Euro wrap-up

Overview

- Bunds were little changed as the ECB's account of its recent policy meeting suggested it will likely revise the rules of its QE programme to ensure it can continue buying assets at the current pace.
- Gilts made significant losses in continued response to PM May's signal of the likelihood of a hard Brexit, her criticisms of QE and low rates, and hints at higher government borrowing to come.
- Friday brings IP data from Germany, France and the UK, and trade reports from the UK and France.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.669	+0.004
OBL 0 10/21	-0.512	+0.002
DBR 0 08/26	-0.007	-0.002
UKT 1¼ 07/18	0.115	+0.001
UKT 3¾ 09/21	0.277	+0.018
UKT 1½ 07/26	0.867	+0.051

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

Euro area

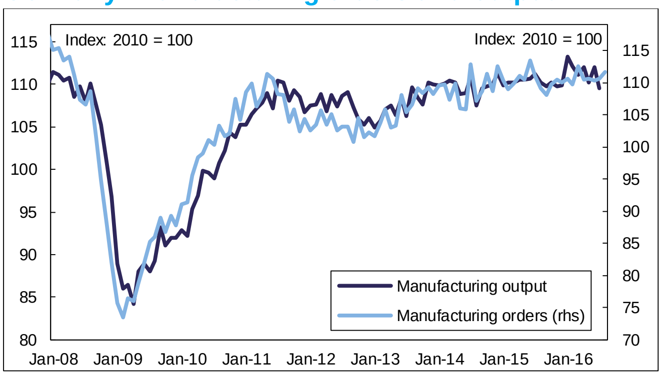
German factory orders signal manufacturing rebound

Having contracted in the second quarter of 2016 and shrunk further at the start of Q3, German manufacturing output looks set for a near-term rebound. German factory orders figures for August comfortably beat expectations with a jump of 1.0%M/M representing the strongest rise since March. The gain in August followed an upwardly revised increase of 0.3%M/M the previous month, and left orders higher on a three-month basis for the first time in four months and more than 2% above the level a year earlier. Demand in the latest month was reassuringly driven by domestic orders, which rose more than 2½%M/M, the most in more than one year thanks to firmer orders for consumer and capital goods alike. That, however, was insufficient to reverse the drop of more than 3% the previous month. Meanwhile orders from abroad slipped back slightly, but were still almost 3% higher than a year earlier. The strong factory orders figures for August tally with the marked improvement in German manufacturing surveys in September, with the Ifo business climate index for the sector having risen to a seventeen-month high and the manufacturing PMI up to its second highest level in more than two years. However, while the near-term outlook for Germany's manufacturing sector looks more favourable, given the notable weakening in the services PMI last month, coupled with increased uncertainty related to the banking sector and politics, we expect the near-term trend in overall GDP growth to be no stronger than the 0.4%Q/Q average rate of the past couple of years.

ECB to act on bond scarcity?

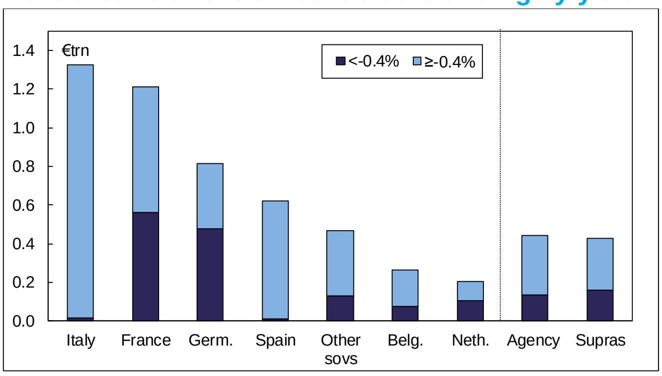
Following Tuesday's Bloomberg report citing comments from an ECB official suggesting that there was a growing consensus on the Governing Council that it would likely taper its monthly bond purchases before ending its QE programme, the ECB's account of the September Governing Council meeting released today inevitably attracted attention. Also predictably, however, there was no reference whatsoever to the QE exit strategy. Nevertheless, the account did provide more colour on the decision of the Governing Council to launch a study of options to ensure smooth implementation of the QE programme, with the scarcity of bonds available for the ECB to purchase – due to the large volume of securities ineligible only on account of having a yield below the -0.40% deposit rate – mentioned for the first time. In particular, in his review of financial market developments, Executive Board member Cœuré noted that "the present constellation of interest rates was posing increasing challenges to implementation [of the asset purchase programme] in the future". But with the account also noting that Governing Council members "widely shared" the view that "reassurance had to be provided" about the Eurosystem's ability to extend QE at the current rate of asset purchases beyond March 2017 if needed, in the absence of a significant improvement in the economic outlook the difficulties faced by the ECB in sourcing bonds to purchase will not lead the Governing Council to taper. Instead, the account suggested that the concerns will be addressed by introducing greater flexibility into the rules of the purchase programme, with precise adjustments to the parameters likely to be determined in December when the staff review of options will be discussed.

Germany: Manufacturing orders and output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Gov & SSA bonds outstanding by yield*



** Bonds yielding less than -0.4% are ineligible for purchase by the ECB.*
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

Friday brings August industrial production figures from Germany, France and Spain. Most notably, following a drop of more than 2%M/M in July, the most in more than two years, German manufacturing production looks set to rebound vigorously. However, with energy and construction output likely to have weakened, overall German industrial production is expected to rise just 1.0%M/M, insufficient to reverse fully the 1.5%M/M decline of the previous month. French goods trade data for August are also due. In addition, ECB Chief Economist Praet will be speaking publicly.

All eyes on Friday, however, will be on the US September labour market report. The consensus expectation for nonfarm payrolls is for a gain close to 175k, the average of the past six months, while the unemployment rate is expected to remain at 4.9%. Growth in average labour earnings is expected to rise to 2.6%Y/Y, close to the top of the range of recent years. In addition, several voting FOMC members (Fischer, Mester, George and Brainard) will be speaking publicly.

UK

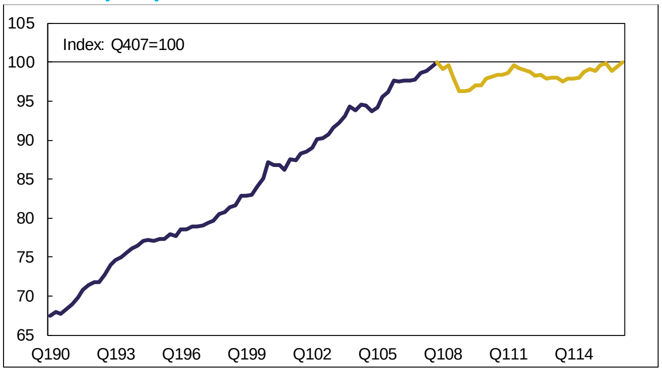
Productivity improvement is unlikely

Stubbornly subdued productivity growth since the financial crisis has contributed to depressed income levels and low interest rates in many advanced economies. The UK has performed particularly poorly in this regard, lagging behind other countries, and today's release of labour productivity figures for Q2 gave no reason to be optimistic that a pick-up is underway. While output per hour finally exceeded its previous peak reached in Q407, thanks to a rise of 0.6%Q/Q, the steepest in four quarters, growth on an annual basis remained particularly disappointing, at just 0.4%Y/Y, contrasting sharply with the pre-crisis years, when it averaged around 2%Y/Y, but also to the 2014-2015 period when growth in excess of 1%Y/Y was not unusual. In fact, the economy in Q216 was more than 17% less productive than it would have been if output per hour had continued following its pre-crisis trend. Meanwhile, growth of labour earnings and related costs picked up in Q2 to leave unit labour costs rising by 1.9%Y/Y, a pace close to the upper end of the recent range and more than 1ppt higher than in Q1. While this might appear to imply somewhat stronger underlying inflationary pressures in the economy, this measure is volatile and prone to downward revisions and so might, for now, be taken with a pinch of salt. Looking ahead, with the latest surveys signaling a significant fall in firms' investment intentions after the Brexit referendum, a sustained recovery in productivity growth over coming quarters and years looks even less likely than before.

The day ahead in the UK

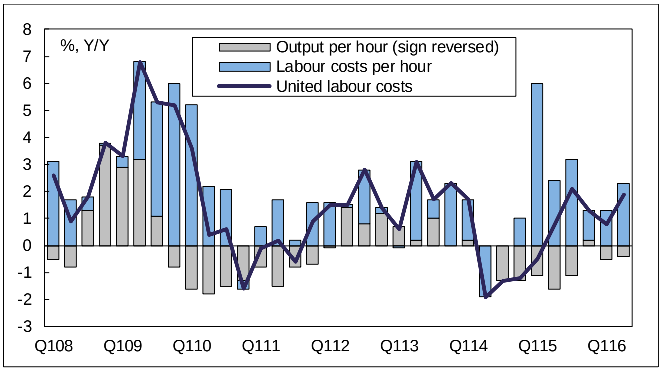
A busy end to the week brings the latest industrial production and trade figures. While industrial output is expected to have risen only marginally in August to match the increase in the previous month of 0.1%M/M, the annual growth rate is set to have fallen to below 1½%Y/Y. And manufacturing growth is likely to have remained low, below 1%Y/Y. Meanwhile, the trade figures are expected to show a modest improvement in the trade deficit in August.

UK: Output per hour



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Unit labour costs



Source: ONS

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Factory orders M/M% (Y/Y%)	Aug	**1.0 (2.1)**	0.3 (1.6)	0.2 (-0.7)	**0.3 (-0.6)**
UK	Unit labour costs Y/Y%	Q2	**1.9**	-	1.9	**0.8**
	BoE corporate bond purchases £mn	Weekly	**507**	-	0	**-**

Auctions

Country	Auction
France sold	€3.2bn of 0.25% 2026 bonds (25-Nov-2026) at an average yield of 0.28%
	€2.9bn of 1.5% 2031 bonds (25-May-2031) at an average yield of 0.6%
	€1.4bn of 1.75% 2066 bonds (25-May-2066) at an average yield of 1.43%
Spain sold	€1.5bn of 1.3% 2026 bonds (31-Oct-2026) at an average yield of 1.072%
	€1.6bn of 0.75% 2021 bonds (30-Jul-2021) at an average yield of 0.088%
	€0.9bn of 4.2% 2037 bonds (31-Jan-2037) at an average yield of 1.77%
	€0.8bn of 0.3% 2021 index-linked bonds (30-Nov-2021) at an average yield of -0.62%
UK sold	£2bn of 1.5% 2047 bonds (22-Jul-2047) at an average yield of 1.488%

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	Industrial production M/M% (Y/Y%)	Aug	1.0 (0.4)	-1.5 (-1.2)
France	07:45	Trade balance €bn	Aug	-3.9	-4.5
	07:45	Current account balance €bn	Aug	-	-2.6
	07:45	Industrial production M/M% (Y/Y%)	Aug	0.6 (-1.3)	-0.6 (-0.1)
	07:45	Manufacturing production M/M% (Y/Y%)	Aug	0.3 (-1.4)	-0.3 (0.4)
Spain	08:00	Industrial production M/M% (Y/Y%)	Aug	-0.1 (1.6)	0.2 (0.3)
UK	08:30	Halifax house price index M/M% (3M/Y%)	Sep	0.0 (5.9)	-0.2 (6.9)
	09:30	Industrial production M/M% (Y/Y%)	Aug	0.1 (1.3)	0.1 (2.1)
	09:30	Manufacturing production M/M% (Y/Y%)	Aug	0.4 (0.8)	-0.9 (0.8)
	09:30	Visible trade balance £bn	Aug	-11.3	-11.8
	09:30	Total trade balance £bn	Aug	-4.0	-4.5
	15:00	NIESR GDP 3M/3M%	Sep	-	0.3

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.