

Euro wrap-up

Overview

- Ahead of tomorrow's ECB policy announcement, Bunds were little changed despite some weaker-than-expected German IP data.
- Gilts were also little changed as Carney suggested that the economy was 'a bit stronger' than he had expected while UK IP data were mixed.
- While we expect the ECB to extend its asset purchase programme at some point in coming months, we expect it to leave policy unchanged tomorrow.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.667	+0.003
OBL 0 10/21	-0.564	-0.006
DBR 0 08/26	-0.118	-0.008
UKT 1¼ 07/18	0.091	-0.004
UKT 3¼ 09/21	0.182	-0.011
UKT 1½ 07/26	0.675	+0.013

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

Euro area

Drop in German IP adds to unease

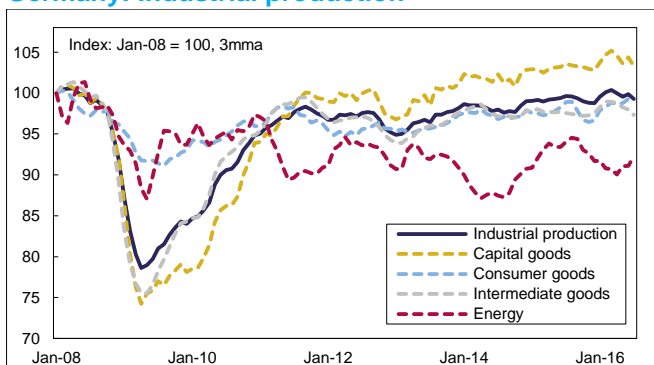
Recent economic data have hinted at a loss of momentum in Germany, e.g. with a softer Ifo survey for August followed by a notable drop in the services PMI to a three-year low in the same month. And after yesterday brought some subdued factory orders figures, the July IP data released today were significantly weaker than expected with overall production down 1.5%M/M, the most in almost two years, to stand more than 1% lower than a year earlier. The detail of the report proved particularly disappointing, with the drop in manufacturing output of more than 2%M/M – similarly the most since August 2014 – only partially offset by significant growth in construction (1.8%M/M) and energy (up more than 2½%M/M). While the decline in manufacturing output in July followed growth in June in excess of 1½%M/M, the current trend in the sector is certainly negative, with overall IP down more than ¾%3M/3M in July for the third consecutive month. Following a very strong showing for German retail sales in July (up more than 1½%M/M) we are not yet alarmed, and continue to expect consumption to maintain broadly stable GDP growth in Germany in the third quarter close to the recent trend. Nevertheless, the softening business sector surveys coupled with the weak figures from the industrial sector suggest that the risks are clearly to the downside.

The day ahead in the euro area and US

Without doubt, the main event on Thursday will be the conclusion of the ECB's latest monetary policy meeting, which will see the Governing Council presented with updated economic forecasts and brings a chance of news on monetary policy. But while an extension of the asset purchase programme, and tweaks to the rules governing it, are possible, we think the Governing Council will prefer to avoid any substantive announcements.

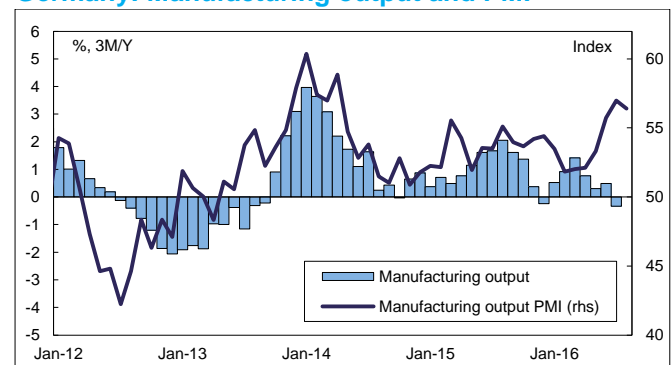
In particular, since policymakers last met in July little has occurred that is likely to change significantly its assessment of the economic outlook. For example, the moderation of euro area GDP growth in Q2 to 0.3%Q/Q will have been broadly in line with the Governing Council's expectations and, with little economic impact visible from the UK's vote to leave the EU, sentiment surveys suggest that growth is likely to be close to that rate in Q3 too – nothing to celebrate but nothing to panic about either. Meanwhile, with the ECB's corporate bond purchases now well underway and the second TLTROII operation scheduled later this month, financial conditions have continued to ease further: bank loan interest rates have fallen to record lows, euro area government bond yields on average have taken a further step down since the start of the summer, and the major euro area equity markets have risen to more than three-month highs with volatility notable by its absence. Additionally, while headline and core inflation have remained stubbornly low, the ECB will still expect both measures to pick up gradually over coming months, not least since the oil price is well above levels prevailing at the back end of 2015 and in early 2016. So,

Germany: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output and PMI



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.



we expect the ECB's updated economic forecasts to be little changed from the most recent set published in June, which foresaw GDP growth at 1.6%Y/Y in 2016 and a fraction higher in 2017 and 2018, and average inflation rising from 0.2%Y/Y in 2016 to 1.3%Y/Y and 1.6%Y/Y in the coming two years.

With little notable changes to be made to the ECB's baseline economic projections and comfort to be taken from recent financial market stability, the Governing Council is likely to be content to avoid contentious debate and leave policy unchanged. But the continued weakness of underlying inflation, some disappointing recent German economic data and the persistence of non-negligible downside risks, not least those associated with the events abroad, means that at a minimum we expect Draghi to remain highly dovish, restating the Governing Council's readiness to take further action to ease policy if necessary. Indeed, at some point, if only to avoid a damaging tightening of financial conditions, we fully expect the ECB to extend the asset purchase programme by a further six months to September 2017 at the earliest. If and when it decides such a move, the Governing Council will also likely need to adjust the purchase programme's rules as the ECB still faces a shortage of certain types of bonds that it can buy, with yields on more than €1.5trn of securities that would otherwise be eligible currently below -0.40%. However, with seemingly no appetite even to acknowledge the issue of asset scarcity at previous meetings and any changes to the rules of the programme likely to be highly contentious, we do not expect any agreement just yet on such amendments, which might involve removal of the yield floor, an increase in the issue limit on purchases, the addition of new classes of assets for purchase, or abandonment of the capital key, each of which would have a significant albeit different impact on the euro area bond market.

Datavise in the euro area, Thursday brings German labour cost figures for the second quarter as well as the latest Bank of France business survey. In the US, meanwhile, Thursday brings the usual weekly claims figures and July consumer credit numbers.

UK

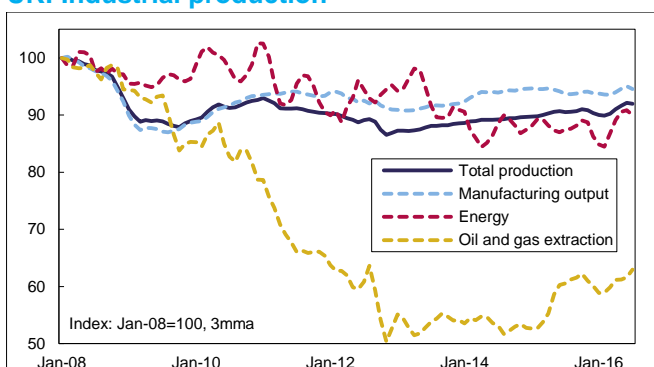
Industrial production broadly flat

There were no particular shocks from the UK industrial production figures for July. Overall output slightly beat expectations, inching up just 0.1%M/M following a flat previous month. But the tiny gain was thanks particularly to the strongest growth in oil and gas production for almost one year. In contrast, manufacturing output was notably weaker than expected, down almost 1%M/M, the most in a year, following a slight dip in June, arguably tallying with the deterioration in the relevant PMI that month. While these data mean that manufacturing output has now declined for three consecutive months, the rebound in the respective PMI in August would point to a subsequent return to growth in the sector. And the post-referendum weakening of sterling will certainly give manufacturers a boost. By the same token, however, past experience would suggest that the oil and gas sector will in due course reverse July's massive gain. And so, overall, the current trend for production might be little better than flat.

Economy a 'bit stronger' than BoE forecast?

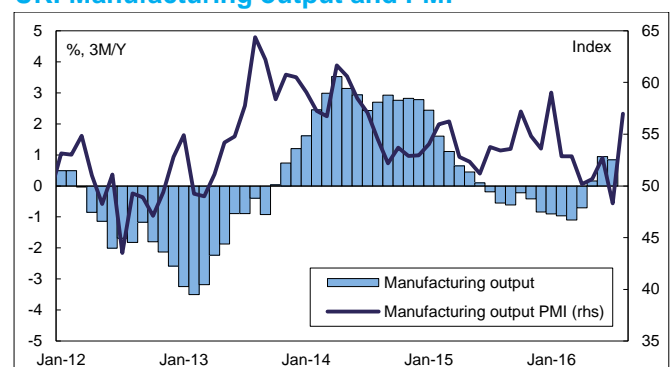
Of course, the manufacturing sector accounts for little more than 10% of GDP and so is effectively a sideshow. Far more relevant for the UK economic outlook is the performance of services, whose share of overall output is more than seven times larger. However, given the recent marked volatility in the surveys for that sector and the lack of hard data – July services output figures won't be released until the end of the month – quite what has happened to overall UK economic activity since the referendum will remain a matter of speculation. According to the NIESR estimate based on the limited data and surveys available so far, the level of GDP was unchanged for the second successive month in August, although that still left it up 0.3%3M/3M. And that figure broadly tallied with comments today by BoE Governor Carney who judged that the economy had recently been only 'a bit stronger' than the BoE had thought when it last published forecasts in August, and that growth was perhaps running about half the rate that it was ahead of the referendum.

UK: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output and PMI












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







The day ahead in the UK

In the UK, Thursday will bring the release of RICS housing market survey for August. The previous survey indicated expectations of downwards pressure on house prices over coming months, with a weakening in new buyer enquiries, sales and new instructions to sell. However, expectations for price growth one year ahead returned to positive territory having deteriorated notably in the immediate aftermath of the referendum. Also due is the Markit/REC report on jobs for August, giving insights into the labour market from the perspective of employment agencies.

European calendar

Today's results							
Economic data							
Country	Release	Period	Actual	Market consensus/ Daiwa forecast	Previous	Revised	
Germany	 Industrial production M/M% (Y/Y%)	Jul	-1.5 (-1.2)	0.1 (0.2)	0.8 (0.5)	1.1 (0.9)	
France	 Trade balance €bn	Jul	-4.5	-3.6	-3.4	-3.5	
	 Current account balance €bn	Jul	-2.6	-	-0.6	0.8	
UK	 Halifax house price index M/M% (3M/Y%)	Aug	-0.2 (6.9)	-0.1 (7.0)	-1.0 (8.4)	-1.1 (-)	
	 Industrial production M/M% (Y/Y%)	Jul	0.1 (2.1)	-0.2 (1.9)	0.1 (1.6)	0.0 (1.4)	
	 Manufacturing production M/M% (Y/Y%)	Jul	-0.9 (0.8)	-0.3 (1.7)	-0.3 (0.9)	-0.2 (0.6)	
	 NIESR GDP 3M/3M%	Aug	0.3	-	0.3	0.4	
Auctions							
Country	Auction						
Germany sold	 €3.5bn of 2026 zero-coupon bonds (15-Aug-2026) at an average yield of -0.11%						
UK	 BoE APF operation: £1.17bn of 7-15Y Gilts purchased (2.93 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	12:45	 ECB refinancing rate %	Sep	<u>0.00</u>	0.00		
	12:45	 ECB deposit rate %	Sep	<u>-0.40</u>	-0.40		
	12:45	 ECB asset purchase target €bn	Sep	<u>80</u>	80		
France	07:30	 Bank of France manufacturing sentiment indicator	Aug	98	98		
UK	00:01	 RICS house price balance %	Aug	2	5		
Auctions and events							
Country	BST	Auction / Event					
EMU	13:30	 ECB's Draghi scheduled to hold a press conference					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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