Daiwa Capital Markets

# Euro wrap-up

## Overview

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- While flash euro area inflation data were subdued and German retail sales fell sharply, Bunds made modest gains and BTPs sold off as another hawkish ECB policymaker questioned the merits of a new round of QE.
- As the UK's political crisis rolled on, Gilts made losses despite some further downbeat economic sentiment surveys.
- The coming week brings plenty more political noise, including efforts by UK MPs to try to prevent a no-deal Brexit, while new economic data include final euro area and UK PMIs, euro area retail sales, and German factory orders and IP.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 0 09/21 | -0.944 | -0.023 |
| OBL 0 10/24 | -0.934 | -0.023 |
| DBR 0 08/29 | -0.719 | -0.023 |
| UKT 3¾ 09/21 | 0.382 | +0.021 |
| UKT 1 04/24 | 0.316 | +0.020 |
| UKT 0⅞ 10/29 | 0.461 | +0.024 |

*Change from close as at 4:00pm BST.
Source: Bloomberg

# Euro area

### Inflation still subdued at just 1.0%

With the ECB's Governing Council policy-setting meeting to be held in less than two weeks' time, the euro area economic dataflow remains downbeat. While yesterday's Commission Economic Sentiment Indicator posted a modest improvement in August, like today's German retail sales data (see below) it still suggested a weaker pace of economic growth in Q3 rather than the acceleration suggested by the ECB's most recent GDP forecasts. And today's flash euro area CPI release suggested that price pressures remain very weak and that the ECB's inflation forecasts will also need to be revised down. In particular, headline inflation moved sideways in August at just 1.0%Y/Y, matching the lowest rate since November 2016. While energy inflation (down 1ppt to -0.6%Y/Y) was a drag on the headline rate for the first time since 2016, food inflation accelerated to a six-month high (up 0.2ppt to 2.1%Y/Y). In addition, the year-on-year increase in non-energy industrial goods prices was unchanged at a paltry 0.4%Y/Y, while services inflation was nudged only slightly higher to 1.3%Y/Y. As such, the core CPI rate was unchanged at just 0.9%Y/Y. Admittedly, to two decimal places, core inflation was 0.08ppt higher at 0.95%Y/Y, nevertheless barely half way to the ECB's price stability target.

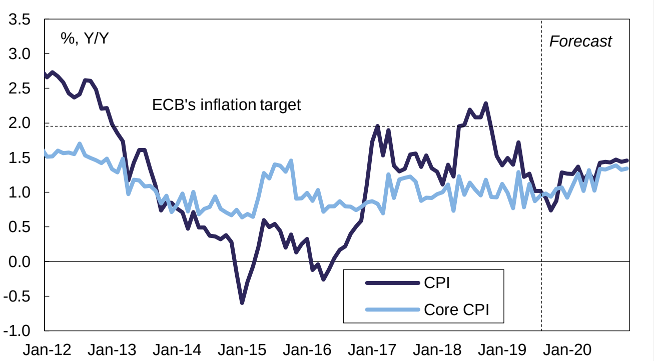
### Labour market remains steady

Like other major central banks, the ECB was hoping that positive developments in the labour market would help it push inflation back to target. The labour market has indeed tightened considerably over recent years, and repeatedly so ahead of the ECB's expectations. Today's figures showed that the euro area unemployment rate remained unchanged at 7.5% in July, the joint-lowest since mid-2008, 0.6ppt lower than a year ago and down 4.6ppts from the peak. At the country level on the harmonised measure, jobless rates fell in Germany (a series low of 3.0%, consistent with shortages in certain sectors) and Spain (13.9%, the lowest in more than a decade), remained unchanged in France (8.5%), but edged higher in Italy (9.9%). With slower economic growth and diminished business confidence, however, there are indications that firms are revising down their recruitment plans. And so, in many member states, labour market slack will remain significant. And while business sector wage growth picked up to a near-seven-year high in Q1, we expect upwards pressure on labour costs to moderate. That is likely to leave domestically-generated inflation – particularly in the services sector, where prices are typically most sensitive to labour costs – below levels consistent with the ECB's target.

### Inflation to remain well below ECB's 2% target

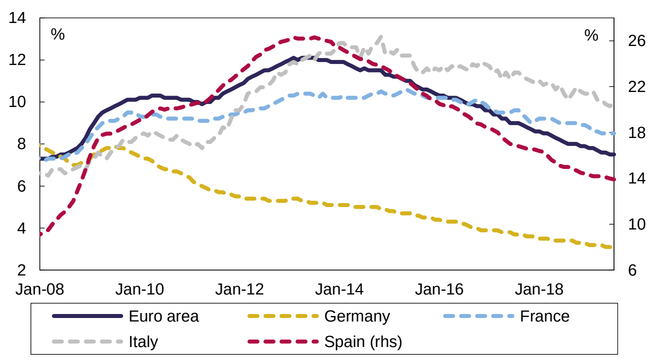
With pressures from the labour market likely to moderate, and inflation expectations around record lows, we see little prospect of the ECB sustaining inflation at its target over the forecast horizon. Indeed, over the near term, with energy prices

**Euro area: Consumer price inflation**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

**Euro area: Unemployment rates by member states**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

to remain a drag, we expect the headline CPI rate to edge back below 1.0%Y/Y from next month. But while it is likely to take a step up at the end of this year, we would expect headline inflation to remain below 1½%Y/Y at least through to the end of 2020. And we expect core inflation to average only just above 1.0%Y/Y next year. Most importantly, at its next meeting, the Governing Council will likely agree that its most recent projections were overoptimistic. As such, it will also expect the medium-term inflation outlook to fall short of its aim. And, in response, it will agree a large-scale monetary easing package.

## Hawks likely to lose battle over new QE programme

Precisely what policy measures the ECB will agree at its next meeting, of course, remains uncertain. While they seem to agree that a further interest rate cut is required, the most hawkish members of the Governing Council appear to be trying to resist the launch of a new programme of net asset purchases. Tallying with comments from Bundesbank President Weidman on the weekend and Dutch National Bank President Knot yesterday, today German ECB Executive Board member Lautenschlaeger argued that she didn't see the need for a new QE programme. We are not overly surprised, however. These three policymakers failed to back, but also failed to prevent, the ECB's previous QE programme. They will remain in a minority this time around too. Chief Economist Lane made a strong case earlier in the year that a package of measures, including both a rate cut and QE, would be more effective at boosting inflation that more selective action. And we strongly believe that a majority of members will agree with him at the next meeting. We still expect a cut of 20bps in the deposit rate to -0.60% and the launch of a new programme of net asset purchases of up to €50bn per month to be conducted through to June 2020, although the arguments of the hawks could see the size of QE programme scaled back somewhat.

## German retail sales data flag recession risk

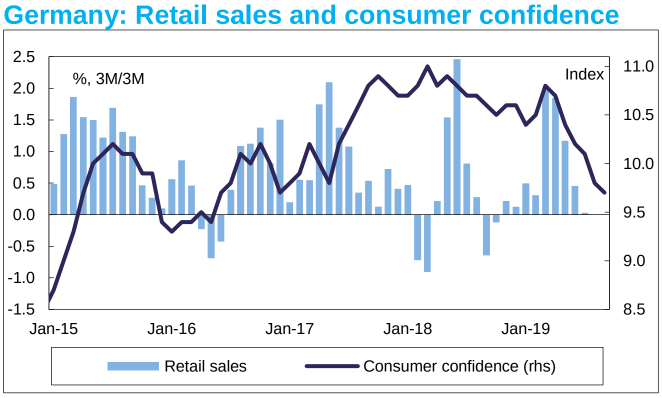
Finally, having slowed markedly in the second quarter, down 0.7ppt to just 0.1%Q/Q, German household consumption appears to have started Q3 on a soft note. Retail sales in real terms fell in July by 2.2%M/M, the steepest decline since December. To a large extent, this represented payback for the leap of 3.1%M/M the prior month. And the annual growth rate of 4.4%Y/Y appeared strong. But that figure partly reflected the higher number of days open for sale compared to the same month last year. And looking through the noise in this highly volatile series, retail sales growth slowed on a three-month basis to zero, the weakest rate in nine months. This doesn't automatically imply that overall consumer spending was weak: spending on services accounts for a larger share. However, today's figures raise the risk that retail sales, and consumption overall, will decline in Q3. So, they also add to evidence that Germany's economy has slipped into technical recession.

## The week ahead in the euro area and US

Politics will remain in the spotlight in the euro area in the coming week. Italy's Prime Minister-designate Giuseppe Conte will compile his list of Cabinet members, with the identities of the key ministers likely to be named on Wednesday before a parliamentary debate, which could be held from Friday. Before then, investors will watch the results of Sunday's German regional elections in Brandenburg and Saxony, where the nationalist AfD party is expected to do particularly well and the centre-left Social Democrats and Merkel's CDU are expected to do poorly, to raise further questions about the future of the federal coalition government.

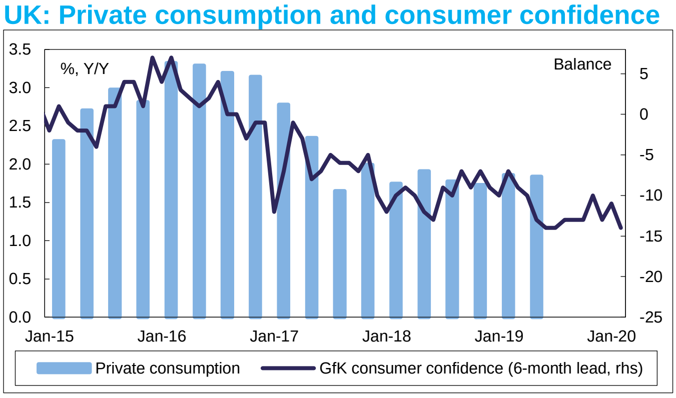
The coming week will bring a number of noteworthy data releases, including the euro area's updated national accounts for Q2 on Friday. While we expect GDP growth to align with the previous estimate of 0.2%Q/Q, this release will provide the first official expenditure breakdown, in which the weakness of exports will be striking. Friday will also see revised euro area employment data for Q2, which are similarly expected to confirm that growth moderated 0.2ppt to 0.2%Q/Q, with the accompanying country breakdown likely to show softer growth across the member states. More up-to-date information about the extent of economic growth in Q3 will come on Wednesday from euro area retail sales figures for July, which are likely to indicate a soft start to the third quarter after a surge at the end of Q2. The first half of the week will also bring the final August manufacturing and services PMIs on Monday and Wednesday respectively. While the preliminary release showed a modest improvement in the headline euro area manufacturing and services PMIs, the former still recorded its second-lowest reading

### Germany: Retail sales and consumer confidence




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

### UK: Private consumption and consumer confidence




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

for more than six years. And while the flash composite PMI rose 0.3pt in August to 51.8, this was merely in line with the average in Q2, and therefore consistent with still-subdued GDP growth.

At the country level, Germany's manufacturing sector will be the main focus, with factory orders and IP data for July due for release on Thursday and Friday respectively. Friday will also bring German labour costs figures for Q2, as well as French trade numbers for July. Elsewhere, ECB chief economist Philip Lane will speak in London on Wednesday and Vice-President Luis de Guindos will speak in Frankfurt on Thursday. In the markets, Germany will sell 5Y BOBLs on Tuesday, while France and Spain will sell bonds with various maturities on Thursday.

In the US, after a quiet start to the week with markets closed on Monday for the Labour Day holiday, the coming week's data calendar will be a busy one for top-tier releases, kicking off with the manufacturing ISM and final Markit PMI for August, and construction spending figures for July. Wednesday's highlights will be July's full trade report and vehicle sales figures for August. Meanwhile, Thursday will bring the non-manufacturing ISM and final Markit services PMI for August, factory orders data for July, revised productivity and labour costs figures for Q2 and the ADP employment survey for August. Of course, of more significance with respect to the labour market will be Friday's employment report, with non-farm payrolls in August expected to have risen at a similar pace to the 164k increase recorded in July. As such, the unemployment rate is likely to remain unchanged at 3.7%, while average hourly earnings growth is expected to have moderated slightly. There are no UST bond auctions due in the coming week.

# UK

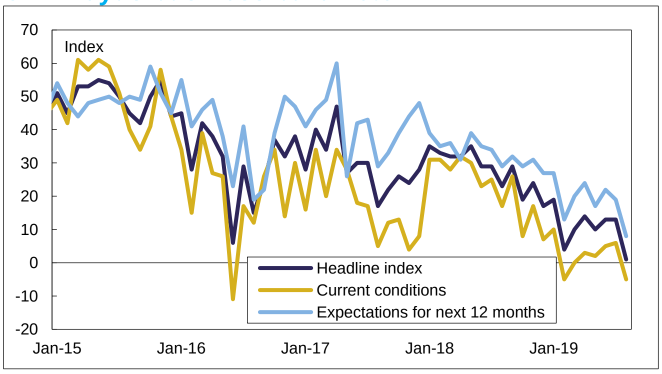
## Consumers most pessimistic since mid-2013

As the UK's political crisis continued to intensify – illustrated by the decision of one former Conservative Prime Minister John Major to join legal action against the decision of current (unelected) Conservative Prime Minister Johnson to shut down Parliament for five weeks – further evidence of the adverse impact of Brexit uncertainty on the economy came from the GfK consumer confidence survey and the Lloyds business barometer. In particular, the GfK survey's headline indicator declined 3pts in August to -14, matching the 5½-year low reached at the start of the year. And while the weakness was broad based, households were notably more downbeat about the economic outlook over the coming twelve months and therefore were more concerned about their personal finances over the next year too. So, it was perhaps not surprising to see their willingness to buy durable goods slip back this month too. This tallies with the increasingly pessimistic tone from recent surveys from the retail sector. So, while today's BoE lending figures showed a further increase in net consumer credit in July, we maintain our view that household consumption growth will weaken in Q3. And even if a no-deal Brexit is avoided, we anticipate more subdued spending growth over coming quarters too.

## Business confidence at a multi-year low

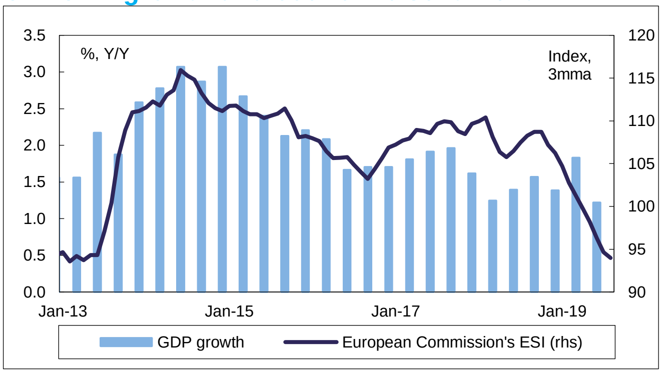
While the Lloyds business barometer has remained broadly stable over the past five months, against the increasingly dysfunctional political backdrop and mounting fears of a no-deal Brexit, this sentiment survey also took a notable turn for the worse in August. Indeed, the headline indicator fell 12pts to 1, the lowest level since 2011. Businesses were unsurprisingly more pessimistic about the current economic conditions – the relevant index fell 11pts to -5, matching February's low, which was the weakest since the post-referendum slump in 2016. But they also assessed the outlook over the coming twelve months to be the worst since early 2009 during the global financial crisis. Within the sector breakdown, confidence among manufacturers, services and retailers saw notable declines, while the construction sector bucked the trend. With the exception of the manufacturing sector, today's Lloyds survey echoed the findings from yesterday's European Commission survey, which saw the headline economic sentiment index fall for the fourth month out of the past five to the lowest since September 2012. On average so far in Q3, this index is almost 3pts below its average in Q2, suggesting that the UK's economy is on track for another contraction in the current quarter.

### UK: Lloyds business barometer




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

### UK: GDP growth and economic sentiment




*Source: European Commission, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

### The week ahead in the UK

The coming week could be a pivotal one for Brexit. On Tuesday, MPs are set to vote on a proposal to provide parliamentary time to prepare legislation compelling the Prime Minister to request an extension to the Article 50 deadline beyond end-October if the alternative would be a no-deal Brexit. If there are sufficient Conservative party rebels to allow the proposal to pass, the question over the remainder of the week will be whether MPs have sufficient time to pass a bill ahead of Johnson's forced extended shutdown of Parliament the following week. It is possible that one House or the other will sit through the following weekend, but even then anti-no-deal MPs could run out of time. Particularly if the attempt to draft legislation to prevent a no-deal Brexit fails, it is also possible that a vote of no confidence in the government will be called. If the government was to lose such a confidence vote, MPs from a range of parties might choose to hold their noses and unite around a coalition led by Labour leader Jeremy Corbyn. An alternative could be a general election, either before or after the Article 50 deadline.

Aside from the politics, the coming week's data calendar will be dominated by August sentiment surveys, with particular focus on the PMIs in the first half of the week. While market expectations are for a modest improvement in the manufacturing survey (due Monday), the headline index (48.0 in July) seems highly likely to signal ongoing marked contraction in the sector in August for the fourth consecutive month. Likewise, the construction PMI (due Tuesday) is likely to remain little changed from July (45.3) to remain firmly in contractionary territory. The services PMI (due Wednesday) might well reverse some of the 1.2pts increase in July (to 51.4) to signal very subdued growth in the sector in August. As such, the composite PMI might well slip back from the 50.7 reading in July, with a chance the all-sector PMI will fall below the key-50 level. Tuesday will also bring the latest BRC retail sales monitor, which is likely to signal weak retail sales growth over the past month, while Thursday's release of new car registrations figures are likely to report a further decline in August. Elsewhere, BoE policy makers, including Carney, Haldane, Haskel and Vlieghe, will appear before the Treasury Select Committee on Wednesday to testify on the Bank's most recent Inflation Report and the UK's economic relationship with the EU. In the markets, the DMO will sell 10Y Gilts on Tuesday and 5Y Gilts on Thursday.

# 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 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 1.9 | 1.0 | 0.7 |
| Germany | 0.4 | -0.1 | -0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 1.5 | 0.5 | 0.4 |
| France | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 | 1.7 | 1.3 | 1.2 |
| Italy | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | -0.1 | -0.1 | 0.7 | 0.0 | 0.1 |
| Spain | 0.7 | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 2.6 | 2.2 | 1.6 |
| UK | 0.5 | -0.2 | 0.2 | 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 | 1.3 | 1.2 | 1.4 | 1.5 | 1.8 | 1.2 | 1.4 |
| Core CPI | 1.0 | 1.1 | 0.9 | 1.0 | 1.1 | 1.1 | 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

| The coming week's key data releases | | | | | | |
|---|---|---|---|---|---|---|
| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
| | | | **Monday 2 September 2019** | | | |
| EMU | | 09.00 | Final manufacturing PMI | Aug | 47.0 | 46.5 |
| Germany | | 08.55 | Final manufacturing PMI | Aug | 43.6 | 43.2 |
| France | | 08.50 | Final manufacturing PMI | Aug | 51.0 | 49.7 |
| Italy | | 08.45 | Manufacturing PMI | Aug | 48.6 | 48.5 |
| Spain | | 08.15 | Manufacturing PMI | Aug | 48.4 | 48.2 |
| UK | | 09.30 | Manufacturing PMI | Aug | 48.8 | 48.0 |
| | | | **Tuesday 3 September 2019** | | | |
| EMU | | 10.00 | PPI M/M% (Y/Y%) | Jul | 0.2 (0.2) | -0.6 (0.7) |
| UK | | 00.01 | BRC retail sales monitor - like-for-like sales Y/Y% | Aug | 0.5 | 0.1 |
| | | 09.30 | Construction PMI | Aug | 46.0 | 45.3 |
| | | | **Wednesday 4 September 2019** | | | |
| EMU | | 09.00 | Final services PMI (composite PMI) | Aug | 53.4 (51.8) | 53.2 (51.5) |
| | | 10.00 | Retail sales M/M% (Y/Y%) | Jul | -0.5 (2.3) | 1.1 (2.6) |
| Germany | | 08.55 | Final services PMI (composite PMI) | Aug | 54.4 (51.4) | 54.5 (50.9) |
| France | | 08.50 | Final services PMI (composite PMI) | Aug | 53.3 (52.7) | 52.6 (51.9) |
| Italy | | 08.45 | Services PMI (composite PMI) | Aug | 51.6 (50.4) | 51.7 (51.0) |
| Spain | | 08.15 | Services PMI (composite PMI) | Aug | 53.0 (-) | 52.9 (51.7) |
| UK | | 09.30 | Services PMI (composite PMI) | Aug | 51.5 (-) | 51.4 (50.7) |
| | | | **Thursday 5 September 2019** | | | |
| Germany | | 07.00 | Factory orders M/M% (Y/Y%) | Jul | -1.4 (-4.0) | 2.5 (-3.6) |
| UK | | 09.00 | New car registrations Y/Y% | Aug | - | -4.1 |
| | | | **Friday 6 September 2019** | | | |
| EMU | | 10.00 | Final GDP Q/Q% (Y/Y%) | Q2 | 0.2 (1.1) | 0.4 (1.2) |
| | | 10.00 | Final employment Q/Q% (Y/Y%) | Q2 | 0.2 (1.1) | 0.4 (1.3) |
| Germany | | 07.00 | Industrial production M/M% Y/Y% | Jul | 0.3 (-3.8) | -1.5 (-5.2) |
| | | 07.00 | Labour costs Q/Q% (Y/Y%) | Q2 | - | 1.1 (2.5) |
| France | | 07.45 | Trade (current account) balance €bn | Jul | -4.5 (-) | -5.2 (-0.8) |
| Italy | | 09.00 | Retail sales M/M% (Y/Y%) | Jul | - | 1.9 (1.3) |
| UK | | 08.30 | Halifax house price index M/M% (3M/Y%) | Aug | 0.2 (3.4) | -0.2 (4.1) |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## The coming week's key events & auctions

| Country | BST | Event / Auction |
|---|---|---|
| **Monday 2 September 2019** | | |
| | | - Nothing scheduled - |
| **Tuesday 3 September August** | | |
| UK | - | MPs return to the House of Commons after summer recess |
| | 10.30 | Auction: to sell £2.75bn of the 0.875% 2029 bonds |
| **Wednesday 4 September 2019** | | |
| EMU | 12.00 | ECB's Lane due to speak in London |
| Germany | 10.30 | Auction: to sell €3bn of the 0% 2024 bonds |
| UK | 14.15 | BoE's Carney, Haldane, Haskel and Vlieghe to testify before the Treasury Select Committee |
| **Thursday 5 September 2019** | | |
| EMU | 08.00 | ECB's Guindos due to speak in Frankfurt |
| France | 09.50 | Auction: to sell bonds |
| Italy | - | Moody's to publish scheduled update on Italy's sovereign credit rating |
| Spain | 09.45 | Auction: to sell bonds |
| UK | 10.30 | Auction: to sell £3bn of the 0.625% 2025 bonds |
| | 15.30 | BoE's Tenreyro due to speak in Frankfurt |
| **Friday 6 September 2019** | | |
| | | - Nothing scheduled - |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Today's results

**Economic data**

| Country | Release | Period | Actual | Market consensus/ *Daiwa forecast* | Previous | Revised |
|---|---|---|---|---|---|---|
| EMU | Preliminary CPI (core CPI) Y/Y% | Aug | **1.0 (0.9)** | *1.0 (1.0)* | 1.0 (0.9) | - |
| | Unemployment rate % | Jul | **7.5** | 7.5 | 7.5 | - |
| Germany | Retail sales M/M% (Y/Y%) | Jul | **-2.2 (4.4)** | -1.3 (3.3) | 3.5 (-1.6) | 3.0 (-) |
| France | Preliminary CPI (EU-harmonised) Y/Y% | Aug | **1.1 (1.2)** | 1.0 (1.2) | 1.1 (1.3) | - |
| Italy | Preliminary CPI (EU-harmonised CPI) Y/Y% | Aug | **0.5 (0.5)** | 0.3 (0.5) | 0.4 (0.3) | - |
| | GDP – second release Q/Q% (Y/Y%) | Q2 | **0.0 (-0.1)** | 0.0 (0.0) | 0.1 (-0.1) | - |
| UK | GfK consumer confidence indicator | Aug | **-14** | -12 | -11 | - |
| | Lloyds business barometer | Aug | **1** | - | 13 | - |
| | Nationwide house price index M/M% (Y/Y%) | Aug | **0.0 (0.6)** | 0.1 (0.7) | 0.3 (0.3) | - |
| | Net consumer credit £bn (Y/Y%) | Jul | **0.9 (5.5)** | 1.0 (-) | 1.0 (5.5) | 1.1 (-) |
| | Mortgage lending £bn (approvals '000s) | Jul | **4.6 (67.3)** | 3.7 (66.1) | 3.7 (66.4) | 3.8 (66.5) |

**Auctions**

| Country | Auction |
|---|---|
| | - Nothing to report - |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*