Euro wrap-up

Overview

- On a day of weaker risk appetite, Bunds made gains while data showed that German trade growth moderated at the start of Q3.
- Gilts made significant gains and sterling weakened as the UK Government confirmed it will present draft legislation that would “break international law” in the event that no new free trade agreement is reached with the EU.
- The next focus for the euro area economy will be Thursday’s ECB policy meeting conclusion, which will also bring updated forecasts.

Chris Scicluna
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.717	-0.008
OBL 0 10/25	-0.707	-0.014
DBR 0 08/30	-0.496	-0.032
UKT 1¾ 09/22	-0.136	-0.045
UKT 0⅝ 06/25	-0.109	-0.054
UKT 4¾ 12/30	0.184	-0.064

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

Euro area

German trade growth moderates at the start of Q3

Consistent with many other indicators which suggested a moderation in recovery momentum at the start of Q3, and broadly in line with expectations, the value of German exports rose 4.7%M/M in July having risen almost 15%M/M the prior month to be still down a marked 10.9%Y/Y. That also left them more than 12% from the pre-lockdown level in February, suggesting that still only about two-thirds of the initial peak-to-trough drop had been reversed. Exports to China were down just 0.1%Y/Y. But exports to the rest of the euro area were down 10.7%Y/Y, with exports to the UK (-12.6%Y/Y) and US (-17.0%Y/Y) weaker still.

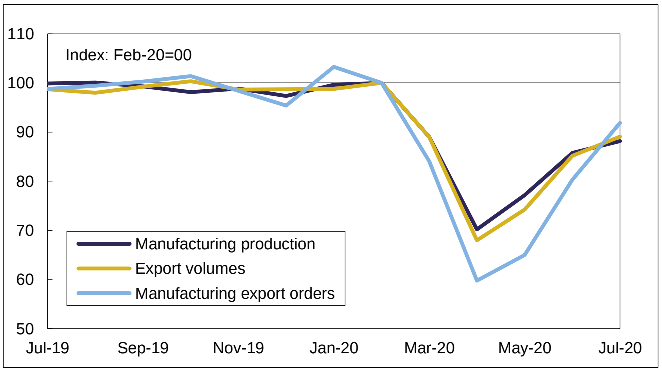
But net trade now providing support to GDP growth

Meanwhile, growth in the value of German imports in July was more subdued than for exports, up just 1.1%M/M following growth of 7.0%M/M previously, to be down 11.3%Y/Y and similarly down about 12% from February. While imports from China were up 7.4%Y/Y, imports from the euro area were down 10.4%Y/Y. And, as for exports, imports from the UK (-24.8%Y/Y) and US (-14.8%Y/Y) were particularly weak. Given the more subdued growth in imports, Germany’s trade surplus increased by about €3.5bn in July to €18bn, the highest in seven months. And adjusting for price changes, growth in German export volumes (4.6%M/M) in July also outpaced that of import volumes (0.6%M/M). So, net trade looks to have provided support to German GDP growth at the start of Q3, having subtracted a very significant 2.8ppts from growth in Q2. And with factory orders from abroad up in July by 14.4%M/M – with those from beyond the euro area up a particularly vigorous 19.2%M/M – and survey indicators pointing to a further increase in external demand in August, we expect continued growth in exports over the remainder of Q3 too.

French trade growth stronger from a lower base in July, but momentum likely fading

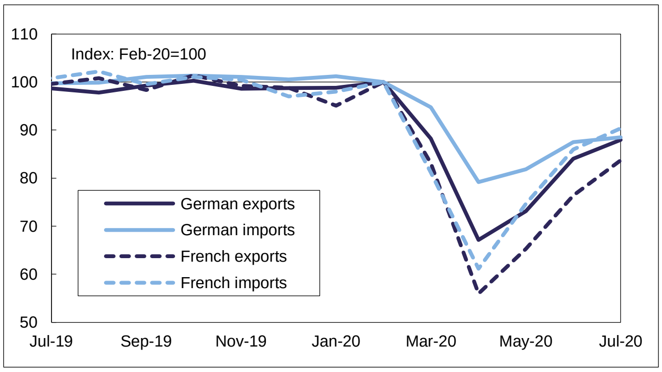
Trade flows saw stronger growth in France than in Germany in July, with the value of exports up 9.6%M/M and imports up 5.1%M/M similarly suggesting a boost to overall GDP growth from net trade. However, the stronger growth in part reflects the steeper initial deterioration in trade, which saw a peak-to-trough drop in export values of more than 44% between February and April. And with export values still down more than 26% in July from February’s pre-lockdown level, like in Germany, only about two-thirds of the initial drop in French exports had been reversed by July. Recent surveys for French manufacturing have been mixed, with the INSEE survey for August having pointed to ongoing growth in export orders but the PMIs having suggested that external demand remained well down on a year ago last month. And overall, INSEE judges that recovery momentum has faded in the face of the revival of the pandemic. In a report today it judged that French GDP in August was probably about 5% below the pre-lockdown level, but also that further growth through to year-end was likely to be minimal.

Germany: IP, exports* and foreign factory orders,



*Real terms. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany and France: Goods trade*



*Nominal terms. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Decline in euro area Q2 GDP only slightly less than previously thought

There were few surprises from the updated euro area national accounts data for Q2. The extent of the decline in GDP was revised down slightly, by just 0.3ppt to mark a still-record drop of 11.8%Q/Q and 14.7%Y/Y. That left the level of GDP at its lowest since Q105. Of the large member states, Spain was confirmed as having the sharpest contraction (down 18.5%Q/Q), with France (-13.8%Q/Q) and Italy (-12.8%Q/Q) also worse off than Germany (-9.7%Q/Q). We expect the ranking among the member states to reverse in Q3, with those member states hit most by lockdowns in Q2 to post the strongest growth as most sub-sectors, in both the private and public sectors, were able to return to work. Meanwhile, the expenditure components of euro area GDP, published for the first time, showed a sharper-than-feared plunge in gross fixed investment of 17.0%Q/Q while household consumption dropped 12.0%Q/Q to account for more than half (6.6ppts) of the drop in GDP. The pace of decline in exports (-18.8%Q/Q) was slightly faster than that in imports (-18.0%Q/Q) and so net trade subtracted 1.0ppt from GDP growth. Government consumption growth was also negative as many sub-sectors – including education and health – saw reduced output during the lockdown periods. But inventories provided modest support.

Record drop in jobs and hours worked confirmed

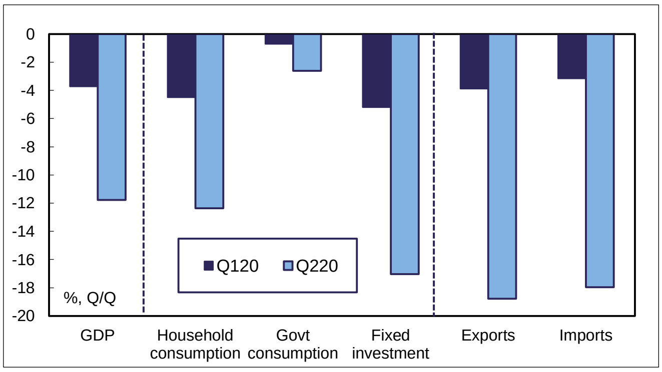
Broadly in line with the initial estimate, euro area employment dropped a record 2.9%Q/Q in Q2 after declining 0.3%Q/Q in Q1. That left the total number of persons in employment down 5.1mn from before the pandemic at 155.6mn. Reflecting differences in government labour market support programmes as well as the extent of the deterioration in GDP, the steepest declines in employment in Q2 were registered in Spain (-7.5%Q/Q) and Ireland (-6.1%Q/Q), with somewhat more moderate and similar falls in France (-2.6%Q/Q) and Italy (-2.5%Q/Q), and much smaller drops in Germany (-1.4%Q/Q) and particularly Belgium (-0.8%Q/Q). But declines in hours worked were precipitous, down a record 12.8%Q/Q and 16.6%Y/Y in the euro area, with the rates among the large member states ranging from -8.0%Q/Q in Germany to -21.4%Q/Q in Spain. In Germany, total labour costs rose 1.9%Q/Q in Q2 to be up 5.1%Y/Y, the most since the introduction of the euro – expect growth in both labour earnings (up 4.9%Y/Y in Q2) and non-wage costs (up 5.7%Y/Y) to slow markedly over coming quarters.

The coming two days in the euro area

With a quiet day ahead for euro area economic news tomorrow, the focus now shifts to the week's main event – the conclusion of the ECB's monetary policy meeting on Thursday. With the PEPP purchase envelope having been increased to €1.35trn just three months ago, Governing Council members will see no need to adjust policy just yet. They will nevertheless want to maintain maximum flexibility in the PEPP purchases. And the Governing Council will also retain the current forward guidance, which would leave the door open to further easing, such as via an increase in the PEPP envelope, in due course. With excess euro liquidity approaching €3trn, an increase in the tiering multiplier to exempt a larger share of excess bank reserves from the negative policy rate might seem appropriate. However, last month Christine Lagarde insisted that such a move wasn't even discussed, not least as the lending subsidy associated with the TLTRO-iii operations would reduce the cost of the negative rate for most banks.

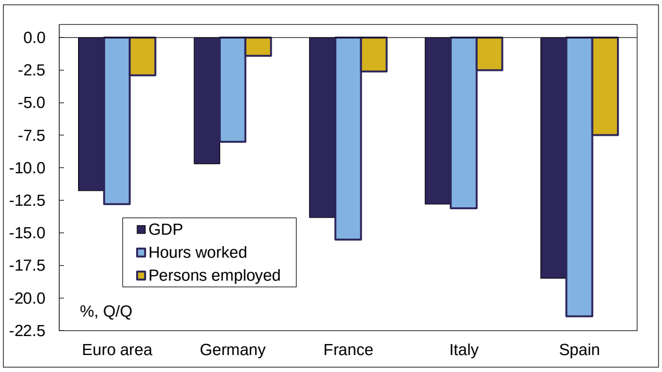
The ECB's updated economic forecasts will be published following the meeting. While recent comments from senior ECB officials suggest that the amendments to the GDP projections are likely to be minimal, economic data suggest that, if anything, the ECB's previous central projection of a contraction of 8.7% in 2020 might have been a little too downbeat. And the growth forecasts for 2021 (5.2%) and 2022 (3.3%) might also be judged conservative in light of the agreement on the EU's €750bn recovery fund and the plans of the French government for a new €100bn fiscal stimulus package to be implemented over the coming two years. In terms of inflation, however, the forecasts will need to take account of last week's flash estimates for August, which revealed a drop in the headline CPI rate into negative territory for the first time since 2016 and a record low core rate, thus underscoring the net disinflationary impact of the pandemic. Crucially, they will also need to reflect recent euro appreciation, which will mechanistically subtract from the inflation forecast up to two years ahead. So, we

Euro area: GDP and components in Q1 and Q2



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP and labour market indicators in Q2



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

to see modest downside revisions made to the inflation projections, which previously suggested that core inflation would still be just 0.9%Y/Y in 2022. Maintenance of that forecast, or indeed a downwards revision, would support the case for additional stimulus in due course.

Data-wise, Thursday will bring July industrial production data from France and Italy. As in Germany, these data will report ongoing growth at the start of Q3, albeit at a softer pace than in June.

UK

Contradictory messages on strength of retail sales in August

After UK retail sales rebounded above the pre-lockdown level in July, surveys are providing different messages about the strength of sales last month. The CBI's distributive trades survey suggested that sales fell back in August. However, today's BRC retail sales monitor suggested decent growth on the high street. Possibly benefiting from a boost to shopping-centre footfall from the Government's "Eat out to help out" restaurant meal subsidies, the BRC survey's measure of like-for-like sales was up 4.7%Y/Y in August, with total sales up 3.5%3M/Y. While food sales again led the way, up 3.5%3M/Y, non-food sales on the BRC measure were up 1.4%3M/Y, the first positive reading since before the lockdown in February. The official ONS data, which will settle the matter, will be released on 18 September. But even if sales posted further growth as suggested by the BRC survey, they will have come too late to save thousands of jobs. Indeed, it was today revealed that the government's Insolvency Service was notified by firms in June and July of the intention to make more than 300k redundancies, the largest share of which will likely take place in retail. Those data add to evidence of a steep increase in unemployment by next month, when the Job Retention Scheme will come to an end.

The coming two days in the UK

Government posturing over Brexit is likely to dominate over coming days, with the extremely controversial Internal Market Bill – set to be inconsistent with the EU-UK Withdrawal Agreement treaty which entered into force in February – set to be published tomorrow. With a Minister confirming today that the draft legal text will seek "break international law", today saw the resignation in protest by the Government's most senior legal official. EU negotiators are likely to be extremely unimpressed by the move, which suggests that the UK Government is not negotiating in good faith and is happy to end the Brexit transition period at the end of the year without a new free trade agreement.

Meanwhile, the quiet tone for news on UK economic data will continue through to Thursday, with no key economic figures scheduled for release tomorrow. On Thursday, the RICS will publish its August house price survey, for which the headline price index is expected to rise further to 25 in August, from 12 in July. The survey is also likely to report increased housing market activity on both the buy and sell sides.

The next edition of the Euro wrap-up will be published on 10 September 2020

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Final GDP Q/Q% (Y/Y%)	Q2	**-11.8 (-14.7)**	-12.1 (-15.0)	-3.6 (-3.1)	-
	Final employment Q/Q% (Y/Y%)	Q2	**-2.9 (-3.1)**	-2.8 (-2.9)	-0.2 (0.4)	-
Germany	Trade balance €bn	Jul	**19.2**	15.9	15.6	**15.5**
	Labour costs Q/Q% (Y/Y%)	Q2	**1.9 (5.1)**	-	2.4 (4.3)	**2.3 (4.7)**
France	Trade balance €bn	Jul	**-7.0**	-6.2	-8.0	**-8.1**
Italy	Retail sales M/M% (Y/Y%)	Jul	**-2.2 (-7.2)**	-1.0 (-1.9)	12.1 (-2.2)	**10.2 (-2.4)**
UK	BRC Retail Sales Monitor, like-for-like sales Y/Y%	Aug	**4.7**	3.5	4.3	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
- Nothing to report -					

Auctions and events

Country	BST	Auction / Event
Germany	10.30	Auction: €4bn of 0% 2030 bonds

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

Thursday's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	12.45	ECB main refinancing rate %	Sep	0.00	0.00
	12.45	ECB marginal lending facility %	Sep	0.25	0.25
	12.45	ECB deposit facility rate %	Sep	-0.50	-0.50
France	07.45	Industrial production M/M% (Y/Y%)	Jul	4.9 (-8.4)	12.7 (-11.7)
	07.45	Manufacturing production M/M% (Y/Y%)	Jul	-	14.4 (-12.5)
Italy	09.00	Industrial production M/M% (Y/Y%)	Jul	3.5 (-9.8)	8.2 (-13.7)
UK	00.01	RICS house price balance	Aug	25	12

Auctions and events

Country	BST	Auction / Event
EMU	12:45	ECB monetary policy announcement
	13:30	ECB President Lagarde's monetary policy meeting press conference
Italy	10.00	Auction: 3Y and 7Y bonds
UK	10.00	Auction: £3.25bn of 0.125% 2023 bonds
	11.30	Auction:£2.0bn of 0.625% 2050 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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