Euro wrap-up

Overview

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- As the ECB policy announcements continued to reverberate, euro area government bonds made further losses, particularly at the long end of the curve, while euro area labour cost growth picked up.
- Gilts followed the global trend of higher yields on a day of more Brexit speculation but no substantive UK economic news.
- The coming week will bring more Brexit noise, another BoE rate announcement and data on UK CPI and euro area consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.723	+0.012
OBL 0 10/24	-0.708	+0.042
DBR 0 08/29	-0.451	+0.069
UKT 3¾ 09/21	0.571	+0.028
UKT 1 04/24	0.553	+0.057
UKT 0⅞ 10/29	0.762	+0.089

*Change from close as at 4:15pm BST.
Source: Bloomberg

Euro area

ECB announcements continue to reverberate

The sell-off in euro area government bonds continued today in the wake of yesterday's ECB policy announcements. The impact of the Swiss-style tiering framework, to exempt a significant share (roughly 35-40%) of banks' excess reserves from the -0.50% deposit rate from 30 October, saw short-dated bonds largely lock in yesterday's increases. And reports late yesterday suggesting that several Governing Council members were opposed to the resumption of QE – even at the modest €20bn per month pace eventually approved without a vote – seemingly maintained pressure at the longer end of the curve, which steepened today. Indeed, among other critics, Dutch central bank Governor Knot issued a statement today calling the package "disproportionate to the present economic conditions" and noted "sound reasons to doubt its effectiveness". While the QE programme is currently open-ended, the Governing Council would likely need to approve, sometime in H220, an increase in the issue/issuer limits above 33% if it wanted to continue buying assets beyond that time. And the relatively high level of dissent to yesterday's announcement suggests that – unless forthcoming ECB President Lagarde has powers of persuasion as strong as Draghi's – that decision would certainly be no done deal.

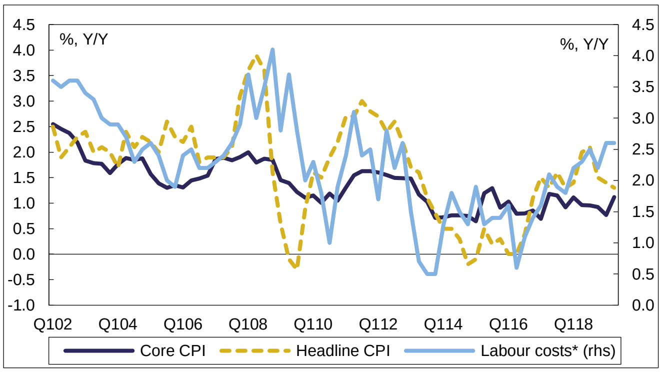
QE beyond one year no done deal

Our economic forecasts (see table), however, remain far more downbeat than the ECB's, which unrealistically envisage quarterly GDP growth rates as high as 0.4%Q/Q from Q220 through Q121. As such, we think that the Governing Council will have little alternative but to keep buying assets into 2021 and raise the issue/issuer limits to facilitate that. However, while the ECB's revised forward guidance left the door open to further rate cuts, given reasonable concerns that the "reversal rate" might be close and Draghi's exhortation that fiscal policy now needs to be the main policy tool for boosting growth and inflation, we suspect that the deposit rate will be left unchanged at -0.50% for the foreseeable future.

Labour cost growth firms

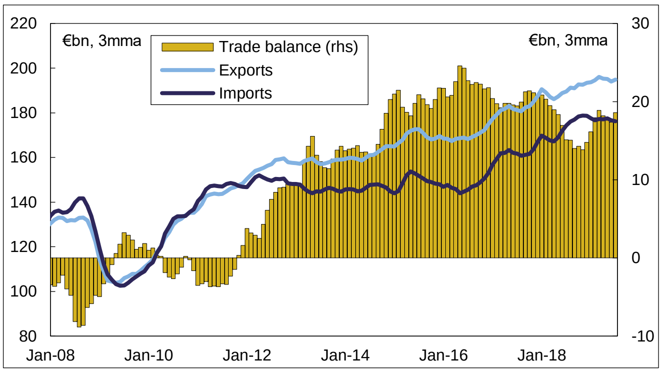
At face value, today's euro area labour cost data appeared to provide better news for the ECB, with an increase of 0.2ppt in whole-economy labour cost growth in Q2 to 2.7%Y/Y, the firmest since Q118. Stronger increases in Germany and Spain (both 3.2%Y/Y) in particular more than offset a moderation in France and Italy (2.0%Y/Y and 1.6%Y/Y respectively). At the business level, however, euro area labour cost growth was merely steady at 2.6%Y/Y, matching the five-year high of Q1. And given upwards pressure from non-wage labour costs, business economy wage growth moderated 0.2pt to 2.5%Y/Y. With the economic slowdown set increasingly to be felt in the labour market, we expect no material acceleration in labour cost growth from current levels over the forecast horizon, leaving domestically-generated inflation little different from recent levels too.

Euro area: Labour costs* and inflation



*Excluding the public sector. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area trade remained subdued in July

Net trade subtracted 0.1ppt from euro area GDP growth in Q2 as exports stagnated but import volumes ticked higher. However, today's goods trade figures for July suggested a slightly more supportive performance at the start of Q3, with the surplus on a seasonally adjusted basis up €1.3bn to €19.0bn, above the average in the first half of the year. While the value of goods exports rose 0.6%M/M to be up 3.1%Y/Y, the value of imports was unchanged for a second month to be down 0.4%Y/Y. The trends for both components, nevertheless, remained weak, with exports down 0.2%3M/3M and imports down 0.4%3M/3M. And with shifts in relative prices unclear, we would hesitate to suggest that net trade provided a boost to economic growth. Indeed, our forecast currently envisages that net trade will subtract 0.1ppt from GDP growth in Q3. And, like the ECB's central projection, we forecast GDP to rise this quarter by just 0.1%Q/Q, which would represent the weakest rate since Q113.

The coming week in the euro area and US

The coming week should be a quieter one for euro area economic news, with the Commission's flash September consumer confidence index on Friday arguably the data highlight. The headline indicator has effectively trended sideways over the past six months. And while it fell a larger-than-expected 0.5pt in August to -7.1, that left it broadly in line with the average since the start of the year. Meanwhile, Wednesday's release of final euro area CPI data for August seems set to confirm very subdued price pressures, with headline inflation expected to align with the preliminary reading of 1.0%Y/Y, unchanged from July's 2½-year low. While core CPI was also unchanged at 0.9%Y/Y in the flash estimate, due to rounding there is a risk this will be nudged slightly higher. Wednesday will also bring new car registrations figures for August and construction output data for July, followed on Thursday by the latest current account report for July. At the country level, final Italian CPI figures for August are due Monday, while Tuesday will bring Germany's ZEW survey of analysts for September. In the markets, Germany will sell super-long-dated bonds on Wednesday, while France and Spain will sell bonds with varying maturities on Thursday.

Of course, all eyes in the coming week will be on the Fed's latest policy announcement on Wednesday. While the target range for the Fed Funds Rate is widely expected to be lowered by 25bps to 1.75-2.00%, the Fed's policy statement, updated economic forecasts and dot-plot charts, as well as Chair Powell's post-meeting press conference will be closely watched for insight into the near-term policy path. Data-wise, the highlight will likely be Tuesday's release of industrial production figures for August, which are expected to show total output reverse the 0.2%M/M drop seen in July, with similarly modest growth in manufacturing despite a steeper decline in the previous month. Ahead of this, the Empire Manufacturing index for September will come on Monday. Meanwhile, the Philly Fed index and Conference Board's leading indices and balance of payments data are due on Thursday. And housing market figures due in the coming week include the NAHB housing index (Tuesday), housing starts (Wednesday) and existing home sales (Thursday). In the markets, the Treasury will sell 10Y TIPS on Thursday.

UK

DUP predictably refutes reports of substantive Brexit concession

Sterling today appreciated to its strongest level against the dollar (above $1.24) since late July seemingly supported by reports – led by the Times – that the Northern Irish DUP had "agreed to shift its red lines in a move that could help to unlock a Brexit deal". Most notably, the newspaper suggested a willingness of the DUP to accept some EU rules in Northern Ireland after Brexit, and thus also accept some regulatory checks in the Irish Sea and divergence from the rest of the UK. The report, however, was refuted by the DUP leader Arlene Foster, who tweeted that the "UK must leave as one nation". Nevertheless, even if – as we doubt – PM Johnson reached agreement with the EU on a new deal that avoided the need for physical border infrastructure on the island of Ireland, we remain sceptical that he would be able to find a sufficient number of MPs – whether or not the DUP is supportive – for it to be approved by the House of Commons. Certainly, the most nationalist Conservatives within the ERG would seem likely to remain opposed. And the vast majority of Labour MPs would likely view any deal proposed by Johnson as inferior to the one proposed by Theresa May which they previously rejected on three occasions. So, while Johnson continues to insist that he will not ask for one, we attach a strong probability to an end-October Article 50 extension.

The coming week in the UK

The coming week will bring a number of key events, including the BoE's latest monetary policy decision on Thursday, although Bank Rate is widely expected to be left unchanged at 0.75%. While GDP in Q2 was weaker than the BoE's expectation, the past week's monthly GDP figures for July were firmer and seemed to rule out the chances of another contraction in Q3. And with wage growth having risen to the highest rate in eleven years, we would expect no change to the MPC's forward guidance that "assuming a smooth Brexit and some recovery in global growth…the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate". That said, Carney will no doubt acknowledge that a smooth Brexit can hardly be taken for granted.

With respect to economic data, Wednesday's CPI release will be closely watched, with the headline rate expected to fall in August by 0.3ppt to 1.8%Y/Y, principally on the back of lower energy prices. But core inflation is also expected to edge lower, by 0.1ppt to 1.8%Y/Y. The following day will bring retail sales figures for August, which, in line with recent downbeat surveys, are expected to report a decline in spending for the first month in three.

On the political front, Boris Johnson will travel to Luxembourg on Monday for talks with European Commission President Jean-Claude Juncker. The following day will see a UK Supreme Court hearing begin on whether Johnson's suspension of Parliament was unlawful – an announcement is expected on Thursday. Should it rule in favour of the complainants, the UK's political crisis will have become a constitutional one. But even if it prompts a chorus of calls for Johnson's resignation for misleading the Queen, and the recall of MPs back to Parliament, the outcome seems unlikely to change the near-term Brexit outlook – Johnson will still be required by law to request an Article 50 extension should a new deal not be agreed with EU leaders by 19 October. Indeed, a separate legal action to be heard in a Scottish court could compel a court clerk to write to the EU to request the Article 50 extension on 19 October if Johnson refused to do so.

	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	-0.1	0.2	0.2	0.2	0.1	1.4	1.0	0.5
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.4	1.4	1.0	1.0	1.2	1.1	1.3	1.3	1.8	1.2	1.2
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	2.0	1.7	2.1	1.7	1.5	1.6	2.5	1.9	1.7
Core CPI	1.9	1.8	1.9	1.9	2.0	2.1	1.8	1.7	2.1	1.9	1.9
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	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.40	-0.50	-0.50
Net asset purchases*	0	0	0	20	20	20	20	20	15	20	20
BoE											
Bank Rate %	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.75	0.75	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

Today's results

Economic data							
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Trade balance €bn	Jul	**19.0**	17.4	17.9	17.7
	Labour costs Y/Y%	Q2	**2.7**	-	2.4	2.5
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Aug	**0.3 (0.4)**	0.3 (0.4)	0.5 (0.6)	-

Auctions	
Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 16 September 2019			
Italy		09.00	Final CPI (EU-harmonised CPI) Y/Y%	Aug	0.5 (0.5)	0.4 (0.3)
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Sep	-	-1.0 (1.2)
			Tuesday 17 September 2019			
Germany		10.00	ZEW current situation (expectations) balance	Sep	-13.5 (-37.8)	-13.5 (-44.1)
Spain		08.00	Labour costs Y/Y%	Q2	-	2.1
			Wednesday 18 September 2019			
EMU		07.00	EU27 new car registrations Y/Y%	Aug	-	-7.8
		10.00	Final CPI (core CPI) Y/Y%	Aug	1.0 (0.9)	1.0 (0.9)
		10.00	Construction output Y/Y%	Jul	-	1.0
Italy		10.00	Total trade balance €bn	Jul	-	5.7
		09.00	Industrial sales (orders) Y/Y%	Jul	-	-0.8 (-4.8)
UK		09.30	CPI (core CPI) Y/Y%	Aug	1.8 (1.8)	2.1 (1.9)
		09.30	PPI input prices (output prices) Y/Y%	Aug	-1.0 (1.7)	1.3 (1.8)
		09.30	ONS house price index Y/Y%	Jul	0.7	0.9
			Thursday 19 September 2019			
EMU		09.00	Current account balance €bn	Jul	-	18.4
Italy		09.00	Current account balance €bn	Jul	-	5.0
UK		09.30	Retail sales including fuel M/M% (Y/Y%)	Jul	-0.2 (2.7)	0.2 (3.3)
		09.30	Retail sales excluding fuel M/M% (Y/Y%)	Jul	-0.3 (2.3)	0.2 (2.9)
		12.00	BoE Bank Rate %	Sep	0.75	0.75
			Friday 20 September 2019			
EMU		15.00	Flash consumer confidence indicator	Sep	-7.1	-7.1
Germany		07.00	PPI Y/Y%	Aug	0.8	1.1
France		07.45	Final wages Q/Q%	Q2	0.5	0.8

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 16 September 2019
EMU		-	UK Prime Minister Johnson to hold Brexit talks with EC President Jean-Claude Juncker in Luxembourg
		12.15	ECB's Lane speaks in London
			Tuesday 17 September August
EMU		17.30	ECB's Villeroy de Galhau speaks in London
			Wednesday 18 September 2019
Germany		10.30	Auction: to sell €1.5bn of 2050 -0.11% bonds
France		16.15	ECB's Villeroy de Galhau speaks in Paris
			Thursday 19 September 2019
EMU		11.00	ECB's Coeure speaks in Frankfurt
France		10.50	Auction: to sell index-linked bonds
Spain		09.45	Auction: to sell bonds
UK		12.00	BoE MPC policy announcement and meeting minutes published
		12.00	BoE to publish Agents' summary of business conditions for Q319
			Friday 20 September 2019
Italy		10.00	Auction: to sell €2bn of bonds
UK		12.00	BoE publishes its Q319 Quarterly Bulletin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

In the absence of significant news, the next edition of the Euro Wrap-up will be published on 18 September 2019

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