Euro wrap-up

Overview

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- Bunds made further gains today as German exports disappointed in Q2. But the sell-off in BTPs accelerated as Italy's coalition government appeared to be falling apart.
- Gilts made notable gains today as UK GDP contracted in Q2 for the first time in six years.
- Italian politics will remain in focus in the coming week, while the first estimate of German Q2 GDP is due.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/21	-0.878	-0.016
OBL 0 10/24	-0.831	-0.011
DBR 0 08/29	-0.582	-0.019
UKT 1½ 01/21	0.438	-0.021
UKT 1 04/24	0.328	-0.034
UKT 1 ⅝ 10/28	0.480	-0.040

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

Euro area

Italian coalition government to be put out of its misery

The sell-off in BTPs accelerated today – with 10Y yields rising more than 25bps to above 1.80% to take the spread over Bunds to above 235bps, the highest since June – as the crisis in Italy's ruling coalition appeared to have passed the point of no return. Following countless disputes with its Five Star Movement partner throughout the fourteen months since the populist government was established, the right-wing League's leader, Matteo Salvini, yesterday confirmed his desire to pull the plug. Rather than taking difficult decisions on the forthcoming 2020 Budget Salvini evidently decided that the time was now right to capitalise on his party's elevated ratings. Indeed, recent opinion polls suggest support for the League now approaching 40%, more than double its share in the last election in March 2018 and roughly 20ppts ahead of Five Star.

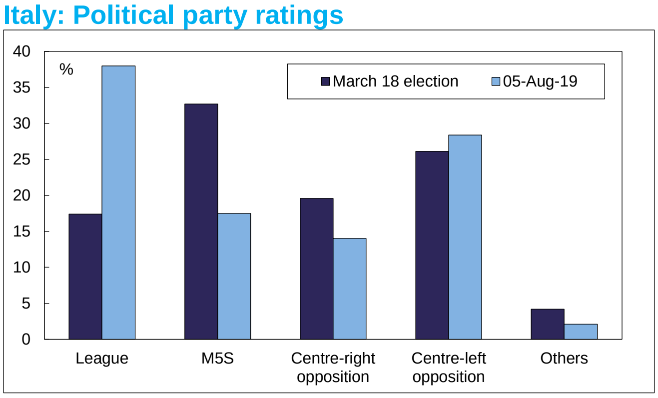
Autumn election to impede Budget process

The timetable for the parliamentary process to formalise the death of the coalition remains unclear, not least as the lower and upper houses are currently on holiday. However, lawmakers look set to be recalled for a parliamentary vote of no-confidence at the end of the coming week, after which Prime Minister Conte would be expected to resign. And while President Mattarella would then discuss with the Presidents of both houses of parliament to see whether support for an alternative administration (with one option being another temporary technocrat government) could be found, we strongly expect a general election to be called. Given the time lags involved, the election would not be able to be held until the second half of October, by which time a draft Budget for 2020 should have been submitted to the European Commission. With the next government – which seems highly likely to be led by the League – unlikely to be in place before December, the political shenanigans could require special temporary legislative measures to allow for the funding of the government in early 2020. And early next year, the new government would need to agree a new Budget against the backdrop of very weak growth with an automatic contractionary rise in VAT currently built into legislation. The chances of renewed conflict with the European Commission, and risks of a formal disciplinary Excessive Deficit Procedure, appear high.

German goods exports had worst quarter since 2012

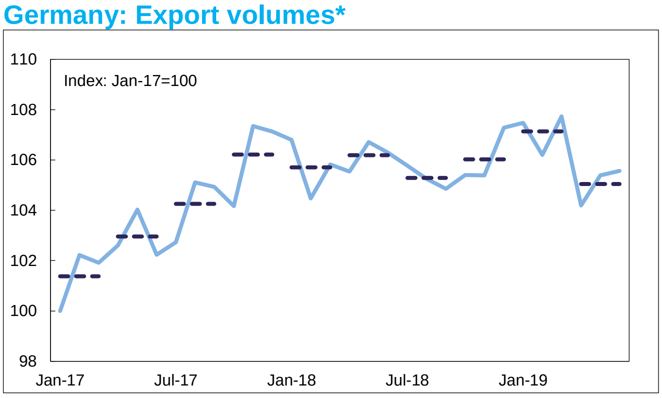
Germany's goods trade report for June highlighted the increasing toll being taken by global events on the manufacturing sector, with the value of exports down 8.0%Y/Y, the most in three years. On a seasonally adjusted basis, the value of exports slipped a modest 0.1%M/M. But that still left them down in Q2 by 1.9%Q/Q, the most since the euro crisis in 2012. The value of imports dropped too, falling for a third consecutive month and by a hefty 2.7%M/M, to be down 2.2%Q/Q. Adjusting for price effects, preliminary data from the Bundesbank suggest that export volumes edged up 0.1%M/M in June but fell

Italy: Political party ratings



Source: Tecnè and Daiwa Capital Markets Europe Ltd.

Germany: Export volumes*



**Dashed lines represent quarterly averages. Source: Bundesbank, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

1.1%Q/Q in Q2, the worst since 2013. On the same basis, import volumes rose 1.7%M/M in June and 2.0%Q/Q in Q2 to suggest strongly that net trade subtracted from GDP growth last quarter. Meanwhile, the goods trade surplus narrowed almost €4bn in June to €16.8bn, and the services balance deteriorated too. However, an improved income account saw the current account surplus rise more than €4bn to €20.6bn, a touch above the average of the past twelve months, albeit down more than €4bn on its level a year earlier. Looking ahead, there seems every reason to expect the dire export performance to continue, with export orders maintaining a downtrend and surveys suggesting a further deterioration in external demand at the start of Q3.

French manufacturing output fell in Q2

Like in Germany, France's industrial sector had a weak end to the second quarter, with the 2.3%M/M drop in production in June the steepest for seventeen months. Manufacturing output suffered a similar decline (-2.2%M/M), with weaker production of intermediate goods (-0.3%M/M), capital (-2.8%M/M) and consumer durables (-2.8%M/M). And energy production fell a steeper 3.7%M/M. But, unlike in Germany, the weakness in that subsector in June was to some extent payback for the strength seen earlier in the quarter. Indeed, energy production was up 3½%Q/Q in Q2. And so, total production eked out a modest increase over the second quarter too (0.3%Q/Q). In contrast, however, manufacturing output fell 0.3%Q/Q in Q2, while construction output fell 1.4%Q/Q. While confidence in construction looks solid and a return to growth is expected in the current quarter, recent surveys have provided more downbeat signals about the outlook for the manufacturing sector. Certainly, there is little reason to expect a significant recovery in factory production anytime soon. Unlike in Germany, however, what matters most for the French economy is services, and perhaps reassuringly surveys suggest that conditions in that sector remain broadly stable and consistent with slightly firmer GDP growth in Q3.

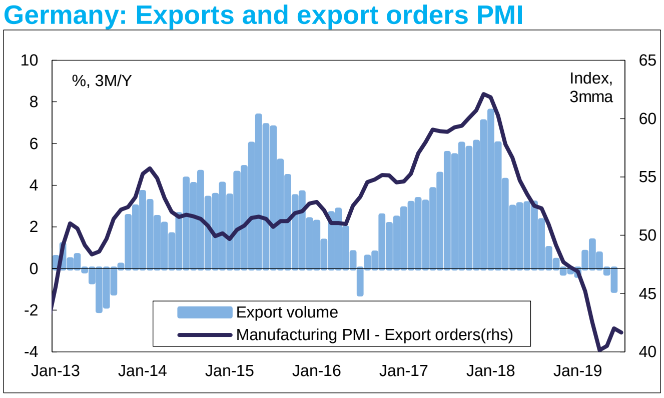
The week ahead in the euro area and US

With the ruling coalition disintegrating, Italian politics will remain centre-stage in the coming week, although a formal no-confidence vote in the government seems unlikely to be held before Friday. Data-wise, meanwhile, Wednesday will be the busiest day of the week, with several releases due including the first estimate of German Q2 GDP. Given the weakness in industrial and construction output in the second quarter, as well as softer retail sales growth, we expect Germany's expansion to have slowed considerably last quarter – our current expectation is for GDP growth of zero, down from 0.4%Q/Q in Q1, with a non-negligible risk that the economy contracted. Euro area IP data for June due the same day are likely to confirm a notable drop in the second quarter, but the updated estimate of euro area GDP growth is expected to align with the flash estimate of 0.2%Q/Q (half the pace of Q1). Against this backdrop, euro area labour market figures (also due Wednesday) are likely to show a moderation in employment growth in Q2 from 0.3%Q/Q in Q1.

Among other days, euro area trade figures for June (due Friday) should provide some insight into the extent to which net exports weighed on GDP growth in Q2. The first half of the coming week, meanwhile, will bring final July inflation figures from Germany, France and Spain. Germany's data on Tuesday will be of particular interest given that June's figures saw revisions to the preliminary release. Moreover, in July, the flash estimates showed a notable discrepancy between the national and EU-harmonised measures, with headline inflation up 0.1ppt to 1.7%Y/Y and down 0.4ppt to 1.1%Y/Y respectively. In the markets, Italy will sell 3Y and 7Y bonds against the backdrop of political turbulence on Tuesday, and Spain will sell bonds on Wednesday.

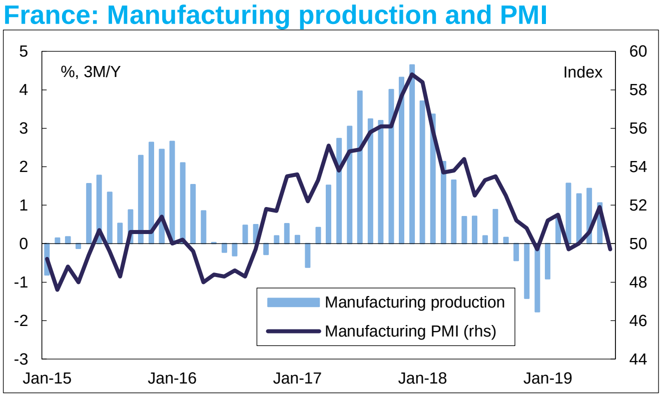
The main US data focus in the first half of the coming week will be July's CPI inflation release on Tuesday. Despite an anticipated pickup in prices last month, the annual CPI rate is expected to remain comfortably below 2%Y/Y. And the core CPI rate is expected to move sideways at 2.1%Y/Y. A data-packed Thursday will also bring some key releases including industrial production and retail sales figures for July, Q3 productivity and labour costs data, the Philly Fed, Empire Manufacturing and NAHB housing market indices for August and business inventories numbers for June. Friday's highlight will be the preliminary University of Michigan's consumer sentiment survey for August, alongside housing starts figures for July. There are no UST bond auctions scheduled in the coming week.

Germany: Exports and export orders PMI



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

France: Manufacturing production and PMI



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

UK

First quarterly drop in GDP for six years

UK economic output shrank for the first time in six years in Q2. GDP dropped a larger-than-expected 0.2%Q/Q, versus the consensus (and BoE) expectation of zero growth, and our own forecast of a decline of 0.1%Q/Q. Compared to a year earlier, output slowed 0.6ppt to 1.2%Y/Y, the weakest rate in five quarters, and close to the bottom of the range of the past nine years. The drop followed growth in Q1 of 0.5%Q/Q, which had been boosted by Brexit-related precautionary stock-building. By the same token, given the temporary relief provided by the Article 50 extension to end-October, inventories subtracted a whopping 3.8ppts from growth in Q2. But just as the boost from stocks in Q1 had been partly negated by a surge in imports (up 10.8%Q/Q), so too was the effect in Q2 partly mitigated by a plunge in imports (down by a record 12.9%Q/Q). But with exports falling too (down 3.3%Q/Q, the steepest drop since the euro crisis in 2012), the contribution from net trade of 3.3ppts was insufficient to compensate for the unfavourable inventory adjustment.

Business investment weakens again

In terms of final domestic demand, the recent trends were maintained. With income growth relatively firm, household behaviour seemingly remained immune to the political mess, with private consumption rising 0.5%Q/Q, down just 0.1ppt from the prior quarter. But the dark cloud cast by Brexit continued to harm business investment, which declined 0.5%Q/Q, more than fully reversing the growth of the first quarter to be down 1.6%Y/Y, to move back below levels seen as far ago as H213. At the sectoral level, services were the sole source of growth, with output up just 0.1%Q/Q, the weakest in three years. In contrast, production fell 1.4%Q/Q, the most since Q412, driven by a decline of 2.3%Q/Q in manufacturing, partly as summer maintenance in car factories was brought forward to April. Construction output also fell sharply, down 1.3%Q/Q, the most in five quarters.

Expect modest rebound in Q3, but weakness thereafter

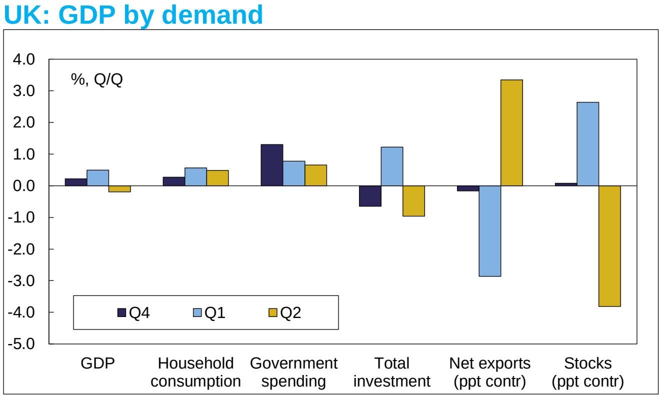
Looking ahead, we expect GDP to return to growth in Q3 as inventory accumulation (and car production) picks up again. But business capex is likely to remain weak and surveys suggest a moderation in consumer spending. Thereafter, of course, everything will depend on Brexit. If, as in our baseline forecast, the Article 50 deadline is extended again to accommodate a general election, we think that the level of GDP will be broadly unchanged in Q4, as temporary factors again unwind against the backdrop of a much weaker growth trend. If, however, the UK leaves at end-October without a deal, we would expect GDP to fall sharply in Q4 and in the first quarter of 2020. Regardless, with inflation set to fall back below target, we think that either scenario would merit BoE monetary easing.

The week ahead in the UK

In the UK, the coming week will bring key figures on the labour market (Tuesday), inflation (Wednesday) and retail sector (Thursday). In particular, employment growth is expected to have picked up in the three months to June, from an equivalent increase of 26.6k in May, not least due to the strength in April (up 434k). So, the headline unemployment rate is expected to remain unchanged at 3.8% in June. Wednesday's inflation release is expected to show both the headline and core CPI rates moving sideways in July at 2.0%Y/Y and 1.8%Y/Y respectively. But producer price figures are likely to illustrate the disinflationary pressures down the pipeline, not least associated with falling energy prices. But while prices on the high street have also declined over recent months, surveys suggest that retail sales weakened in July – indeed, sales are expected to have declined ½%M/M, albeit only partly offsetting the increase in June. In the markets, the DMO will sell 2049 Gilts on Tuesday.

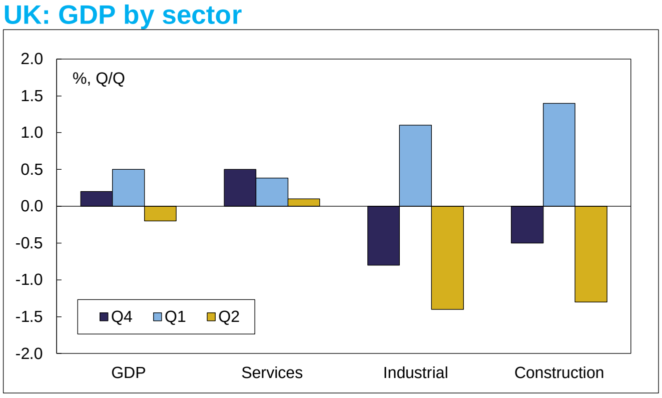
In the absence of significant news, the next edition of the Euro wrap-up will be published on 13 August 2019

UK: GDP by demand



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP by sector



Source Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Daiwa economic forecasts

	2019				2020				2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP forecasts %, Q/Q											
Euro area	0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.1	1.8	1.0	0.8
Germany	0.4	0.0	0.2	0.2	0.2	0.3	0.2	0.1	1.4	0.7	0.9
France	0.3	0.2	0.3	0.3	0.3	0.3	0.2	0.2	1.7	1.1	1.1
Italy	0.1	0.0	0.0	0.0	0.0	0.1	-0.1	-0.1	0.7	0.1	0.1
Spain	0.7	0.5	0.4	0.4	0.4	0.4	0.4	0.3	2.6	2.3	1.6
UK	0.5	-0.2	0.3	0.0	0.2	0.2	0.2	0.1	1.4	1.1	0.6
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.4	1.4	1.0	1.0	1.4	1.3	1.4	1.5	1.8	1.2	1.4
Core CPI	1.0	1.0	0.9	1.0	1.1	1.2	1.3	1.4	1.0	1.0	1.2
UK											
Headline CPI	1.9	2.0	1.8	1.6	1.9	1.6	1.5	1.7	2.5	1.8	1.8
Core CPI	1.9	1.7	1.7	1.7	1.8	1.9	1.8	1.7	2.1	1.7	1.8
Monetary policy											
ECB											
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.40	-0.40	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.40	-0.60	-0.60
Net asset purchases*	0	0	0	50	50	50	0	0	15	50	0
BoE											
Bank Rate %	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.75	0.50	0.50
Net asset purchases**	0	0	0	0	0	0	0	0	0	0	0

**Monthly target €bn, end of period. **Monthly target £bn, end of period. Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ <u>*Daiwa forecast*</u>	Previous	Revised
Germany	Trade (current account) balance €bn	Jun	**16.8 (20.6)**	19.5 (21.7)	20.6 (16.5)	- (16.2)
	Exports (imports) M/M%	Jun	**-0.1 (0.5)**	-0.0 (0.3)	1.1 (-0.5)	1.3 (-0.3)
France	Industrial production M/M% (Y/Y%)	Jun	**-2.3 (0.0)**	-1.2 (1.0)	2.1 (4.0)	2.0 (3.9)
	Manufacturing production M/M% (Y/Y%)	Jun	**-2.2 (-0.6)**	-1.3 (0.7)	1.6 (3.4)	- (3.3)
Italy	Total trade balance €bn	Jun	**5.7**	-	5.3	5.4
	Final CPI (EU-harmonised CPI) Y/Y%	Jul	**0.4 (0.3)**	0.5 (0.4)	0.7 (0.8)	-
UK	Preliminary GDP Q/Q% (Y/Y%)	Q2	**-0.2 (1.2)**	-0.1 (1.2)	0.5 (1.8)	-
	Monthly GDP estimate M/M%	Jun	**0.0**	0.1	0.3	0.2
	Industrial production M/M% (Y/Y%)	Jun	**-0.1 (-0.6)**	-0.2 (-0.3)	1.4 (0.9)	1.2 (0.5)
	Manufacturing production M/M% (Y/Y%)	Jun	**-0.2 (-1.4)**	-0.3 (-1.1)	1.4 (0.0)	- (-0.2)
	Construction output M/M% (Y/Y%)	Jun	**-0.7 (-0.2)**	-0.4 (0.2)	0.6 (1.7)	0.3 (1.3)
	Services activity M/M% (3M/3M%)	Jun	**0.0 (0.1)**	0.1 (0.2)	0.0 (0.3)	- (0.2)
	Trade balance (goods trade balance) £bn	Jun	**1.8 (-7.0)**	-2.6 (-11.8)	-2.3 (-11.5)	-2.0 (-10.7)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 12 August 2019			
			- Nothing scheduled -			
			Tuesday 13 August 2019			
Germany		07.00	Final CPI (EU-harmonised CPI) Y/Y%	Jul	1.7 (1.1)	1.6 (1.5)
		10.00	ZEW current conditions balance (expectations)	Aug	-5.0 (-27.0)	-1.1 (-24.5)
Spain		08.00	Final CPI (EU-harmonised CPI) Y/Y%	Jul	0.5 (0.7)	0.4 (0.6)
UK		09.30	ILO unemployment rate 3M%	Jun	3.8	3.8
		09.30	Employment change 3M/3M '000s	Jun	69	28
		09.30	Average weekly earnings (excl. bonuses) 3M/Y%	Jun	3.7 (3.8)	3.4 (3.6)
		09.30	Claimant count rate % (change '000s)	Jul	-	3.2 (38.0)
			Wednesday 14 August 2019			
EMU		10.00	GDP – second estimate Q/Q% (Y/Y%)	Q2	0.2 (1.1)	0.4 (1.2)
		10.00	Industrial production M/M% (Y/Y%)	Jun	-1.1 (-1.3)	0.9 (-0.5)
		10.00	Employment Q/Q% (Y/Y%)	Q2	0.2 (1.1)	0.3 (1.3)
Germany		07.00	GDP – first estimate Q/Q% (Y/Y%)	Q2	-0.1 (0.1)	0.4 (0.7)
France		06.30	ILO unemployment rate %	Q2	8.6	8.7
		07.45	Final CPI (EU-harmonised) Y/Y%	Jul	1.1 (1.3)	1.2 (1.4)
UK		09.30	CPI (core CPI) Y/Y%	Jul	1.9 (1.8)	2.0 (1.8)
		09.30	PPI input prices (output prices) Y/Y%	Jul	0.2 (1.7)	-0.3 (1.6)
		09.30	ONS house price index Y/Y%	Jun	1.0	1.2
			Thursday 15 August 2019			
UK		09.30	Retail sales including fuel M/M% (Y/Y%)	Jul	-0.2 (2.5)	1.0 (3.8)
		09.30	Retail sales excluding fuel M/M% (Y/Y%)	Jul	-0.2 (2.3)	0.9 (3.6)
			Friday 16 August 2019			
EMU		10.00	Trade balance €bn	Jun	18.6	20.2

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 12 August 2019
			- Nothing scheduled -
			Tuesday 13 August 2019
Italy		10.00	Auction: to sell €3bn of 0.49% 3Y bonds
		10.00	Auction: to sell €2.5bn of 1.24% 7Y bonds
UK		10.30	Auction: to sell €2bn of 1¾% 30Y bonds
			Wednesday 14 August 2019
Spain		09.45	Auction: to sell bonds
			Thursday 15 August 2019
			- Nothing scheduled -
			Friday 16 August 2019
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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