Euro wrap-up

Overview

- Bunds followed Treasuries lower after a very strong US ISM, while markets continued to react to a report suggesting that the ECB would (at some point) taper its asset purchases.
- Gilts also made losses as the UK composite PMI signalled positive GDP growth in Q3, while the probability of a November rate cut fell further.
- Focus tomorrow will be on the ECB's account from September's Governing Council meeting, as well as the BoE's publication of the total stock of its corporate bond purchases over the past week.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.656	+0.001
OBL 0 10/21	-0.518	+0.031
DBR 0 08/26	-0.007	+0.048
UKT 1¼ 07/18	0.111	-0.004
UKT 3¾ 09/21	0.253	+0.022
UKT 1½ 07/26	0.814	+0.036

*Change from close as at 4.30pm BST.
Source: Bloomberg

Euro area

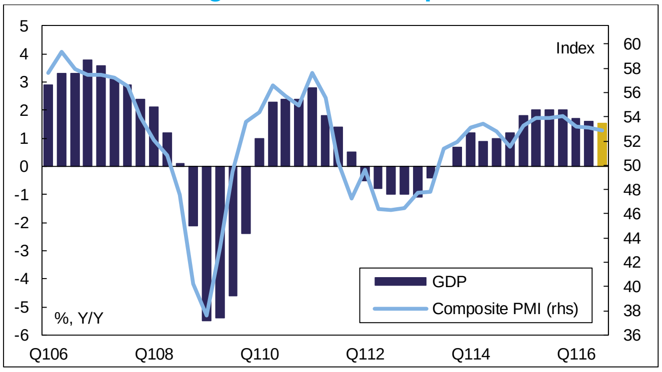
Euro area composite PMI consistent with Q3 GDP growth of 0.3%Q/Q

Business sentiment surveys have provided mixed messages about the economic performance of the euro area in the third quarter. The final services activity PMI for September released today saw only a modest upward revision from the flash estimate, which left it down 0.6pt on the month at 52.2, a twenty-one-month low, and the average over the third quarter as a whole at its lowest since Q414 and 0.5pt lower than in Q2. With the manufacturing output PMI released at the start of the week having been left unchanged from the flash estimate (53.8), the headline euro area composite index was also unrevised at 52.6, down 0.3pt from August at its lowest since the start of 2015. As a result, the quarterly average for the composite PMI edged marginally lower from Q2, down 0.2pt to 52.9, consistent with another quarter of modest GDP growth in the third quarter of 0.3%Q/Q. Today's euro area retail sales figures for August were consistent with such a subdued performance, with sales falling 0.1% on the month, following downwardly revised growth of just 0.3%M/M in July (from an initially estimated rise of 1.1%M/M). While this left the average in the first two months of Q3 0.4% higher than in Q2, when excluding sales of food and fuel, core sales were up just 0.1% on the same basis. And in the absence of an increase in September, core retail sales growth in the third quarter, while still positive, would be the weakest since Q414.

French composite PMI strengthens, other member states weaken

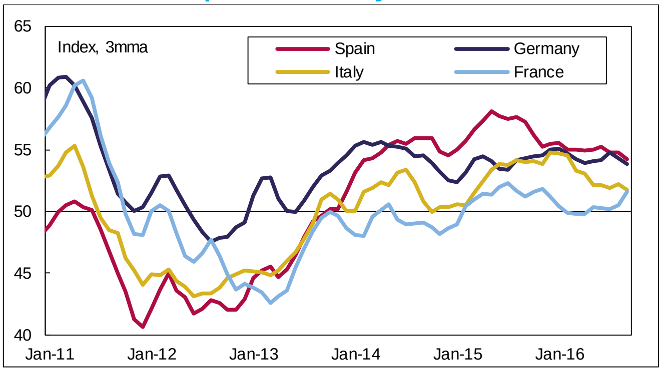
Within the country breakdown of the PMI survey, despite a modest upward revision, the German services PMI at 50.9 was still the lowest for more than three years and more than 5pts lower than the end-2015 peak. And it was only just above the equivalent Italian PMI, which fell more than 1½pts on the month to just 50.7. There was also a notable decline in the Spanish services PMI to 54.7, partially reversing the increase in August. In contrast, despite a downward revision from the flash estimate the French services PMI was up 1pt on the month to a fifteen-month high of 53.3. And, as a result, France was the only member state to see its composite PMI rise in September, by 0.8pt to 52.7, to leave the quarterly average almost 1½pts higher than Q2. The other larger member states saw their composite PMIs decline between ½-1pt on the quarter, with the German index (53.8) at a four-quarter low, the Italian (51.7) at a six-quarter low and the Spanish (54.2) at an eleven-quarter low, suggesting that GDP growth slowed in these countries last quarter. Indeed, the Bank of Spain last week estimated that growth in that country moderated 0.1ppt to a seven-quarter low of 0.7%Q/Q in Q3. But Spain seems bound to have led the way among the larger member states once again, with growth in Germany possibly having slowed slightly to 0.3%Q/Q while Italy's economy might well have failed to expand for the second successive quarter.

Euro area: GDP growth* and composite PMI



*Q316 GDP figure is Daiwa forecast.
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMIs by member state



Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

No case (yet) for an ECB taper tantrum

Yesterday's Bloomberg report citing comments from an 'ECB official', suggesting that there was a growing consensus on the Governing Council that the ECB would likely taper its monthly bond purchases before ending its QE programme, inevitably attracted attention. However, in our view, the comments were simply stating the obvious. When the Governing Council eventually decides that the economic outlook no longer demands asset purchases of €80bn per month, it is highly unlikely to bring an immediate halt to QE since that would risk a sudden damaging marked tightening of financial conditions. So, instead, it would be highly likely to elect for a gradual Fed-style taper of its asset purchases, with the suggested reduction of about €10bn per meeting seeming perfectly feasible. Indeed, Draghi has recently repeatedly underscored the importance of maintaining highly supportive financial conditions as a precondition for pushing inflation steadily higher over the coming two years, strongly suggesting that the ECB would certainly not risk a sudden stop to its asset purchases.

Economic conditions currently call for ongoing stimulus

With the ECB having forecast in September that inflation would still likely fall short of its target in 2018, and several recent euro area data releases having disappointed – not least the continued weakness of core inflation at just 0.8%Y/Y in September, the flat-lining of the unemployment rate above 10% over the past five months, and a weakening of wage growth to below 1%Y/Y in Q2 – economic conditions simply do not yet merit even a gradual phasing out of asset purchases, let alone an end to QE. And with the ECB now undertaking a review of 'options to ensure a smooth implementation' of QE, when the Governing Council discusses the conclusion of that review, most likely at the December policy meeting, we expect it to confirm the extension of QE beyond March. Whether the ECB will keep buying assets beyond March at the current rate of €80bn per month, however, will depend on how economic and financial conditions evolve between now and then. If the economic data improve, e.g. if euro area GDP growth, core inflation and labour cost growth pick up and the unemployment rate resumes a steady decline, policymakers might well dare to slow the rate of asset purchases at some point next year. But if not, an extension of asset purchases at the current pace of €80bn a month might seem most likely. And the higher that bond yields rise or the more that investors fret about the health of certain banks in Germany or Italy, the less likely the ECB will be to trim back its asset purchases.

The day ahead in the euro area and US

Given yesterday's Bloomberg report, attention on Thursday will no doubt be on the ECB's account of the September Governing Council meeting, which is due for publication. We do not expect to see any reference to the QE exit strategy. However, the account should hopefully provide more colour on the decision of the Governing Council to launch a study of options to ensure smooth implementation of the QE programme, with issues related to the scarcity of bonds available to purchase possibly mentioned. Datawise, meanwhile, focus in the euro area tomorrow turns back to the industrial sector, with German factory orders data for August due for release. In the bond markets, France will sell 10Y, 15Y and 50Y paper.

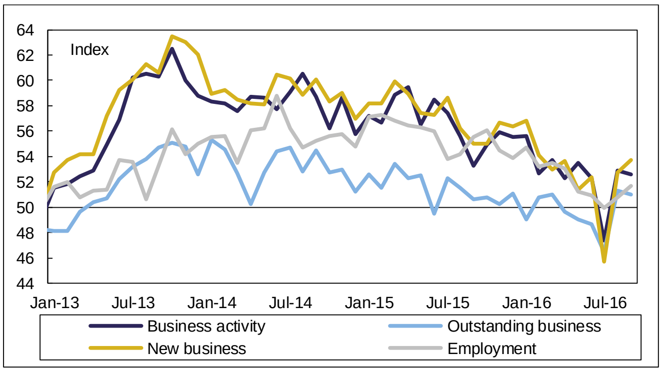
In the US, ahead of Friday's payroll report tomorrow brings Challenger Job Cuts data for September as well as the usual weekly jobless claims figures.

UK

Services PMI fails to impress

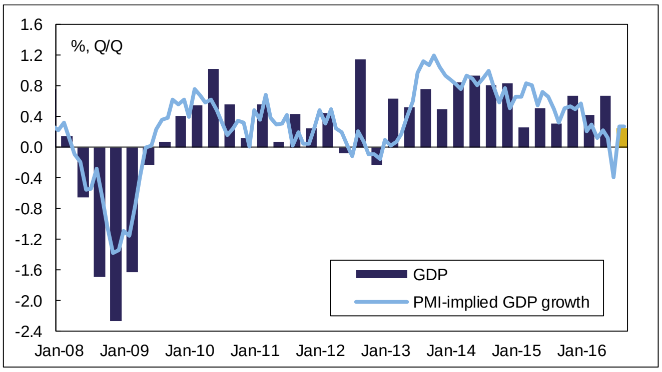
Contrasting with the sharp increases reported in the equivalent manufacturing and construction surveys earlier this week, the UK's services PMI eased slightly in September, from 52.9 to 52.6. Looking at the details, the overall message seems to be mixed: the outstanding business indicator inched lower, having recovered from the initial Brexit shock in the previous month,

UK: Services PMIs



Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP* and PMI's



**Q316 GDP figure is Daiwa forecast.*
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

but new business and employment indices both continued to rise and each increased by about 1pt. More generally, today's figures left the composite PMI up only slightly, from 53.6 to 53.9, the highest level since the start of this year, but much lower than may have been expected after the particularly strong rise in the manufacturing PMI. And if the equivalent construction PMI is also taken into account, the PMIs were consistent with growth of about 0.3%Q/Q at the end of the quarter. However, given that the survey indices fell particularly sharply and perhaps overreacted in the wake of the referendum, the average Q3 values imply GDP growth of only 0.1%Q/Q, below our own forecast of a 0.3%Q/Q increase.

MPC members undecided about the vote in November

The MPC's newest member, Michael Saunders, delivered his first speech as an MPC member today. The BoE had already published the text of the speech yesterday afternoon, which suggested that Saunders is relatively more optimistic about the near-term growth outlook, suspecting that the economy will not slow as much over the next year or two as implied by the MPC's central forecast published in August, thanks in part to looser financial conditions. However, he also concluded that the natural rate of unemployment is probably lower than the BoE had assessed, implying that there is more slack in the labour market. Against the backdrop of these two opposing assessments, Saunders hinted that his vote on the MPC in November will be very much data dependent. But if economic data continue to surprise on the upside, we suspect he is likely to withhold from voting for further easing. Meanwhile, Ben Broadbent, the longest serving MPC member, also spoke today, highlighting the effects of uncertainty on firms' investment decisions, suggesting that he remains concerned about the UK economic outlook in the medium and longer term. However, Broadbent also acknowledged that growth currently appears to be higher than the BoE expected in August, attributing the upward surprise to three major factors – the momentum in domestic demand, the impact of sterling depreciation on the economy and the resilience of the housing market.

The day ahead in the UK

A relatively quiet day tomorrow brings only labour productivity figures for Q2. With regard to monetary policy, the BoE will publish for the first time the aggregate total stock of its corporate bond purchases since the start of the scheme last week.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Final services PMI (final composite PMI)	Sep	**52.2 (52.6)**	52.1 (52.6)	52.8 (52.9)	-
	Retail sales M/M% (Y/Y%)	Aug	**-0.1 (0.6)**	-0.3 (1.5)	1.1 (2.9)	**0.3 (1.8)**
Germany	Final services PMI (final composite PMI)	Sep	**50.9 (52.8)**	50.6 (52.7)	51.7 (53.3)	-
France	Final services PMI (final composite PMI)	Sep	**53.3 (52.7)**	54.1 (53.3)	52.3 (51.9)	-
Italy	Services PMI (composite PMI)	Sep	**50.7 (51.1)**	52.0 (51.5)	52.3 (51.9)	-
Spain	Services PMI (composite PMI)	Sep	**54.7 (54.1)**	54.6 (53.8)	56.0 (54.8)	-
UK	BRC shop price index Y/Y%	Sep	**-1.8**	-	-2.0	-
	New car registrations Y/Y%	Sep	**1.6**	-	3.3	-
	Services PMI (composite PMI)	Sep	**52.6 (53.9)**	52.2 (52.3)	52.9 (53.6)	-

Auctions

Country	Auction
Germany sold	€3.26bn of 2026 zero-coupon bonds (15-Aug-2026) at an average yield of -0.03%
UK	BoE APF operation purchased £1.17bn of 7-15Y Gilts (4.01 cover ratio)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07:00	Factory orders M/M% (Y/Y%)	Aug	0.3 (1.6)	0.2 (-0.7)
UK	09:30	Unit labour costs Y/Y%	Q2	-	1.9

Auctions and events

Country	BST	Auction / Event
EMU	12:30	ECB publishes account of the monetary policy meeting held on 7-8 September
France	09:50	Auction: To sell 0.25% 2026 bonds (25-Nov-2026)
	09:50	Auction: To sell 1.5% 2031 bonds (25-May-2031)
	09:50	Auction: To sell 1.75% 2066 bonds (25-May-2066)
UK	10:30	Auction: To sell £2bn of 1.5% 2047 bonds (22-Jul-2047)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	ECB public sector asset purchases €bn	Weekly	**11.5**	*16.0*	15.4	**-**
Spain	Unemployment M/M '000s	Sep	**22.8**	23.3	14.4	**-**
UK	Construction PMI	Sep	**52.3**	49.0	49.2	**-**

Auctions

Country	Auction
UK sold	£2.75bn of 0.5% 2022 bonds (22-Jul-2022) at an average yield of 0.33%
	BoE APF operation purchased £1.17bn of 15Y+ Gilts (3.26 cover ratio)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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