Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds made losses and the euro strengthened after the ECB left policy unchanged and revised up its forecasts for both GDP and inflation.
- Gilts made modest gains at the shorter end of the curve and sterling depreciated as the EU gave the UK until the end of the month to amend its internal market bill to bring it in line with the Brexit Withdrawal Agreement.
- Friday will bring data for UK GDP in July, and final estimates of German and Spanish inflation in August.

Chris Scicluna
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change
BKO 0 09/22	-0.679	+0.025
OBL 0 10/25	-0.647	+0.032
DBR 0 08/30	-0.429	+0.036
UKT 1¾ 09/22	-0.105	-0.013
UKT 0⅝ 06/25	-0.078	-0.014
UKT 4¾ 12/30	0.237	+0.002

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

Euro area

ECB leaves policy unchanged, keeps door open to further easing

Today's ECB Governing Council meeting conclusion brought no surprises in terms of policies, which were all left unchanged. So, there were no amendments made to the ECB's interest rate settings, or to the tiering multiplier that exempts a certain share of bank reserves from the negative rate. The ECB's asset purchase programmes were also left unchanged, with Lagarde repeating that the full €1.35trn PEPP envelope is expected to be used. And those purchases will continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions. The ECB's forward guidance was left unchanged too, thus leaving the door open to future policy easing, such as via an increase in asset purchases.

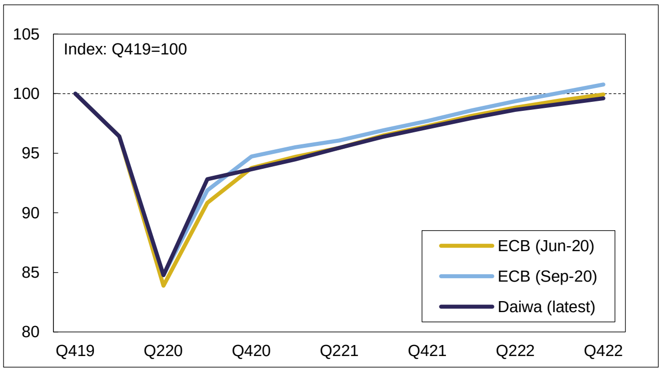
Lagarde optimism suggests no hurry to ease further despite stronger euro

The decision not to amend policy was in line with expectations. But the broadly upbeat tone of Christine Lagarde's press conference, which was underpinned by the ECB's updated and upgraded economic projections, was less anticipated. Admittedly, Lagarde acknowledged the continued uncertainty about the outlook, which remained dependent first and foremost on the path of the pandemic and the success of containment measures. She also conceded that momentum in the services sector had slowed somewhat recently. And she flagged concerns about the recent strengthening of the euro, stating that the impact of the exchange rate on the inflation outlook would need to be continually assessed. Lagarde nonethless appeared relatively unperturbed and, indeed, arguably complacent about both the strength of the euro and the inflation outlook.

Inflation forecast still too low despite upgrade

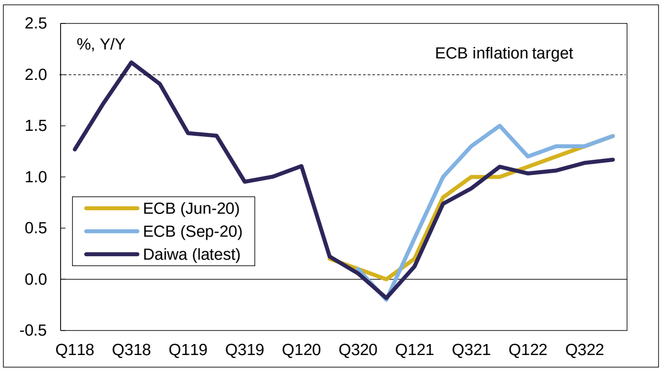
Given recent data, not least the contraction in GDP in Q2 that had been less acute than the ECB had expected, it was not overly surprising that the GDP profile was revised up in the central bank’s updated projections. In particular, the ECB now anticipates a contraction of 8.0% this year (compared to the previous projection of a drop of 8.7%), to be followed by growth of 5.0% in 2021 and 3.2% in 2022 (from 5.2% and 3.3% previously). Given the higher path for GDP, and hence slightly smaller amount of spare capacity, as well as optimism about the potency of its policy response, the ECB is also now more upbeat about the inflation outlook. Admittedly, the ECB’s profile for headline inflation saw minimal uplift, with no changes to the projections for this year (0.3%) or 2022 (1.3%). However, that masked a more optimistic profile for core inflation, which is now expected to rise to 1.1% in 2022 (compared to the previous forecast of 0.9%). Our own baseline for GDP is very similar to that of the ECB. But given the past persistence of low inflation in the euro area, our profile for inflation is softer than that of the ECB. And even if the ECB’s inflation projection is reaffirmed in December, it would likely be so far below target two-to-

Euro area: GDP forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

three years ahead as to merit additional stimulus. So, we maintain our forecast that the ECB will add a further €650bn to the PEPP asset purchase envelope at the December meeting. Of course, by then, the downside risks to the outlook from any failure to agree a new EU-UK FTA might well be crystallising (see below), justifying in their own right additional stimulus too.

Manufacturing recovery continued in France and Italy in July

As in Germany, industrial output in France and Italy continued to recover in July, albeit at a slightly more moderate pace than in June. In particular, French manufacturing production rose 4.5%M/M, broadly in line with expectations, following a leap of 14.8%M/M the previous month. That left it down 7.9% from the pre-pandemic level in February - thus reversing more than three quarters of the initial peak-to-trough decline - and down 8.5%Y/Y. Within the detail in France, growth was strongest in output of machinery and equipment (up 8.6%M/M to be just 4.5% below February's level albeit still down 13.6%Y/Y) and transport goods (up 8.1%M/M but still down 22.9% from February and a whopping 36.5%Y/Y). Beyond the manufacturing sector, construction output rose 5.0%M/M to be down 4.8% from the pre-pandemic level. But energy output fell 0.4%M/M to be down 2.6% from February. So, total French IP rose 3.8%M/M in July to be down 7.1% from February. In Italy, production growth in July was more vigorous than in Germany and France. Indeed, manufacturing output rose 8.7%M/M, just 0.2ppt weaker than in June, to be just 5.4% below the February level, albeit down 8.3%Y/Y. Like in France, production of capital goods was strongest, up 11.8%M/M to be 6.5% below February's level. Perhaps inevitably, survey indicators in both Italy and France point to the likelihood of far slower growth from August onwards.

The day ahead in the euro area

It should be a very uneventful end to the week for economic data from the euro area, with the final August inflation figures from Germany and Spain the most notable new releases. These are expected to align with the preliminary estimates, which saw the headline inflation rate on the EU harmonised measure fall 0.1ppt in Germany to a four-year low of -0.1%Y/Y, but the equivalent figure in Spain rise 0.1ppt to -0.6%Y/Y. Meanwhile, EU Finance Ministers and Central Bank Governors will attend the latest six-monthly Informal Ecofin meeting in Berlin to discuss the state of the economic recovery from the Covid-19 shock. The Eurogroup will also meet at the same occasion.

UK

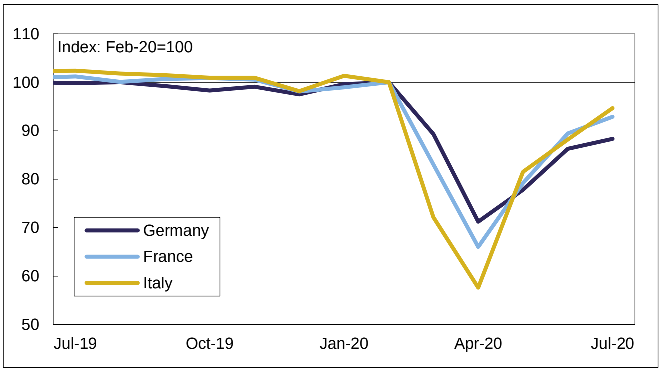
EU gives UK deadline to amend internal market bill

Yesterday saw the UK Government ramp up its provocation of the EU in the negotiations on a new free trade agreement (FTA), with publication of its draft internal market bill incorporating provisions clearly in breach of the Brexit Withdrawal Agreement and a new policy on state aid committing to nothing more stringent than WTO rules. In response, the EU called for an emergency meeting of the EU-UK Withdrawal Agreement Joint Committee, whose remit is to oversee the implementation of the application and interpretation of that treaty, which took effect in February. That meeting was held today, and failed to diffuse tensions. Indeed, the EU (understandably) accused the UK of seriously damaging trust. And it set a deadline of the end of the month to amend the internal market bill, with a failure to do so likely to see the EU launch legal action against the UK.

FTA hopes on shaky ground, but not yet collapsed

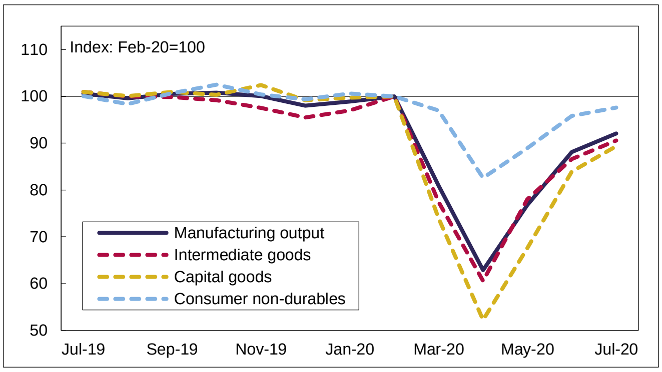
Against that acrimonious backdrop, it might seem improbable that a FTA can still be agreed by year-end. However, the response so far from the EU to the UK's appears relatively measured, and suggests that it does not want to give up hope of agreeing a deal. It also does not want to get the blame for any collapse in those negotiations. And the EU also knows that the UK Government will face significant difficulty passing its internal market bill swiftly through the UK Parliament, with the House of Lords set to represent a key barrier. Most importantly perhaps, the EU might also likely have interpreted the UK's gambits as Trump-like 'madman' negotiation tactics that principally aim to give the impression of a willingness to end the year with no FTA in order to extract new concessions. Indeed, the specific concessions sought – related to the rules

Euro area: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

governing goods exports from Northern Ireland to Great Britain, and the application of EU state aid rules in Great Britain (but not Northern Ireland) – are relatively targeted, and suggest that some leeway might be offered by the EU in due course. At the same time, yesterday's response of US House Speaker Nancy Pelosi – that if the UK presses on and "violates" the Withdrawal Agreement and "undermines the [Northern Irish] Good Friday accord, there will be absolutely no change of a US-UK trade agreement passing the Congress" – should also have warned the UK Government of the risks of international isolation from the start of 2021 if it fails to give ground. So, we have not yet entirely given up hope that an FTA will ultimately be agreed. But there is no doubt that, while they have not yet collapsed, the negotiations are now on exceedingly shaky ground.

The day ahead in the UK

After a quiet week for new economic data from the UK, Friday will bring the release of monthly GDP figures for July, which will be accompanied by sectoral output and trade numbers for the same month. With lockdown measures across the hospitality sector having been relaxed further that month, and surveys signaling ongoing improvements in business conditions, we would expect to see another solid increase in activity at the start of Q3, with expectations for a rise of more than 6.5%M/M. However, this would still leave output down more than 11% compared with the pre-pandemic level in February and down about 7.5% 3M/3M. Output in services, manufacturing and construction alike will all have posted substantive growth in July.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	ECB main refinancing rate %	Sep	**0.00**	0.00	0.00	-
	ECB marginal lending facility %	Sep	**0.25**	0.25	0.25	-
	ECB deposit facility rate %	Sep	**-0.50**	-0.50	-0.50	-
France	Industrial production M/M% (Y/Y%)	Jul	**3.8 (-8.3)**	5.0 (-8.0)	12.7 (-11.7)	**13.0 (-11.3)**
	Manufacturing production M/M% (Y/Y%)	Jul	**4.5 (-8.5)**	3.5 (-9.7)	14.4 (-12.5)	**14.8 (-12.1)**
Italy	Industrial production M/M% (Y/Y%)	Jul	**7.4 (-8.0)**	3.5 (-9.8)	8.2 (-13.7)	**- (-13.9)**
UK	RICS house price balance	Aug	**44**	25	12	**13**

Auctions

Country	Auction
Italy	sold €3.25bn of 0.3% 2023 bonds at an average yield of 0.007%
	sold €3.0bn of 0.95% 2027 bonds at an average yield of 0.75%
UK	sold £3.25bn of 0.125% 2023 bonds at an average yield of -0.061%
	sold £2bn of 0.625% 2050 bonds at an average yield of 0.826%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

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

Auctions

Country	Auction
Germany	sold €3.391bn of 0% 2030 bonds at an average yield of -0.5%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Final CPI (EU harmonised CPI) Y/Y%	Aug	0.0 (-0.1)	-0.1 (0.0)
Spain	08.00	Final CPI (EU harmonised CPI) Y/Y%	Aug	-0.5 (-0.6)	-0.6 (-0.7)
	08.00	Industrial production M/M% (Y/Y%)	Jul	-	14.0 (-14.0)
UK	07.00	Monthly GDP M/M% (3M/3M%)	Jul	6.7 (-7.5)	8.7 (-19.1)
	07.00	Industrial production M/M% (Y/Y%)	Jul	4.1 (-8.7)	9.3 (-12.5)
	07.00	Manufacturing production M/M% (Y/Y%)	Jul	5.0 (-10.5)	11.0 (-14.6)
	07.00	Construction output M/M% (Y/Y%)	Jul	10.0 (-17.6)	23.5 (-24.8)
	07.00	Index of services M/M% (3M/3M)	Jul	7.0 (-7.7)	7.7 (-19.9)
	07.00	Total trade balance (goods trade balance) £bn	Jul	3.0 (-6.9)	5.3 (5.1)

Auctions and events		
Country	BST	Auction / Event
EMU	09.00	ECB's Weidmann and Villeroy scheduled to speak
	-	ECB President Lagarde to attend Eurogroup and informal ECOFIN meetings
	13.00	ECB's Chief Economist Lane to participate in online event
UK	-	BoE publishes Inflation Attitudes Survey

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs