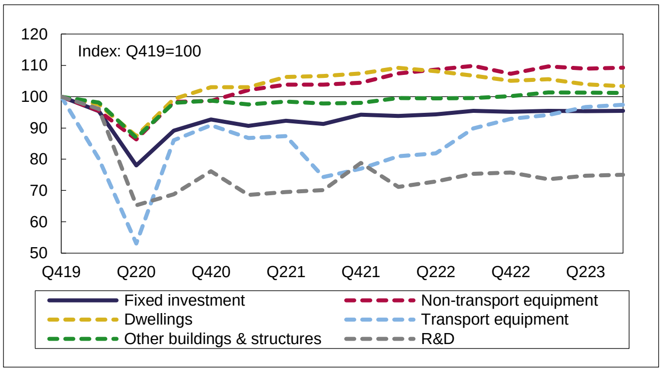
Within the manufacturing detail, production of capital goods fell for a fourth month out of the past five in October (-1.0%M/M), due principally to a sharp drop in machinery and equipment output (-6.3%M/M) to the lowest level since December 2020 and some 6% below the pre-pandemic benchmark. But despite a modest increase (0.7%M/M), autos production was still broadly in line with the Q3 average and some 13% below the February 2020 level. Production of intermediate goods fell for a second successive month (-0.4%M/M) to a ten-month low, while production in energy-intensive sectors fell (-1.9%M/M) to a new series low amid sizeable declines in the chemicals, coke and petroleum subsectors. And while there was a modest increase in consumer goods output (0.4M/M) for the first month in four, this still left it some 3% lower than the Q3 average.

Euro area: GDP & expenditure components



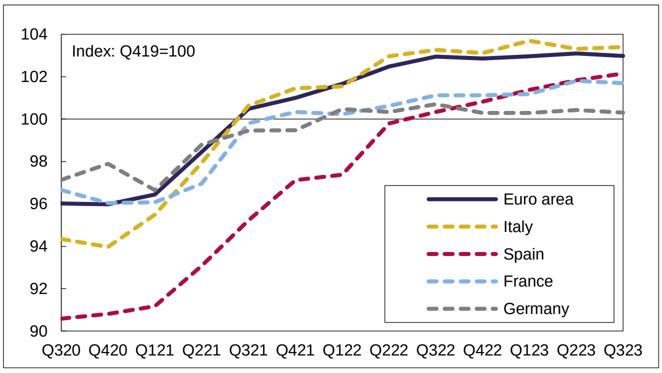
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Fixed investment – selected components



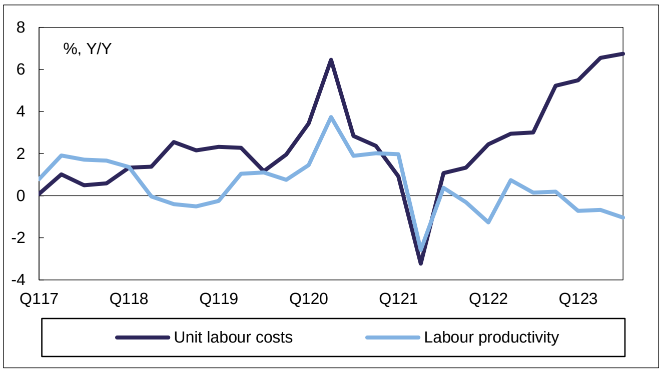
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: GDP by selected member state



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Unit labour costs & productivity*



**Per hour worked basis. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Outlook for German manufacturers remains subdued

Survey indicators – including the PMIs and ifo institute business climate indices – suggest that the pace of decline in production moderated in November. And there was a significant pickup in business gas usage towards the end of the month, which might imply a boost to energy-intensive production over the near term. But overall, with demand weak and inventories elevated, output will remain subdued. Certainly, the latest truck toll mileage figures, which often offer a useful guide to manufacturing activity, implied a further weakening in November and early December. Overall, we expect manufacturing output to remain a drag on German GDP growth this quarter as inventory adjustments continue. And taken together with the latest data from France (-0.3%M/M), Italy (-0.2%M/M) and Spain (-0.3%M/M), today's figures suggest that, in the absence of a notable rise in Ireland (data due tomorrow), aggregate euro area IP (data due on 13 December) also started the fourth quarter on the back foot.

The day ahead in the euro area

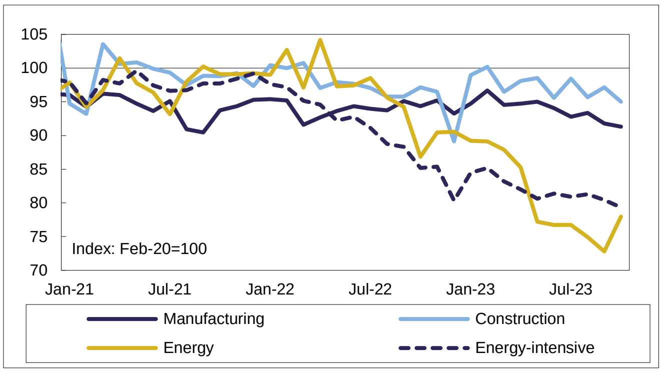
It should be a relatively quiet end to the week for top-tier euro area releases, with just the final German inflation figures for November due. The flash estimates saw the headline HICP rate fall a larger-than-expected 0.7ppt to a 29-month low of 2.3%Y/Y. And the national CPI rate was down 0.6ppt on the month to 3.2%Y/Y, the lowest since June 2021. The detail published so far has suggested that the moderation in price pressures was broad based, including encouragingly a notable fall in services inflation to its lowest in fifteen months, as well as the softest core goods and food inflation in 21 and 20 months respectively, and the steepest annual drop in energy inflation in three years. As such, tomorrow's figures are also likely to confirm that core inflation on both the national and EU-harmonised measures fell to 15-month lows, at 3.8%Y/Y and 3.5%Y/Y respectively.

UK

The day ahead in the UK

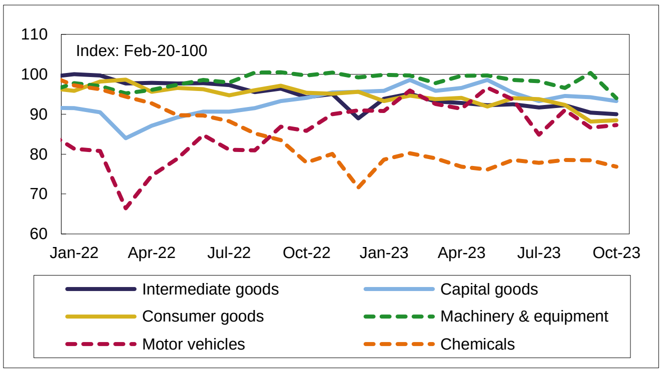
Ahead of the coming week's BoE policy decision, focus tomorrow will be on the November results of the REC/KPMG report on jobs, with survey indicators having become increasingly important for the MPC's assessment of the state of the labour market in light of the current suspension of the ONS's key Labour Force Survey (LFS). And while the PMIs signalled some stabilisation in economic momentum in November, the REC survey might well continue to report a further decline in permanent placements for a fourteenth consecutive month, while the measure of permanent staff starting salaries might well fall for a seventh successive month. In addition, tomorrow will bring the release of the BoE's quarterly household inflation

Germany: Industrial production



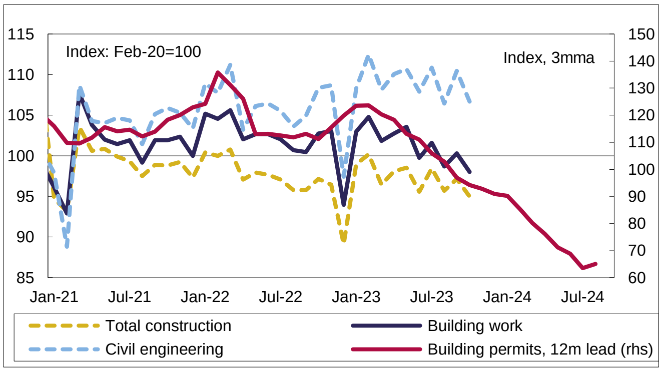
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production by sector



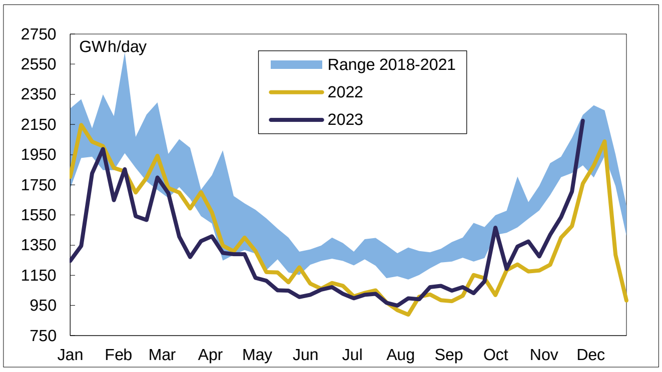
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Construction output & building permits



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

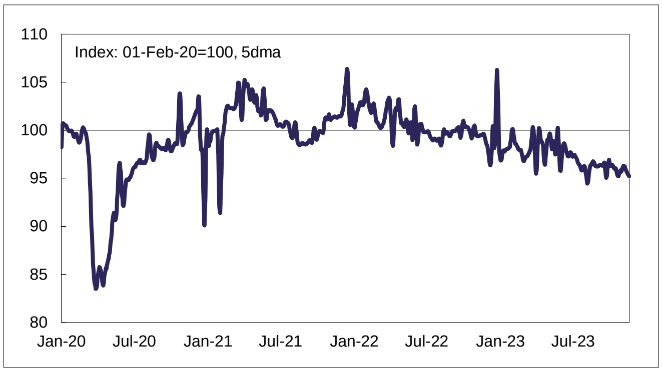
Germany: Business gas usage



Source: Bundesnetzagentur and Daiwa Capital Markets Europe Ltd.

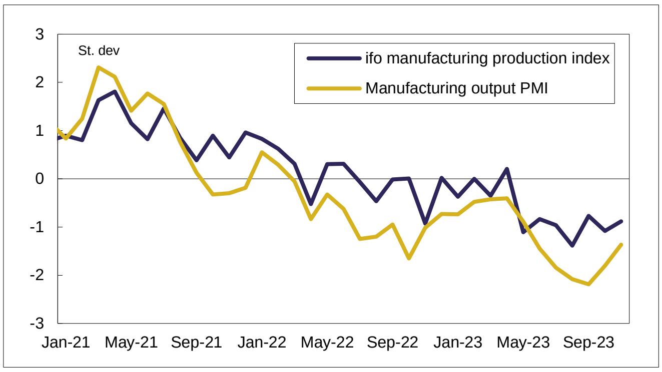
attitudes survey. Given the recent step-down in inflation, this will likely report an easing in households' inflation expectations for twelve months' time, having ticked slightly higher in the previous survey in August (3.6%Y/Y). But while longer-term expectations might also have edged lower from 2.9% in August to move further below the long-run average (3.2%) they will nevertheless remain above the Bank's 2% target.

Germany: Truck toll mileage



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Business survey production indices



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

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		GDP – 3rd estimate Q/Q% (Y/Y%)	Q3	**-0.1 (0.0)**	*-0.1 (0.1)*	0.2 (0.5)	0.1 (0.6)
		Employment – 2nd estimate Q/Q% (Y/Y%)	Q3	**0.2 (1.3)**	*0.3 (1.4)*	0.1 (1.3)	- (1.4)
Germany		Industrial production M/M% (Y/Y%)	Oct	**-0.4 (-3.5)**	0.2 (-3.0)	-1.4 (-3.7)	-1.3 (-3.6)
France		Trade balance €bn	Oct	**-8.6**	-	-8.9	-8.9
Italy		Industrial production M/M% (Y/Y%)	Oct	**-0.2 (-1.1)**	-0.4 (-1.4)	0.0 (-2.0)	0.1 (-)

Auctions

Country		Auction
France		sold €988mn of 2.75% 2027 bonds at an average yield of 2.45%
		sold €1.32bn of 0.00% 2032 bonds at an average yield of 2.59%
		sold €2.00bn of 1.25% 2034 bonds at an average yield of 2.75%
		sold €680mn of 0.10% 2029 index-linked bonds at an average yield of 0.44%
Spain		sold €1.20bn of 0.6% 2029 bonds at an average yield of 2.831%
		sold €1.73bn of 3.9% 2039 bonds at an average yield of 3.589%
		sold €505mn of 0.7% 2033 index-linked bonds at an average yield of 1.199%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Final HICP (CPI) Y/Y%	Nov	*2.3 (3.2)*	3.0 (3.8)
UK		09.30	BoE household inflation expectations 12M ahead, Y/Y%	Nov	-	3.6

Auctions and events

Country		GMT	Event
UK		00.01	REC/KPMG report on jobs

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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