Euro wrap-up

Overview

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- Despite a downwards revision to euro area CPI and a Bundesbank report flagging recession risks, euro area equities made solid gains while govvies made notable losses.
- Gilts also made modest losses, despite a leaked UK government paper suggesting widespread disruption in a no-deal Brexit outcome.
- Tomorrow will bring euro area construction output and a UK manufacturing sentiment survey. In addition, Italy's PM Conte faces a no-confidence vote.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/21	-0.911	+0.016
OBL 0 10/24	-0.883	+0.016
DBR 0 08/29	-0.649	+0.041
UKT 1½ 01/21	0.510	+0.002
UKT 1 04/24	0.400	+0.006
UKT 1 ⅝ 10/28	0.485	+0.018

*Change from close as at 4:15pm BST.
Source: Bloomberg

Euro area

Euro area CPI revised lower

As we had expected, today's final euro area inflation figures saw the headline CPI rate revised lower from the flash estimate in July by 0.1ppt to 1.0%Y/Y, leaving it 0.3ppt lower than June and the lowest rate since November 2016. The downwards revision principally reflected lower energy inflation with the 0.1ppt adjustment leaving it 1.2ppts lower on the month at 0.5%Y/Y, similarly the lowest for more than 2½ years. While food price inflation was also nudged slightly lower from the flash release it was still 0.3ppt higher on the month at 1.9%Y/Y, a five-month high. But the core elements were left unchanged from the initial estimate i.e. non-energy industrial goods prices were up 0.4%Y/Y, a rise of 0.1ppt on the month, while services inflation stood at 1.2%Y/Y, a drop of 0.3ppt from June. So, core CPI was unrevised at 0.9%Y/Y, to leave it 0.2ppt lower than June. While core inflation is expected to move broadly sideways over coming months, the current rate is less than half the ECB's price stability target. And with energy prices set to subtract from inflation over the near term, headline CPI will fall slightly below 1%Y/Y over coming months too, further reinforcing our expectation that the ECB will unveil an extensive easing package at its meeting next month, including a 20bps rate cut to -0.60%, a tiered interest framework and a new net asset purchase programme, of circa €50bn per month over nine months to end-June 2020.

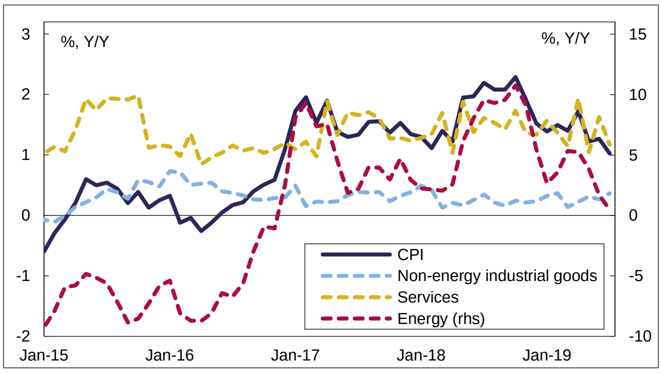
Bundesbank flags recession risks

Of course, the ECB's decision will be guided by updated staff projections for both inflation and growth. In his respect, the Bundesbank's latest monthly report, published today, further illustrated the growing downside risks to the growth outlook in the euro area's largest member state. Indeed, after GDP figures last week confirmed that the economy contracted in Q2, the Bundesbank expects output to remain 'lacklustre' in the third quarter. The report also flagged concerns about the impact of persistent external weakness on the manufacturing sector eventually feeding through to the service sector. The Bundesbank also drew attention to the impact of the recent slowdown on the labour market, with employment rising at a considerably slower rate in the second quarter. So, with surveys having signalled a further deterioration in business conditions at the start of Q3, overall, the Bundesbank concluded that there was a risk that Germany's output could 'continue to fall slightly in Q3', which would take the economy into a technical recession for the first time since the financial crisis over a decade ago.

Current account narrows in June

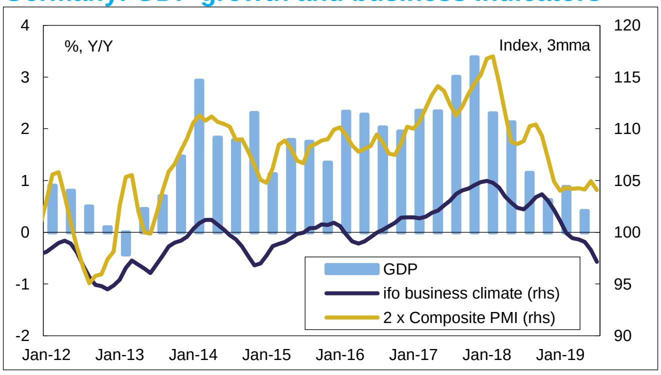
In other news, the euro area's balance of payments figures today saw the current account surplus fall a larger-than-expected €12bn, to €18.4bn, a near-2½-year low. This partly reflected a more challenging external environment, with an associated narrowing of the euro area's trade goods surplus to €25.2bn. But there was a larger drop in the services surplus, to €2.9bn,

Euro area: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth and business indicators



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

the lowest since 2016. And the primary and secondary income balances fell to a three-month and six-month low respectively. In the twelve months to June, the current account balance stood at a still-healthy €318bn (2.7% of GDP), albeit down from €391bn (3.4% of GDP) in June 2018. The financial account data reported another month of net inflow of capital in the euro area as residents were again net sellers of foreign assets. Non-residents were also net sellers of euro area debt in June. However, that development is likely to have reversed over the past month or so as expectations of new ECB policy easing increased.

The day ahead in the euro area and US

Tomorrow will bring euro area construction output figures for June. Following the modest growth seen in construction activity in Germany (0.2%M/M) and France (1.2%M/M) in June, we expect aggregate euro area output to have risen in the sector too. But given the weakness in the previous two months, we still expect construction to have contracted in Q2, albeit reversing only part of the near-2%Q/Q increase in Q1. Focus tomorrow will also turn to Italian politics, with PM Conte facing a likely defeat in the Senate’s no confidence vote. What comes thereafter, however, will depend on President Mattarella, who, on the basis of forthcoming consultations, will have to determine whether to call a new general election or instead propose an alternative government capable of winning the support of a majority in parliament.

It should be a quiet day in the US with no top-tier data due for release.

UK

The day ahead in the UK

While the UK government attempted to play down the findings from the weekend’s leaked ‘Operation Yellowhammer’ paper predicting that a no-deal Brexit would lead to, among other damaging impacts, severe extended delays to medical supplies, food and petrol shortages, and the return to a hard border in Ireland, business groups admitted that many companies, particularly small firms, were still ill-prepared for a no-deal Brexit on 31 October, not least blaming a lack of clarity from the government. And tomorrow’s CBI industrial trends survey seems bound to further highlight the downside risks facing British manufacturers against the backdrop of continued Brexit uncertainty. Indeed, in July, manufacturers suggested that orders were at their weakest for more than nine years.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Current account balance €bn	Jun	**18.4**	-	29.7	30.3
		Final CPI (core CPI) Y/Y%	Jul	**1.0 (0.9)**	*1.0 (0.9)*	1.3 (1.1)	-
Italy		Current account balance €bn	Jun	**5.0**	-	2.6	2.7
UK		Rightmove house prices M/M% (Y/Y%)	Aug	**-1.0 (1.2)**	-1.0 (1.2)	-0.2 (-0.2)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		10.00	Construction output M/M% (Y/Y%)	Jun	-	-0.3 (2.0)
Germany		07.00	PPI M/M% (Y/Y%)	Jul	0.0 (1.0)	-0.4 (1.2)
UK		11.00	CBI industrial trends survey - total orders (selling prices)	Aug	-25 (-)	-34 (12)

Auctions

Country		BST	Auction/Event
Italy		-	Italian Prime Minister Conte faces vote of no confidence
UK		10.30	Auction: to sell 0.125% index-linked 2028 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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