Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest losses despite some disappointingly subdued euro area inflation figures.
- Gilts were little changed as surveys provided mixed messages about economic sentiment in the UK.
- The manufacturing PMIs for August will be Thursday's main economics focus in the euro area and UK.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.620	-0.002
OBL 0 10/21	-0.501	+0.015
DBR 0 08/26	-0.062	+0.029
UKT 1¼ 07/18	0.149	-0.002
UKT 3¾ 09/21	0.220	+0.002
UKT 1½ 07/26	0.648	+0.010

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

Euro area

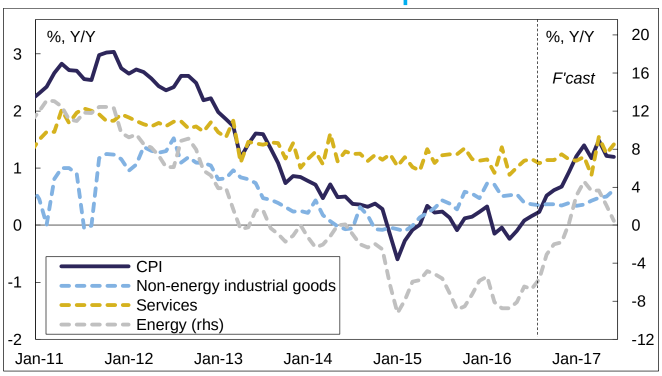
Core inflation weakness persists

As the ECB finalises its new economic forecasts ahead of next week's Governing Council meeting, the flash estimates of euro area inflation in August will have come as a disappointment. Despite the significant monetary easing of recent quarters, which saw the ECB's deposit rate taken further into negative territory and purchases under its asset purchase programme reach close to a cumulative €1trn in the past week, headline inflation remained stubbornly close to zero, unchanged at 0.2%Y/Y, matching July's six-month high. Meanwhile, the main core CPI measure slipped 0.1ppt to 0.8%Y/Y, no firmer than the average rate of the past two years, illustrating the difficulty policymakers face in shifting underlying inflation back onto a higher plane towards the ECB's target of close to 2%Y/Y. Within the detail, inflation of both main core components – services (1.1%Y/Y) and non-energy industrial goods (an eleven-month low of 0.3%Y/Y) – was weaker, while food price inflation also softened to offset partly the impact of the slower rate of decline of energy prices. Despite the latest readings, we expect headline inflation to take a step up from September onwards, not least as the contribution from energy prices fades significantly and eventually – perhaps by December – turns positive. As a result, we currently forecast CPI to rise to 0.5%Y/Y in September and to above 1.0%Y/Y in January. With core inflation measures likely to remain no firmer than 1.0%Y/Y through to year-end, however, the ECB will ultimately feel obliged to extend its asset purchase programme beyond March 2017. But whether the Governing Council announces such a measure as soon as next week remains to be seen.

German sales robust, French spending subdued

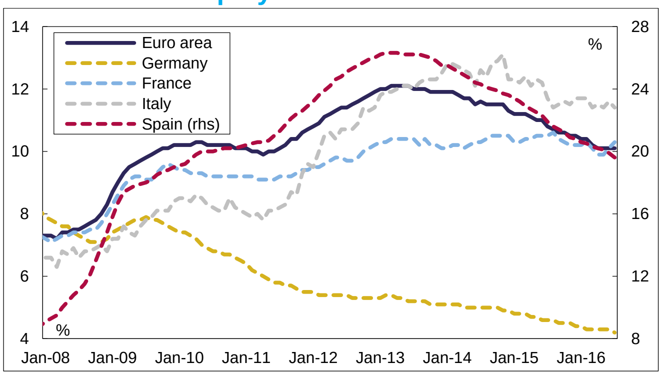
The latest spending figures from the euro area's largest member states suggested contrasting fortunes at the start of the third quarter. Certainly, consumption in Germany appears to remain on an upwards trend, with retail sales posting their strongest monthly growth in more than two years, up 1.7%M/M. Admittedly, this series is particularly volatile and the latest gain followed a drop the previous month. Nevertheless, looking through the noise, sales rose 0.6%3M/3M, the most in four months, to support our view of a stronger contribution to GDP growth from consumption in the current quarter than in Q2. In contrast, the latest French consumer spending figures were a disappointment, flagging the risks of another very subdued quarter for GDP growth in Q3. In particular, household expenditure on goods fell for the fourth consecutive month, down 0.2%M/M in July following a drop of 0.8% previously, to stand 1.0% lower on a 3M/3M basis. And apparent weakness in the French economy in July was at least in part the cause of disappointment in the latest labour market data. Contrary to expectations of a further decline, the euro area's unemployment rate was stubbornly flat at the start of the third quarter at 10.1%, with the 0.2ppt increase in the French rate to 10.3% contrasting with further falls in the equivalent measures in Germany (to a new series low of 4.2%), Italy (11.4%) and Spain (19.6%). Nevertheless, we expect the downtrend in the euro area unemployment rate to resume in coming months, led by Spain and supported by Germany for which national data released today showed a further

Euro area: Inflation and its components



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

Euro area: Unemployment rates



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

decline in joblessness in August to a post-reunification low. And while the significant amount of persistent slack in the labour market across the euro area as a whole will ensure that wage and price pressures remain modest over coming quarters, steady employment gains should support ongoing moderate growth in euro area consumption too.

The day ahead in the euro area and US

Thursday brings the final manufacturing PMIs for August. The flash headline euro area manufacturing PMI fell just 0.2pt to a three-month low of 51.8, in line with the average of the year to date and consistent with continued moderate growth in the sector. In the bond markets, France and Spain will sell a range of government bonds.

In the US, Thursday will be busy for economic data bringing, among other releases, the manufacturing ISM indices for August, figures for July construction output and Q2 productivity and unit labour costs, and the usual weekly jobless claims numbers.

UK

Sentiment indicators continue to point to post-referendum slowdown

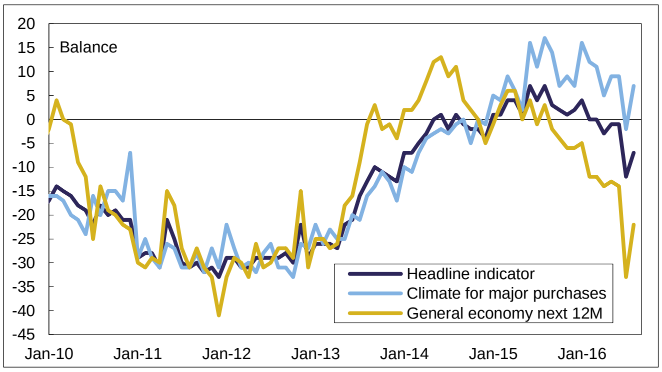
The latest sentiment indicators brought mixed messages about economic momentum in the UK. Today's GfK consumer confidence survey was consistent with other recent survey data which have shown something of a recovery in sentiment following the precipitous falls in the immediate aftermath of the referendum. The headline survey indicator recovered in August from -12 to -7, perhaps as consumers reassessed the likely immediate consequences of the Brexit vote given that the launch of the political process to leave the EU is not yet on the horizon. Nevertheless, this reading, when the July number is excluded, still marked the lowest in about two and a half years and was firmly below this year's pre-referendum average of zero, pointing to a continued post-referendum marked fall in consumer confidence. Within the detail of the survey consumers remained very downbeat about both current and future economic prospects, with both of those indices remaining well below their recent averages. And while there was an improvement in the balance related to consumers' willingness to make major purchases, it too remained below its average in the first half of the year.

Meanwhile, the Lloyds Business Barometer, also released today, was more pessimistic. The headline index suggested that business confidence fell again in August, having recovered somewhat in July after the initial post-referendum drop at end-June. Indeed, apart from that June reading, the latest figure represents the lowest since 2012. However, the Nationwide house price index brought more positive news, suggesting that the housing market is holding up well, with house price growth up by 0.4ppt in August to 5.6%Y/Y, the highest level in five months. While housing market activity has been slow in recent months following the Stamp Duty tax change in April, a fall in a housing demand seems to have been matched by a similar reduction in the number of properties coming on to the market, keeping supply-demand dynamics broadly favourable.

The day ahead in the UK

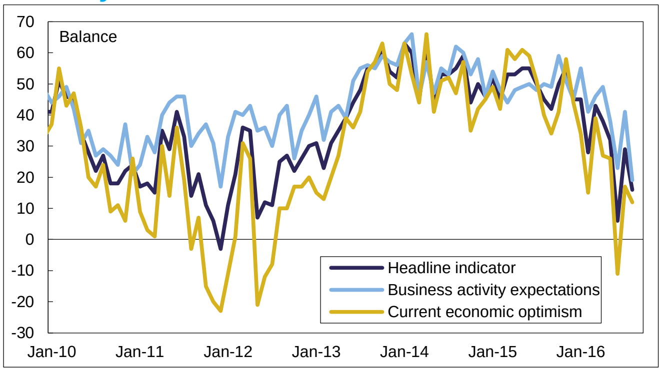
The flow of latest economic sentiment surveys continues tomorrow with the release of the manufacturing PMI. After a sharp post-referendum drop in July to 48.2, the lowest level in almost three and a half years, the headline index is expected to have recovered a little in August to 49.0, a level still consistent with a continuing contraction in the manufacturing sector and well below the average seen in the months leading up to the referendum.

UK: GfK Consumer Confidence



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

UK: Lloyds Business Barometer



Source: Lloyds, Bloomberg and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		Unemployment rate %	Jul	**10.1**	10.0	10.1	**-**
		Flash CPI estimate Y/Y%	Aug	**0.2**	*0.2*	0.2	**-**
		Flash core CPI estimate Y/Y%	Aug	**0.8**	*0.9*	0.9	**-**
Germany		Retail sales M/M% (Y/Y%)	Jul	**1.7 (-1.5)**	0.5 (0.3)	-0.1 (2.7)	**-0.6 (2.3)**
		Unemployment change `000s (rate %)	Jul	**-7 (6.1)**	-4 (6.1)	- (6.1)	**-**
France		Preliminary EU-harmonised CPI Y/Y%	Aug	**0.4**	0.4	0.4	**-**
		Consumer spending M/M% (Y/Y%)	Jul	**-0.2 (0.5)**	0.3 (1.1)	-0.8 (0.6)	**- (0.7)**
Italy		Unemployment rate %	Jul	**11.4**	11.6	11.6	**-**
		Preliminary EU-harmonised CPI Y/Y%	Aug	**0.0**	-0.1	-0.2	**-**
Spain		Current account balance €bn	Jun	**2.0**	-	2.8	**-**
UK		Lloyds business barometer	Aug	**16**	-	29	**-**
		GfK consumer confidence survey	Aug	**-7**	-8	-12	**-**
		Nationwide house price index M/M% (Y/Y%)	Aug	**0.6 (5.6)**	-0.2 (4.8)	0.5 (5.2)	**-**

Auctions

Country		Auction
Germany sold		€3.1bn of 2018 zero-coupon bonds (14-Sept-2018) at an average yield of -0.63%
UK		BoE APF operation: £1.17bn of 7-15Y Gilts purchased (3.19 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
EMU		09:00	Final manufacturing PMI	Aug	51.8	52.0
Germany		08:55	Final manufacturing PMI	Aug	53.6	53.8
France		08:50	Final manufacturing PMI	Aug	48.5	48.6
Italy		08:45	Manufacturing PMI	Aug	51.2	51.2
Spain		08:15	Manufacturing PMI	Aug	50.9	51.0
UK		09:30	Manufacturing PMI	Aug	49.0	48.2

Auctions and events

Country		BST	Auction / Event
France		09:50	Auction: To sell 0.25% 2026 bonds (25-Nov-2026)
		09:50	Auction: To sell 1.25% 2036 bonds (25-May -2036)
		13:50	Auction: To sell 3.25% 2045 bonds (25-May-2045)
Spain		09:30	Auction: To sell 0.25% 2019 bonds (31-Jan -2019)
		09:30	Auction: To sell 1.3% 2026 bonds (31-Oct-2026)
		09:30	Auction: To sell 2.9% 2046 bonds (31-Oct-2046)
		09:30	Auction: To sell 1% 2030 index-linked bonds (30-Nov-2030)
UK		10:30	Auction: To sell £2.75bn of 0.5% 2022 bonds (22-Jul-2022)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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