Euro wrap-up

Overview

- Bunds made losses as the ECB left policy unchanged but announced a review of options to ensure smooth implementation of its QE programme.
- Gilts also made losses as further surveys suggested a gradual improvement in UK economic confidence.
- Friday brings German and UK trade data and IP figures from France and Spain.

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.641	+0.026
OBL 0 10/21	-0.520	+0.047
DBR 0 08/26	-0.062	+0.056
UKT 1¼ 07/18	0.147	+0.049
UKT 3¾ 09/21	0.256	+0.068
UKT 1½ 07/26	0.769	+0.089

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

Euro area

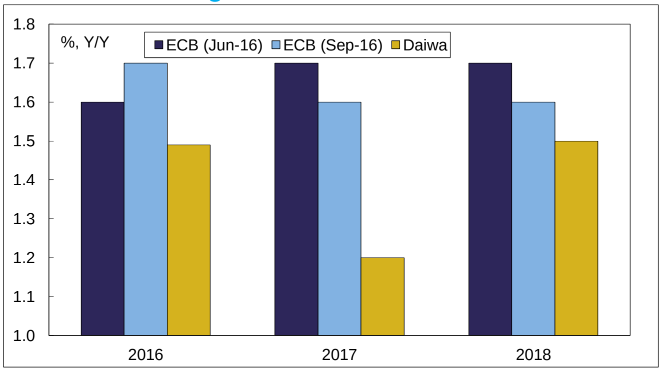
ECB leaves policy on hold, but only for the time being

As we expected, today's conclusion of the ECB's Governing Council meeting saw policy in terms of rates and asset purchases left unchanged. While that disappointed some in the financial markets who had expected a substantive shift to the QE programme today and so saw euro area government bonds make losses, Draghi remained dovish, emphasising the readiness of the ECB to act further if needed to steer inflation back to target. And announcing a review of 'options to ensure a smooth implementation' of QE, he signalled the likelihood of amendments to the purchase programme by year-end. While Draghi was cagey about the nature of the measures to be considered, several likely options – such as the removal of the yield floor for purchases; an increase in the issue and issuer limits on purchases; the addition of new classes of assets for purchase; and/or abandonment of the capital key to guide purchases – would likely help to address concerns about the scarcity of bonds available for the ECB to purchase. And so they should also facilitate the extension of asset purchase programme beyond March, a measure which – while Draghi said was not discussed by the Governing Council this time around – now seems only a matter of time before it is agreed. Whether the Governing Council is willing to keep buying assets beyond March *at the current rate*, however, remains to be seen.

Very easy financial conditions necessary (but not sufficient) for higher inflation

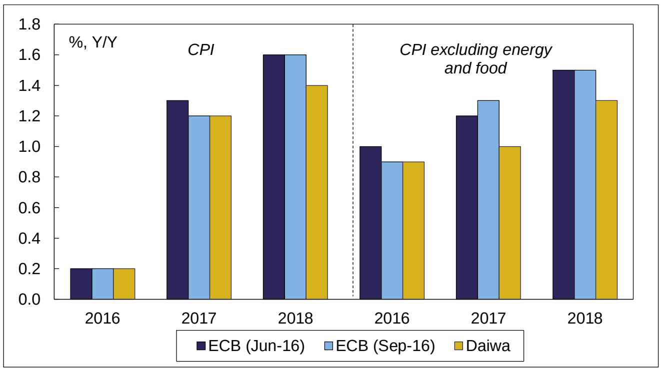
The case for extending the asset purchase programme was supported by the ECB's updated economic forecasts. Admittedly, there were precious few changes from the previous set of projections published in June. GDP growth in 2016 is now expected by the ECB to be 1.7%, just 0.1ppt stronger than anticipated in June, but growth in each of the coming two years (1.6% per year) is expected to be 0.1ppt softer than previously thought. And the updated forecast profile for inflation was little different too, with headline CPI expected to rise from an average of 0.2%Y/Y this year to 1.6%Y/Y in 2018 and core inflation expected to rise to average 1.5%Y/Y by the end of the forecast period. Draghi emphasised that a pre-condition for that rise in inflation will be the maintenance of continued very easy financial conditions over the forecast horizon. And by acknowledging that current easy financial conditions reflect in large part market expectations of continued asset purchases by the ECB, he also implied that an extension of QE beyond next March was a necessary condition for a return of inflation back towards the 2% target. At the same time, Draghi rightly highlighted the recent persistent weakness of core inflation measures as illustrating how the risks to the outlook for CPI are skewed to the downside. And in the absence of a more substantive contribution of government policies to GDP growth – including a fiscal loosening in countries, such as Germany, with the space to do so – Draghi will also be aware that an extension of QE might well still prove insufficient for the ECB to meet its inflation objective. Indeed, given our expectation of continued excessively tight fiscal policy and the impact of persistent structural weaknesses, our own forecasts for GDP growth and inflation remain somewhat weaker than those of the ECB.

Euro area: GDP growth forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

German labour costs weaker, but French sentiment improves

Certainly, the latest German labour cost figures published today illustrated how underlying price pressures in the euro area remain weak. In particular, labour costs per hour worked rose just 1.8%Y/Y in Q2, down 1ppt from Q1 and the weakest rate in more than two years, with gross labour earnings even weaker, up just 1.1%Y/Y. So, although the German unemployment rate continues to touch post-reunification lows, the seemingly tight German labour market remains incapable of generating the kinds of cost pressures required to shift inflation anywhere close to the ECB's 2% inflation target. Indeed, given that Germany's economy remains so much more cyclically advanced than any other member state – and in Q1 German labour costs were rising almost twice as fast as the euro area average – it is difficult to envisage any other member state offsetting the lack of cost pressure in Germany. However, today's other notable data release was a touch more encouraging as the latest Bank of France business sentiment survey hinted at increased optimism in the euro area's second largest member state, reporting moderate growth in manufacturing, a pickup in construction and stable conditions in the services sector in August. And with firms expecting a further improvement in September, the central bank suggests that French GDP growth will pick up to 0.3%Q/Q in Q3 following a flat second quarter.

The day ahead in the euro area and US

It should be a much quieter day for euro area economic news on Friday. Data-wise, German trade figures for July will be accompanied by French and Spanish industrial production data for the same month. Expectations are for a modest increase in output from both countries at the start of Q3, although notable weakness in the German numbers published yesterday might suggest that risks to this forecast are skewed to the downside. In the US, Friday brings just wholesale trade figures for July, while the Fed's Rosengren and Kaplan are due to speak.

UK

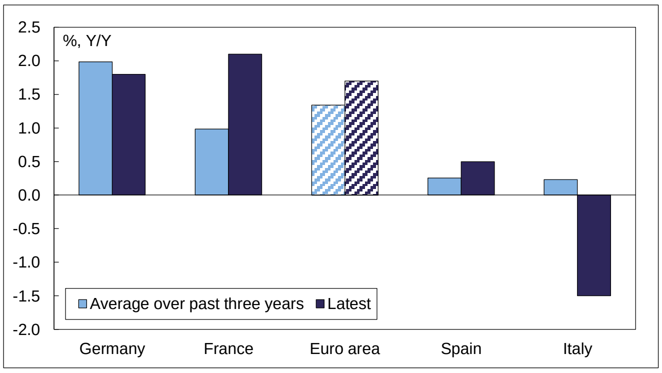
Housing and labour market surveys suggest improved confidence

After Carney yesterday suggested that economic conditions were just a 'bit stronger' than the BoE had expected, the RICS housing market survey for August added to the sense of gradual improvement indicating that confidence in the housing market has started to return after the steep deterioration in the immediate aftermath of the referendum. Most notably, the survey suggested that house prices and sales volumes are both expected to rise from now on, a contrast from the past couple of surveys which signalled falling prices over the near term. Nevertheless, the headline price indicator, which reflects changes in prices over the past three months, was still the second lowest in the past eighteen months and was in negative territory for a sixth consecutive month in London. The latest REC/KPMG Report on Jobs today also suggested that some normality had resumed in the labour market following the notable weakening reported by recruitment consultants around the time of the referendum. In particular, the survey reported an increase in the number of permanent staff placements in August, with the relevant index back above 50 for the first time in three months, while there was also a pickup in temporary/contract staff billings. But looking through the monthly volatility, the relevant index for permanent staff placements fell to a near-four-year low on a three-month basis, while demand for permanent and temporary staff reportedly fell further in August. And although the survey signalled a modest improvement in wage growth last month, that index still recorded the second-lowest reading of the past three years.

The day ahead in the UK

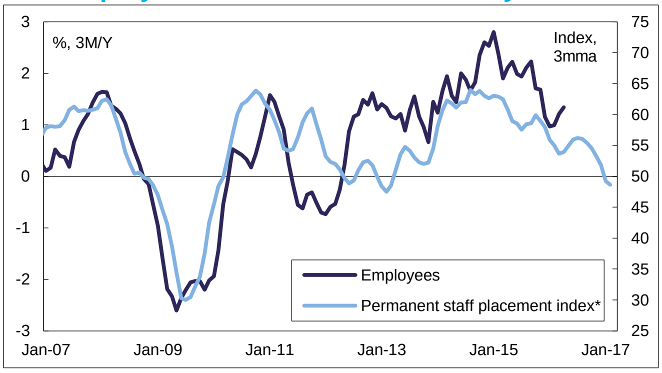
It will be a busier end to the week for UK top-tier releases, with July's trade report and construction output figures due. Expectations are for a modest decline in the trade deficit at the start of the third quarter from the eleven-month high of £5.1bn in June. Meanwhile, the recent weakness seen in the construction sector looks set to have continued in early Q3, with output forecast to have declined for the sixth month out of the past seven to leave it almost 3½% lower than one year earlier.

Euro area: Labour costs*



**Latest data are for Q116 except for Germany which are Q216. Source: Destatis, Eurostat, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

UK: Employment and REC/KPMG survey indicator



**Permanent staff placement index has six-month lead.*
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	ECB refinancing rate %	Sep	**0.00**	*0.00*	0.00	**-**
	ECB deposit rate %	Sep	**-0.40**	*-0.40*	-0.40	**-**
	ECB asset purchase target €bn	Sep	**80**	*80*	80	**-**
Germany	Labour costs Y/Y%	Q2	**1.8**	-	3.1	**2.8**
France	Bank of France manufacturing sentiment indicator	Aug	**98**	98	98	**-**
UK	RICS house price balance %	Aug	**12**	2	5	**-**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07:00	Trade balance €bn	Jul	23.7	24.7
	07.00	Current account balance €bn	Jul	24.5	26.3
	07.00	Imports (exports) M/M%	Jul	0.5 (0.4)	1.1 (0.2)
France	07:45	Industrial production M/M% (Y/Y%)	Jul	0.3 (1.0)	-0.8 (-1.3)
	07:45	Manufacturing production M/M% (Y/Y%)	Jul	0.7 (1.8)	-1.2 (-1.5)
Spain	08:00	Industrial production M/M% (Y/Y%)	Jul	0.1 (0.4)	0.2 (0.8)
UK	09:30	Visible trade balance £bn	Jul	-11.7	-12.4
	09:30	Total trade balance £bn	Jul	-4.2	-5.1
	09:30	Construction output M/M% (Y/Y%)	Jul	-0.5 (-3.4)	-0.9 (-2.2)

Auctions and events

Country	BST	Auction / Event
- Nothing scheduled -		

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.