Euro wrap-up

Overview

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- Longer-dated Bunds made modest gains as the euro area's manufacturing PMIs signalled a steeper pace of contraction in July.
- Gilts also made gains as the BoE revised down its near-term GDP forecasts and signalled its readiness to support the economy if required.
- Tomorrow will bring euro area retail sales figures for June, along with Italian IP data for the same month.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/21	-0.771	-0.020
OBL 0 04/24	-0.752	+0.004
DBR 0¼ 02/29	-0.495	+0.014
UKT 1½ 01/21	0.426	-
UKT 1 04/24	0.362	-0.019
UKT 1 ⅝ 10/28	0.588	-0.021

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

Final manufacturing PMI still very weak

Like the Commission's economic sentiment survey earlier in the week, the flash PMIs for July highlighted the persistent weakness in the euro area manufacturing sector. And while today's final manufacturing PMIs saw a modest upwards tweak (by 0.1pt) to the headline euro area index, at 46.5 it was still 1.1pts lower than in June, marking the lowest level since 2012 and consistent with a steeper pace of contraction in the sector at the start of Q3. Indeed, the output index was nudged lower from the flash release (by 0.1pt) to 46.9, leaving it 1.6pts lower than in June, similarly a more-than 6½-year low. The new orders and employment components also continued to indicate a steeper pace of decline than in June. And the output price PMI was down 1.7pts to 48.8, the lowest since April 2016. So overall, today's survey suggests that the outlook for the manufacturing sector is still deteriorating, a view flagged by Draghi in last week's post-meeting press conference.

Germany leading the manufacturing weakness

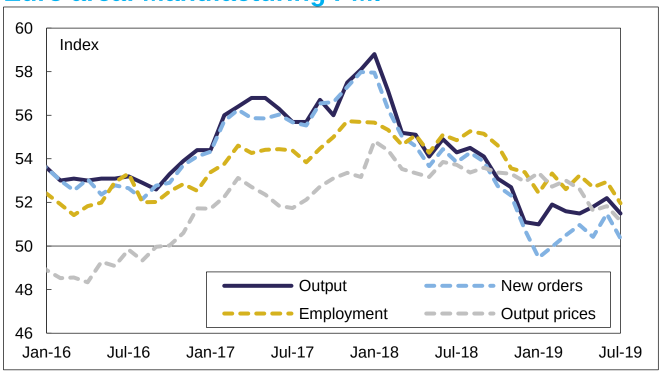
This worsening outlook has been particularly evident in Germany. And while the final manufacturing PMI for that country was not quite as bad as the initial estimate, it still implied a further significant weakening in the sector in July, with the headline PMI down 1.8pts to 43.2, a seven-year low. Moreover, new-exports orders declined at their fastest pace for over a decade. Meanwhile, the French manufacturing PMI was nudged lower from its preliminary estimate to leave it down more than 2pts on the month to 49.7, a four-month low. In contrast, the Italian and Spanish indices, which were released for the first time, came in marginally higher in July, albeit remaining below the key 50-expansion/contraction level. Italy's headline PMI rose 0.1pt to 48.5, while Spain's headline PMI rose 0.3pt to 48.2, the second-lowest level in more than six years. So, it was just Greece's manufacturing sector that bucked the trend, with the headline PMI up 2.2pts in July to 54.6.

The day ahead in the euro area and US

Focus tomorrow will turn to the consumer sector, with euro area retail sales for June set to provide a guide to household consumption in Q2. While total sales are expected to have increased by 0.3%M/M, this would merely reverse the decline in May, to leave sales broadly flat over the quarter as a whole. Tomorrow will also bring the latest euro area PPI figures for June, as well as Italian industrial production data for the same month.

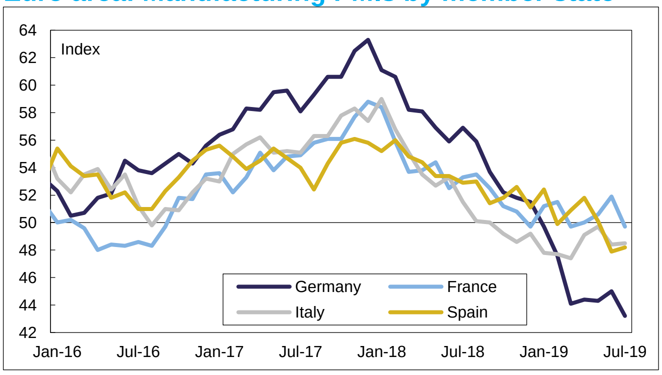
Of course, attention in the US will be firmly on July's labour market report, with non-farm payrolls expected to have risen by a healthy 165k, albeit down from the surge (224k) seen in June. As such, the unemployment rate might well tick lower, by

Euro area: Manufacturing PMI



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

Euro area: Manufacturing PMIs by member state



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

0.1ppt to 3.6%. Meanwhile, average hourly earnings growth is expected to be unchanged at 3.1%Y/Y. Friday will also bring the full trade report and revised durable goods orders figures for June, as well as the final University of Michigan's consumer sentiment survey for July.

UK

BoE keeps policy stance unchanged

There were no major surprises from today's BoE monetary policy announcement and Inflation Report. As expected, the MPC voted unanimously to leave Bank Rate unchanged at 0.75%. And the Committee's guidance on future policy appeared barely amended too, stating that "assuming a smooth Brexit and some recovery in global growth…the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate". But the BoE's confidence that a deal on Brexit will be reached by 31 October has clearly diminished, and it acknowledged that "increased uncertainty about the nature of EU withdrawal means the economy could follow a wide range of paths over coming years". Moreover, the detail of its forecasts - in particular a downwards revision to the near-term growth profile - made it clear that, even if there is an orderly Brexit over the near term, the BoE would be in no rush to tighten policy. Indeed, if uncertainty persists, the forecasts would arguably suggest that a rate cut could well be merited.

Growth forecast revised down

Certainly, the MPC was more downbeat than it was in May, forecasting growth to remain below potential over the next few quarters, not least as business investment was expected to weaken further. As such, a negative output gap was expected to persist over the next year or so. And, certainly, we would expect sub-potential growth to persist for as long as Brexit uncertainties continue and probably longer than the Committee currently anticipates. Nevertheless, while the MPC's median GDP growth forecasts were revised lower for the coming two years – to a sub-potential 1.3% in 2019 and 2020 – before accelerating to 2.3% in 2021 thanks to the certainty afforded by a Brexit deal, these should be viewed merely as an illustrative projection. Moreover, the Bank's central expectation that headline inflation will rise back above its 2% target from Q420 if rates followed the path implied by the markets (i.e. with a near-term 25bp rate cut), is also less useful than normal.

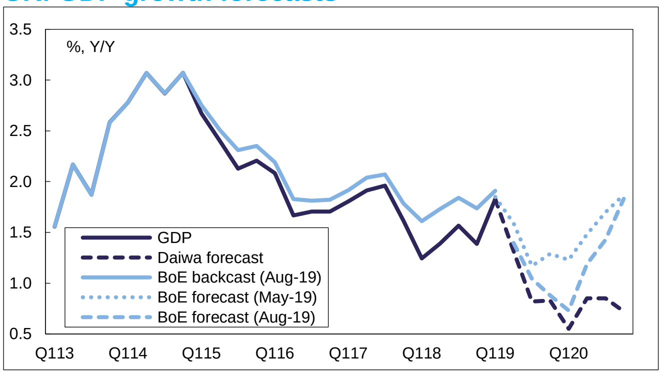
BoE's forecasts discounted by inconsistencies

Indeed, the MPC today downplayed the value of its economic projections, emphasising the inconsistencies between the Bank's assumption of a smooth Brexit and the conditions underpinning recent moves in market asset prices, which appropriately reflect the increasing probability of a no-deal and the likely consequences. Moreover, in addition to its questionable assumption that domestic output will be boosted once Brexit-related uncertainties dissipate, we note that the BoE's expectation that global growth will gradually pickup to its potential rate is also brave.

BoE reiterates readiness to support economy

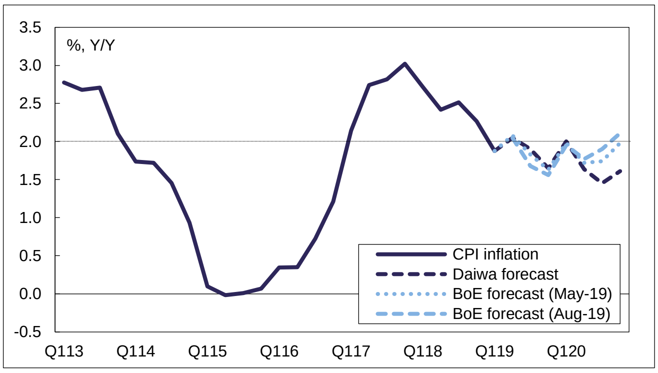
Given the significant uncertainty surrounding the Brexit outlook, and increased risks of a no-deal Brexit, Carney also reiterated in his press conference that the MPC will "take all appropriate measures to support jobs and activity, consistent with achieving the 2% inflation target commitment". So, overall he did nothing to suggest that current market pricing on rates is inappropriate. And with a significant risk that Brexit uncertainty will drag on to accommodate an early General Election, or indeed that a disorderly no-deal Brexit will eventually be reached, we think the MPC's next policy move will be an easing rather than a tightening. Our central expectation is for a 25bps rate cut in November, with QE to be required also in the event of a no deal. Certainly, the BoE's updated worst-case Brexit scenario to the Treasury Select Committee next month will also no doubt reinforce our view that in the case of a no-deal the Bank will need to provide significant support.

UK: GDP growth forecasts



Source BoE, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation forecasts



Source BoE Thomson Reuters and Daiwa Capital Markets Europe Ltd.

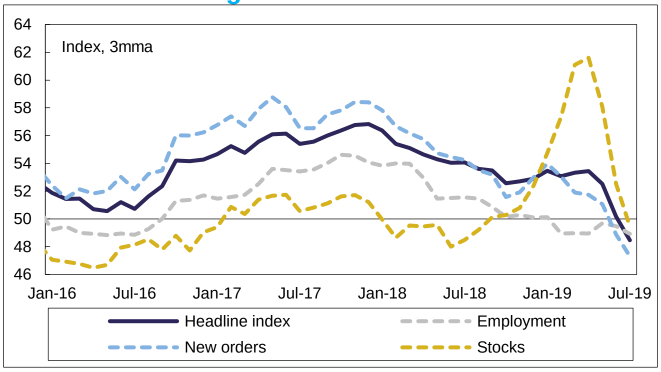
Manufacturing PMI signals ongoing sharp contraction

Like in the euro area, the UK's manufacturing sector appears most exposed to heightened downside risks. This was again evident in today's manufacturing PMI survey, which showed the headline index unchanged at 48.0 in July, a 6½-year low and more than 7pts below March's recent peak, which was boosted by a Brexit-related build-up of inventories. But there was also a further deterioration in the output component which fell for the fourth consecutive month to just 47.0, a seven-year low and consistent with significant contraction. The survey also suggested that production of consumer goods fell for the first month in nine, while there were further sizeable declines in output of intermediate and investment goods - indeed, the relevant PMI for the latter was at its lowest since November 2012. But given ongoing uncertainties related not least to Brexit, geopolitical tensions and slower global growth, firms continued to struggle to draw new orders too. And so, unsurprisingly manufacturers reportedly scaled back significantly their workforces at the start of Q3. Price pressures in the sector also appear to be waning, with the output and input price PMIs declining to their lowest levels for more than three years.

The day ahead in the UK

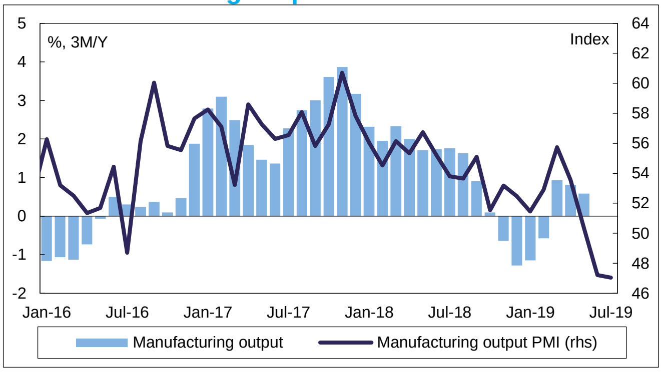
Following today's weak manufacturing PMI, tomorrow's equivalent construction sector survey is unlikely to offer much optimism about the UK's near-term economic outlook either. While the headline PMI is expected to have risen in July, this followed a collapse in June to a ten-year low of 43.1, and is therefore likely to still indicate another steep decline in activity. Friday will also bring the Lloyd's business barometer for July.

UK: Manufacturing PMIs



Source Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output and PMI



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 manufacturing PMI	Jul	**46.5**	46.4	47.6	-
Germany	Final manufacturing PMI	Jul	**43.2**	43.1	45.0	-
France	Final manufacturing PMI	Jul	**49.7**	50.0	51.9	-
Italy	Manufacturing PMI	Jul	**48.5**	48.0	48.4	-
Spain	Manufacturing PMI	Jul	**48.2**	48.1	47.9	-
UK	Manufacturing PMI	Jul	**48.0**	49.2	48.0	-
	BoE Bank Rate %	Jul	**0.75**	*0.75*	0.75	-

Auctions

Country	Auction
France	sold €1.78bn of 4.75% 2035 bonds at an average yield of 0.18%
	sold €2.09bn of 2.75% 2027 bonds at an average yield of -0.35%
	sold €2.13bn of 2.5% 2030 bonds at an average yield of -0.1%

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	Retail sales M/M% (Y/Y%)	Jun	0.3 (1.3)	-0.3 (1.3)
	10.00	PPI Y/Y%	Jun	0.9	1.6
Italy	09.00	Industrial production M/M% (Y/Y%)	Jun	-0.4 (-1.3)	0.9 (-0.7)
	10.00	Retail sales M/M% (Y/Y%)	Jun	-	-0.7 (-1.8)
Spain	08.15	Unemployment change '000s	Jul	-22.5	-63.8
UK	09.30	Construction PMI	Jul	46.0	43.1
	00.01	Lloyds business barometer	Jul	-	13

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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