Euro wrap-up

Overview

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- Bunds made gains as euro area labour cost growth moderated and the job vacancy rate fell to a three-year low.
- Gilts also made gains even as UK net public borrowing continued to overshoot the OBR's forecast.
- Thursday will bring the flash PMIs and Commission consumer confidence index for August as well as euro area negotiated wage data for Q2.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.357	-0.041
OBL 2½ 10/29	2.113	-0.024
DBR 2.6 08/34	2.198	-0.012
UKT 0⅛ 01/26	3.654	-0.021
UKT 0½ 01/29	3.702	-0.027
UKT 4⅝ 01/34	3.895	-0.019

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

Euro area

Labour cost growth moderates in Q2

Ahead of tomorrow's update on wage settlements, today's preliminary labour cost and job vacancy data for Q2 should have alleviated concerns somewhat about second-round effects on inflation emanating from the euro area labour market. With figures for Q1 having been skewed to the upside by one-off payments in Germany, labour cost growth moderated in Q2. Labour costs in the business economy slowed 0.7ppt from Q1 to a seven-quarter low of 4.0%Y/Y, 0.5ppt softer than a year earlier and almost 2ppts below the peak in Q422. Growth in wages and salaries slowed 1.0ppt on the quarter to 3.9%Y/Y. Most sectors registered a softening of pay growth, with a moderation of around 1ppt in both manufacturing (3.9%Y/Y) and services (3.8%Y/Y) and most tertiary sub-sectors also down from recent highs.

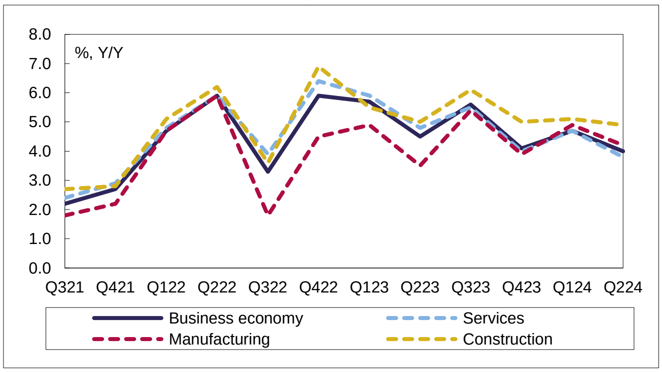
Vacancies fall again to support case for gradual rate cuts

Euro area pay data are typically highly volatile. But evidence on the diminishing tightness of the jobs market suggests that the gradually moderating trend in labour cost growth – which is a feature of the ECB's current projections – should remain intact into next year, supporting the case for gradual rate cuts. According to today's flash figures, the job vacancy rate in the business economy fell in Q2 for the fourth quarter out of the past five, and by 0.3ppt – the most in that sequence – to a three-year low of 2.7. Declines in vacancies to the lowest level in three years was registered in services, industry and construction alike. Moreover, each of the three largest member states recorded their lowest vacancy rates since 2021. With the euro area unemployment rate ticking up to 6.5% in June, the vacancies-to-unemployment ratio – which provides a useful guide to the tightness of the labour market – fell 5bps in Q2 to 0.40. While still 9bps above the pre-pandemic level in Q419, that was down 9bps from the peak two years ago and suggestive of the most labour market slack since Q321. Tomorrow's negotiated wage data, also for Q2, will provide a guide to future labour cost growth, likely similarly reporting a moderation in growth in part due to fewer German one-offs while also reflecting rising slack.

The day ahead in the euro area

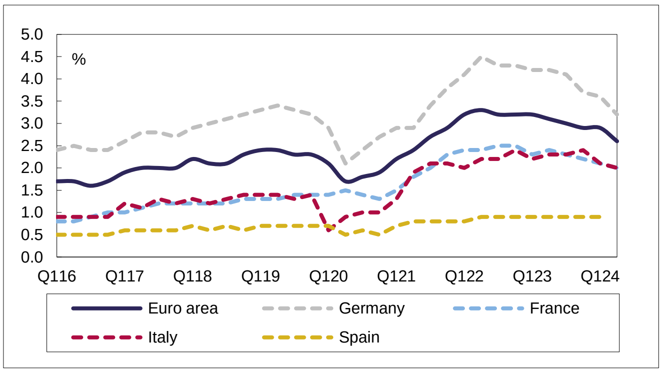
Thursday will bring the flash August PMIs as well as the Commission's flash estimate of consumer confidence for the same month and euro area negotiated wage growth data for Q2. The July PMIs raised significant concerns about a loss of growth momentum in the second half of the year. The final services activity PMI (51.9) signalled the weakest growth in the sector for four months while the manufacturing output PMI (45.6) pointed to the sharpest contraction in the sector so far this year. As a result, the euro area composite output PMI (50.2) implied that economic growth has effectively ground to a halt amid contraction in both Germany and France. In contrast, the Commission's consumer confidence index rose for the sixth

Euro area: Labour cost growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Job vacancy rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

successive month in July to -13.0, the highest level since February 2022. Finally, in part due to one-off payments in Germany, negotiated wage growth rebounded 0.4ppt in Q1 back to the series high of 4.7%Y/Y. Less support from German one-offs as well as a softening in France should contribute to a moderation in Q2.

UK

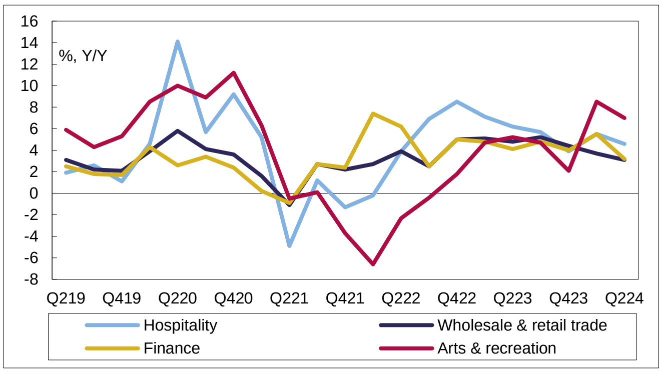
Public sector borrowing running above OBR projection

Today's UK public sector finances data for July underscored the likelihood that new Chancellor Rachel Reeves will announce tax hikes in her first Budget announcement on 30 October. At the same time, the OBR is likely to raise its projection for public sector borrowing over the medium term too. Today's data showed that public sector net borrowing (excluding banks) in July was £3.1bn, up £1.8bn from a year earlier and the highest for the month in three years. It was also £3bn above the OBR's forecast published in March. So, despite a favourable net revision to the figure for April to June, cumulative public sector net borrowing over the first four months of the fiscal year totalled £51.4bn, down £0.5bn from the same period last year but almost £5bn above the OBR's expectation. Net borrowing in FY23/4 also exceeded the OBR's March projection by some £6bn.

Pressures principally on the spending side

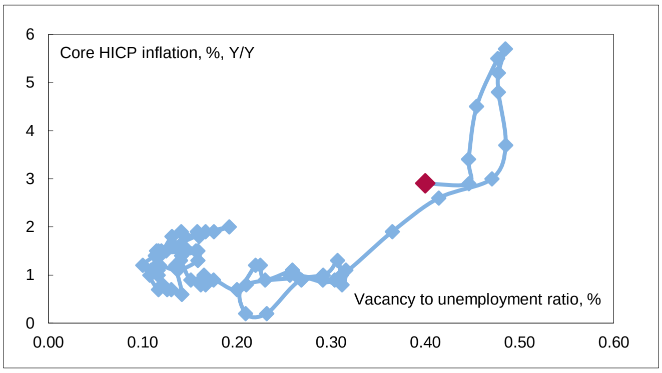
Despite stronger GDP growth and higher inflation than anticipated, tax revenues in the current fiscal year have so far come in more than £1bn below the OBR's projection. That shortfall is modest and might simply reflect shifts in the timing of payments. More significantly, central government spending is running well above expectations, by more than £9bn over the OBR's forecast for the first four months of the current fiscal year. The Treasury's initial post-election audit predicted an overspend by departments in FY24/5 of almost £22bn reflecting new event-driven spending pressures on policies ranging from military assistance to Ukraine, asylum-seeker support and rail services, as well as higher inflation and previous government policy announcements that had been unfunded. The new government has also committed to higher public sector pay – with new settlements for frontline services staff around 5-6% in FY24/5 – to address recent real-terms wage cuts, the widening shortfall between public and private sector pay and high number of working days lost to strike action over the past couple of years. At the Budget, Reeves will provide information on other spending pressures such as the cost of compensation for victims of a decades-long infected blood scandal, which could reach some £20bn. By then, given major strains on a range of public services, further demands on government spending might be expected to rear their head. And the OBR might also have to revise up the expected profile for debt interest and transfers to the BoE to cover the costs of QE.

Euro area: Wage growth in selected services



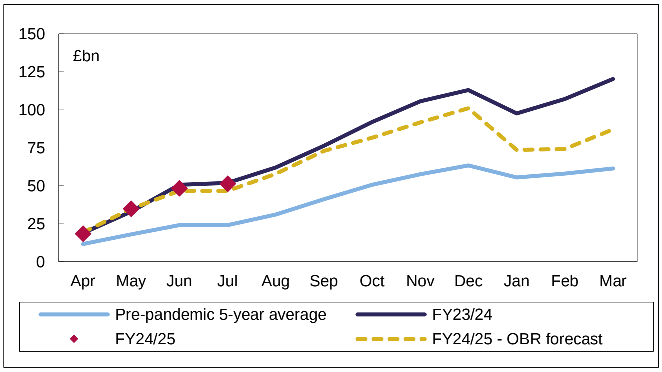
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Phillips curve*



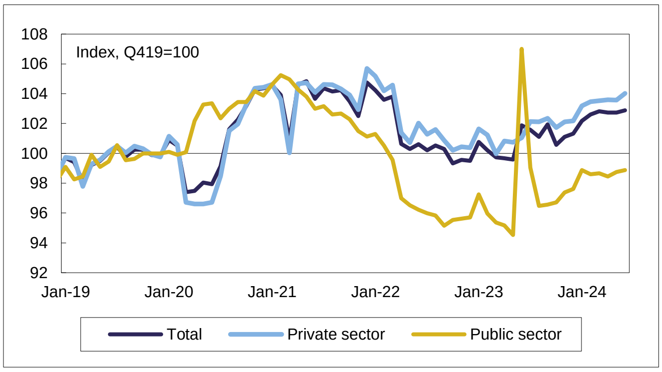
**Red diamond represents outturn for Q224. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Cumulative net public sector borrowing*



**Excluding banks. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Private & public sector real total pay



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

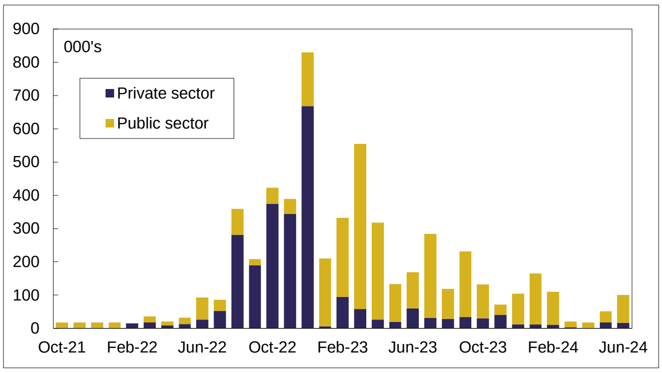
Tax hikes to come in October along with plans for higher borrowing

The government's fiscal rules specify that public sector borrowing excluding the costs of investment must move into balance and public sector net debt must be falling as a share of GDP by the fifth year of the OBR's forecast. As currently specified, the debt rule looks set to bind significantly. The Labour party election manifesto had already proposed significant spending cuts on 'unprotected' government departments. And existing plans envisage more than £20bn of additional tax revenues by FY28/9 to take their share of GDP to a new high. But given the current borrowing overshoot and additional pressures on public spending, extra tax increases seem bound to be announced on 30 October. Higher taxes on capital gains and inheritance as well as reduced tax relief on pension contributions seem likely. But to provide scope for higher borrowing – perhaps by significantly more than £10bn a year by the end of the projection horizon – we also expect a decision to limit or exclude altogether the costs of BoE QE from the public debt rule.

The day ahead in the UK

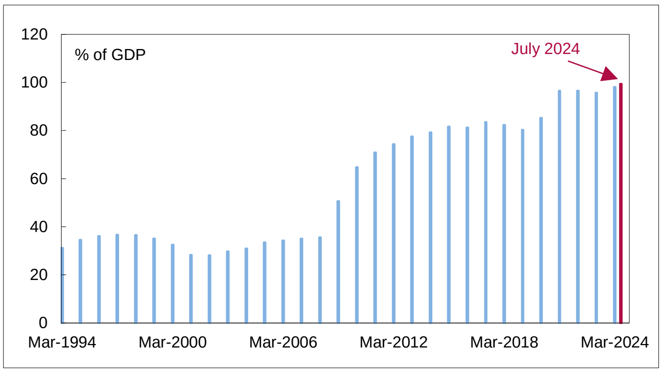
As in the euro area, Thursday will bring the UK flash PMIs for August. In contrast to the euro area survey, the UK PMIs in July suggested ongoing moderate growth momentum. Indeed, the final composite output PMI rose 0.5pt to 52.8, only marginally below the average for the first half of the year when GDP growth was firm. The services activity PMI (52.5) suggested a slight pickup in momentum after a softening in June while the manufacturing output PMI (54.9) signalled the strongest growth in the sector since early 2022. The CBI industrial trends survey results for August, also due on Thursday, will provide additional information about conditions in the manufacturing sector.

UK: Working days lost to strike action



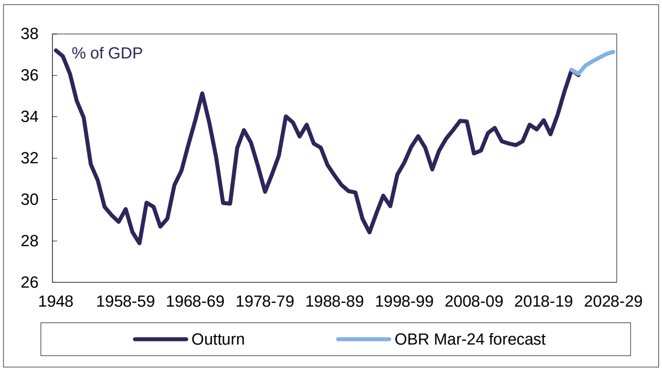
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Net public sector debt



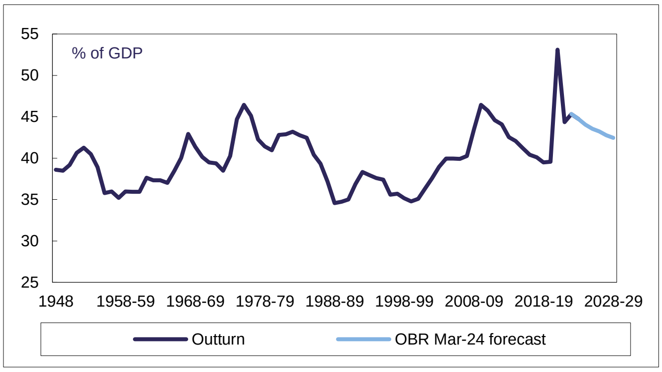
Source: ONS, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Taxes



Source: OBR, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Total managed public expenditure



Source: OBR, Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Labour costs – 1st estimate Y/Y%	Q2	**4.1**	-	5.1	4.9
UK		Public sector net borrowing £bn	Jul	**3.1**	1.5	14.5	13.5

Auctions

Country		Auction
Germany		sold €3.673bn of 2.6% 2034 bonds at an average yield of 2.22%
UK		sold €3.75bn of 3.75% 2027 bonds at an average yield of 4.068%

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	Preliminary manufacturing (services) PMI	Aug	45.8 (51.7)	45.8 (51.9)
		09.00	Preliminary composite PMI	Aug	50.1	50.2
		10.00	Negotiated wages Y/Y%	Q2	-	4.7
		15.00	Preliminary Commission consumer confidence indicator	Aug	-12.6	-13.0
Germany		08.30	Preliminary manufacturing (services) PMI	Aug	43.3 (52.3)	43.2 (52.5)
		08.30	Preliminary composite PMI	Aug	49.2	49.1
France		08.15	Preliminary manufacturing (services) PMI	Aug	44.5 (50.3)	44.0 (50.1)
		08.15	Preliminary composite PMI	Aug	49.2	49.1
		-	Retail sales Y/Y%	Jul	-	-0.7
UK		09.30	Preliminary manufacturing (services) PMI	Aug	52.2 (52.8)	52.1 (52.5)
		09.30	Preliminary composite PMI	Aug	53.0	52.8
		11.00	CBI industrial trends survey – total orders (selling price) balance	Aug	-25 (5)	-32 (2)

Auctions and events

Country		BST	Event
Euro area		12.30	ECB monetary policy account from 18 July Governing Council meeting to be published

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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