Euro wrap-up

Overview

- Bunds were little changed as PMIs signalled ongoing growth in the euro area manufacturing sector.
- Gilts made losses at the longer end of the curve as PMIs suggested that fortunes among UK manufacturers have improved significantly.
- Friday brings revised Italian GDP figures, euro area PPI data and the UK construction PMI, which will all be overshadowed by the US labour market report.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.626	-0.006
OBL 0 10/21	-0.508	-0.005
DBR 0 08/26	-0.065	-0.001
UKT 1¼ 07/18	0.119	-0.025
UKT 3¾ 09/21	0.217	+0.002
UKT 1½ 07/26	0.672	+0.027

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

Euro area

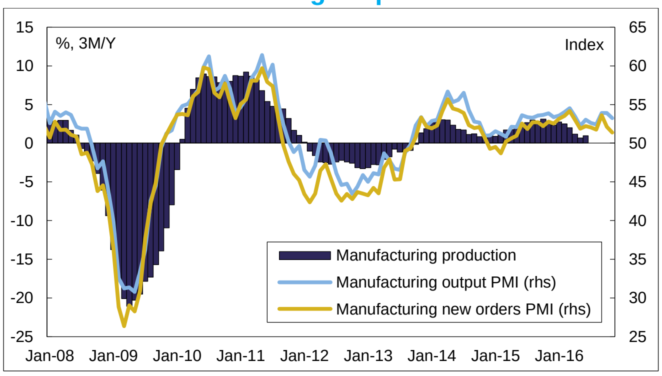
Spanish politics back to the fore

Political uncertainty has returned to the fore in Spain after last night's parliamentary vote saw caretaker Prime Minister Rajoy of the conservative Partido Popular (PP) fail to gain backing to form a minority administration. Despite the support of the centre-right populist Ciudadanos and one lawmaker from the Canary Islands, Rajoy was outnumbered 170-180 by the votes of the opposition, with the PP's traditional Socialist rivals teaming up with the populist far-left Podemos to block progress. A further parliamentary vote, at which Rajoy will require merely a simple majority, is scheduled for tomorrow evening. However, given the posturing of the Socialists and the basic arithmetic in the chamber, a breakthrough at that vote currently seems unlikely, and so another general election – the third in little more than a year – seems likely to follow at Christmas time. Of course, while the PP had the ascendancy at June's election, given the deep political divisions in Spain, another plebiscite in December might be expected to struggle once again to produce a majority, raising the possibility that some time in 2017 Spain could beat Belgium's unenviable record from 2009-10 of 589 days without an elected government. Should the economic and financial environment take a turn for the worse, the inability of the caretaker government to act effectively would be a significant cause for concern. However, thankfully, for now the economic backdrop for the political dysfunction is broadly favourable, as Spain continues repeatedly to chalk up the fastest growth rates in the euro area (GDP rose 0.8%Q/Q in each of the past four quarters), unemployment is steadily declining albeit from an extraordinary high level, and – despite the likelihood of continued fiscal policy drift – the ECB's sovereign bond purchases should provide ongoing support for the government bond market.

Manufacturing PMI signals continued expansion in Q3

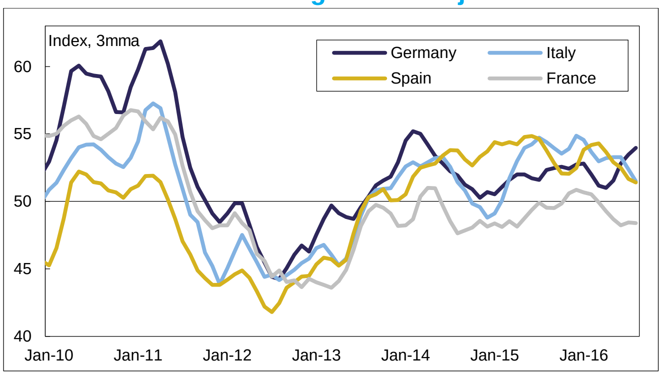
The final euro area manufacturing PMIs for August saw slight downward revisions, with the headline index nudged down a fraction from the flash figure to a three-month low of 51.7. That level, however, is only a touch below the average for the year to-date and so still seemingly consistent with gradual expansion in the sector around the recent trend close to 1½%Y/Y. Indeed, while the euro area output index was also revised down to a three-month low, at 53.3 it was still above the average for the year so far and suggested a slight pickup in growth in the sector in Q3 from the second quarter. Nevertheless, the detail of the survey gave a number of reasons for concern about developments in the sector, e.g. the relevant indices suggested the weakest growth in new orders for eighteen months, the softest growth in employment since January and persistent deflationary output price pressures for the twelfth consecutive month. In addition, while the German, Dutch and Spanish indices all continued to signal ongoing growth to a greater or lesser extent, the Italian manufacturing PMI slipped below 50 for the first time since January 2015 to join the French index in suggesting contraction in the sector.

Euro area: Manufacturing output and PMIs*



**PMIs have three-month lead*
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing PMI in major countries



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

Bank lending rates continue to decline

Finally, the latest euro area bank interest rate statistics showed that ongoing monetary accommodation continues to feed through to lower borrowing costs for non-financial corporations (NFCs) and households alike. Indeed, notwithstanding the usual month-to-month volatility affecting certain types of loans and country differences, the average composite costs of borrowing edged down in July to new series lows, with the headline measures for both NFCs and households now some 30bps lower than a year earlier and almost 20bps lower than in March when the ECB cut its deposit rate to -0.4%. That, of course, is good news for firms looking to invest or households looking to buy a new home or simply remortgage existing debt. But it also means that bank margins continue to be squeezed. Indeed, deposit rates for NFCs were little changed in the latest month, e.g. with the average rate on corporate deposits with an agreed maturity of up to one year edging up to 16bps, little different from the level in March and down only half as much as the composite cost of NFC borrowing over the past year. And while household deposit rates fell, the average rate on their deposits with an agreed maturity of one year was still a touch above 50bps, less than 10bps below the level in March and less than 20bps below the level one year earlier.

The day ahead in the euro area and US

Friday's most notable new economic data from the euro area will be the revised estimate of Italian Q2 GDP and its expenditure breakdown. The initial estimate suggested that GDP was disappointingly flat in the second quarter, the weakest rate in six quarters, but revisions to this series are certainly not uncommon. Nevertheless, even if we see an upwards revision, it is worth noting that recent surveys suggest that economic conditions in the third quarter have deteriorated, e.g. tallying with the deterioration in today's manufacturing PMI, the Commission's economic sentiment index for Italy dropped in August to an eighteen-month low. Also due Friday are July's euro area producer price data, which will illustrate continued disinflationary pipeline pressures.

Far more importantly, Friday will bring the August US jobs report, which is expected to show that nonfarm payrolls rose 180k following two consecutive months of growth above 250k. In addition, the unemployment rate is expected to edge down 0.1ppt to 4.8%, but average hourly earnings growth is expected to moderate 0.1ppt to 2.5%Y/Y. Also due in the US will be July's trade report and final durable goods order numbers.

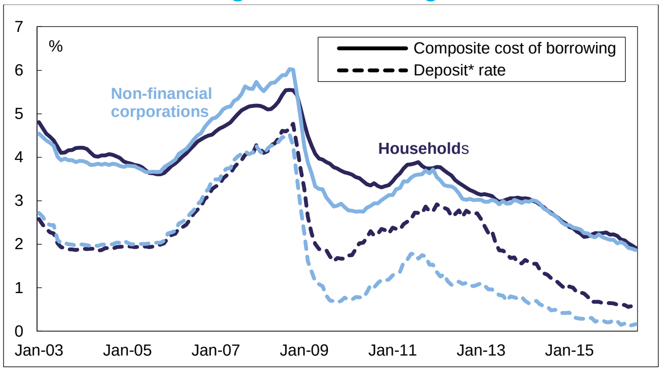
UK

Strong manufacturing PMIs point to a recovery after the initial Brexit shock

The record fall in the composite PMI in July was a key driver of the BoE's decision to ease policy in August. And the PMIs will continue to play an important part in whether the BoE eases again in November, as it has said it will if the economy performs as it expected in its August forecast. Today's manufacturing PMI pointed to a significant rebound in the sector in August, with the headline index surging 5pts, representing the joint steepest month-on-month increase on record, to reach a ten-month high of 53.3. And the details of the survey were very positive too: the employment index rose by 2.8pts and was above 50 for the first time this year, the output index rose by 8.7pts to 57.0 and the new orders index increased by 6.8pts to 54.6. Given the mammoth depreciation in sterling, a rise in export orders had been widely expected. However, it seems that domestic orders played an important role in supporting manufacturing growth too.

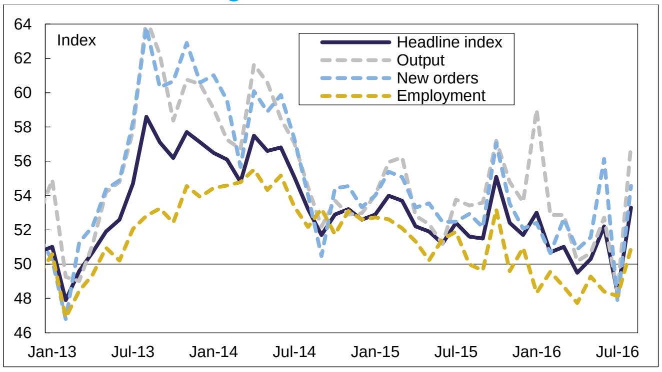
But while the weaker currency has boosted exports, it is also pushing input prices up. Indeed, the survey's relevant index posted another sharp increase in August to reach 67.1, a staggering 24.7pts higher than it was at the start of the year. And although the equivalent indicator for output prices has been advancing at a more modest pace – it was up by 3.4pts on the month and 7.8pts since January – it still suggested that inflationary pressures increased notably, reinforcing our view that UK inflation will rise markedly over the coming months and quarters.

Euro area: Lending and borrowing rates



**Agreed maturity up to 1 year.*
Source: ECB, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing PMIs



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

Notwithstanding the upward surprise to today's survey and the headlines it triggered, the average manufacturing PMI of 50.8 in the first two months of Q3 remains unimpressive and is consistent with only modest growth in the sector. And, of course, manufacturing accounts for only around 10% of the economy. Much more important for the BoE will be the services PMI, out on Monday, where exchange rate movements are less likely to have provided support to activity.

Brexit means Brexit. But not much else yet

Yesterday saw the British Cabinet meet for the first time since the summer break, with the focus very much on how the Government intends to take forward the process of Brexit. To date, the Government has provided no information on how it expects to deliver Brexit, either in terms of the sort of post-Brexit arrangements it plans to seek with the EU or even on the timing of the triggering of Article 50. The purpose of yesterday's Cabinet meeting was in part a "brainstorming" session aimed at making progress on at least some of the issues. As such, we learnt very little on the detail. But the Prime Minister, Theresa May, was at pains to point out once again that "Brexit means Brexit", that there would be no second referendum and that she intends to trigger Article 50 without a Parliamentary vote (although the Supreme Court will have the final say on that later in the year).

The Cabinet did agree that "the model we are seeking is one unique to the United Kingdom" and that "this must mean controls on the numbers of people who come to Britain from Europe but also a positive outcome for those who wish to trade goods and services." This implies that the UK will not be seeking EEA membership (the so-called Norway option). But if the rest of the EU remains good to its insistence that membership of the single market requires the acceptance of the free movement of people, the stance on immigration implies that the UK will lose single market membership.

As such, this delivers considerable uncertainty for businesses about their ability to continue to operate in the way that they have become used to since the single market was created in the 1980s. This is particularly true for the manufacturing and financial services sectors, both of which rely heavily on single market membership for a large part of their exports. And with the Cabinet reportedly split on precisely how much the Government should be willing to compromise on immigration control (and, more importantly, how much appetite there is among EU countries to accept any controls), this uncertainty will persist right through the Article 50 negotiations and almost certainly beyond that (the Article 50 negotiations will not necessarily cover the UK's post-Brexit trading relationship with the EU), inevitably hitting investment in those sectors for years to come.

The day ahead in the UK

The end of the week in the UK brings the release of the Markit/CIPS construction PMI. The headline survey index dropped in July to 45.9, the lowest level since mid-2009. And so while it is expected to have risen in August, the survey is unlikely to match the upward surprise of today's manufacturing data, not least given that the construction sector was arguably the hardest hit by Brexit related uncertainty.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Final manufacturing PMI	Aug	**51.7**	51.8	52.0	-
Germany	Final manufacturing PMI	Aug	**53.6**	53.6	53.8	-
France	Final manufacturing PMI	Aug	**48.3**	48.5	48.6	-
Italy	Manufacturing PMI	Aug	**49.8**	51.2	51.2	-
Spain	Manufacturing PMI	Aug	**51.0**	50.9	51.0	-
UK	Manufacturing PMI	Aug	**53.3**	49.0	48.2	**48.3**

Auctions

Country	Auction
France sold	€5.3bn of 0.25% 2026 bonds (25-Nov-2026) at an average yield of 0.26%
	€1.9bn of 1.25% 2036 bonds (25-May -2036) at an average yield of 0.82%
	€1.8bn of 3.25% 2045 bonds (25-May-2045) at an average yield of 1.01%
Spain sold	€2bn of 0.25% 2019 bonds (31-Jan -2019) at an average yield of -0.098%
	€1.3bn of 1.3% 2026 bonds (31-Oct-2026) at an average yield of 1.095%
	€0.6bn of 2.9% 2046 bonds (31-Oct-2046) at an average yield of 2.115%
	€0.5bn of 1% 2030 index-linked bonds (30-Nov-2030) at an average yield of 0.485%
UK sold	£2.75bn of 0.5% 2022 bonds (22-Jul-2022) at an average yield of 0.373%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy	09:00	GDP – second release Q/Q% (Y/Y%)	Q2	0.0 (0.7)	0.3 (1.0)
Spain	08:00	Unemployment M/M '000s	Aug	3.4	-84.0
UK	09:30	Construction PMI	Aug	46.3	45.9

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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