Euro wrap-up

Overview

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- Bunds were little changed as the final euro area manufacturing PMIs underscored the impression of ongoing major weakness in the sector.
- Sterling weakened and Gilts made gains as the UK manufacturing PMI signalled sharp contraction, rebel MPs prepared an attempt to block a no-deal Brexit, and the Government appeared to prepare for an early election.
- Tuesday will see UK MPs try to legislate to prevent a no-deal Brexit, while euro area producer price data and UK retail and construction sector surveys will be released.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.940	-
OBL 0 10/24	-0.934	-0.004
DBR 0 08/29	-0.701	+0.004
UKT 3¾ 09/21	0.347	-0.039
UKT 1 04/24	0.282	-0.047
UKT 0⅞ 10/29	0.431	-0.051

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

Euro area

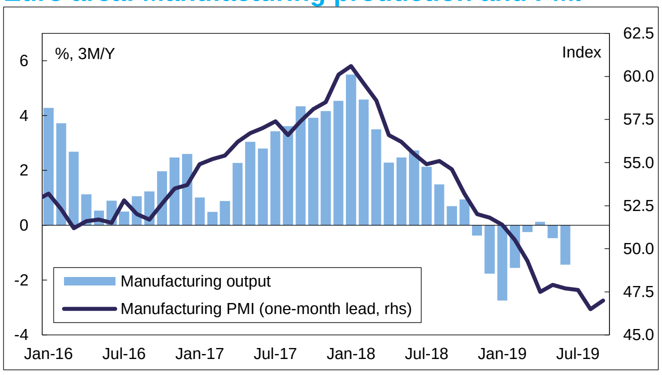
Euro area manufacturing PMI still weak

There were no major surprises from the final euro area manufacturing PMIs today, which, despite confirming the modest improvement seen in the flash release, still pointed to very weak conditions in the sector in August. Indeed, while the headline manufacturing index was 0.5pt higher than July, at 47.0 it was still the second-weakest since April 2013 and consistent with significant contraction. There were only very modest tweaks to the components too – for example, the output PMI was nudged slightly higher from the flash release (0.1pt) to 47.9, leaving it 1.0pt higher than July but nevertheless still signalling a decline in production last month, with the report suggesting particular weakness in the intermediate and investment goods sub-sectors. Indeed, Markit assessed today's figure to be consistent with a decline in production of roughly 1.0%Q/Q. While the improvement in the new export orders PMI was smaller than initially estimated in August, the total new orders component was unrevised at 45.9, 0.3pt higher than July but the eleventh consecutive sub-50 reading. Against this backdrop, manufacturers reportedly continued to scale back their workforces for the fourth consecutive month and were the least optimistic about the outlook over the coming twelve months since the euro crisis.

German, Italian and Spanish manufacturers still struggling

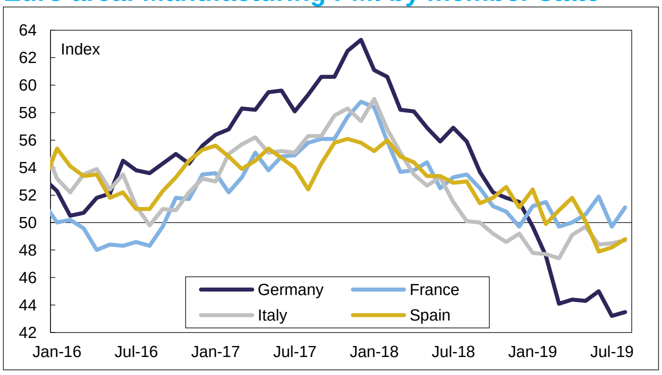
At the country level, there was a small downwards revision to Germany's final headline manufacturing PMI reducing the increase from July to just 0.3pt and at 43.5 still the second-lowest since 2012. While the solid improvement in the output component (1.6pts) was unrevised, at 45.8 it still marked a steep rate of decline in August for the seventh successive month. With new orders still declining at a sharp pace, there was an accelerated drop in the number of employees in the sector by the most since 2012, while sentiment about the near-term outlook was the weakest on record. In contrast, the final French manufacturing PMI was nudged slightly higher from the preliminary estimate to leave the headline index 1.4pts higher on the month at 51.1, with the output and new orders indices up 1.7pts and 2.0pts respectively, both back into expansionary territory. The Italian manufacturing PMI, published for the first time today, showed a more modest improvement in the headline and output indices than the two largest member states, up 0.2pt to 48.7 and 49.3 respectively. And the new orders component posted a notable decline of 1.7pts to just 46.0. The pickup in Spain's headline manufacturing PMI was only marginally more convincing, up 0.6pt to a still-contractionary 48.8. Moreover, the output component indicated a steeper pace of decline in August, down 0.9pt to 47.1, the weakest level for more than six years. So, according to the PMIs, Greece's manufacturing sector once again was the best performer in August, with the headline PMI up 0.3pt to 54.9.

Euro area: Manufacturing production and PMI



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

Euro area: Manufacturing PMI by member state



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

German nationalists just about kept at bay by establishment parties

Germany's federal government 'grand coalition' (or 'GroKo') has avoided a new crisis but remains fragile. The weekend's regional elections in two Eastern states saw the establishment parties ward off a challenge from the nationalist AfD, which nevertheless made significant gains from the previous such polls in 2014, particularly at the expense of the far-left Linke party. In Saxony, Merkel's CDU topped the poll again. But its share of the vote fell more than 7ppts, to a little more than 32%, while the AfD's rose almost 18ppts to 27.5%. Likewise, in Brandenburg, the SPD retained first position with about 26% of the vote, but was down about 6ppts from 2014. And the AfD came a competitive second there with 23.5%, up more than 10ppts from the previous poll. In each region, the leading party will need to form a coalition without the AfD. They might seek partnership with the Greens, which made significant gains albeit not quite as much as had been expected. But, as is often the case in Germany, those coalition negotiations will not be straightforward.

'GroKo' given breathing space until December

The establishment parties will, however, breathe a sigh of relief that the AfD failed to significantly boost its showing from that in the 2017 national election. So, they give breathing space to CDU leader, Annegret Kramp-Karrenbauer, who has failed to impress since succeeding Merkel in the role but might yet fail to be the party's candidate for next Chancellor. And the GroKo should also remain intact at least until the conclusion of the SPD leadership election in December. Thereafter, however, the SPD might well choose a new direction and pull the plug on the federal coalition, likely triggering a new general election, which would seem bound to result in a highly fragmented Bundestag.

The day ahead in the euro area and US

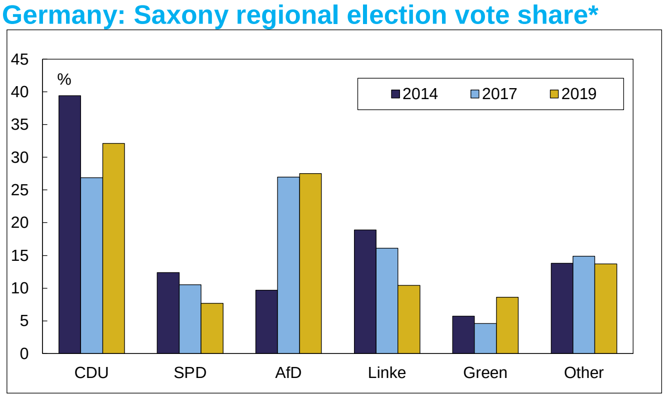
It should be a quiet day for euro area economic news tomorrow with just euro area PPI figures for July and Spanish unemployment numbers for August due for release. In the US, meanwhile, tomorrow will bring the manufacturing ISM and final Markit manufacturing PMI for August. The headline ISM is expected to have moved sideways at 51.2, while the PMI is expected to signal stagnation in the sector, with the index at 50. Tuesday will also see US construction spending figures for July released.

UK

Manufacturing PMI signals steeper contraction

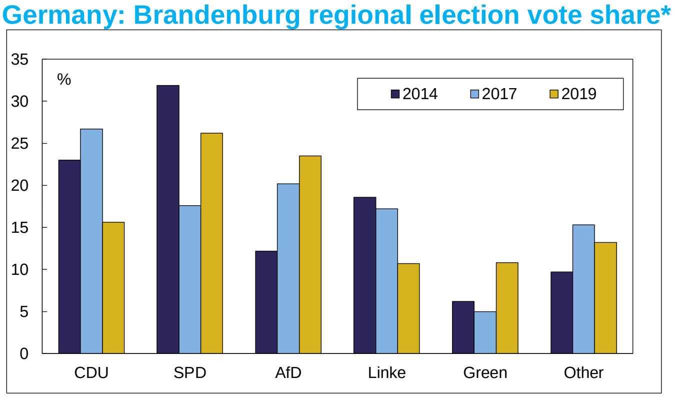
With Brexit uncertainty having intensified over the past month, today's manufacturing PMI made for disappointing, albeit perhaps unsurprising, reading. The headline index declined in August for the fourth month out of the past five, down 0.6pt to 47.4, the lowest since mid-2012. Admittedly, the output component rose for the first month in five, although at 47.7 the index was still consistent with a marked pace of contraction. Indeed, Markit assessed today's figure to be in line with a decline in production of around 2.0%Q/Q. On average over the first two months of Q3, the index was 3pts lower than the average in Q2. Moreover, the survey signalled a steeper pace of decline in new orders last month – the relevant index fell a sizeable 2.5pts to 44.4, the lowest for more than seven years – reflecting weaker domestic and external demand alike. Indeed, despite further sterling depreciation in August to its lowest level since October 2016, there was absolutely no sign that the weaker exchange rate was providing a boost to competitiveness, with new export orders reportedly declining at their fastest pace since mid-2012. And Markit reported that some EU-based clients were routing supply chains away from the UK due to Brexit. So, perhaps unsurprisingly, the survey suggested that manufacturers' confidence about the outlook for the coming twelve months was the lowest since the series began in 2012. Overall, today's survey further supports our view that the manufacturing sector will remain a significant drag on growth in Q3, with limited prospects of a meaningful improvement over the foreseeable future either.

Germany: Saxony regional election vote share*



*Regional elections for 2014 & 2019. Federal election for 2017.
Source: Bundeswahlleiter, Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Brandenburg regional election vote share*



*Regional elections for 2014 & 2019. Federal election for 2017.
Source: Bundeswahlleiter, Reuters and Daiwa Capital Markets Europe Ltd.

A pivotal week for Brexit

Tomorrow will be a key day in the Brexit saga, as MPs will return from their summer recess. And while a cross-party group of MPs plans to take action immediately to try to prevent the UK from leaving the EU at the end of October without a deal, the eventual outcome might be an early general election. In particular, MPs from a range of parties, crucially including some senior Conservative rebels, intend first tomorrow to vote to try to take control of the order of business of the House of Commons away from the Government. If successful, they then intend to rapidly force through legislation that would compel the Prime Minister to request an extension of the Article 50 deadline beyond 31 October if he has not agreed a deal with the EU by a certain date next month. Reports over the weekend suggested that PM Johnson has threatened to withdraw the party whip from any rebel MPs and prevent them from standing as Conservative MPs at the next general election if they vote against the Government tomorrow. However, at the time of writing, it appeared that more than a dozen Conservative MPs would likely vote against the Government, sufficient to allow the anti-no-deal legislation to pass the House of Commons either later on Tuesday or sometime on Wednesday.

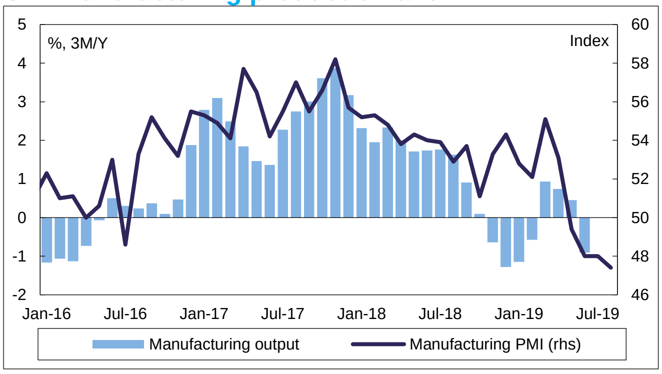
General election to be called for mid-October?

One risk thereafter is that the anti-no-deal bill might get bogged down by filibustering by Conservative members in the House of Lords. However, even before it reaches that point, Johnson might be tempted to try to trigger an early general election to block its progress. Indeed, at the time of writing, reports suggested that Johnson was set to hold an emergency cabinet meeting to discuss such a strategy, that could see an early election called sometime this week, perhaps most likely on Thursday. Under the Fixed-Term Parliaments Act (FTPA), however, two thirds of all MPs would have to approve a motion calling an early general election. Having previously demanded one, Labour leader Corbyn today hinted that he might be ready to back such a move for a poll on 17 October (the date of the next EU summit and just a fortnight before the Article 50 deadline) if Johnson proposed it. However, whether he and his fellow opposition MPs would vote in favour of such a move before anti-no-deal Brexit legislation has been adopted seems doubtful. Indeed, if MPs voted to approve a motion calling an early general election without a no-deal Brexit having been ruled out, the FTPA would give Johnson the freedom to set its date whenever he wished, including perhaps for some time after the Article 50 deadline, which would likely all-but guarantee a no-deal Brexit.

The day ahead in the UK

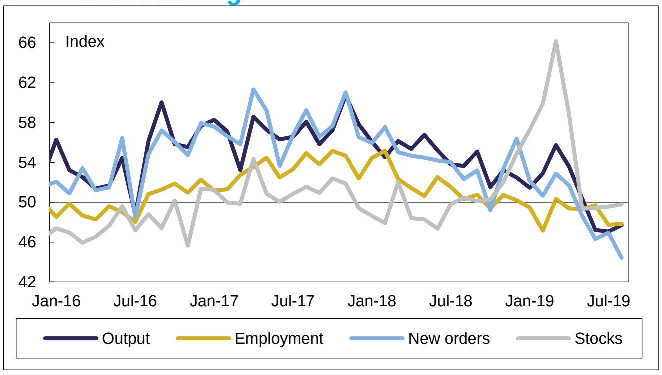
The aforementioned political manoeuvring will dominate attention on Tuesday. Data-wise, however, tomorrow will bring the construction PMI for August, which is likely to remain little changed from July (45.3) to remain firmly in contractionary territory for the fourth consecutive month. Tuesday will also bring the BRC's latest retail sales monitor which is likely to signal ongoing subdued growth last month against the backdrop of weaker consumer confidence.

UK: Manufacturing production and PMI



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

UK: Manufacturing PMI



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

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Final manufacturing PMI	Aug	**47.0**	47.0	46.5	-
Germany	Final manufacturing PMI	Aug	**43.5**	43.6	43.2	-
France	Final manufacturing PMI	Aug	**51.1**	51.0	49.7	-
Italy	Manufacturing PMI	Aug	**48.7**	48.6	48.5	-
Spain	Manufacturing PMI	Aug	**48.8**	48.4	48.2	-
UK	Manufacturing PMI	Aug	**47.4**	48.8	48.0	

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	PPI M/M% (Y/Y%)	Jul	0.2 (0.2)	-0.6 (0.7)
Spain	08.00	Unemployment change '000s	Aug	-	-4.3
UK	00.01	BRC retail sales monitor - like-for-like sales Y/Y%	Aug	0.5	0.1
	09.30	Construction PMI	Aug	46.6	45.3

Auctions

Country	BST	Auction/Event
UK	-	MPs return to the House of Commons after summer recess
	10.30	Auction: to sell £3.0bn of the 0.625% 2025 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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