Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made significant losses as German trade data and a French business survey beat expectations.
- Gilts also made big losses as UK GDP returned to growth and anti-no-deal legislation passed into law.
- Tuesday will bring new data on French and Italian IP and the UK labour market.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.864	+0.016
OBL 0 10/24	-0.858	+0.033
DBR 0 08/29	-0.587	+0.055
UKT 3¾ 09/21	0.433	+0.046
UKT 1 04/24	0.394	+0.053
UKT 0⅞ 10/29	0.590	+0.085

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

Euro area

German exports posts modest gain

Germany's manufacturers have seen demand weaken through the course of 2019 from external and domestic sources alike. But while last week's industrial production data signalled another weak month for manufacturing output at the start of Q3, today's German trade figures were somewhat better, with the goods trade surplus rising in July by €2.2bn to €20.2bn, a fourteen-month high. This in part reflected a pickup in exports (up 0.7%M/M, 3.8%Y/Y), with year-on-year growth boosted by strong demand from countries outside the EU (9.8%Y/Y). When adjusting for price effects, the export performance was also improved, with volumes up for the third consecutive month (0.5%M/M), nevertheless leaving the level still 1½% below the peak in March. The increased trade surplus, however, also reflected weaker domestic demand, with another notable drop in imports in July, of 1.6%M/M, the steepest for almost a year, to leave them down 0.9%Y/Y.

French manufacturing confidence gets a boost

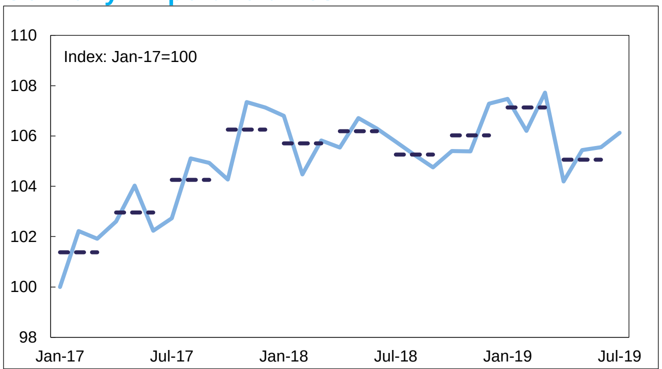
In contrast to Germany, France has seen its economy hold up relatively well since the start of the year partly due to its lesser reliance on manufacturing as well as its government's more supportive fiscal policy. The Bank of France's latest business sentiment survey today suggested a notable improvement in manufacturing confidence in August, with the headline index for the sector rising 3pts to 99, a four-month high, reportedly reflecting a marked pickup in production – indeed, the survey's relevant index jumped 9pts on the month to the highest for more than eleven years. With services activity also reported to have improved in August, conditions in the sector were assessed to have remained stable and hence broadly favourable that month, bang in line with the long-run average. Conditions in the construction sector were also stable, while order books remained strong. As such, the Bank of France assessed today's survey to be consistent with GDP growth of 0.3%Q/Q in Q3, unchanged from growth in the first two quarters of the year and bang in line with our own forecast for Q3.

The day ahead in the euro area and US

Against the backdrop of improved manufacturing conditions, tomorrow's French industrial production figures for July are expected to show a modest improvement at the start of Q3, by 0.5%M/M in July. But this would reverse only a fraction of the more than 2%M/M decline in June, to leave output up just 0.1%Y/Y. Italian IP figures are also due, but expected to report another modest decline in output for the fourth month out of the past five. In the markets, German will sell index-linked 2046 bonds.

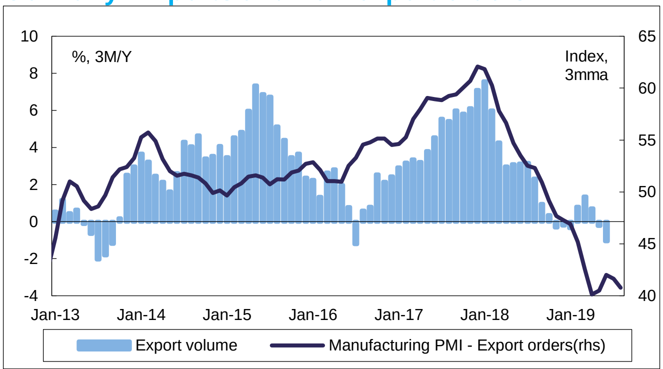
In the US, another quiet day for top-tier releases tomorrow will bring the NFIB small business optimism survey for August,

Germany: Export volumes*



*Dark blue dashed line represents quarterly average. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Exports and new export orders PMI



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

along with JOLTs job openings figures for July. In the markets, the Treasury will sell 3Y notes.

UK

Brexit uncertainty to persist as Parliament is prorogued

At the time of writing, MPs appeared set this evening to deliver PM Johnson his fifth successive defeat in each of his Government's first five votes in the House of Commons, by rejecting again his proposal for a general election on 15 October. With the Government on the weekend having confirmed its intention to prorogue (i.e. shut down) Parliament from tonight until 14 October, no general election will be held before late November (28 November or 5 December appear the most likely dates in our opinion). And while the anti-no-deal legislation today received royal assent (i.e. formally entered into law), major uncertainty is now set to persist over Johnson's intentions for Brexit throughout Parliament's break.

Northern Ireland backstop eventually to be proposed by Johnson?

Under the anti-no-deal legislation, Johnson will be compelled to write to the EU to request an extension to the Article 50 deadline beyond end-October if no deal has been reached by 19 October. However, he continues to insist that, even if he is compelled by law, he would not do so. One solution for him to avoid having to write a letter at all without breaking the law, of course, would be to agree a Brexit deal with the EU, which might most likely be similar to that negotiated by Theresa May. A possible change to May's deal that would be acceptable to the EU would be to replace the UK-wide backstop arrangement that Johnson opposes with a backstop that keeps only Northern Ireland (rather than the whole UK) integrated with key elements of the EU's Single Market and Customs Union until workable alternative arrangements to maintain an open border on the island of Ireland became available. And Johnson has already signalled support for common agricultural rules on the island of Ireland. But even if a role was provided for the Northern Ireland Assembly in overseeing that system (something that the EU might be reluctant to agree), it would split the UK into two separate economic systems. In talks today in Dublin with the Irish Taoiseach Leo Varadkar, there was no indication that Johnson would eventually choose to propose such an approach. And with the Northern Irish DUP and several Conservative nationalist ERG MPs almost certain to vote against such a proposal, there is a significant probability that no majority would be found in the House of Commons for it. As such, our baseline forecast remains that a request for an extension will be made. But whether or not Johnson would be the Prime Minister to make that request would remain to be seen.

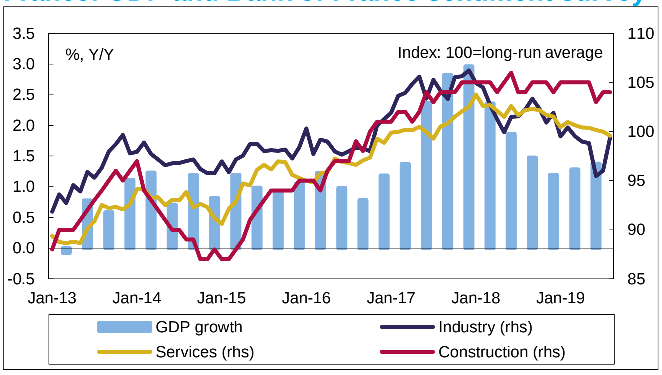
Monthly GDP boosted by Brexit preparations

After the UK's economy contracted in Q2 for the first quarter since Q412 and by a steeper-than-expected 0.2%Q/Q, today's monthly GDP figures for July surprised on the upside, with output rising 0.3%M/M, the strongest monthly rise since January. Admittedly, when smoothing out monthly volatility, this left output merely flat on a three-month basis in July, with services extending the downward trend seen through 2019, while manufacturing and construction continued to fall on this basis. This notwithstanding, the one-month figures reported increases across the sectors. For example, services activity rose for the first month in three in July and by 0.3%M/M, underpinned by a jump in rental and leasing activities and the transportation and storage sector, perhaps reflecting a step-up in Brexit-related preparations. There was also a modest increase in manufacturing output with the 0.3%M/M rise more than reversing the decline in June, boosted in particular by production of pharmaceutical products (3.8%M/M). And construction output (0.8%M/M) was underpinned by private sector new housing.

Positive growth in Q3 looks assured

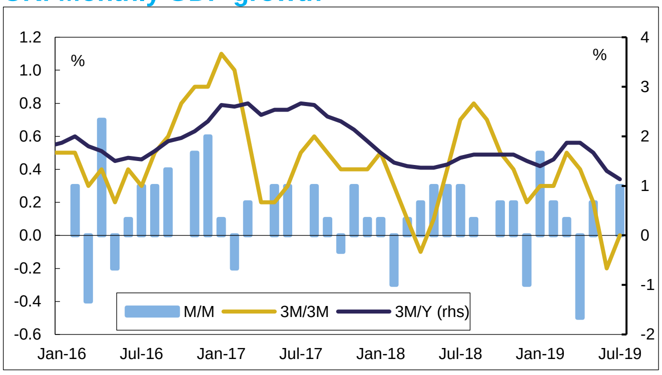
The pickup in output in July coincided with an improvement in the PMI surveys that month. But if the August PMIs are to be believed, output went into reverse last month, with the all-sector index consistent with negative GDP growth of around 0.1%Q/Q. However, output is likely to have been boosted by a jump in production of motor vehicles in August, with many car

France: GDP and Bank of France sentiment survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Monthly GDP growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

factories having brought forward their usual summer shutdown to April as a contingency plan in the event of a no-deal Brexit at the initial end-March deadline. Indeed, as a result of the shutdown in April, manufacturing production fell by a whopping 4.3%M/M. Moreover, given the recent monthly profile for GDP, we would need to see a decline of 0.4%M/M in both August and September to avoid positive growth over the third quarter as a whole. So, UK GDP growth over the third quarter as a whole seems likely to reverse the 0.2%Q/Q decline in Q2. However, there is no doubt that economic momentum in the UK remains subdued, with heightened uncertainty associated with Brexit remaining the key downside risk – indeed, like the BoE, we think the underlying trend in the economy is close to zero.

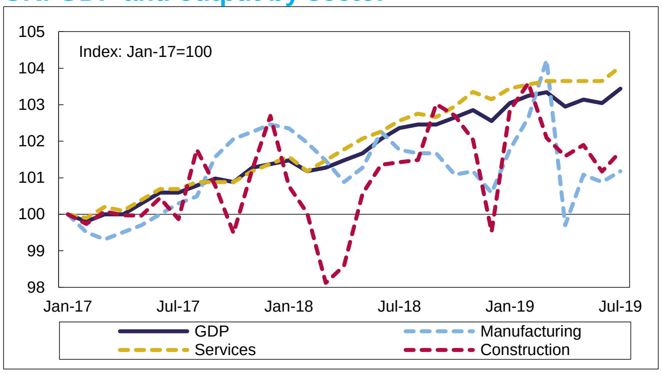
3-month trade deficit at 3½-year low

The UK's total trade deficit narrowed in the three months to July by £14.9bn to just £2.9bn, the smallest since January 2016. This was not a sign of export strength, however. Instead, it largely reflected a sharp decline in the value of goods imports, which fell 8.5%3M/3M, partly due to lower imports of capital goods and pharmaceuticals reflecting the reversal of the impact of Brexit stock-building earlier in the year. Goods exports declined a minimal 0.2%3M/3M, with the headline figure masking a similar larger fall in exports of chemicals and machinery related to weaker shipments to the EU related to the Brexit. The surplus in services, meanwhile, was little changed in the three months to July, at £26.4bn. Adjusting for prices, the total trade deficit also narrowed significantly, principally due to lower volumes of goods imports, down a whopping 14.5%3M/3M, while export volumes fell a minimal 0.3%3M/3M. It is notable, however, that this improvement largely reflected shifts in Q2, when the volume of imports fell sharply in each month. Indeed, in July, import volume growth (2.1%M/M) was slightly firmer than that of exports (2.0%M/M). And so, while net trade made a huge contribution (+3.5ppts) to GDP growth in Q2, we expect it to make a negative contribution to growth in Q3.

The day ahead in the UK

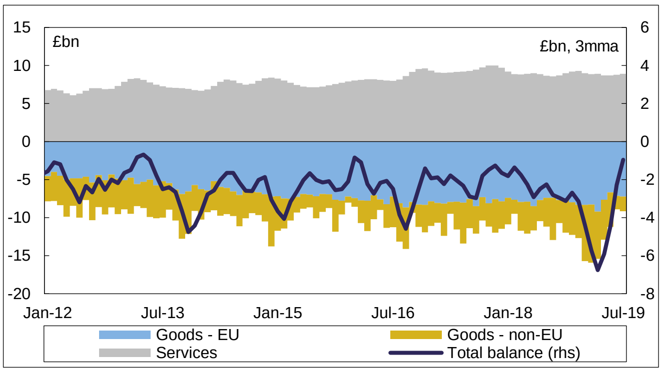
Focus in the UK tomorrow will be on the latest labour market report, which is expected to report a notable slowing of job growth in the three months to July but no change to the unemployment rate (3.9%) or average weekly earnings growth (3.7%Y/Y).

UK: GDP and output by sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Trade balance



Source: 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
Germany		Trade (current account) balance €bn	Jul	**21.4 (22.1)**	17.4 (16.4)	16.8 (20.6)	16.6 (20.9)
France		Bank of France sentiment survey – industry index	Aug	**99**	96	95	96
UK		Monthly GDP estimate M/M% (3M/3M%)	Jul	**0.3 (0.0)**	0.1 (-0.1)	0.0 (-0.2)	-
		Industrial production M/M% (Y/Y%)	Jul	**0.1 (-0.9)**	-0.2 (-1.3)	-0.1 (-0.6)	-
		Manufacturing production M/M% (Y/Y%)	Jul	**0.3 (-0.6)**	-0.3 (-1.3)	-0.2 (-1.4)	-
		Construction output M/M% (Y/Y%)	Jul	**0.5 (0.3)**	0.2 (0.0)	-0.7 (-0.2)	-
		Services activity M/M% (3M/3M%)	Jul	**0.3 (0.2)**	0.1 (0.1)	0.0 (0.1)	-
		Trade balance (goods trade balance) £bn	Jul	**-0.2 (-9.1)**	-1.5 (-9.5)	1.8 (-7.0)	-0.1 (-8.9)

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
France		07.45	Industrial production M/M% (Y/Y%)	Jul	0.5 (0.5)	-2.3 (0.0)
		07.45	Manufacturing production M/M% (Y/Y%)	Jul	0.8 (0.1)	-2.2 (-0.6)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jul	-0.1 (0.3)	-0.2 (-1.2)
UK		09:30	Claimant count rate % (change '000s)	Aug	-	3.2 (28.0)
		09:30	Average weekly earnings (excl. bonuses) 3M/Y%	Jul	3.7 (3.7)	3.7 (3.9)
		09:30	ILO unemployment rate 3M%	Jul	3.9	3.9
		09:30	Employment change 3M/3M '000s	Jul	55	115

Auctions

Country		BST	Auction/Event
Germany		10.30	Auction: to sell €0.5bn of 0.1% 2046 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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