Euro wrap-up

Overview

- Bunds were little changed as revised PMIs suggested that momentum in the German services sector was weaker than previously thought but other data suggested a strong start to Q3 for euro area retail sales.
- Gilts were also little changed while the UK services PMIs suggested that economic activity was significantly stronger than expected in August.
- Tuesday brings the final estimate of euro area GDP growth in Q2, German factory orders figures and a UK retail sector survey.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.640	-0.007
OBL 0 10/21	-0.509	-0.008
DBR 0 08/26	-0.047	-0.004
UKT 1¼ 07/18	0.134	+0.004
UKT 3¾ 09/21	0.248	-0.004
UKT 1½ 07/26	0.714	-0.014

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

Euro area

Euro area and German services PMIs revised down

The final estimates of the euro area services and composite PMIs for August were disappointing with downwards revisions made from the initial figures as the German survey proved notably softer than previously suggested. In particular, Germany's services PMI was revised down more than 1½pt from the preliminary estimate to a three-year low of 51.7, with the respective new business index similarly revised down to the lowest in more than one year. The PMIs from the other member states were less of a concern, however, with the French services PMI revised up to 52.3, the highest for more than one year, and the Italian and Spanish indices, released for the first time, also posting gains from July. So, the euro area services PMI was revised down a less marked 0.3pt from the flash estimate to 52.8, only a fraction lower than the previous month to match June's figure. That reading, however, was an eighteen-month low, and the average for Q3 so far suggests that growth in the euro area services sector this quarter could be the softest since end-2014.

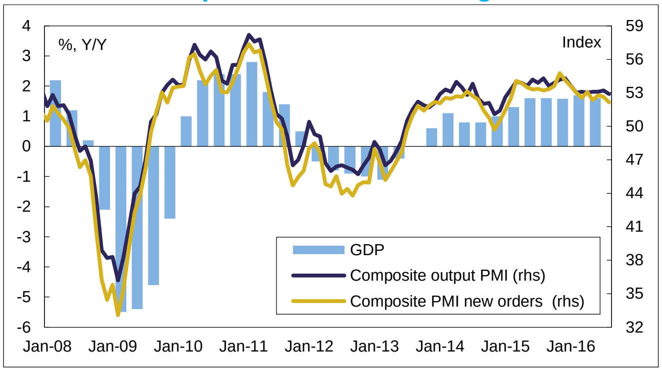
But composite PMIs still broadly consistent with steady growth

With the revision to the euro area services PMI following a larger revision to the manufacturing output PMI last week, the euro area composite PMI was revised down 0.4pt from the flash to 52.9, the lowest level since January 2015. Likewise, the composite new orders index fell to a nineteen-month low to suggest some cause for concern about the outlook. However, looking through recent volatility, the trend in the PMIs since February has been broadly sideways, and the latest reading still points to overall euro area GDP growth in the third quarter close to the 0.3%Q/Q rate of Q2. Likewise, despite a negative revision in the German composite PMI to 53.3, down 2pts from July to the lowest in more than one year, the average for Q3 so far is slightly above the equivalent figure for Q2 suggesting that economic growth in the euro area's largest member state should similarly remain close to the 0.4%Q/Q rate of last quarter.

A strong start to Q3 for retail sales

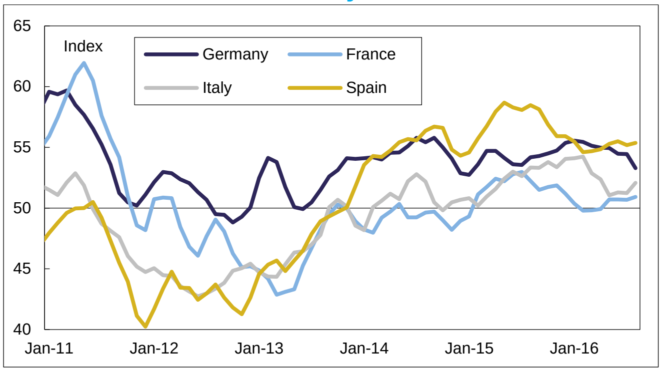
Evidence of continued positive momentum in the third quarter came from July's euro area retail sales figures, which beat expectations with a gain of 1.1%M/M, the most in more than five years, propelled by growth in excess of 1%%M/M in Germany and France. Admittedly, the headline figure was flattered by strong sales of food (up 1.1%M/M) and fuel (1.8%M/M), and sales of 'core' items were merely moderate at 0.4%M/M. Nevertheless, that still left 'core' sales up more than 3%Y/Y and 0.7%3M/3M, the most since the first quarter, suggesting that a very significant pull-back will be required in the following two months to prevent positive growth in the retail sector over the third quarter as a whole. So, these data support our view that consumption will be the principal driver of economic growth in the euro area in Q3.

Euro area: Composite PMIs and GDP growth



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

Euro area: Services PMIs by member state



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

The day ahead in the euro area and US

Tuesday brings the final estimate of euro area GDP in Q2, which is likely to confirm the initial estimates of growth of 0.3%Q/Q, 1.7%Y/Y. The expenditure breakdown, to be released for the first time, is likely to show that consumption slowed and investment contracted, while net trade supported growth for the first quarter in a year. German factory orders figures for July are also due tomorrow and are expected to post a gain of about ½%M/M following a drop close to that rate in June. In the bond markets, Germany will sell 10Y index-linked Bunds.

In the US, Tuesday brings the non-manufacturing ISM survey, which is expected to slip back for the second successive month, albeit remaining a touch above the average for the year at about 55.

UK

Services and composite PMIs stronger than expected

The UK's manufacturing and construction PMIs last week surprised on the upside, and today's services PMI joined the party. The headline business activity index rebounded from July's seven-year low of 47.4 to 52.9 – the largest one-month jump in the series to follow the largest one-month drop in the index in July. There were strong recoveries in all of the sub-indices that crated in July, with all indices back above 50. The rebound meant that for the first two months of Q3, the services PMI averaged 50.2, down from Q2's average of 52.9. If the September reading matches August's, the Q3 average will be 51.1, signalling growth but at a much slower pace than in Q2. And it is clear that notwithstanding the bounce back in August, sentiment remains depressed by the outcome of the referendum – while the business expectations index rebounded more than 8pts on the month, the 65.9 reading was the lowest since the end of 2012 (when the July reading was excluded). And the average for the first two months of Q3 was down more than 6pts on the Q2 average.

When allied with the rebound in the manufacturing PMI, the composite PMI also posted a record rebound (following the record fall in July), to 53.6, leaving the average for the first two months of Q3 at 50.6, down from the 52.4 average seen in Q2, pointing to a still-marked slowdown in growth. Assuming that the September reading matches the August, one, the average for Q3 would be 51.6, again pointing to an easing from the 0.6%Q/Q growth seen in Q2, but no contraction in output on the quarter.

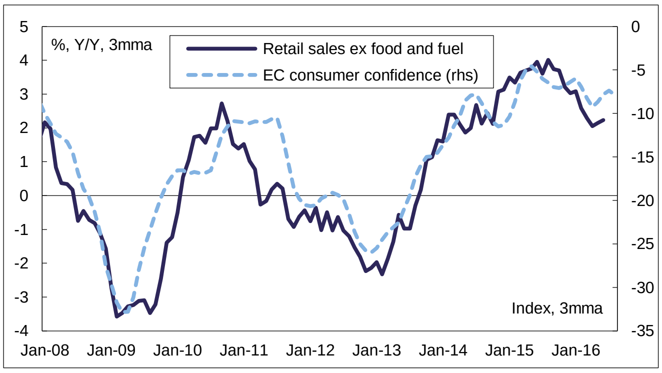
How will the BoE respond?

The precipitous drop in the PMIs in July played an important part in the MPC's decision in August to ease policy further. But they were not the only consideration – the anticipated slowdown in quarterly growth rates through the remainder of 2016 to 0.1-0.2% was expected to be driven in large part by a drop off in investment in the wake of the vote. And these PMIs tell us nothing concrete about the outlook for capital spending. Nevertheless, if the recovery in the PMIs is maintained through September and beyond, they will likely lead the BoE to raise its near-term GDP growth forecast and, hence, prevent the further reduction in Bank Rate later this year that was promised if the economy turned out as it expected in August. But, for that, the Bank will want to see more hard data. Indeed, given the recent wild volatility in the PMIs, the MPC will be suspicious of putting too much weight on them. But the fact that the PMIs have recovered so quickly is undoubtedly good news and, if maintained, suggests that while economic growth post-referendum will still be meaningfully lower, technical recession may be avoided.

The day ahead in the UK

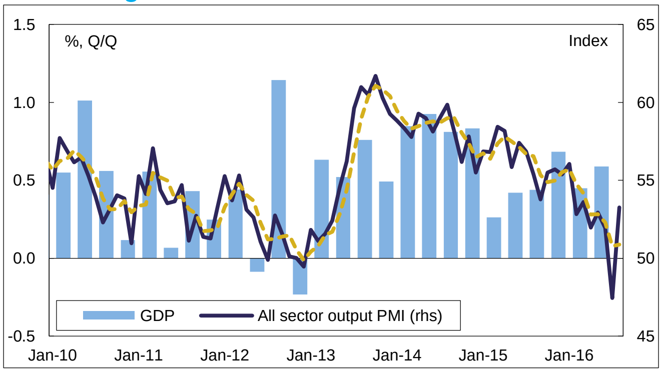
Tomorrow brings another August survey, with the BRC's latest retail sales monitor. After an unanticipated jump in official retail sales figures in July, the BRC's survey is expected to show that like-for-like sales growth accelerated last month to almost 1½%Y/Y, which would be the strongest rate on this survey since January.

Euro area: Retail sales and consumer confidence



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP growth and PMIs*



**Gold dashed line represents three-month moving average.*
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU		Final services PMI (final composite PMI)	Aug	**52.8 (52.9)**	53.1 (53.3)	52.9 (53.2)	-
		Retail sales M/M% (Y/Y%)	Jul	**1.1 (2.9)**	0.5 (1.8)	0.0 (1.6)	**-0.1 (1.7)**
		ECB QE net purchases €bn	Weekly	**11.1**	*11.5*	10.3	-
Germany		Final services PMI (final composite PMI)	Aug	**51.7 (53.3)**	53.3 (54.4)	54.4 (55.3)	-
France		Final services PMI (final composite PMI)	Aug	**52.3 (51.9)**	52.0 (51.6)	50.5 (50.1)	-
Italy		Services PMI (composite PMI)	Aug	**52.3 (51.9)**	51.8 (52.0)	52.0 (52.2)	-
Spain		Services PMI (composite PMI)	Aug	**56.0 (54.8)**	54.2 (53.8)	54.1 (53.7)	-
UK		BRC shop price index Y/Y%	Aug	**-2.0**	-2.0	-1.6	-
		Services PMI (composite PMI)	Aug	**52.9 (53.6)**	50.0 (50.8)	47.4 (47.5)	**- (47.6)**
		New car registrations Y/Y%	Aug	**3.3**	-	0.1	-

Auctions

Country		Auction
UK		BoE APF operation: £1.17bn of 3-7Y Gilts purchased (2.82 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		10:00	GDP – final estimate Q/Q% (Y/Y%)	Q2	*0.3 (1.6)*	0.6 (1.7)
Germany		07:00	Factory orders M/M% (Y/Y%)	Jul	0.5 (-0.2)	-0.4 (-3.1)
UK		00:01	BRC Sales like-for-like Y/Y%	Aug	1.4	1.1

Auctions and events

Country		BST	Auction / Event
Germany		10:30	Auction: To sell 0.1% 2026 index-linked bonds (15-Apr-2026)
UK		10:30	Auction: To sell £2.5bn of 1.5% 2026 bonds (22-Jul-2026)
		14.50	BoE APF operation: To purchase 15Y+ Gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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