

# Euro wrap-up

## Overview

- Bunds followed Treasuries higher as the final euro area services PMI signalled a significant weakening in activity at the end of Q3.
- Gilts also rose as the UK services and composite PMI signalled contraction and Johnson's Brexit plan received a cool reception from the EU.
- A quieter end to the week for European economic data will bring Germany's construction PMI and UK new car registrations figures, while much attention will be on the US labour market report.

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### Daily bond market movements

| Bond         | Yield  | Change |
|--------------|--------|--------|
| BKO 0 09/21  | -0.793 | -0.013 |
| OBL 0 10/24  | -0.799 | -0.028 |
| DBR 0 08/29  | -0.588 | -0.037 |
| UKT 3% 09/21 | 0.373  | -0.010 |
| UKT 1 04/24  | 0.282  | -0.013 |
| UKT 0% 10/29 | 0.483  | -0.020 |

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

Source: Bloomberg

## Euro area

### Retail sales at risk of reverse in Q3

Broadly in line with expectations, euro area retail sales rose 0.3%M/M in August, a modest rebound following the (revised) drop of 0.5%M/M the prior month. Following weakness in each country in July, sales rose about ½%M/M in Germany, France and Spain (Italy has yet to release its figures). The increase in euro area sales in August left them up a seemingly respectable 2.1%Y/Y, bang in line with the average of the past year. Within the detail, food sales were flat on the month in August to be up just 0.4%Y/Y. In contrast, core (i.e. non-food and non-fuel) items rose 0.4%M/M, insufficient to reverse the decline the previous month but enough to be up a firm 4.1%Y/Y. With growth in August relatively modest, the average level of sales in the first two months of Q3 was just 0.1% above the Q2 average, suggesting a clear risk of a first quarterly decline in sales since Q415. However, with consumer confidence continuing to trend broadly sideways, and employment and wages still rising, we expect a somewhat stronger performance in Q4 despite the ongoing deterioration in business confidence.

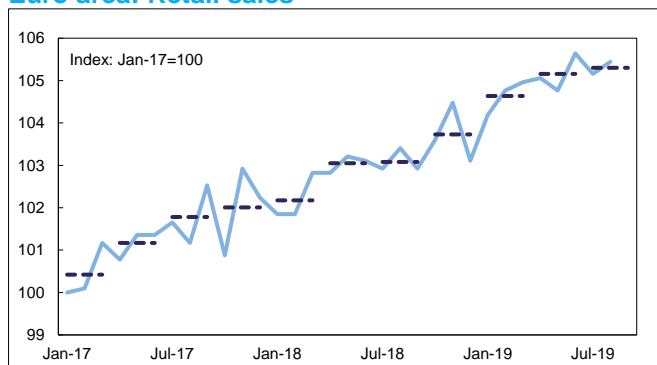
### Final composite PMI revised even lower

While the final euro area [manufacturing PMI](#) for September was nudged slightly higher, it still implied weakening activity in the sector with the index down 1.3pts on the month to 45.7, the lowest since 2012. And today's final services PMI suggested an even sharper deterioration in conditions at the end of Q3 than was initially thought, with the headline PMI for the sector downwardly revised (0.4pt) to 51.6, a decline of 1.9pts from August and the lowest since January. As such, the composite PMI was also pushed lower from the preliminary release to 50.1, a drop of 1.8pts on the month, the lowest since June 2013 and a level suggesting that economic growth has all but come to a halt. Over the third quarter as a whole, the composite index stood at 51.2, the weakest for more than three years and consistent with GDP growth of 0.1%Q/Q at best. And the survey suggested that risks to the near-term outlook remained firmly to the downside, with the new orders component falling into contractionary territory in September for the first month in seven and signalling the steepest pace of decline for more than six years.

### Germany leading the decline

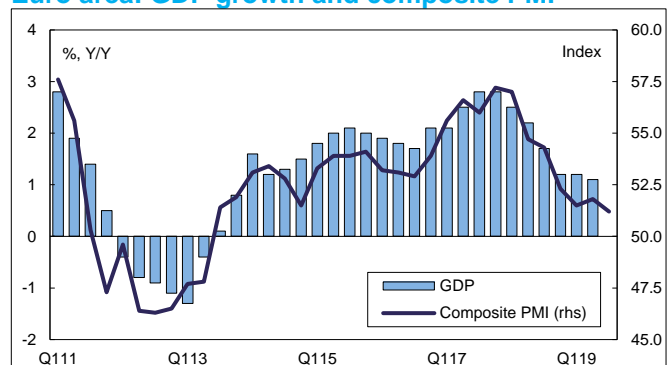
Within the country detail, like in the euro area, the already significant deterioration in Germany's services PMI was deemed to be larger still at the end of the third quarter, with the near-1pt downwards revision leaving the index at 51.4, a drop of 3.4pts from August and the lowest since mid-2013. As such, the composite PMI implied a steeper pace of contraction last month, with 48.5 the weakest reading for almost seven years. And while the new orders component was unrevised, at 45.0 it pointed to further significant weakness ahead. The French services and composite PMIs were also nudged lower from the preliminary release to 51.1 and 50.8 respectively, albeit still signalling another quarter of moderate GDP growth in Q3. While Italy's services PMI bucked the trend in September (rising 0.8pt to 51.4), the composite PMI (50.6) was still consistent with broad stagnation in the economy. And although

### Euro area: Retail sales\*



\*Dashed dark blue lines represent quarterly average.  
Source: 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.



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Spain's services PMI still suggested that the sector continued to outperform that in other member states, it fell 1pt in September to 53.3, to leave the composite PMI 0.9pt lower at 51.7, near the bottom of the recent range.

## The day ahead in the euro area and US

It should be a quiet end to the week for euro area economic data, with just Germany's construction PMI for September due for release on Friday. In the US, however, all eyes will be on the BLS employment report, with non-farm payrolls expected to have increased by about 140k in September, slightly below the average for the year so far. The unemployment rate is expected to be unchanged at 3.7%, while average earnings growth is also forecast to be unchanged at 3.2%Y/Y. In terms of Fed speak, Chair Powell will make opening remarks at a 'Fed listens' event, while voting member Rosengren and non-voting member Bostic are due to speak publicly.

## UK

### A mixed response to Johnson's Brexit proposals

The response to Boris Johnson's first formal Brexit proposals has inevitably been mixed. While the plans represent a harder Brexit than envisaged by Theresa May and would thus have more adverse economic consequences, the early evidence suggests that a majority in favour might well exist in the House of Commons. In contrast, although Johnson claimed that his plans represent a "Fair and Reasonable Compromise" to form the basis of a revised Withdrawal Agreement and Political Declaration, in current form they cannot be accepted by the EU. Hence the initial cool responses yesterday evening from Commission President Juncker (who stated that there are "some problematic points") and Irish Taoiseach Varadkar (who sees "a real difficulty that's going to be very hard to reconcile"), and today from the European Parliament's Brexit Steering Group (which expressed "grave concerns" and judged that the proposals "do not match even remotely what was agreed as a sufficient compromise"). Certainly, there are many appropriate criticisms of Johnson's proposals, which lack detail and have also left much to be ironed out only if and when the Withdrawal Treaty comes into force during the transition period. And, crucially, they clearly go beyond well-known EU redlines.

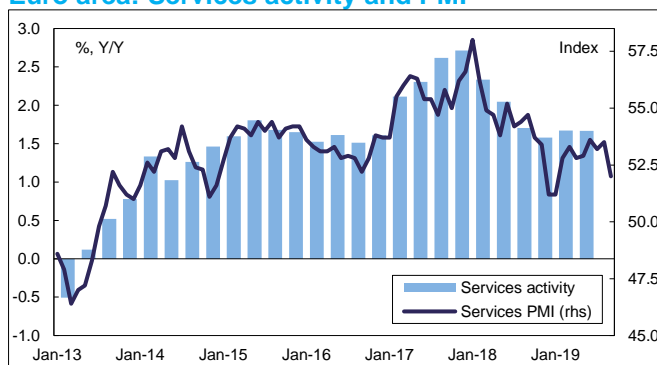
### Assembly veto to All-Ireland Regulatory Zone key obstacle to agreement

The heart of Johnson's plan, which centres on replacing Theresa May's Irish border backstop, would see Northern Ireland remain aligned with the EU's single market rules for all goods, including food, in an "all-Ireland regulatory zone". But how this might work in practice remains unclear. And the arrangements would throw up plenty of oddities. For example, regulatory checks would have to be conducted on goods moving within the UK from Great Britain to Northern Ireland by UK authorities on the EU's behalf. But at the same time, there would be no checks on goods moving in the opposite direction, from Northern Ireland to England, Scotland or Wales. And particularly problematically the arrangements for such an "all-Ireland regulatory zone" would have to be endorsed by the Northern Ireland Executive and Assembly during the transition period before they go into force, and then every four years thereafter. That would effectively give the Democratic Unionist Party a regular veto over the nature of the Irish border, i.e. raising the prospect of a much harder border at its whim, something that surely can't be accepted in Dublin, Brussels or among more than half of Northern Ireland's community, including businesses that operate across the border.

### Customs arrangements a further problem for EU

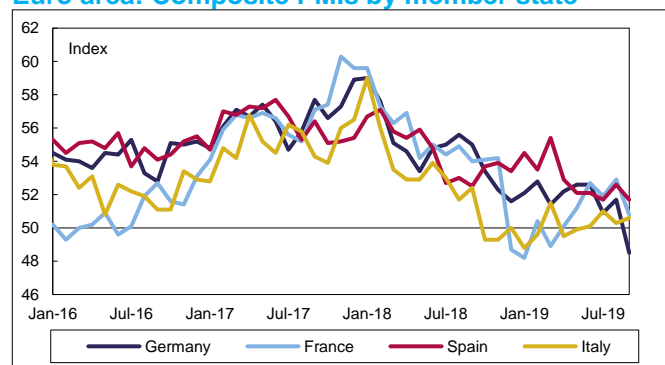
In terms of customs arrangements, meanwhile, Northern Ireland would remain fully part of UK arrangements, which – contrary to an option that had been left open by Theresa May – would be wholly distinct from the EU at the end of the transition period. Among other things, that would imply the need for tariffs to apply to goods exported from the whole of the UK including Northern Ireland to the Irish Republic. Most importantly perhaps, these proposals would require checks to ensure compliance with the different customs (and VAT) regimes as goods move between the two countries. Johnson claims that such physical checks could be minimal and "conducted at traders' premises or other points in the supply chain". But the technology is lacking and the infrastructure seems impossible to install by the end of the transition period, which is currently set for December 2020. And the arrangements are unlikely to provide effective enforcement along a border that in the past was a focal point for smuggling and paramilitary activity. Moreover, however light touch the enforcement, surveillance in the border communities will be resented. And so, the EU side will understandably judge that Johnson's proposals raise profound issues about compatibility with the Northern Ireland agreement as well as serious questions about the integrity of the single market and customs union.

### Euro area: Services activity and PMI



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

### Euro area: Composite PMIs by member state



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

## EU to discuss proposals but unlikely to reach agreement

Despite the obvious flaws, the public response of EU officials has been predictably polite. In private, they will be much more critical. But the EU does not wish to be blamed for the failure to reach a deal. So, negotiations between the UK and EU will take place over coming days. Even if there are sudden shifts in position behind the scenes, it seems impossible to believe that the differences can be sufficiently bridged and necessary detail completed in time for agreement to be reached at the EU Summit on 17-18 October to allow the UK to leave the EU with a deal at end-October. While that means that Johnson is highly likely then to pivot towards a no-deal Brexit, given the Benn-Burt anti-no-deal legislation, we continue to attach a high probability to our baseline assumption of an extension of the Article 50 deadline. That, however, might well require further recourse to the UK's Supreme Court in the back end of the month.

## Services PMI signals contraction

Unsurprisingly given heightened Brexit uncertainty, September's services PMI today provided an extremely bleak assessment of current and future conditions in the sector. Indeed, the headline activity index declined by a larger-than-expected 1.1pts to 49.5, only the fifth reading in contractionary territory over the past decade. This left the quarterly index unchanged at 50.5 in Q3, 3pts lower than a year ago and barely consistent with expansion. And the survey components implied further weakness ahead. For example, the new orders PMI fell for the second successive month and by 1.6pts to 49.3, with expectations about conditions over the coming year at the lowest since the Global Financial Crisis. Against this backdrop, firms reportedly scaled back their workforces at the fastest pace for almost a decade.

## Construction PMI continues to collapse

Yesterday's construction PMI similarly suggested that the negative consequences of Brexit uncertainty had been acute in the third quarter and were likely to weigh further on output for as long as the no-deal risks persisted. The headline activity PMI fell (1.7pts) for the fourth month out of the past five in September to 43.3, the second-lowest reading since April 2009. This left the quarterly average at just 44.5, almost 2pts lower than in Q2 and down a whopping 9pts lower than a year earlier. While the weakness was widespread, the survey suggested a further notable decline in civil engineering activity, with the relevant PMI down 2.9pts to 41.3, the lowest for almost a decade. A similar pace of contraction was seen in commercial activity too, while residential construction fell for the fourth consecutive month. But looking ahead, despite a modest increase on the month, the new orders component (40.8) was close to the lowest levels since the Global Financial Crisis and consistent with ongoing contraction. And with business expectations still well below the long-run average, construction firms continued to scale back their workforces, with the relevant index suggesting the steepest pace of job losses since early 2010.

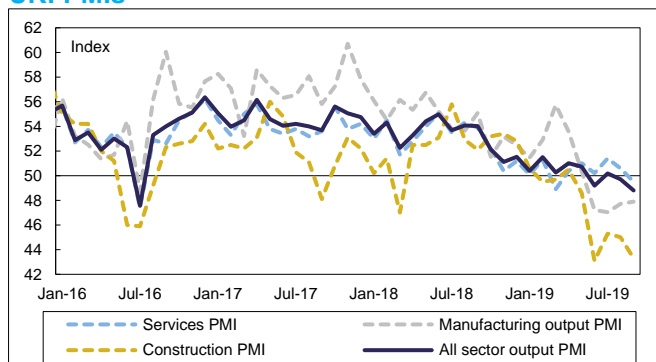
## Composite PMI second-lowest since GFC

So, despite the modest improvement in the manufacturing PMI earlier this week, today's headline composite PMI fell 0.9pt to 49.3, the lowest since the brief slump in the aftermath of the 2016 referendum. And the all-sector PMI (which also includes the construction sector) declined to just 48.8, similarly the second-lowest reading since the Global Financial Crisis and a level that would imply GDP growth of -0.2%Q/Q. Over the quarter as a whole, the composite output index averaged 49.6, which Markit assessed to be consistent with a contraction of 0.1%Q/Q in Q3. Admittedly, we expect to see a modest expansion in Q3 as growth likely received temporary support from car production and Brexit-related stock building ahead of this month's Article 50 deadline. But the survey offered little reassurances about the outlook for Q4, with the new orders PMI down 0.8pt in September to just 48.1, and expectations for future output close to the lowest in the survey's history and the employment index signalling the deepest job cuts since 2009.

## The day ahead in the UK

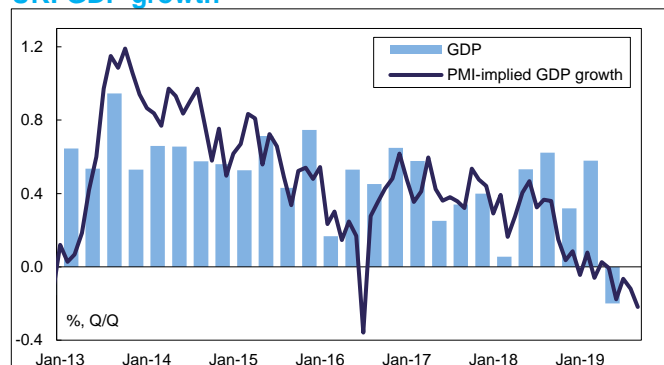
In the UK, tomorrow will bring new car registrations figures for September. While annual growth might well be flattered by base effects following the sharp decline this month last year as new emissions testing came into effect, the number of cars registered in the year to date is still likely to be lower compared with last year as persistent Brexit uncertainty continues to weigh on confidence.

### UK: PMIs



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

### UK: GDP growth











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







# European calendar

## Today's results

### Economic data

| Country | Release  | Period | Actual             | Market consensus/<br><i>Daiwa forecast</i> | Previous    | Revised  |
|---------|--|--------|--------------------|--|-------------|----------|
| EMU     |  Final services PMI (composite PMI) | Sep    | <b>51.6 (50.1)</b> | 52.0 (50.4)                                | 53.5 (51.9) | -        |
|         |  Retail sales M/M% (Y/Y%)           | Aug    | <b>0.3 (2.1)</b>   | 0.3 (2.1)                                  | -0.6 (2.2)  | -0.5 (-) |
|         |  PPI Y/Y%                           | Aug    | <b>-0.8</b>        | -0.5                                       | 0.2         | 0.1      |
| Germany |  Final services PMI (composite PMI) | Sep    | <b>51.4 (48.5)</b> | 52.5 (49.1)                                | 54.8 (51.7) | -        |
| France  |  Final services PMI (composite PMI) | Sep    | <b>51.1 (50.8)</b> | 51.6 (51.3)                                | 53.4 (52.9) | -        |
| Italy   |  Services PMI (composite PMI)       | Sep    | <b>51.4 (50.6)</b> | 50.5 (50.0)                                | 50.6 (50.3) | -        |
| Spain   |  Services PMI (composite PMI)       | Sep    | <b>53.3 (51.7)</b> | 53.8 (51.8)                                | 54.3 (52.6) | -        |
| UK      |  Services PMI (composite PMI)       | Sep    | <b>49.5 (49.3)</b> | 50.3 (50.0)                                | 50.6 (50.2) | -        |




### Auctions

| Country | Auction  |
|---------|--|
| France  |  Auction: sold €5.8bn of 0%2029 bonds at an average yield of -0.24%                     |
|         |  Auction: sold €2.4bn of 1.5% 2050 bonds at an average yield of 0.55%                   |
|         |  Auction: sold €1.3bn of 4% 2055 bonds at an average yield of 0.6%                      |
| Spain   |  Auction: sold €2.2bn of 0.6% 2029 bonds at an average yield of 0.115%                 |
|         |  Auction: sold €749mn of 2.7% 2048 bonds at an average yield of 1.003%                |
|         |  Auction: sold €524mn of 0.65% 2027 index-linked bonds at an average yield of -0.817% |


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

## Yesterday's releases

### Economic data



| Country | Release   | Period | Actual      | Market consensus/<br><i>Daiwa forecast</i> | Previous | Revised |
|---------|---|--------|-------------|--|----------|---------|
| Spain   |  Unemployment change '000s | Sep    | <b>13.9</b> | -  | 54.4     | -       |
| UK      |  BRC shop price index Y/Y% | Sep    | <b>-0.6</b> | -  | -0.4     | -       |
|         |  Construction PMI          | Sep    | <b>43.3</b> | 45.0                                       | 45.0     | -       |

### Auctions

| Country | Auction  |
|---------|--|
| Germany |  Auction: sold €2.32bn of 0% 2024 bonds at an average yield of -0.77% |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

## Tomorrow's releases

| Country               | BST   | Release                    | Period | Market consensus/<br><i>Daiwa forecast</i> | Previous |
|-----------------------|---|----------------------------|--------|--|----------|
| Germany               |  08.30 | Construction PMI           | Sep    | -  | 46.3     |
| UK                    |  09.30 | New car registrations Y/Y% | Sep    | -  | -1.6     |
| Country               | BST   | Auction/Event              |        |  |          |
| - Nothing scheduled - |   |                            |        |  |          |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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