

Euro wrap-up

Overview

- Bunds and BTPs were little changed following a devastating earthquake in central Italy and as data showed that Germany's government is on track to register another budget surplus this year.
- Gilts were little changed as figures suggested that the Brexit referendum has yet to have a meaningful impact on UK bank lending patterns.
- Thursday brings results from the German Ifo and French INSEE business surveys and a UK retail survey.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.627	+0.004
OBL 0 10/21	-0.516	+0.006
DBR 0 08/26	-0.089	+0.006
UKT 1¼ 07/18	0.142	+0.017
UKT 1½ 01/21	0.210	+0.008
UKT 2 09/25	0.556	+0.012

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

Euro area

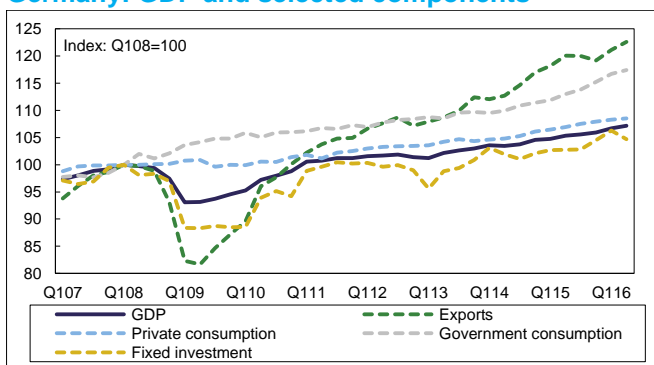
Italian quake: Watch for indirect effects

After an encouraging first two years in office, which saw Italy's economy return to modest growth and some worthwhile structural reforms implemented, recent events have been more problematic for Prime Minister Renzi. Economic recovery appeared to falter in the second quarter with GDP and the unemployment rate flat-lining, concerns have mounted about the health of the country's banks prompting a questionable rescue of Banca Monte dei Paschi, and support for the populist Five Star Movement has increasingly raised questions about Renzi's political future. The earthquake which hit central Italy early Wednesday morning with seemingly devastating consequences for the towns (such as Amatrice and Accumoli) close to the epicenter could add to the pressure on the PM. At the time of publication at least 73 fatalities had been confirmed, a figure which is highly likely to increase: the earthquake of a similar magnitude in 2009, which struck the neighboring area near L'Aquila, killed more than 300. However, while the tremors were felt in Rome, which is about 100km south-west of the epicenter, and in total more than 250k people live in the area affected, the direct macroeconomic consequences seem likely to be relatively modest given the region's focus on tourism and agricultural activity. The fiscal impact should be modest and manageable too: the L'Aquila catastrophe added less than 0.05% of GDP to Italian public spending in 2009-10. Nevertheless, the indirect political and economic impact of the quake could yet prove profound and lasting. The competence (or incompetence) of the authorities in managing the impact of the quake might well, in due course, have a significant bearing on support for the Prime Minister ahead of Italy's important referendum on constitutional matters, due in November, which could prove pivotal for Renzi's political future. And it might also weigh on Italian economic confidence, which this year slipped back from the multi-year highs reached at the end of 2015 and will be a key determinant of GDP growth over coming quarters.

German domestic demand weakness in Q2 likely to prove temporary

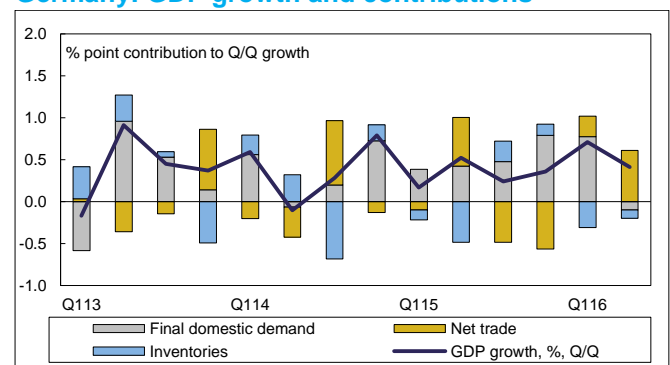
Predictably, the second estimate of German Q2 GDP confirmed the preliminary reading, showing a slowdown in growth from 0.7%Q/Q in the first quarter to 0.4%Q/Q to match the average since the economic recovery began just over three years ago. There were also no particular surprises from the full expenditure breakdown, which was released for the first time and showed that the expansion was more than fully accounted for by net exports, which contributed 0.6ppt to the headline growth figure. But while export growth of 1.2%Q/Q was only a touch firmer than the average of the past few years, the boost from net trade also reflected a drop in imports for the first time since Q412. That tallied with the weakness of domestic demand, with total investment falling 1.5%Q/Q, the most since Q113, with spending on machinery and equipment as well as construction investment down in payback for the vigorous growth over the two previous quarters. Given elevated consumer confidence and firm growth in household disposable income (3.0%Y/Y) thanks to solid labour earnings growth and a rise in employment

Germany: GDP and selected components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth and contributions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.



to a record high, the weakness of private consumption – which slowed to a two-year low of 0.2%Q/Q – appeared a further source of consternation. But, like for investment, we expect the weakness in consumption in the second quarter to be a temporary phenomenon, although it would certainly be most out of character for German households suddenly to go on a wild spending splurge. With the contribution from net trade set to be much softer, however, we expect German GDP growth in the current quarter to be broadly unchanged from Q2 at 0.4%Q/Q.

Germany on track for another budget surplus in 2016

Germany's GDP data also confirmed that government consumption made a positive contribution to growth (0.1ppt in Q2) for the ninth consecutive quarter. Nevertheless, the authorities were able to maintain a sizeable budget surplus, with other figures released today showing that the general government balance rose to €18.5bn, 1.2% of GDP, in the first half of 2016. While government spending rose more than 3½%Y/Y due partly to increased support for asylum-seekers, and investment spending growth was vigorous at more than 7½%Y/Y, exceptionally low Bund yields saw debt interest payments fall almost 14%Y/Y. Meanwhile, thanks to steady economic growth, government revenues were buoyant (up more than 4%Y/Y). While the dynamics of the fiscal aggregates over the course of the year suggest that the full-year balance will likely be smaller as a share of GDP, the data suggest that the authorities are on course to record an annual budget surplus in 2016 for the third successive year.

The day ahead in the euro area and US

Thursday's main economics focus will be further August business sentiment survey results from the euro area's two largest member states. Having dipped slightly in July, the German Ifo business climate index is expected to rise back close to June's seven-month high, although the weakening in the country's flash composite PMI reported yesterday might suggest otherwise. Meanwhile, the French INSEE business climate indicator is expected to remain stable at the top of the range of the past few years and above its long-run average. In addition, the second estimate of Spanish GDP in Q2 is likely to confirm the initial estimate of growth of 0.7%Q/Q while the expenditure breakdown, to be published for the first time, will likely show that consumer spending made the largest contribution to growth.

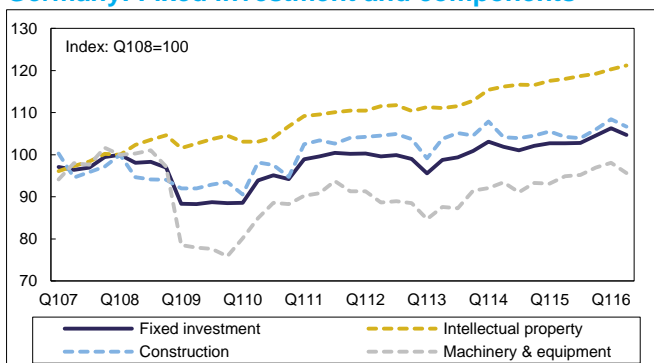
In the US, preliminary durable goods order data for July, which are expected to post a rebound from the weak previous month, are due along with the usual weekly jobless claims figures. In the bond markets, the Treasury will sell 7Y USTs.

UK

BBA data suggest no change in lending patterns after the referendum

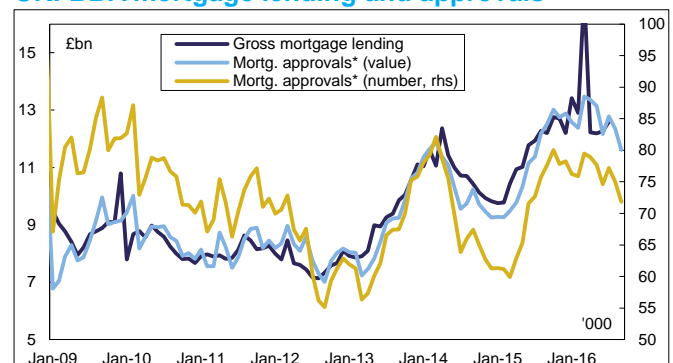
The BBA High Street Banking statistics for July, published today, suggested no reduction in credit flows in the UK economy following the result of the EU referendum. In fact, the figures reported an increase in lending to non-financial companies at the second steepest rate since 2009. And lending to households seems to have been little affected too, with gross new mortgage lending up at a four-month high and gross new credit card lending reaching the highest level on record. Of course, some of the borrowing decisions, in particular regarding mortgage lending, will have been made well in advance. Indeed, the number of mortgage approvals, a more forward-looking indicator of mortgage market activity, continued to fall, suggesting weaker new lending ahead. However, approvals for house purchase were still at levels seen in early 2015, the trough of the previous housing market adjustment following a regulator-induced tightening of credit standards. So, overall, there is reason to hope that the Brexit impact on the housing market so far has not been as severe as initially feared. That conclusion is also supported by market activity figures, with yesterday's HM Revenue & Customs data showing that residential property transactions were broadly unchanged in July. Nonetheless, there remains no shortage of reasons why Brexit uncertainty is likely to weigh on the housing market in the medium term.

Germany: Fixed investment and components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: BBA mortgage lending and approvals



*2M lead. The figures include loans for house purchase, remortgaging and other secured lending.

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



The day ahead in the UK



Tomorrow brings the CBI Distributive Trades survey for August. This survey reported a sharp fall in retail sales in July. However, those figures contrasted with the official retail sector numbers from the ONS, which showed an increase in sales that month. So the survey indices are expected to have recovered somewhat in August.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany	 GDP – second release Q/Q% (Y/Y%)	Q2	0.4 (1.8)	<u>0.4 (1.8)</u>	0.7 (1.9)	-
UK	 BBA loans for house purchase 000s	Jul	37.7	38.0	40.1	39.8

Country	Auction
Germany sold	 €3.1bn of 0% 2021 bonds (08-Oct-2021) at an average yield of -0.51%
UK	 BoE APF operation: £1.17bn of 7-15Y Gilts purchased (3.10 cover ratio)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany	09:00	Ifo business climate index	Aug	108.5	108.3
	09:00	Ifo current assessment balance (expectations)	Aug	114.9 (102.4)	114.7 (102.2)
France	07:45	Business confidence indicator (production outlook)	Aug	102 (-)	102 (3)
Spain	08:00	GDP – second release Q/Q% (Y/Y%)	Q2	<u>0.7 (3.2)</u>	0.8 (3.4)
UK	11:00	CBI Distributive Trades survey, retail sales	Aug	0	-14

Country	BST	Auction / Event
Global	-	Jackson Hole Policy Symposium starts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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