Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses as the latest euro area economic data were consistent with positive growth, and BTPs underperformed as Deputy Prime Minister Salvini maintained threats to collapse the Italian government.
- Gilts also made losses despite some soft UK economic surveys and more reports of the Government's determination to avoid a further Brexit delay.
- Friday will bring the first estimate of UK Q2 GDP as well as French IP and German goods trade data for June.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.860	+0.008
OBL 0 10/24	-0.814	+0.010
DBR 0 08/29	-0.562	+0.024
UKT 1½ 01/21	0.477	+0.020
UKT 1 04/24	0.370	+0.044
UKT 1⅝ 10/28	0.530	+0.044

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

Euro area

French business sentiment stable

After yesterday's dire German industrial production report, a relatively quiet day for top-tier data from the euro area today at least brought somewhat better news. The Bank of France's July business survey, for example, was arguably as upbeat as might have been hoped. The headline indices for manufacturing (admittedly just 95, some way below the long-run average and the lowest in six years), services (a respectable 100, in line with the long-run average) and construction (a relatively upbeat 104) were all unchanged from June, and signalled growth at the start of Q3. And, while subsectors such as autos indicated a downwards trend, on the whole survey recipients reported expectations of ongoing expansion ahead. Indeed, the findings of the survey led the Bank of France to suggest that GDP will rise 0.3%Q/Q in Q3, up 0.1ppt from Q2 and a rate which also matches our own forecast.

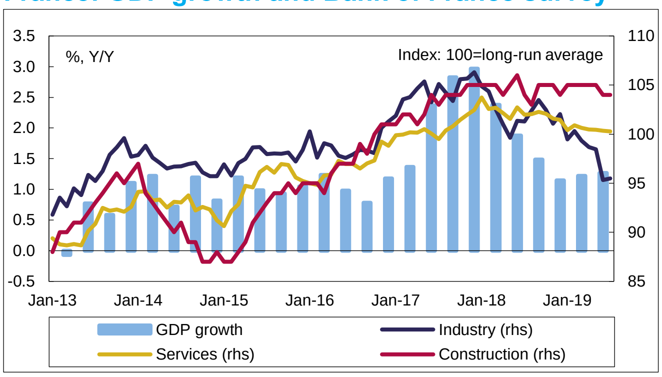
Spanish IP data beat expectations

Similarly contrasting with the German figures, Spain's industrial production figures for June were much better than expected. Total output declined a much smaller-than-expected 0.2%M/M, to leave it up a moderate 1.8%Y/Y. Admittedly, this in part reflected a pickup in energy production (0.9%M/M). And while production of capital goods was firmer (+1.1%M/M), there was a decline in output of intermediate (-0.2%M/M) and consumer goods (-1.9%M/M). Nevertheless, despite this rather soft end to the quarter, production of consumer goods was still up almost 1½%Q/Q in Q2, matching the increase in Q1. And overall, total industrial production was still up a solid 0.9%Q/Q, with manufacturing output up 0.4%Q/Q. With survey indictors having deteriorated notably over recent months – e.g. the manufacturing output and new orders PMIs were some way below 50 in July – a drop in Spanish IP in Q3 would hardly come as a surprise.

The day ahead in the euro area and US

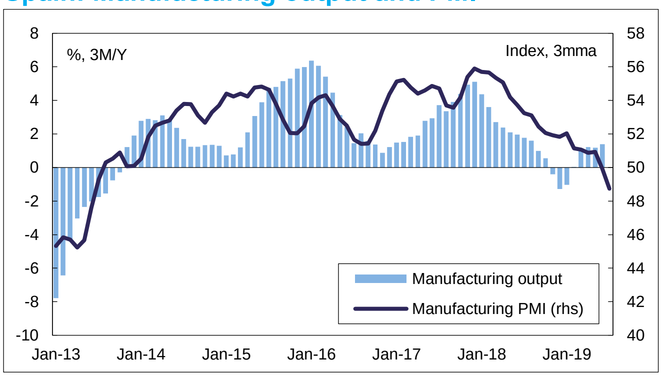
Friday will bring French industrial production data for June, which, like in Germany, are expected to report a decline in output close to 1½%M/M. That, however, would likely leave total IP up about ½%Q/Q in Q2, although manufacturing output would be little better than flat on the quarter. The June goods trade reports from Germany and Italy are also due, along with final Italian inflation figures for July. In addition, beyond the economic data, Friday will see Fitch publish a scheduled review of its Italian sovereign credit rating, which is currently on negative outlook. In the US, Friday will bring producer price inflation data for July.

France: GDP growth and Bank of France survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Spain: Manufacturing output and PMI



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

UK

Johnson hell-bent on no deal

If the UK leaves the EU without a deal when the Article 50 deadline expires at end-October, the precise economic impact is impossible to gauge. But sterling would certainly plunge, perhaps testing its all-time low close to $1.05. Amid a marked shock to economic confidence and supply-side disruption, recession would ensue and inflation would leap. And years of political turmoil and economic weakness would likely follow as the UK struggled to define its future relationships with the EU and other nations. But a fortnight on from Boris Johnson's appointment as Prime Minister and the probability of such a harmful outcome has never appeared higher. Calculating that, to secure its survival, his government needs to win back support lost to Nigel Farage's Brexit party, Johnson has insisted the UK must leave the EU on 31 October with or without a deal. He has also refused to negotiate with the EU unless it drops the "Irish backstop" proposals previously agreed by Theresa May's government. And while his government has accused the EU of intransigence, Johnson has failed to present any sincere or substantive new proposal. So, despite insisting that some form of deal is still possible, the populist Prime Minister, his Cabinet and advisers are all giving the impression of being hell-bent on no deal. And reports today that Johnson is considering holding a general election in early November, before the full damage of a no-deal Brexit might be felt, sought to reinforce that perception.

Expect little light for another fortnight

The precise path ahead for Brexit, however, will remain highly uncertain for several weeks to come, and media gossip of Johnson's intentions might be taken with a pinch of salt for a while yet too. First informal discussions between Johnson and the leaders of Germany, France, Italy and the European Commission are only likely to be held in the margins of the Biarritz G7 Summit on 24-26 August, a full month after the start of Johnson's premiership. Such a setting would seem incompatible with an ill-tempered showdown. By the same token, however, elements for a compromise seem highly unlikely to emerge from the wreckage of Theresa May's rejected withdrawal agreement. The EU will certainly continue to defend the interests of the Irish government, and prioritise the preservation of the integrity of the single market and customs union. And the EU might well have already concluded that Johnson is incapable of negotiating in good faith.

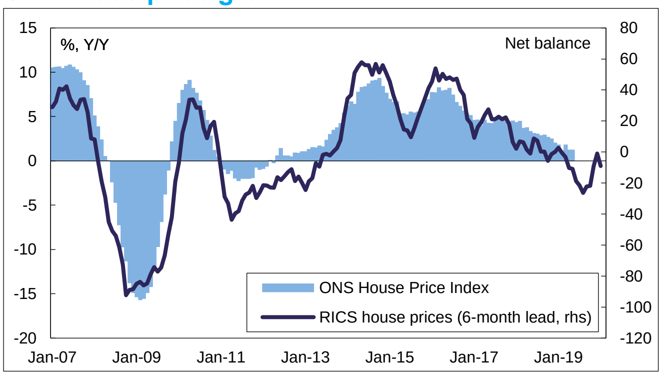
Despite obstacles, extension remains our baseline

Nevertheless, we still see the probability that the UK will leave the EU at end-October as less than 50%. In our view, more likely – but only marginally so – is that MPs will prevent a no-deal Brexit on that date by helping to secure a further extension of the Article 50 deadline. While Johnson's parliamentary majority is strictly speaking now down to just one MP, in practice it is still larger than that. But a parliamentary vote last month strongly suggested that there is still no majority among MPs in favour of leaving without a deal. With no-deal the legal default, however, finding a precise mechanism – compatible with the current parliamentary arithmetic, the interests of various opposition political parties, and the Fixed-term Parliaments Act and the broader UK constitution – to achieve that outcome will be far from straightforward. And while several options are theoretically possible, none is guaranteed to succeed. The defeat of the Johnson government in a vote of no-confidence – perhaps shortly after Parliament resumes in early September – and the swift establishment of a broad cross-party coalition with the sole mandate to avoid a no-deal Brexit ahead of an early general election, is perhaps the most likely scenario. And that represents our baseline forecast. We recognise, however, that such an approach could test the limits of the UK's constitution, including the role of the Queen. And, relying among other things on the Labour leadership playing ball, it risks failure. So, certainly, the early autumn will see UK political noise rise to a crescendo with inevitable consequences for sterling.

Housing and labour surveys downbeat

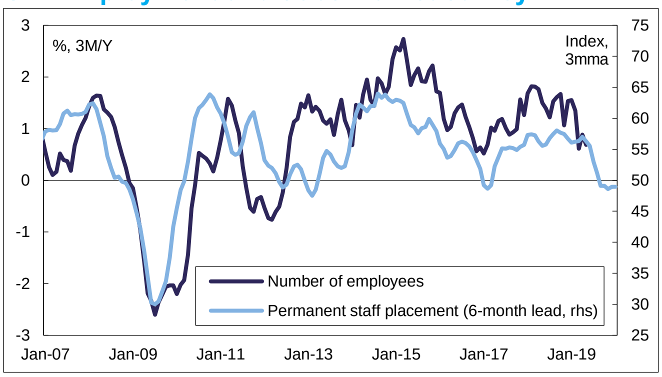
Data-wise, a relatively quiet day for economic reports brought a couple of surveys illustrating how Brexit uncertainty continues

UK: House price growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Employment and Jobs Market survey



Source: REC/KPMG, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

to weigh on economic activity. The RICS residential market survey for July cast light on the ongoing torpor in the housing market. Despite a pickup in buyer enquiries last month, surveyors suggested that the number of agreed sales fell from a low level. Moreover, the survey's headline house price balance also fell further into negative territory last month, fully reversing the modest pickup seen in June, with prices continuing to fall in London, the South East and East Anglia. And the outlook for prices remained downbeat too, with expectations for the year ahead falling to a seven-month low. Meanwhile, the impact of uncertain economic outlook on the outlook for the labour market was reflected in the KPMG and REC Report on UK jobs. This suggested that permanent staff appointments fell for the fifth month in a row in July, while recruitment consultants suggested temporary billings increased at the slowest rate for more than six years. The labour market still appears relatively tight, however, with consultancies indicating low candidate availability.

The day ahead in the UK

Friday will bring the most notable UK economic release of the week in the shape of the first estimate of Q2 GDP, which is bound to report a marked easing in growth from 0.5%Q/Q in Q1. The consensus expectation is for GDP to have moved sideways. But we see a significant chance that output contracted in Q2 for the first time since Q412, with the manufacturing sector in particular a major drag on GDP growth. Meanwhile, services and construction output likely remained subdued. Friday will also bring the monthly output and trade figures for June.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Bank of France industrial sentiment indicator	Jul	**95**	96	95	-
Spain	Industrial production M/M% (Y/Y%)	Jun	**-0.2 (1.8)**	-1.0 (1.1)	0.3 (1.4)	-
UK	RICS house price balance %	Jul	**-9**	-1	-1	-

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 (current account) balance €bn	Jun	19.5 (21.7)	20.6 (16.5)
	07.00	Exports (imports) M/M%	Jun	-0.0 (0.3)	1.1 (-0.5)
France	07.45	Industrial production M/M% (Y/Y%)	Jun	-1.2 (1.0)	2.1 (4.0)
	07.45	Manufacturing production M/M% (Y/Y%)	Jun	-1.3 (0.7)	1.6 (3.4)
Italy	09.00	Total trade balance €bn	Jun	-	5.3
	10.00	Final CPI (EU-harmonised CPI) Y/Y%	Jul	0.5 (0.4)	0.7 (0.8)
UK	09:30	Preliminary GDP Q/Q% (Y/Y%)	Q2	-0.1 (1.2)	0.5 (1.8)
UK	09:30	Monthly GDP estimate M/M%	Jun	0.1	0.3
	09:30	Industrial production M/M% (Y/Y%)	Jun	-0.2 (-0.3)	1.4 (0.9)
	09:30	Manufacturing production M/M% (Y/Y%)	Jun	-0.3 (-1.1)	1.4 (0.0)
	09:30	Construction output M/M% (Y/Y%)	Jun	-0.4 (0.2)	0.6 (1.7)
	09:30	Services activity M/M% (3M/3M%)	Jun	0.1 (0.2)	0.0 (0.3)
	09:30	Trade balance (goods trade balance) £bn	Jun	-2.6 (-11.8)	-2.3 (-11.5)

Auctions and events

Country	BST	Auction / Event
Italy	-	Fitch to publish regular review on Italy's sovereign credit rating

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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