Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds and BTPs made significant gains as Italian PM Conte announced his resignation and data confirmed another poor month for euro area construction output.
- Gilts were little changed after UK PM Johnson proposed a Brexit policy incompatible with an open border on the island of Ireland.
- After a relatively quiet Wednesday, Thursday will bring the euro area's flash PMIs for August and the account of the ECB's latest policy meeting.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/21	-0.919	-0.010
OBL 0 10/24	-0.913	-0.029
DBR 0 08/29	-0.695	-0.043
UKT 1½ 01/21	0.486	+0.026
UKT 1 04/24	0.377	+0.009
UKT 1 ⅝ 10/28	0.459	-0.006

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

Euro area

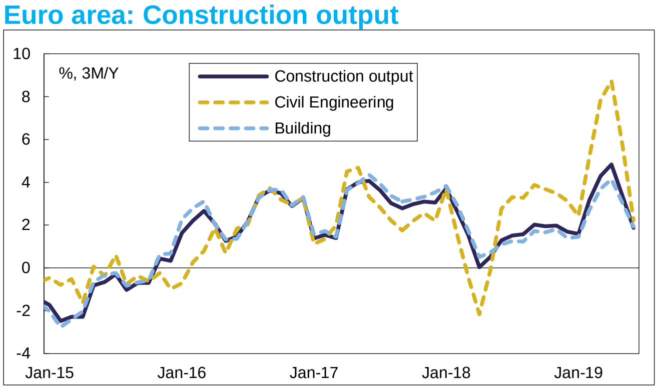
Italian PM Conte resigns, but next steps unclear

There were no major surprises on the Italian political front today, as Prime Minister Giuseppe Conte announced his resignation in a special session of the Senate. With Deputy Prime Minister Matteo Salvini of the far-right League having already effectively pulled the plug on his party's coalition government with the populist Five Star Movement, the announcement from the politically independent Conte simply avoided the ignominy of a defeat in a vote of no confidence that would otherwise have been inevitable. What comes next, however, will depend on President Sergio Mattarella, who will consult with the various party leaders over coming days. Depending on his findings, he will determine whether to call a new general election for late October at the earliest – which would seem highly likely to result in a new right-wing government led by Salvini – or instead propose a new government tasked, at a minimum, with preparing a Budget for 2020. If such a new government is indeed to be established without the need for an early election, agreement between Five Star and the centre-left Democrats will likely be required. Relations between those parties over recent years have been acrimonious. However, reports today suggested that initial discussions this week on a possible new pact had been positive. Nevertheless, even if an early general election can be avoided this autumn, given the difficult decisions on fiscal policy to be taken, we would expect any new government to be relatively short-lived. So, sooner or later, a new general election will be required, and before too long Salvini will probably become Prime Minister – a development that would likely imply renewed conflict with the EU institutions and increased concerns about Italy's fiscal metrics.

Euro area construction contracted in Q2

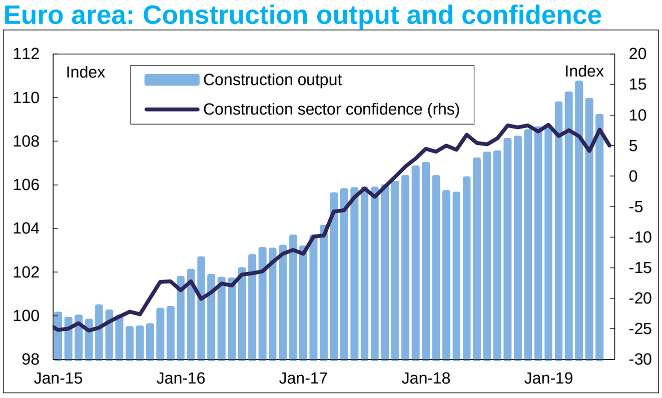
Having reached a series high at the start of the year, confidence among euro area construction firms has subsequently been on a gradual downward trend. Consistent with that softening of sentiment, activity in the sector declined in four out of the first five months of the year. And, contrasting with expectations, today's figures suggested that construction output failed to grow again in June. While building work increased for the first month in four in June (0.3%M/M), civil engineering fell for the third consecutive month (-0.4%M/M). So, total output in the sector was just 1.0% higher compared with a year earlier, considerably lower than the near-7%Y/Y increase seen in February. Moreover, over the second quarter as a whole, output was down 0.9%Q/Q, the first contraction for five quarters. But while Germany and France saw sizeable declines over the quarter too (down 1.1%Q/Q and 1.4%Q/Q respectively), construction output in Spain rose 1.4%Q/Q reversing some of the steep drop recorded in Q1. While some of the weakness last quarter might well be attributed to the heat-wave affecting the largest member states, surveys are hardly encouraging about the outlook at the start of Q3, with the Commission's confidence indicator having fallen in July to its second lowest reading in fifteen months.

Euro area: Construction output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output and confidence



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The coming two days in the euro area and US

After a day with no notable economic data tomorrow, Thursday will bring the most noteworthy releases of the week with the flash PMIs and Commission's consumer confidence indicator for August. While consumer confidence improved slightly in July, there was a further deterioration in business confidence, particularly in the industrial sector. Indeed, the euro area's manufacturing PMI fell 1.1pts to 46.5, the lowest since December 2012. And with geopolitical tensions having risen over recent weeks, we would expect to see a further worsening of conditions reported in that sector this month too. Service sector sentiment was more stable in July – with the headline activity index down 0.4pt to 53.2 – to leave the composite PMI in expansionary territory (51.5). But while this indicator should remain above the key-50 level in August it is likely to signal a further moderation in economic growth.

Also of interest on Thursday will be the ECB's account from its July Governing Council meeting, at which President Draghi gave a clear steer that a multi-faceted easing package will be forthcoming in September, for any further insight into the policy measures likely to be preferred by Governing Council members. Supply-wise, Germany will tomorrow sell €2.2bn of a 0% coupon 30Y bond for the first time.

In the US, ahead of Fed Chair Powell's keynote speech at Jackson Hole on Friday, the publication of the minutes tomorrow from the FOMC's end-July meeting, where it cut the FFR target range by 25bps to 2.00-2.25% but offered a less dovish assessment than expected in its statement, will also attract some attention. Data-wise, tomorrow will bring existing home sales figures for July, followed on Thursday by the flash PMIs for August, the Conference Board's leading index for July and the weekly jobless claims numbers.

UK

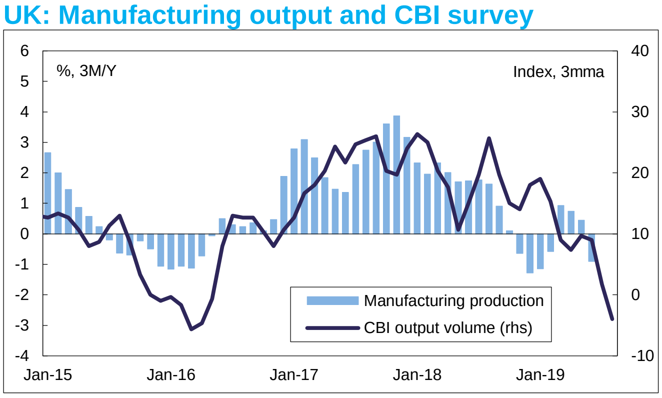
Johnson advocates "alternative arrangements" to the backstop

Ahead of his first meetings as UK Prime Minister with the German and French leaders over the coming two days, Boris Johnson's letter to EU Council President Tusk yesterday evening set out his government's new position on what to do about the Irish border after Brexit. True to form for Johnson, however, the letter was not a serious effort to help find a solution. It offered no new constructive proposals for how the UK and EU might possibly meet the obligations of the Good Friday Agreement by maintaining an open border if and when the UK leaves the Single Market and Customs Union. Instead, Johnson merely advocated "alternative arrangements" to the current negotiated backstop arrangements. And he provided no detail how these might be implemented in practice. However, that should not come as a surprise, since workable "alternative arrangements" simply don't – and might never – exist.

Proposal a non-starter for the EU

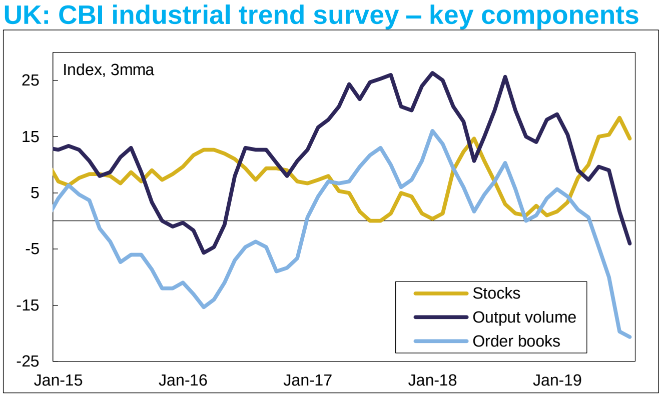
Being well aware that his suggestion fails to offer a legal, operational solution to prevent the return of a hard border on Ireland, the EU leaders will certainly not agree to the approach put forward in Johnson's letter. And a tweet from Tusk today made clear that, as far as he is concerned, Johnson's proposals would indeed be tantamount to re-establishing a border. Moreover, while Johnson's letter might (generously) be interpreted as only an opening gambit in an attempt to win new concessions – such as some form of time limit on the backstop – to be able eventually to secure a parliamentary majority for a deal, his tactics are likely to have significantly annoyed European leaders and seem bound to have further eroded their trust and goodwill. So, once again, the overall impression is that Johnson has no interest in meaningful negotiations, and would care little if the UK left the EU without a deal at end-October. And rather than representing a meaningful first attempt to try to find new common ground with the EU, Johnson's letter was most likely aimed principally at a domestic political audience, representing another attempt to regain support from Brexit Party voters ahead of a likely autumn general election.

UK: Manufacturing output and CBI survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trend survey – key components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturers still downbeat about outlook

Persistent Brexit uncertainty, combined with a more challenging global environment, has seen conditions in the UK manufacturing sector deteriorate significantly over recent months. Indeed, the decline of more than 2%Q/Q in output in Q2 was the steepest for more than a decade, albeit largely representing a reversal of the Brexit-related boost in Q1. And while today's CBI industrial trends survey suggested that output stabilised somewhat in August, the underlying message was still one of significant weakness. For example, despite rising 8pts in August the output indicator (-3) remained in negative territory for the second successive month, the first consecutive negative readings since the start of 2016. While order books improved somewhat from July's levels – when the relevant index had fallen to its lowest for more than nine years – they were still judged to be well below the norm for this time of year. And with inventories still at elevated levels, manufacturers were more downbeat about their expectations for output over the coming three months, with the relevant indicator falling 7pts to -1, the third-lowest reading since 2015. As significant uncertainty about the path for Brexit is likely to persist well into September – and perhaps right up to the end-October Article 50 deadline or beyond –manufacturers seem likely to remain highly uneasy for a while to come.

The coming two days in the UK

Most attention in the UK over coming days will be on the first meetings between PM Johnson and German Chancellor Merkel (tomorrow) and French President Macron (Thursday), ahead of the G7 leaders' summit at the end of the week. Not least given the unhelpful nature of Johnson's letter to Donald Tusk, however, we would expect little constructive on Brexit to arise from these discussions.

Data-wise, tomorrow will bring just UK public finance figures for June, followed on Thursday by the CBI's distributive trades survey for August. And, not least given ongoing Brexit uncertainty, retailers are likely to remain broadly downbeat about conditions, with the survey's headline balance expected to report the fourth consecutive negative reading, which would be the worst performance since 2011.

In the absence of significant news, the next edition of the Euro wrap-up will be published on 22 August 2019

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Construction output M/M% (Y/Y%)	Jun	**0.0 (1.0)**	-	-0.3 (2.0)	-0.5 (1.7)
Germany	PPI M/M% (Y/Y%)	Jul	**0.1 (1.1)**	0.0 (1.0)	-0.4 (1.2)	-
UK	CBI industrial trends survey - total orders (selling prices)	Aug	**-13 (-2)**	-25 (-)	-34 (12)	-

Auctions

Country	Auction
UK sold	£1.1bn of 0.125% index-linked 2028 bonds at an average yield of 2.965%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Spain	09.00	Trade balance €bn	Jun	-	-2.1
UK	09.30	Public sector net borrowing £bn	Jul	-2.7	7.2

Auctions

Country	BST	Auction/Event
Germany	10.30	Auction: to sell €2bn of 0% 2050 bonds
	-	German Chancellor Merkel to meet with UK Prime Minister Johnson

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09.00	Preliminary composite PMI	Aug	51.2	51.5
	09.00	Preliminary manufacturing PMI (services PMI)	Aug	46.3 (53.0)	46.5 (53.2)
	15.00	Preliminary consumer confidence	Aug	-7.0	-6.6
Germany	08.30	Preliminary composite PMI	Aug	50.6	50.9
	08.30	Preliminary manufacturing PMI (services PMI)	Aug	43.0 (54.0)	43.2 (54.5)
France	08.15	Preliminary composite PMI	Aug	51.8	51.9
	08.15	Preliminary manufacturing PMI (services PMI)	Aug	49.5 (52.5)	49.7 (52.6)
UK	11.00	CBI distributive trades survey – reported retail sales	Aug	-13	-16

Auctions

Country	BST	Auction/Event
EMU	12.30	ECB publishes account of July Governing Council meeting
France	-	French President Macro to meet with UK Prime Minister Johnson

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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