Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds made modest losses today as the euro area manufacturing PMIs signalled ongoing expansion at the start of Q3.
- Gilts made losses today despite a significant downside surprise to the UK manufacturing PMIs.
- Tomorrow brings the UK construction PMI for July, as well as Spanish labour market figures.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.616	+0.010
OBL 0 10/21	-0.513	+0.015
DBR 0 08/26	-0.096	+0.024
UKT 1¼ 07/18	0.164	+0.059
UKT 1½ 01/21	0.322	+0.042
UKT 2 09/25	0.731	+0.046

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

Euro area

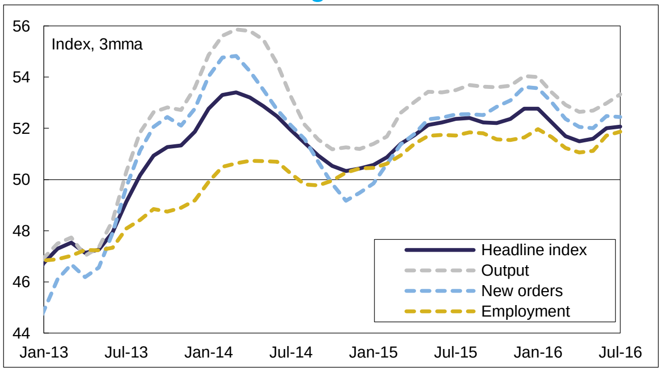
Final manufacturing PMI revised slightly higher

The final manufacturing PMIs today provided further evidence that the euro area's economy has held up relatively well in the immediate aftermath of the UK's vote to leave the EU, with the headline PMI revised up by 0.1pt from the flash estimate to 52.0. While this still left the index down 0.8pt on the month, it remained just above the average of the first half of the year. Within the survey detail, the modest upward revision to the output component (0.3pt) saw the index unchanged at 53.9, the firmest level since 2015 and almost 1pt higher than the average in the first half of the year. The decline in the new orders component was also slightly less than initially thought (down -1.5pts on the month) to leave it at a still-healthy 52.2, while the employment component recorded the second-highest reading in five years. At the country level, the decline in the German headline index was also slightly smaller than initially thought (down -0.7pt from June) to leave it at 53.8, still the firmest of the member states. And there was a further improvement in the output PMI, up by 1.3pts to 57.0 the highest since April 2014. In contrast, the French PMI was confirmed at the flash estimate, which despite a modest increase on the month (0.3pt) was still firmly in negative territory at 48.6. There was a notable loss of momentum in the manufacturing sectors of the next two largest member states at the start of Q3 too, with the Italian headline index down more than 2pts to an 18-month low of 51.2, while the Spanish PMI was down more than 1pt to a 31-month low of 51.0. And there was a marked drop in the new orders components for both countries, down 3.6pts and 1.9pts respectively, suggesting that downside risks to the sector will remain to the fore over coming months.

Italian banks fared slightly better than expected in stress tests

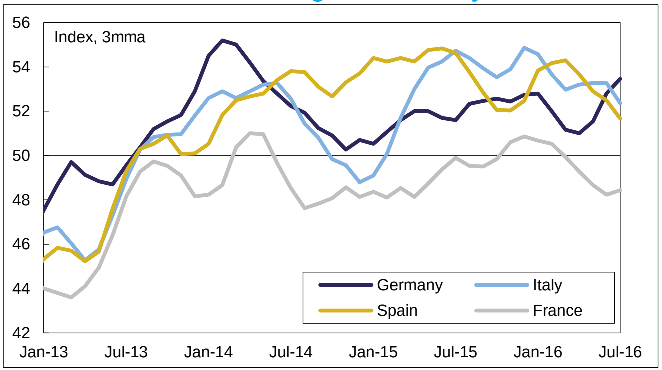
A key uncertainty regarding Italy's economy is the health of its banking sector. So the results of the European Banking Authority's (EBA) latest stress tests on Friday showing that Italy's banks – with the notable exception of Monte dei Paschi – performed better than expected was a surprise. Nevertheless, only one of the five banks was expected to have a common equity tier 1 (CET1) ratio under the adverse scenario above the average of the 51 European banks tested. And the stress test inevitably highlighted significant weaknesses at Monte dei Paschi, which was the only bank expected to have a negative core capital ratio under the adverse scenario. But Monte dei Paschi pre-empted the EBA results with the announcement of plans for a private sector-led recapitalisation to transfer almost €28bn (gross) of its bad loan portfolio to a SPV and the injection of €5bn of capital guaranteed by a syndicate of banks. While this plan will stabilise concerns about near-term capital inadequacy at the bank and the prospects that junior creditors will face losses, it is unlikely to be a game-changer for the economic outlook. This was reflected in Italian banking stocks today, which despite an initial boost upon opening saw Monte dei Paschi shares close up less than 1% on the day, while UniCredit shares were temporarily suspended before closing 9% lower on the day. And it will remain to be seen whether it will provide a boost to Renzi ahead of the referendum on constitutional changes later in the year.

Euro area: Manufacturing PMIs



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

Euro area: Manufacturing PMIs in major countries



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

The day ahead in the euro area and US

It should be a relatively quiet day for economic news from the euro area tomorrow, with just Spanish labour market numbers for July due for release. In the US, the latest personal income and spending data for June, as well as July vehicle sales are due, while the Fed's Kaplan is due to speak in China.

UK

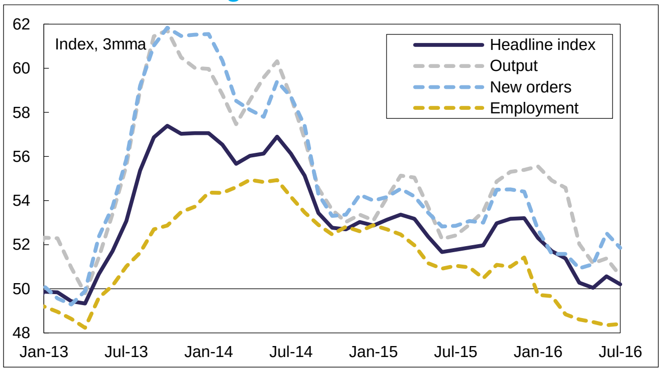
Final PMIs show hit on manufacturing sector bigger than initially thought

The flash July UK PMIs released ten days ago signalled the largest monthly deterioration in overall business sentiment on record following the EU referendum. But it appears that the flash readings underestimated the impact, at least in the manufacturing sector, with today's final manufacturing PMI bringing a downward revision to the headline indicator of 0.9pt. This meant that the index fell by more than 4pts from the June level, the second-largest monthly drop on record, to 48.2, the lowest level since February 2013. Within the detail, the revisions in the output, new orders and employment components were all downwards, leaving all of them in contractionary territory below 50. And while exporters saw a boost from the weaker pound, the new export orders component was revised down markedly from the flash estimate and as a result reported a 0.3pt fall on a month to 50.9. So today's survey provides further evidence of the enormous negative shock to the economy caused by the referendum vote, with the sizeable downward revision indicating that the flash reading was not just an immediate emotional reaction to the referendum outcome and that sentiment deteriorated as the month went on. Recession now looks inevitable for the remainder of the year and with the BoE's Inflation Report likely to signal a much weaker GDP forecast than three months ago, we expect that the MPC will deliver a package of easing measures on Thursday, including a rate cut as well as additional gilt purchases and an amendment/extension of the Funding for Lending Scheme.

The day ahead in the UK

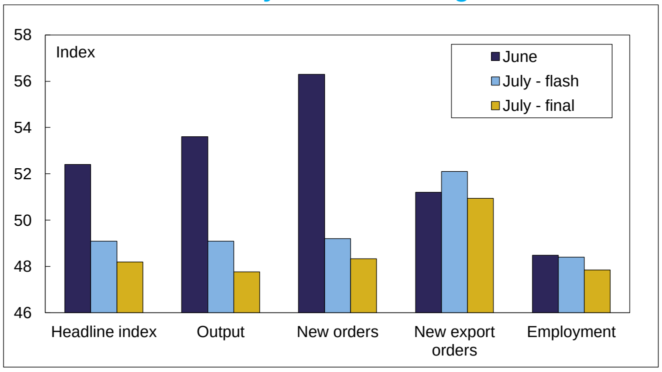
Tomorrow brings the construction PMI survey for July. Output growth in this sector was weak before the referendum and sentiment in this sector after the vote is likely to have deteriorated even more sharply than elsewhere in the economy.

UK: Manufacturing PMIs



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

UK: Revisions to July manufacturing PMIs



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

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		Final manufacturing PMI	Jul	**52.0**	51.9	52.8	-
		ECB public sector net purchases €bn	Weekly	**16.5**	*15.0*	17.5	-
Germany		Final manufacturing PMI	Jul	**53.8**	53.7	54.5	-
France		Final manufacturing PMI	Jul	**48.6**	48.6	48.3	-
Italy		Manufacturing PMI	Jul	**51.2**	52.5	53.5	-
Spain		Manufacturing PMI	Jul	**51.0**	51.5	52.2	-
UK		Final manufacturing PMI	Jul	**48.2**	49.1	52.4	-
Auctions							
Country		Auction					
- Nothing to report -							

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases						
Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Spain		08:00	Unemployment M/M '000s	Jul	-70.0	-124.3
UK		09:30	Construction PMI	Jul	44.0	46.0
Auctions and events						
Country		BST	Auction / Event			
UK		10:30	Auction: To sell £2.5bn of 0.5% 2022 bonds (22-Jul-2022)			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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