Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made gains as the ifo survey suggested a weakening German economic outlook.
- Gilts also made gains as the UK Supreme Court found that Johnson's decision to shut down Parliament was unlawful and a CBI survey pointed to a notable drop in manufacturing output in Q4.
- Wednesday will bring results of surveys on French consumer confidence and UK retail activity, while the UK Parliament will reconvene.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.746	+0.006
OBL 0 10/24	-0.767	-0.009
DBR 0 08/29	-0.608	-0.024
UKT 3¾ 09/21	0.455	-0.019
UKT 1 04/24	0.378	-0.025
UKT 0⅞ 10/29	0.530	-0.020

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

Euro area

Ifo survey not quite as bad as PMIs

After yesterday's dire German flash PMIs, there was significant trepidation ahead of today's German ifo survey results for September. Thankfully, the headline ifo business climate index wasn't quite so awful, rising 0.3pt from August's near-seven-year low to 94.6. That reflected an improvement in the current conditions index, which, following five successive declines, rose 1.1pt to 98.5. While that was sufficient for the ifo Institute to judge that "The downturn is taking a breather" it still marked the second-lowest reading this cycle. And although the survey detail reported an improvement in services, it also suggested ongoing deterioration in the assessment of current conditions in the manufacturing sector, as well as a softer month for construction and wholesale/retail trade.

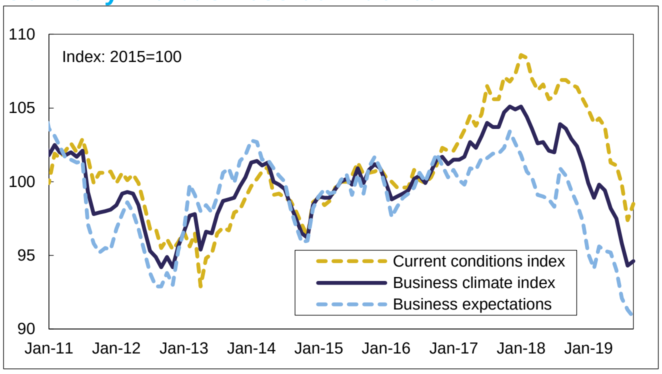
…but still points to trouble ahead

There was little to cheer about the ifo survey's forward-looking indices, however, as the index of expectations for the coming six months edged down to 91.0, the lowest since June 2009. Admittedly, according to the detail, services firms are more upbeat about future conditions. But manufacturers see no light at the end of the tunnel, wholesale and retail firms anticipate a further deterioration in conditions, and construction firms are somewhat less upbeat about the outlook too. As noted yesterday by Mario Draghi, the longer that conditions in the manufacturing sector deteriorate, the greater the likelihood that other sectors will be negatively affected. Overall, therefore, like the PMIs, the ifo survey suggests that GDP might well struggle to grow at all in Q4 and quite possibly into 2020 too.

French business sentiment remains stable

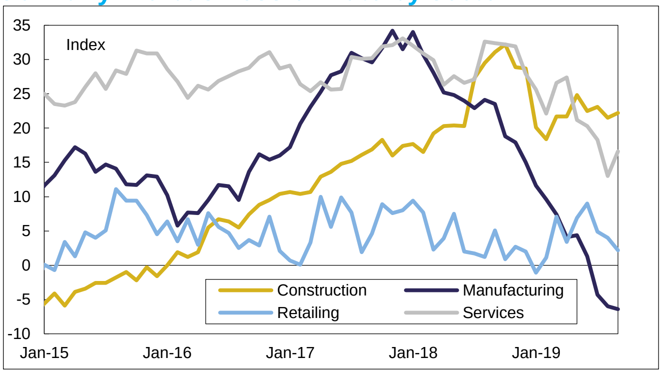
Likewise in contrast to the weaker French PMI in September, the INSEE business survey today suggested that conditions in the euro area's second-largest member state remained broadly stable at the end of Q3, with the headline business composite indicator rising 1pt to 106 and the turning point indicator signalling a broadly favourable short-term economic outlook. Within the sectoral detail, the headline manufacturing index slipped back 1pt in September. But at 102 it still remained above the long-run average, with firms in the sector on the whole a touch more upbeat about their order books and therefore more optimistic about the near-term production expectations. Services firms were reportedly more optimistic too, with the headline index rising 1pt to 106. Retailers suggested a marked improvement in business climate in September, with the relevant index up 4pts to 104. And construction firms were reportedly the most upbeat since May 2008. Overall, like the PMIs – which despite the softer September readings saw the quarterly index rise above the respective averages in Q2 and Q1 – today's survey further supports our forecast of ongoing solid French GDP growth of 0.3%Q/Q in Q3.

Germany: Ifo business confidence



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Ifo business climate by sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

The data focus tomorrow turns to the consumer sector, with the French INSEE confidence survey expected to show the headline indicator still at the top of the recent range in September, moving sideways at 102 for the third consecutive month. Elsewhere, ECB Governing Council members Cœuré and Lautenschläger are due to speak, with both reportedly having objected to the recent decision to resume QE. Meanwhile, in the markets, Germany will sell 10Y Bunds and Italy will sell zero-coupon and index-linked bonds. In the US, data-wise, tomorrow will bring just new home sales figures for August. In the markets the Treasury will sell 2Y floating-rate and 5Y fixed-rate bonds.

UK

Supreme Court rules against Government

In a damning unanimous historical judgement, the UK's Supreme Court today found that the advice given by Prime Minister Johnson to the Queen that led to the suspension of Parliament earlier this month for five weeks was unlawful. The ruling was based on the fact that the prorogation prevented MPs from doing their job in scrutinising policy-making and holding the Government to account, in this instance particularly with respect to Brexit. The Supreme Court also concluded that the shutdown of Parliament should be considered null and void, and so the Speaker subsequently called for Parliament to resume tomorrow.

Calls on Johnson to resign for misleading the Queen

Elected to office only by Conservative party members, Johnson has no clear mandate from the public as Prime Minister. And in the little more than two months since entering 10 Downing Street, his track record is ignominious in the extreme. Having lost his majority in the House of Commons by a significant margin, he has been defeated in every one of his six key votes in the Chamber. His proposal for an early General Election was blocked. He has seen key Ministers resign. He is repeatedly economical with the truth. And now he has been found attempting to bend the UK's constitution in his favour, unlawfully shutting down Parliament and misleading the Queen. In any previous political period in the UK, that latter offence alone would have been a resigning matter. So, unsurprisingly, today's judgement brought calls from leaders of opposition parties for him to quit as Prime Minister.

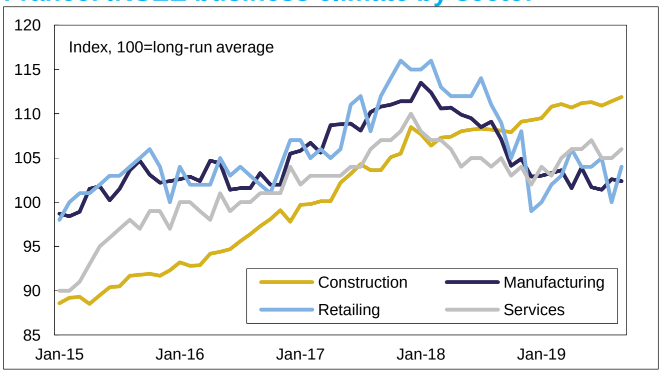
Divisions among opposition parties let Johnson off the hook

These are not, however, normal times. If they united in Parliament, the opposition parties would have the numbers required to unseat the Prime Minister and take control of Government with the aim of extending the Article 50 deadline. However, they are divided in many important areas. For example, while the Labour Party yesterday confirmed its intention to support a referendum after a new General Election, it rejected for the time being a proposal to campaign unequivocally to remain in the EU, which would have aligned it with other opposition parties. Most pressing perhaps, disagreement exists not least with respect to who among them would succeed Johnson as an interim Prime Minister if they removed him. As such, while political pressure on the Government will increase, the near-term emphasis will be on its scrutiny rather than replacement.

Events to come to a head next month

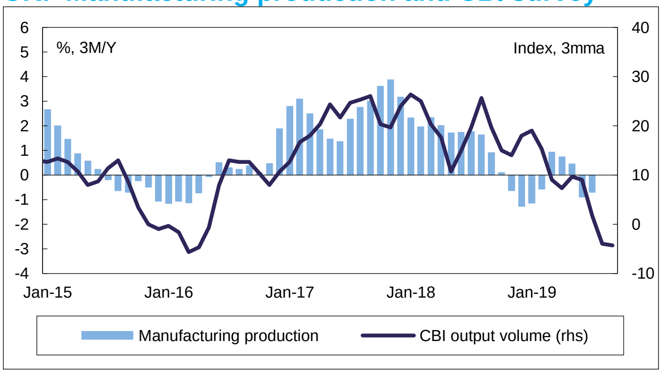
Therefore, the outlook for Brexit will still depend principally on whether or not Johnson can secure a deal with the EU at the Summit on 17-18 October, and how MPs decide to respond. So far, the lack of workable proposals from Johnson with respect to arrangements on the island of Ireland that might be acceptable to the EU has been notable. That suggests that – like on many policy issues – he might well not be serious about reaching an agreement. And given the arithmetic in the House of Commons and the extent to which the PM has poisoned political discourse in the UK over recent weeks, Johnson's ability to find a majority in Parliament in favour of any deal negotiated by him must be in doubt. However, a wide range of

France: INSEE business climate by sector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing production and CBI survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

outcomes next month – from approval of some kind a deal by MPs to its outright rejection, or submission of a deal to a second referendum against the option of remaining in the EU – remains feasible. Today's judgement should at least, however, prevent Johnson from using prorogation as a tool to force a no-deal Brexit next month. And our baseline scenario, to which we attach a strong probability, remains an extension of the Article 50 deadline beyond the end of October, to facilitate a General Election and/or second referendum.

Manufacturing orders signal drop in output ahead

Despite ongoing Brexit uncertainty, according to today's CBI industrial trends survey, manufacturers were somewhat less downbeat about production at the end of the third quarter. Indeed, almost half of the sub-sectors surveyed suggest a modest pickup in output in the three months to September, with the relevant index for total output volumes rising for the second successive month to +1, the first positive reading since June. But this still left the index over the third quarter as a whole at its weakest since Q116 and consistent with a sizeable decline compared with a year earlier. Moreover, manufacturers were notably more pessimistic about production over the coming three months, with the survey's indicator down a whopping 18pts to -19, the lowest since the Global Financial Crisis. This no doubt reflected weaker order books, which were reported to have remained below normal levels in September and to a much greater extent than August, while current inventory of finished goods was reported to be above adequate to the greatest degree since mid-2009. Of course, this gloomy outlook is hardly surprising given the troubles in the manufacturing sector in many major economies, as well as the likelihood of de-stocking once the end-October Article 50 deadline has passed. And it further supports our view that the manufacturing sector will provide a notable drag on GDP growth in Q4.

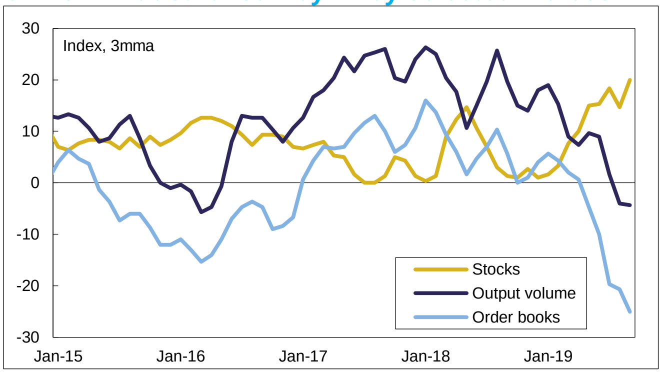
Public sector borrowing trending higher

Today's public finance figures saw net borrowing more or less unchanged compared with a year earlier in August, at £6.4bn compared to £6.9bn in August 2018. However, while government spending was little changed last month (up £0.2bn compared with August 2018 to £58.6bn), this largely reflected lower debt interest payments thanks to the steady decline in Gilt yields. Indeed, departmental expenditure on goods and services increased by £1.8bn year-on-year in August, with almost one third of that rise reflecting higher staffing costs. Moreover, since April, cumulative government spending was £6.8bn higher than the equivalent period in 2018, at £31.8bn, 28% higher than equivalent period last year, partly due to extra expenditure on the National Health Service. That on its own suggested that governing borrowing in the current fiscal year would overshoot the OBR's forecast. Moreover, today's release also brought the confirmation that revised methodology and data changes had already increased net borrowing in FY18/19 by £17.8bn to £41.1bn (1.9% of GDP) compared with £23.6bn (1.1% of GDP) previously estimated, with a revised treatment of student loans alone increasing borrowing by £12.4bn. And overall, given a further anticipated increase in public expenditure on Brexit preparations, today's release strongly suggests that the net borrowing for the fiscal year as a whole will significantly exceed that in the previous financial year, likely rising above £50bn (to more than 2½% of GDP). That means that the Government is likely to have to relax its fiscal rules if it is still in office throughout the remainder of the fiscal year. And with both the Conservative and Labour parties promising significant further increases in public spending from FY20/21 if they are in charge of the Government then, higher and rising deficits look in store for the UK over coming years.

The day ahead in the UK

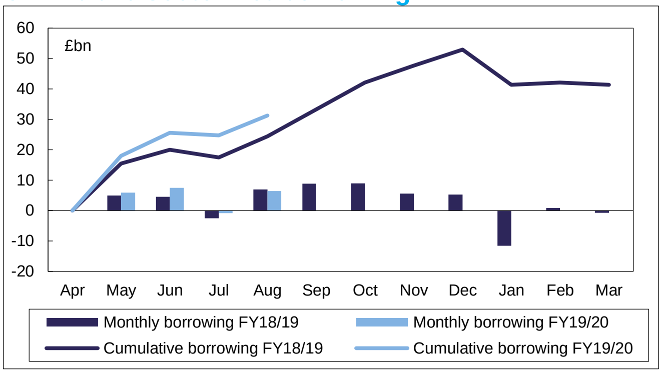
While Parliament will resume, tomorrow will bring the CBI's distributive trades survey, which will provide an update on retail sector conditions at the end of the third quarter. With the retail sales balance having slumped in August to its lowest since the Global Financial Crisis, tomorrow's survey is expected to report a modest improvement. That, nevertheless, will still likely point to a sizeable decline in retail sales compared with a year earlier and consistent with a notable slowing in consumption growth over the third quarter as a whole. However, we caution that this survey hasn't provided a very reliable guide to official retail sales data over recent quarters. And despite the likely downbeat CBI survey and ongoing Brexit uncertainty, tomorrow's UK Finance figures for August are likely to signal still solid consumer credit and mortgage lending growth.

UK: CBI industrial survey – key selected indices



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing*



**Based on new methodology. Source: ONS and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results							
Economic data							
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Ifo business climate index	Sep	**94.6**	94.5	94.3	
	Ifo current assessment (expectations) balance	Sep	**98.5 (90.8)**	96.9 (92.0)	97.3 (91.3)	97.4 (-)
France	Business confidence indicator	Sep	**106**	105	105	-
	Manufacturing confidence (production outlook) indicator	Sep	**102 (4)**	102 (3)	102 (2)	103 (-)
UK	Public sector not borrowing £bn	Aug	**6.4**	6.5	-1.3	-0.8
	CBI industrial trends survey - total orders	Sep	**-28**	-16	-13	-
Auctions						
Country	Auction					
Germany	sold €3.2bn of 0% 2021 bonds at an average yield of -0.73%					
UK	sold £500mn of 0.125% index-linked 2048 bonds at an average yield of -2.154%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France	07.45	Consumer confidence indicator	Sep	103	102
UK	09.30	UK Finance loans for house purchase £bn	Aug	43.2	43.3
	11.00	CBI distributive trades survey - reported sales	Sep	-25	-49
Auctions					
Country	BST	Auction/Event			
EMU	08.00	ECB's Cœuré speaks in Frankfurt			
Germany	10.30	Auction: to sell €3bn of 0% 2029 bonds			
Italy	10.00	Auction: to sell €1.5bn of 2021 zero-coupon bonds			
	10.00	Auction: to sell €500mn of 2.55% 2041 index-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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