Euro wrap-up

Overview

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- Bunds ended the day little changed as an upside surprise to today's German retail sales figures offset softer-than-expected inflation.
- Gilts made modest gains as revised UK GDP figures confirmed that the economy contracted in Q2, with household consumption weaker than previously estimated.
- Tuesday will bring the euro area's flash CPI estimate, as well as final manufacturing PMIs from euro area member states and the UK.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.778	+0.005
OBL 0 10/24	-0.776	+0.002
DBR 0 08/29	-0.574	+0.004
UKT 3¾ 09/21	0.367	-0.010
UKT 1 04/24	0.285	-0.023
UKT 0⅞ 10/29	0.483	-0.016

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

Euro area

A welcome upside surprise from German retail sales

After last week's very downbeat survey results, the latest German retail sales figures provided some relief with a welcome upside surprise. In particular, sales rose 0.5%M/M in August after a revised drop of -0.8%M/M the prior month. That updated figure for July represented a marked improvement on the initial estimate, which had suggested that sales had declined 2.1%M/M. So the moderate increase in August left sales up 3.2%Y/Y and trending about 0.4% higher in Q3 than the average in Q2. And while the retail sales figures don't always provide a reliable guide to overall private consumption, with auto sales also looking firmer this quarter, household spending does appear to have provided support to overall GDP growth once again in Q3.

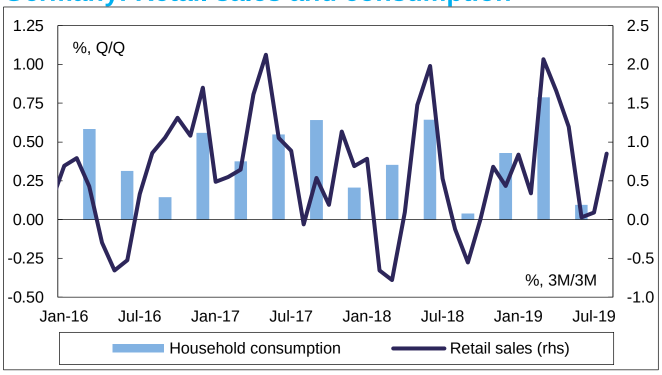
But a loss of momentum in the German labour market?

At face value, the latest German labour market data also appeared better than expected, with a first drop in five months in the number of people out of work. Admittedly, the decline of 10k in September was modest and left the unemployment rate unchanged at 5.0%, still 0.1ppt above its series low reached in March and April. Most notable, perhaps, the level of vacancies declined for a sixth month in succession on a seasonally adjusted basis to the lowest level since October 2017. With economic growth set to remain weak, and surveys pointing to a more significant weakening in labour market conditions than these data suggest – e.g. the composite employment PMI fell more than 1pt in September to just 50.1, the lowest since 2013 – we expect the German unemployment rate to tick higher over coming months.

Euro area unemployment rate down again

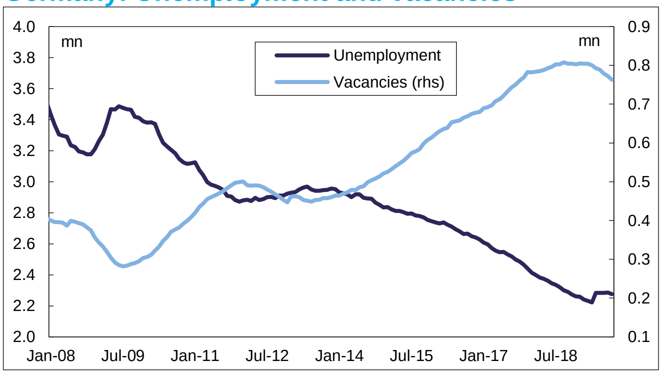
The latest euro area unemployment data, however, reported further improvements in the labour market in August. The headline rate edged down a further 0.1ppt to 7.4%, the lowest since 2008, 0.6ppt below its level a year earlier and 4.7ppts below the peak in 2013. The number of people out of work fell for the tenth successive month and by 115k to 12.169mn, down a notable 7.2mn from the post-crisis peak. Almost one third of the decline in joblessness reflected a drop in youth unemployment, which fell to 2.2mn, more than 1.5mn below the post-crisis peak and a new euro-era low. Among the large member states, despite a third consecutive monthly rise in the level of joblessness, the unemployment rate declined in Spain by 0.1ppt to 13.8%, the lowest since November 2008. And Italy's unemployment rate fell 0.3ppt to 9.5%. But that reflected unemployed workers leaving the labour force rather than an increase in employment, and we look for payback in coming months. Meanwhile, like in Germany (3.1% on the EU measure), the headline rate was unchanged in France (8.5%). And for the second month in three it rose in the Netherlands (to a still low 3.5%), while Austria and Finland also recorded increases

Germany: Retail sales and consumption



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: Unemployment and vacancies



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

in unemployment. Given the slowing economy, we expect the pace of decline in the euro area unemployment rate to moderate further over coming months before it levels off early next year.

National inflation data surprise on the downside

Just like the French figures released on Friday, which saw the headline CPI rate on the EU measure drop 0.2ppt to 1.1%Y/Y, today's flash estimates of September inflation in Germany, Italy and Spain all surprised on the downside. In particular, German inflation on the same basis slipped back by 0.1ppt to 0.9%Y/Y, while the equivalent Italian and Spanish figures dropped 0.2ppt to 0.3%Y/Y and 0.2%Y/Y respectively. The figures in each of the three countries were the lowest since the autumn of 2016. While only limited detail was provided about various components, the information offered by the respective statistical agencies made it clear that lower energy prices were the key driver of the declines in headline inflation. In Italy, however, ISTAT reported that core inflation on the EU measure was stable (0.6%Y/Y). And in Germany, on the national measure, inflation of food and non-energy industrial goods fell but services inflation picked up. Today's data make it clear that the euro area flash data, due tomorrow, are bound to report a decline in the headline rate, probably of 0.2ppt to 0.8%Y/Y, which would be the lowest since November 2016. But the core rate might well tick up 0.1ppt to 1.0%Y/Y.

The day ahead in the euro area and US

The main economic focus in the euro area tomorrow will be the aforementioned flash estimate of CPI for September. Despite the recent pickup in the oil price, headline CPI is expected to have fallen below 1%Y/Y for the first time since November 2016, while core inflation might well tick higher to 1.0%Y/Y. Tomorrow will also bring the final manufacturing PMIs for September, which seems highly likely to confirm the extremely disappointing flash release that showed the headline euro area index declining 1.4pts to 45.6, the lowest in more than seven years. Elsewhere, ECB Chief Economist Lane will speak in Los Angeles in the early hours of tomorrow morning, while Bundesbank President Weidmann is due to speak in Vienna later in the day.

In the US, tomorrow will bring the manufacturing ISM for September, which is expected to show that the headline index remained consistent with stagnation in the sector. The final manufacturing PMI from Markit, which is less closely watched than the ISM survey, is likely to give a slightly more positive signal, aligning with the flash estimate which reported a modest recovery at the end of Q3. Construction spending figures for August and vehicle sales numbers for September are also due. Elsewhere, the Fed's Evans is due to speak in Frankfurt, while Governors Clarida and Bowman will speak in the US.

UK

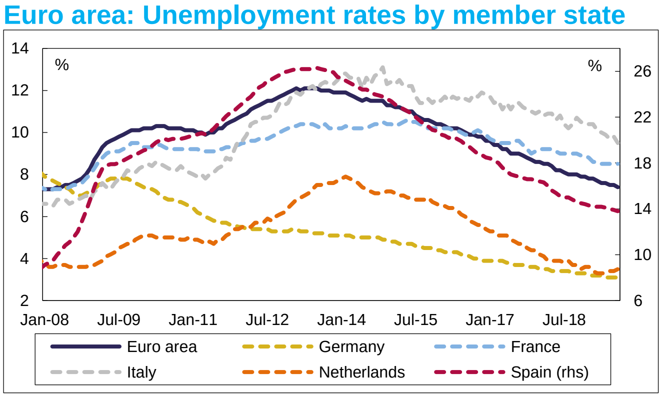
Q2 GDP unrevised at -0.2%Q/Q

While the final estimate of Q2 GDP saw headline growth unrevised at -0.2%Q/Q – the first quarterly contraction since Q412 – today's national accounts release saw notable revisions to the expenditure components that quarter, as well adjustments to the figures for previous quarters. In particular, GDP growth was revised up by 0.1ppt in Q218 (to +0.5%Q/Q), Q418 (to +0.3%Q/Q) and Q119 (to +0.6%Q/Q) and revised down by 0.1ppt in Q318 (to +0.6%Q/Q). As such, the annual GDP growth rate stood at 1.3%Y/Y in Q2, 0.1ppt higher than previously estimated, but still down from growth of 2.1%Y/Y in Q1.

Weaker private consumption offset by government spending

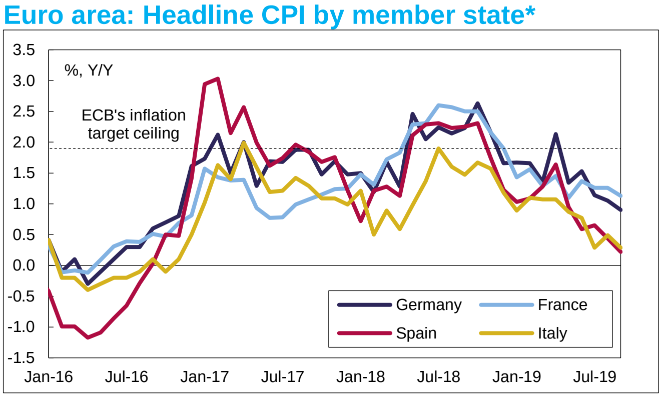
The detail of the report offered a more downbeat assessment of the underlying economic performance over recent quarters. For example, while the savings ratio was estimated to have risen back to its level around the time of the 2016 referendum, household consumption was weaker than previously assessed in each quarter since Q318, with growth averaging just 0.2%Q/Q over the four quarters to Q219, half the rate previously estimated. But while the decline in business investment was

Euro area: Unemployment rates by member state



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Headline CPI by member state*



**EU harmonised measures. September figures are flash estimates.*
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

a touch softer than initially estimated (by 0.1ppt to -0.4%Q/Q), this still marked the fifth quarterly contraction in this component out of the past six. And revisions suggest a weaker performance than previously thought for this component since the general election in Q217.

While private domestic demand was weaker than previously thought, however, government spending over the past five quarters was stronger, with the average quarterly increase during that period (0.8%Q/Q) almost double that previously estimated. And while other components of final domestic demand look set to remain subdued, government spending should be supported by increased no-deal Brexit preparations in the current quarter too. Meanwhile, although today's release confirmed a notable decline in inventories in Q2, the fall was less than previously expected. So, while the negative contribution to GDP growth was still a hefty 2.9ppts, this compared favourably with the initial estimate of 3.8ppts. By the same token, however, there are several reasons to believe that the boost from precautionary stock building in Q3 ahead of the current end-October Brexit deadline will be less marked than the contribution of 2.8ppts in Q1.

Current account deficit narrows slightly

Today's national accounts figures also saw a significant revision to the positive contribution from net trade too. While the plunge in imports (down by a record 13.0%Q/Q) was confirmed, the decline in exports was steeper than previously thought – the 6.6%Q/Q drop was double that initially estimated and the largest for almost thirteen years. So, the contribution from net trade was revised to 2.5ppts, a series record albeit not fully reversing the drag on growth in Q1. The improved trade performance was also reflected in the narrowing of the current account deficit, down almost £8.0bn in Q2 to £25.2bn, a three-quarter low. But at 4.6% of GDP, the current account deficit still remains very high by historical (and international) standards, illustrating the UK's significant reliance on foreign net capital inflows and further suggesting significant economic vulnerability in the event of a no-deal Brexit.

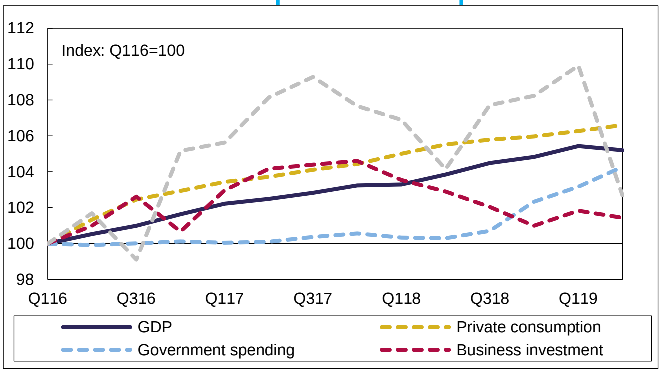
Consumer credit growth moderates further

Today's lending figures from the Bank of England suggested that household spending might well remain subdued in the current quarter. For example, net consumer credit fell to £0.9bn in August, slightly below the average of the past year, with net credit card borrowing up just £0.2bn, the lowest since December. As such, the annual pace of consumer credit growth moderated to 5.4%Y/Y, the softest pace since February 2014 and considerably lower than the near-11%Y/Y peak towards the end of 2016. Meanwhile, net mortgage lending also slipped back in August to £3.9bn, although this was down from a particularly strong reading in July (£4.5bn) and therefore remained in line with the average since 2016. And while mortgage approvals for house purchase were down from July's eighteen-month high, they too were in line with the range of the past three years. Of course, the outlook for the housing market and demand for household loans will depend in no small part on the path of Brexit. But despite recent declines in borrowing rates, the longer uncertainty persists, a weakening lending trend seems likely to materialise.

The day ahead in the UK

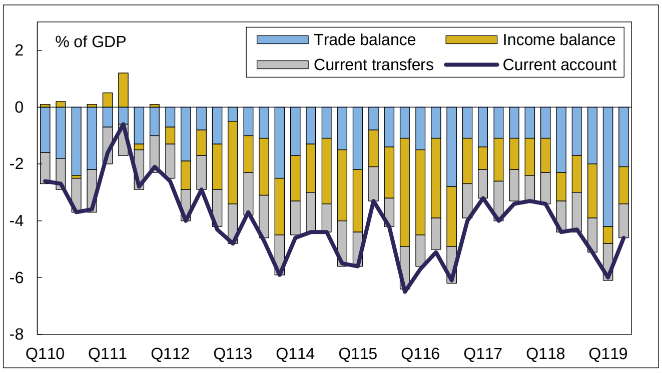
While politics will continue to dominate the news flow, tomorrow's UK manufacturing PMI will also be closely watched. Having declined to the lowest level for more than six years in August (47.4) the headline manufacturing index is expected to fall further into contractionary territory in September as downside risks – domestic and external alike – intensified. In the markets, the DMO will sell 18Y Gilts.

UK: GDP level and expenditure components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Current account 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
EMU		Unemployment rate %	Aug	**7.4**	7.5	7.5	-
Germany		Retail sales M/M% (Y/Y%)	Aug	**0.5 (3.2)**	0.5 (3.2)	-2.2 (4.4)	-0.8 (5.2)
		Unemployment rate % (change '000s)	Sep	**5.0 (-10.0)**	5.0 (5.0)	5.0 (4.0)	- (2.0)
		Preliminary CPI (EU-harmonised CPI) Y/Y%	Sep	**1.2 (0.9)**	1.3 (1.0)	1.4 (1.0)	-
Italy		Unemployment rate %	Aug	**9.5**	9.8	9.9	9.8
		Preliminary CPI (EU-harmonised CPI) Y/Y%	Sep	**0.4 (0.3)**	0.6 (0.5)	0.4 (0.5)	-
Spain		Preliminary CPI (EU harmonised CPI) Y/Y%	Sep	**0.1 (0.2)**	0.3 (0.3)	0.3 (0.4)	-
		Final GDP Q/Q% (Y/Y%)	Q2	**0.4 (2.0)**	0.5 (2.3)	0.7 (2.4)	-
UK		Lloyds buinness barometer	Sep	**2**	-	1	-
		Final GDP Q/Q% (Y/Y%)	Q2	**-0.2 (1.3)**	-0.2 (1.2)	0.5 (1.8)	0.6 (2.1)
		Current account balance £bn	Q2	**-25.2**	-19.0	-30.0	-33.1
		Net consumer credit £bn (Y/Y%)	Aug	**0.9 (5.4)**	0.9 (5.5)	0.9 (5.5)	1.0 (5.6)
		Net mortgage lending £bn (mortgage approvals '000s)	Aug	**3.9 (65.5)**	4.2 (66.5)	4.6 (67.3)	4.5 (67.0)

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		09.00	Final manufacturing PMI	Sep	45.6	47.0
		10.00	Flash CPI estimate (core CPI) Y/Y%	Sep	*0.8 (1.0)*	1.0 (0.9)
Germany		08.55	Final manufacturing PMI	Sep	41.4	43.5
France		08.50	Final manufacuturing PMI	Sep	50.3	51.1
Italy		08.45	Manufacturing PMI	Sep	48.1	48.7
Spain		08.15	Manufacturing PMI	Sep	48.2	48.8
UK		09.30	Manufacturing PMI	Sep	47.0	47.4

Country		BST	Auction/Event
EMU		02.00	ECB Chief Economist Lane due to speak in Los Angeles
		18.30	ECB's Weidmann due to speak in Vienna
UK		10.30	Auction: to sell 1.75% 2037 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.