Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Despite some weaker euro area retail sales data, Bunds made losses and BTPs made further gains after Five Star Movement members yesterday gave strong backing to the new Italian coalition government programme.
- Gilts made significant gains as MPs were expected this evening to back a Bill seeking to prevent a no-deal Brexit, and withhold support for a new general election until that Bill becomes is made law.
- Thursday will bring data on German factory orders and UK car registrations.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.910	+0.015
OBL 0 10/24	-0.910	+0.018
DBR 0 08/29	-0.681	+0.028
UKT 3¾ 09/21	0.362	+0.027
UKT 1 04/24	0.337	+0.062
UKT 0⅞ 10/29	0.494	+0.088

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

UK

Anti-no-deal legislation set for Commons vote

After last night's key vote in the House of Commons saw PM Boris Johnson defeated decisively in his first parliamentary test, by 328 to 301 (perhaps inevitably, a ratio of 52:48), MPs were this evening set to approve draft legislation – the European Union (Withdrawal) (No.6) Bill – which, if eventually passed into law, would compel the Prime Minister to request a three-month extension of the Article 50 deadline (i.e. to 31 January) if a deal with the EU has not been agreed by 19 October. Somewhat more controversially, and hence a key focus for possible amendment this evening, the legislation would also provide for possible further extensions of the Article 50 deadline beyond that date, as well as regular reporting by the Government on the progress in its negotiations with the EU.

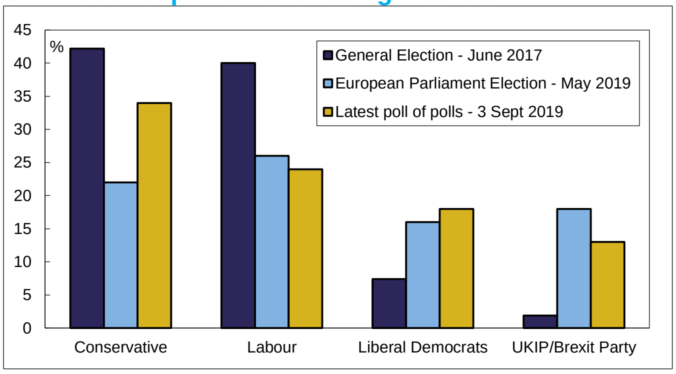
MPs seem bound to approve the Bill

Not least in light of Tuesday night's result, at the time of writing, MPs seemed bound to approve a version of the Bill this evening, allowing it to advance in the House of Lords. Progress in that upper house will be far slower, with peers supportive of the government determined to hinder progress. Nevertheless, we still expect the approval of the House of Lords to be granted by the start of next week, to allow time for the Bill to receive royal assent, which is required for it to become law, before Parliament's prorogation. If Johnson attempts to block progress by using further manoeuvres of questionable constitutional legitimacy – e.g. refusing royal assent for the legislation before prorogation, which would kill the Bill – yesterday's rebellion by MPs would pale in comparison with what would follow once Parliament resumes in October.

Johnson has lost control

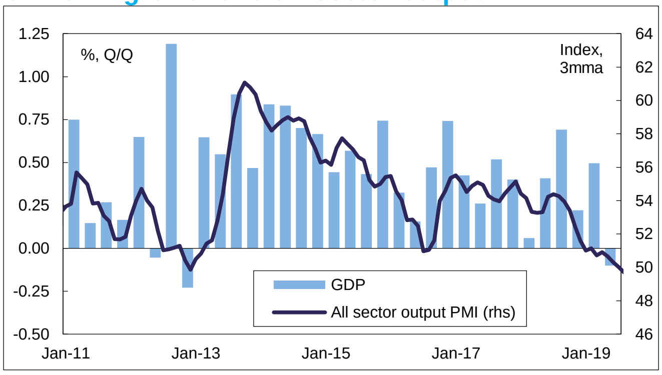
Of course, Johnson responded to last night's defeat by stating that, if MPs vote for the Bill, he will table a motion in Parliament today proposing an early general election. And he repeated that pledge today. But having seen a further defection to the Liberal Democrats during the course of yesterday's debate, and (self-defeatingly) expelled from his party the twenty-one (largely respected) rebel Conservative MPs who voted against him yesterday, Johnson's working parliamentary majority has gone in a flash from +1 to -43. So, after a mere two days of parliamentary scrutiny as Prime Minister, Johnson has already lost control of the House of Commons, the Brexit process, and the fate of his government. And whatever legislative form his proposal for an early general election will take, opposition MPs will likely withhold their backing, particularly unless the timing is politically convenient for them.

UK: National parliament voting intention*



**Result of 2017 General Election. Westminster voting intention on date of European Parliament election. Source: Politico poll of polls and Daiwa Capital Markets Europe Ltd.*

UK: GDP growth and all-sector output PMI



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

Johnson hopes early election will provide a lifeline

Labour has made it clear that it will not back a general election at least until the anti-no-deal legislation has received royal assent. But even once it has been formally adopted into law, Labour need not be in a rush to confirm an election date. Johnson today clarified his preference for an election of 15 October. And, if he was to win a majority then, he would be able to repeal the legislation preventing a no-deal Brexit on 31 October. Moreover, the sooner the election is held, the greater will be Johnson's ability to take advantage of his current elevated poll ratings. Those ratings partly reflect the temporary 'honeymoon' effect that usually benefits new Prime Ministers, as well as promises of lashings of extra (unfunded) public expenditure (such as those presented today in the Chancellor's spending review announcement), and increased backing from Brexit Party supporters attracted by his support for a no-deal Brexit and political shift to the far right.

Labour likely to prefer a November poll

Before long, however, just as it did for Theresa May, the 'honeymoon' boost to Johnson's ratings will wear off. Indeed, if the anti-no-deal legislation is adopted and no election is held until November, Johnson will have clearly failed in his key pledge to deliver Brexit 'do or die' by end-October, something that will instantly lose him backing from Brexit Party supporters. Moreover, given the evaporation of his parliamentary majority, Johnson is now politically impotent. And the longer that he is in office but unable to achieve anything, the weaker he will appear. So, the chances of Johnson winning a majority in an election in November would seem far lower than in October.

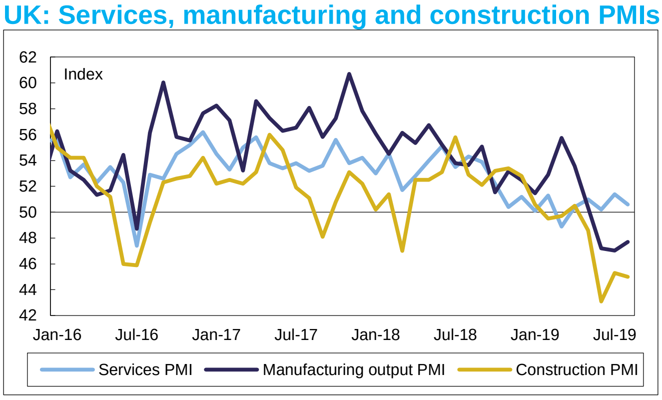
Corbyn the Prime Minister in waiting?

Therefore, while the situation is highly fluid, our baseline forecast remains an Article 50 extension beyond end-October with a general election held only once that milestone has passed. And not least given the first-past-the-post system whereby five parties could each win a significant number of seats, the result of the next election will be highly uncertain, with much hinging on the geographical distribution of each party's votes. Not least since the Conservatives will lose seats to the Liberal Democrats in London and the South West, and to the Scottish National Party in Scotland, we would expect no single party to win a majority. And, on balance, we currently expect Labour to lead the resulting minority government – backed in a confidence and supply arrangement by the LibDems and SNP – on a programme including a second Brexit referendum, perhaps also a second Scottish independence referendum, and certain elements (but by no means all) of Corbyn's radical reform agenda. Many investors are likely to balk at Labour's proposed tax and corporate sector reforms, which include the nationalisation of rail and utilities firms, higher taxes on the wealthy, reforms to tenants' rights and the enforced transfer of shares to workers in large firms. But fiscal policy might be no less irresponsible than under a Johnson-led government. And a minority Labour-led government would at least give the UK economy an opportunity to dodge a no-deal Brexit, which today the BoE judged could trigger an initial peak-to-trough decline in GDP of 5½% (revised from an earlier estimate of 8%), a rise in the unemployment rate to 7% and a peak in inflation – due largely to further steep sterling depreciation – above 5%, as well as a long-lasting painful adjustment to significant structural change and a big hit to longer-term economic growth potential.

Services PMI disappoints

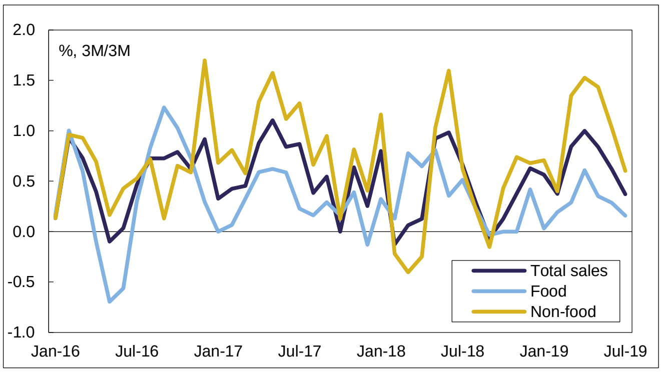
The UK's economic woes, caused not least by the current political crisis, were highlighted by today's services PMI, which suggested that the economy is on track for another weaker quarter in Q3. Indeed, the headline services activity index fell a larger-than-expected 0.8pt in August to 50.6, well below the long-run average and close to the bottom of the range of the past decade. The detail of the report offered little optimism for the near-term outlook either. While a number of firms cited a boost to overseas sales on the back of sterling depreciation, demand for orders was reportedly hit by heightened Brexit uncertainty. As such, the new business index declined more than 2pts in August to 50.8, back close to the average this year. With firms more downbeat about future demand and suggesting that profit margins remain under pressure, today's survey also implied a further notable slowing in employment growth in the sector – indeed, the relevant PMI stood at just 50.2.

UK: Services, manufacturing and construction PMIs



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

Euro area: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Composite PMI consistent with negative GDP growth

So, despite a modest improvement in the manufacturing output PMI (up 0.7pt to a still-paltry 47.7), the composite PMI fell 0.8pt to just 50.2 – a level that might normally be consistent with a decline in GDP of around 0.1%Q/Q. With the composite new orders index back below 50 for the sixth month out of the past eight, the survey also signalled ongoing weakness ahead. When also including the construction sector, the all-sector PMI declined 0.5pt to 49.7, the second-lowest reading since 2012, leaving the index on average so far in Q3 a touch below the average in Q2. So, while we now expect the economy to have moved sideways in Q3, today's survey flagged the risk that the UK might well have slipped into recession. And with the survey suggesting that inflationary pressures remain subdued – the composite output price PMI fell to a more-than three-year low – we continue to expect the BoE's next policy move to be a rate cut.

The day ahead in the UK

In the UK, tomorrow will bring new car registrations figures for August, which are likely to show a sizeable decline compared with a year earlier when registrations saw a surge ahead of the implementation of the new testing standards in September 2018.

Euro area

Euro area retail sales slip back

While household consumption growth in the euro area moderated in Q2, there was a notable surge in retail sales at the end of the quarter, with growth in June the strongest for more than 1½ years. As such, some payback at the start of Q3 was always anticipated. But while today's figures showed the steepest monthly decline for seven months in July, the 0.6%M/M% drop reversed just half the increase in June, to leave retail sales still more than 2% higher than a year earlier. This principally reflected a notable drop in Germany (-2.2%M/M), while sales in France and Spain were flat. In contrast, sales in Ireland (1.9%M/M) posted the largest monthly increase for fifteen months. Within the euro area detail, spending on food slipped back in July (-0.3%M/M) and fuel sales were flat. But the weakness principally reflected a notable decline in sales of core items, with the 1.0%M/M drop largely reversing the increase in June. And while these data are notoriously volatile, on a three-month basis, today's release maintained the steady downward trend in both headline (to 0.4%3M/3M) and core sales growth (0.6%3M/3M) seen since the recent peak in April.

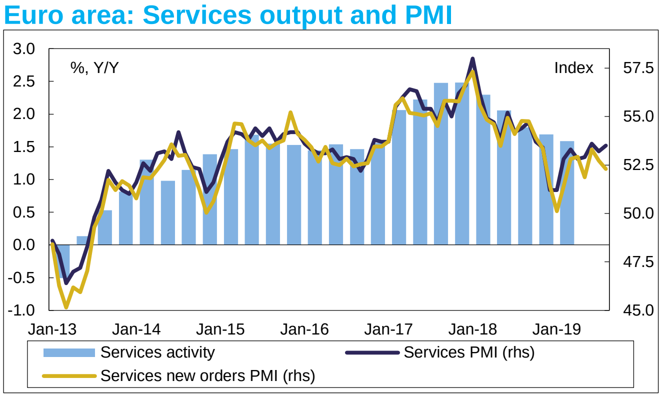
Euro area composite PMI revised slightly higher

Like the manufacturing survey earlier this week, there were no major surprises from today's final euro area services PMI. But also similar to the manufacturing PMI, there was a very modest upwards revision to the headline services activity PMI in August (by 0.1pt) to 53.5, leaving it 0.3pt higher than July, more than ½pt higher than the average so far this year and marking the 73rd consecutive above-50 reading. The forward-looking indicators were, however, less upbeat, with a larger than initially estimated drop in the new orders and employment PMIs in August, while the business expectations component was unrevised at its joint-weakest since mid-2013. Overall, the services indices meant that the final composite PMI was nudged slightly higher in August, by 0.1pt to 51.9, leaving it 0.4pt higher than July. Nevertheless, this still left the headline index on average in the first two months of Q3 slightly lower than the average in Q2. And with the survey implying a softer pace of new orders growth, and reporting the weakest optimism about future output for more than six years, we expect little improvement in economic momentum over the near term.

Mixed service sector performance across member states

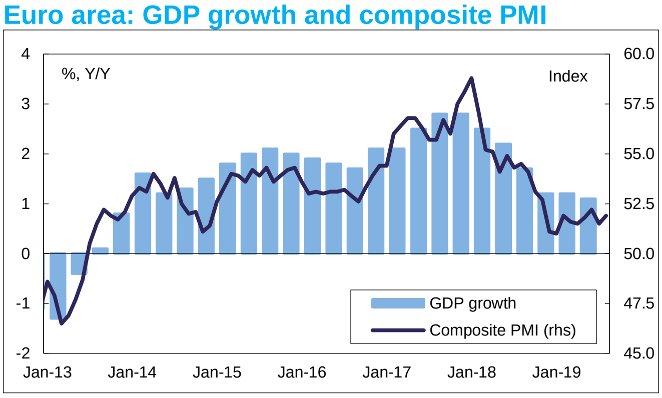
There was a more noticeable upwards revision to the German services PMI (0.4pt) to 54.5, although this was still the

Euro area: Services output and PMI



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

Euro area: GDP growth and composite PMI



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

second-lowest reading in the past seven months. And while the decline in the new orders component was slightly smaller than initially estimated, it was still the second-lowest for more than three years. So, while the German composite PMI was revised higher to 51.7 in August, the average level so far in Q3 was still notably lower than the average in Q2. The final French services and composite PMIs were also nudged higher to 53.4 and 52.9 respectively, both nine-month highs and, in contrast with Germany, consistent with ongoing steady expansion in Q3. However, the Italian services PMI, published today for the first time, disappointed, with the headline index falling 1.1pts to 50.6, with more substantial declines in the new orders and business expectations components too. So, the Italian composite PMI fell to just 50.3, a level (unsurprisingly) consistent with ongoing stagnation in the third largest member state. Meanwhile, the improvement in the Spanish services PMI (up 1.4pts to 54.3) helped more than offset the significant weakness in the manufacturing sector, to leave the composite PMI up 0.9pt to 52.6.

The day ahead in the euro area and US

Focus in the euro area tomorrow will turn back to the industrial sector, with German factory orders data for July the highlight. While orders rose at the end of Q2 by the most for almost two years, this was boosted by likely one-off large items. So, some payback was always likely at the start of Q3. But with the economic backdrop having deteriorated further, and business surveys signalling significantly weaker order books, we would expect manufacturing orders – both domestically and from overseas – to have declined significantly in July. Elsewhere, ECB Vice-President Luis de Guindos is due to speak at a research conference organised by the ECB.

A busy day in the US brings several top-tier releases tomorrow, including the non-manufacturing ISM and final Markit services PMI for August and factory orders data for July. Thursday will also see final unit labour costs and productivity data for Q2, the ADP employment report and Challenger job cuts figures for August and weekly jobless claims numbers.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Final services PMI (composite PMI)	Aug	**53.4 (51.9)**	53.4 (51.8)	53.2 (51.5)	-
		Retail sales M/M% (Y/Y%)	Jul	**-0.6 (2.2)**	-0.5 (2.3)	1.1 (2.6)	1.2 (2.8)
Germany		Final services PMI (composite PMI)	Aug	**54.8 (51.7)**	54.4 (51.4)	54.5 (50.9)	-
France		Final services PMI (composite PMI)	Aug	**53.4 (52.9)**	53.3 (52.7)	52.6 (51.9)	-
Italy		Services PMI (composite PMI)	Aug	**50.6 (50.3)**	51.6 (50.6)	51.7 (51.0)	-
Spain		Services PMI (composite PMI)	Aug	**54.3 (52.6)**	53.0 (52.0)	52.9 (51.7)	-
UK		Services PMI (composite PMI)	Aug	**50.6 (50.2)**	51.5 (50.5)	51.4 (50.7)	-
Auctions							
Country		Auction					
Germany sold		€2.4bn of the 0% 2024 bonds at an average yield of -0.88%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Factory orders M/M% (Y/Y%)	Jul	-1.4 (-4.2)	2.5 (-3.6)
UK		09.00	New car registrations Y/Y%	Aug	-	-4.1
Auctions						
Country		BST	Auction/Event			
EMU		08.00	ECB's Guindos due to speak in Frankfurt			
France		09.50	Auction: to sell 0.5% 2029 bonds			
		09.50	Auction: to sell 1.25% 2034 bonds			
		09.50	Auction: to sell 1.75% 2039 bonds			
		09.50	Auction: to sell 1.5% 2050 bonds			
Italy		-	Moody's to publish scheduled update on Italy's sovereign credit rating			
Spain		09.30	Auction: to sell 0.25% 2024 bonds			
		09.30	Auction: to sell 0.6% 2029 bonds			
		09.30	Auction: to sell 3.45% 2066 bonds			
		09.30	Auction: to sell 1% 2030 index-linked bonds			
UK		10.30	Auction: to sell £2.75bn of the 0.875% 2029 bonds			
		15.30	BoE's Tenreyro due to speak in Frankfurt			