Daiwa Capital Markets

# Euro wrap-up

## Overview

- Bunds followed USTs slightly lower as today's euro area manufacturing PMI confirmed the flash estimate of a slight pickup in the sector at end-Q3.
- Despite an upside surprise to the UK manufacturing PMI, Gilts made gains as Theresa May indicated that Article 50 would be triggered by end-Q117.
- The data focus over coming days will be the final September services and composite PMIs from the euro area and UK, while euro area retail sales will also be published on Wednesday.

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**Daily bond market movements**

| Bond | Yield | Change* |
|---|---|---|
| BKO 0 09/18 | -0.686 | +0.005 |
| OBL 0 10/21 | -0.564 | +0.011 |
| DBR 0 08/26 | -0.096 | +0.026 |
| UKT 1¼ 07/18 | 0.084 | -0.018 |
| UKT 3¾ 09/21 | 0.202 | -0.025 |
| UKT 1½ 07/26 | 0.730 | -0.016 |

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

# Euro area

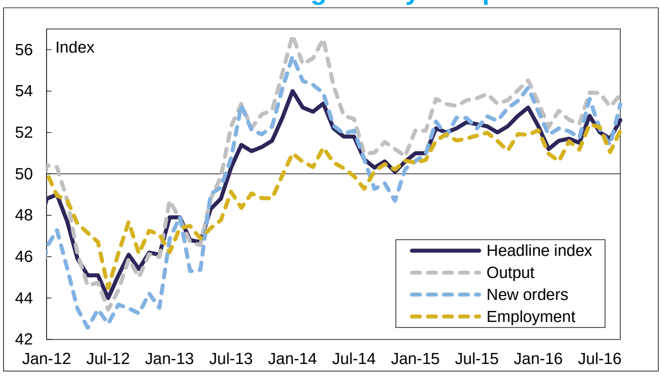
### Manufacturing PMI signals slight pickup in the sector

The final euro area manufacturing PMI signalled a slight pickup in activity in the sector at the end of the third quarter, aligning with the flash estimate of 52.6, up 0.9pt on the month to a three-month high. While the output component was nudged slightly lower from the preliminary reading it was still up 0.6pt on the month to 53.8, leaving the average over the third quarter as a whole at its firmest quarterly reading this year and 0.7pt higher than in Q2. And there was a slight upward revision to the new orders index to 53.4, up 2pts on the month the largest monthly increase for more than three years, with the new exports PMI (53.3) at its highest since April 2014. There was a similar pattern to the German survey, with the headline PMI unrevised at 54.3, up 0.7pt on the month at a three-month high. And likewise the output PMI was a touch softer than initially thought in September to leave it unchanged on the month at 56.4, while the new orders component was upwardly revised from the flash estimate to 56.1, up 1.7pts on the month to a three-month high. Although the equivalent French headline PMI was revised slightly higher from the flash reading to see it record the largest monthly increase of the member states (1.4pts to a seven-month high) it still remained below the key 50 level, with Greece the only member state with a PMI lower. Indeed, there were also notable improvements in the Italian and Spanish PMIs in September, with both up by more than 1pt to 51.0 and 52.3 respectively, albeit still leaving their quarterly averages down significantly from their levels in Q2. Looking ahead, we expect manufacturing output to continue to grow close to 1½% average annual rate recorded over the past two years.

### Spanish political stalemate to come to an end?

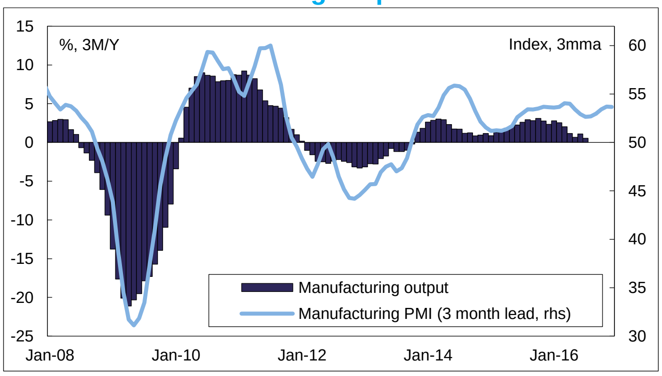
The weekend brought a potential breakthrough in the political stalemate that has enshrined Spain since elections last December, with the resignation of the Socialist party (PSOE) leader Pedro Sánchez after he lost a confidence vote among a party committee. Sánchez had repeatedly refused to work with acting Prime Minister Mariano Rajoy and his centre-right Partido Popular (PP). And with the PSOE having blocked the formation of a minority administration at the end of August, Spain had been looking to be heading to another general election – the third in little more than a year – around Christmas time. The PSOE's committee will have until the end of the month to decide whether they will be willing to tacitly endorse a minority PP government or trigger new elections later in the year. Of course, this assumes that Rajoy is even willing to form a minority administration with the current parliamentary makeup. Indeed, with economic recovery well maintained – the Bank of Spain last week suggested that GDP rose a still-healthy 0.7%Q/Q, 3.2%Y/Y in Q3 – polls suggest that the PP is regaining support. And given the disarray of its main opposition party, Rajoy might well feel that his party could make significant headway at new elections. Certainly, while an outright majority might well be a big ask, a new election might well provide PP the best chance of forming a sustainable government with the tacit approval or even formal participation of the populist centre-right Citizens party.

**Euro area: Manufacturing PMI by component**




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

**Euro area: Manufacturing output and PMI**




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

## The coming two days in the euro area and US

Tuesday should be quiet for economic news from the euro area with no top-tier economic data due for release. Wednesday, however, brings the final September services and composite PMIs. Following a notable drop in Germany, the flash services PMI fell to 51.6, the lowest since December 2014, to leave the composite PMI at 52.6, the lowest since the start of 2015. Euro area retail sales figures for August are also due on Wednesday and seem likely to post a drop of about ½%M/M, with the rise of 1.1%M/M in July also likely to be subject to a downwards revision. In the bond markets, Germany will sell 10Y Bunds on Wednesday.

In the US, after a day bereft of data tomorrow, Wednesday brings a number of releases including September's non-manufacturing ISM, the full trade report for August and factory orders data for the same month. And ahead of Friday's non-farm payrolls report, the ADP employment survey will also attract attention. Meanwhile, the Fed's Evans, Kashkari and Lacker are due to speak on Wednesday.

# UK

## May commits to triggering Article 50 in Q117…

Brexit means Brexit has been the Prime Minister's mantra ever since she took office in July. That, of course, provided no information on precisely what sort of Brexit, or when, the Government would seek. So, faced with growing pressure to provide further detail, Theresa May's speech at the Conservative Party's annual conference yesterday saw her put some flesh on the bones. In particular, she committed to triggering Article 50, which will set in train up to two years of negotiations on the UK's exit (but not on the nature of the UK's future economic relationship with the EU), by the end of March next year. In addition, she announced what she has dubbed a "Great Repeal Bill", which is a proposed Act of Parliament that will establish a framework to incorporate all current EU legislation (and presumably any legislation adopted between now and when the UK leaves) in to UK law at the moment that the UK leaves the EU.

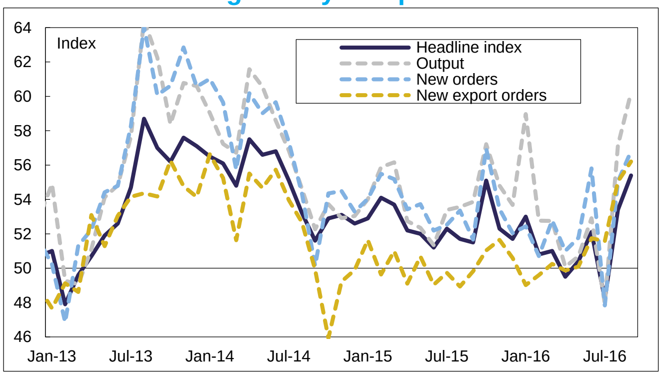
## …pointing to a hard Brexit

While the Prime Minister would not be drawn on whether she favoured a 'hard' or 'soft' Brexit, the approach she has outlined suggests that a hard Brexit, whereby the UK will leave the EU without any new trade arrangements in place, is the more likely outcome. Certainly, once the UK triggers Article 50, the outcome is largely out of the UK Government's hands – the two-year negotiation period is set out in the EU Treaty and can only be extended with the unanimous approval of all other 27 EU countries. Given that those countries now just want to see Brexit done as quickly as possible, an extension to the negotiation period seems highly unlikely. Meanwhile, any new trade deal will almost certainly not be concluded by the time that the UK leaves under this timetable, with the UK's economic relationship with the EU most likely reverting to WTO rules, with the imposition of all the tariffs and non-tariff barriers on its exports to its largest export partner that implies.

## Announcement will put further pressure on investment

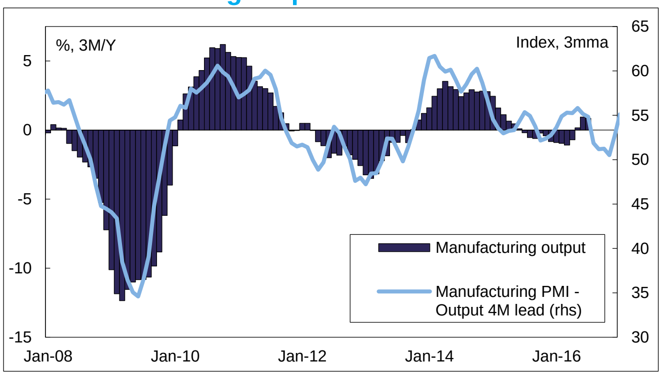
May's move, therefore, has the potential to have a further chilling effect on business investment in the near term, while a reversion to WTO trading arrangements in April 2019 would have profound economic consequences, hitting exports hard and pushing up the prices of imports even further (adding to the effect of the 15% depreciation in sterling that has yet to feed through on to the High Street). Certainly, this signals to firms such as Nissan, which last week said that it would not invest further in its plant in Sunderland until it had greater clarity on the future economic relationship between the UK and the EU, that single market membership is not going to be retained (May said yesterday that she was determined to put in place controls on immigration from the EU, while EU leaders reiterated their position that without free movement of people there

### UK: Manufacturing PMI by component




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

### UK: Manufacturing output and PMI




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

could be no continued UK membership of the single market). This will have profound consequences across larger swathes of the UK economy, particularly because overseas firms invest here precisely because of the UK's access to the single market. And this is no more true than of the financial services sector, where the loss of single market membership means that the ability to operate freely from London right across the EU will almost certainly be lost. No doubt those firms that were putting in contingency plans to move some of their operations to other EU locations so as to be able to continue doing business in the world's largest single market after the UK has left, will now step up those efforts. In all, what the Government set out yesterday will merely serve to add to the post-referendum slowdown in investment already detected by, for instance, the Bank of England's regional agents. Certainly, forex markets did not take the news well, with sterling falling sharply at the open today to move to a fresh post-referendum low.

## Manufacturing PMI rose in September

Notwithstanding the fact that the UK economy is facing a challenging period ahead, with actual Brexit still some time away, the latest UK data continue to suggest that the economy has held up well. Today's manufacturing PMIs surprised on the upside once again, with the headline indicator in September rising from 53.4 to 55.4, the highest level since mid-2014. The details of the survey were positive too, with the output index increasing to above 60, having been at just 47.9 only two months ago, and new orders reaching 56.8, a level not seen in more than two years. Given the collapse in sterling, it is no surprise that the improvement is partly due to stronger demand from overseas markets – the export orders index hit a thirty-two-month high of 56.2. But domestic demand for consumer goods also reportedly contributed significantly. Overall, after the initial Brexit shock, the momentum in the manufacturing sector, according to this survey, has fully recovered lost ground and with the average of the output index up by nearly 4pts to 55.1 in Q3, points to stronger growth in this sector. However, looking ahead, with the government taking a hard stance towards Brexit, it seems almost inevitable that the separation from the EU at some point will hit UK exporters and those domestic firms that service them hard.

## The coming two days the UK

Tomorrow the flow of September PMIs brings the survey for construction, which is expected to show that momentum in this sector was broadly unchanged in September, with the headline index remaining below 50. Meanwhile, the services PMI, due on Wednesday, is expected to have moved broadly sideways too.

***The next edition of Euro wrap-up will be published on 05 October 2016.***

# European calendar

**Today's results**

**Economic data**

| Country | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | **Revised** |
|---|---|---|---|---|---|---|
| EMU | Final manufacturing PMI | Sep | **52.6** | 52.6 | 51.7 | **-** |
| Germany | Final manufacturing PMI | Sep | **54.3** | 54.3 | 53.6 | **-** |
| France | Final manufacturing PMI | Sep | **49.7** | 49.5 | 48.3 | **-** |
| Italy | Manufacturing PMI | Sep | **51.0** | 50.3 | 49.8 | **-** |
| Spain | Manufacturing PMI | Sep | **52.3** | 51.5 | 51.0 | **-** |
| UK | Manufacturing PMI | Sep | **55.4** | 52.1 | 53.3 | **53.4** |

**Auctions**

| Country | Auction |
|---|---|
| UK | BoE APF operation purchased £1.17bn of 3-7Y Gilts (3.04 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 | 14:45 | ECB public sector asset purchases €bn | Weekly | *16.0* | 15.4 |
| Spain | 08:00 | Unemployment M/M '000s | Sep | 23.3 | 14.4 |
| UK | 09:30 | Construction PMI | Sep | 49.0 | 49.2 |

**Auctions and events**

| Country | BST | Auction / Event |
|---|---|---|
| EMU | 11:50 | ECB's Praet is scheduled to speak in Madrid |
| UK | 10:30 | Auction: To sell £2.75bn of 0.5% 2022 bonds (22-Jul-2022) |
| | 14:50 | BoE APF operation: To purchase 15Y+ Gilts |
| | 16:00 | BoE's Saunders publishes the text of a speech to be delivered on 5 October in Manchester |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Wednesday's data releases

**Economic data**

| Country | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|
| EMU | 09:00 | Final services PMI (final composite PMI) | Sep | 52.1 (52.6) | 52.8 (52.9) |
| | 10:00 | Retail sales M/M% (Y/Y%) | Aug | -0.3 (1.5) | 1.1 (2.9) |
| Germany | 08:55 | Final services PMI (final composite PMI) | Sep | 50.6 (52.7) | 51.7 (53.3) |
| France | 08:50 | Final services PMI (final composite PMI) | Sep | 54.1 (53.3) | 52.3 (51.9) |
| Italy | 08:45 | Services PMI (composite PMI) | Sep | 52.0 (51.5) | 52.3 (51.9) |
| Spain | 08:15 | Services PMI (composite PMI) | Sep | 54.6 (53.8) | 56.0 (54.8) |
| UK | 00:01 | BRC shop price index Y/Y% | Sep | - | -2.0 |
| | 09:30 | Services PMI (composite PMI) | Sep | 52.0 (52.3) | 52.9 (53.6) |

**Auctions and events**

| Country | BST | Auction / Event |
|---|---|---|
| Germany | 10:30 | Auction: To sell €4bn of 2026 zero-coupon bonds (15-Aug-2026) |
| UK | 09:30 | BoE's Broadbent scheduled to speak in London |
| | 14:50 | BoE APF operation: To purchase 7-15Y Gilts |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*