Euro wrap-up

Overview

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- On a quieter day for euro area economic data, Bunds made gains and BTPs outperformed, while European wholesale natural gas prices fell to the lowest level in more than a month, as the European Commission continued to develop plans for interventions in EU energy markets.
- Gilts also made modest gains as UK GDP surprised slightly on the downside in July.
- Tuesday will bring the latest UK labour market data along with the ZEW investor survey and final German and Spanish inflation figures for August.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	1.272	-0.021
OBL 1.3 10/27	1.474	-0.053
DBR 1.7 08/32	1.644	-0.047
UKT 1 04/24	3.022	-0.043
UKT 1¼ 07/27	2.964	-0.015
UKT 4¼ 06/32	3.058	-0.034

*Change from close as at 4:00pm BST.
Source: Bloomberg

UK

GDP growth softer than expected in July as IP and construction contract

UK GDP was slightly more subdued than expected at the start of Q3, rising just 0.2%M/M following the drop of 0.6%M/M in June. That left it 1.1% above the pre-pandemic level in February 2020 but still marginally below the level in January 2022. Indeed, the trend in economic output this year has been broadly sideways, and there was zero growth in July on a 3M/3M basis while the level was also little changed from the Q2 average. Services provided the main source of growth in July, although the rise in activity of 0.4%M/M in that sector was also insufficient to reverse the drop of 0.5%M/M the prior month. Growth was led by information and communication (1.5%M/M) and health and social work (0.8%M/M). And consumer-facing services overall returned to growth (0.6%M/M) following a flat prior month, boosted by sporting events (the European women's football championships and Commonwealth Games) and the impact of record hot weather on certain other items. In contrast, industrial production fell for a second successive month (-0.3%M/M following a drop of 0.9%M/M in June) principally due to lower output of energy related to the aforementioned weather, while manufacturing rose a minimal 0.1%M/M thanks in part to a pickup in machinery and equipment (3.3%M/M) and transport goods (1.3%M/M). Construction output also fell for a second successive month (-0.8%M/M following -1.4%M/M in June).

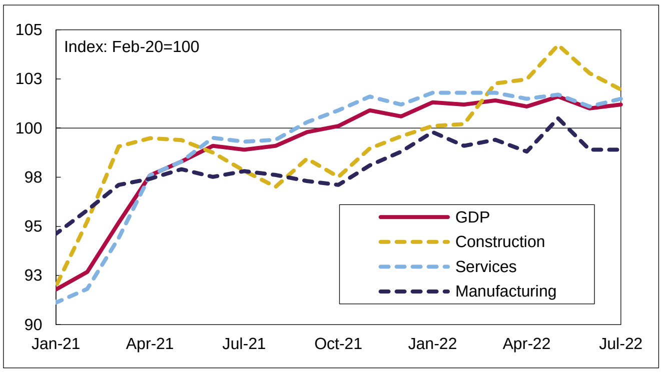
Risk rises of second successive drop in GDP in Q3

Business surveys suggest that economic activity in August lost further momentum, with the composite output PMI dropping below the key 50 level for the first time since the lockdowns in early 2021. And output this month is now set to be hit by the period of national mourning following the death of the Queen, including the special Bank Holiday now scheduled for 19 September. Indeed, the extra Jubilee Bank Holidays were a key driver of the contraction in GDP of 0.6%M/M in June, while a range of activities – including all of the past weekend's professional football matches – have already been interrupted. So, we maintain our forecast of a second successive modest drop of GDP in Q3 following the marginal fall of 0.1%Q/Q in Q2, to represent a shallow technical recession. Unfortunately, while the government's energy price cap policy will limit the damage somewhat, real disposable income growth will still remain firmly in negative territory into next year, likely contributing to a further contraction in GDP in Q4.

Trade deficit narrows somewhat in July as exports rebound from holiday lull

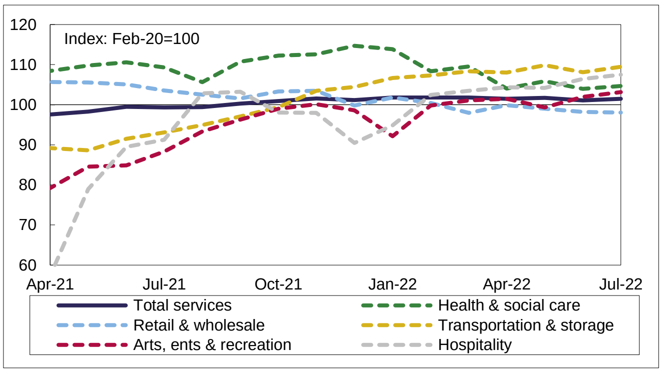
Just as GDP rebounded moderately in July after weakness in June, so too the trade balance improved following the deterioration at the end of Q2. Indeed, excluding the impact of precious metals which often distort the underlying picture, the value of goods and services exports rebounded 3.9%M/M in July having dropped a steep 4.2%M/M in June due to the

UK: GDP and major sectoral components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

impact of the Jubilee Bank Holidays. That in part reflected increased shipments of machinery to Germany and China, and oil and gas to the Netherlands and France. And with the value of imports of goods and services down about ½%M/M for a second successive month despite increased imports of Norwegian gas, the trade deficit narrowed on a seasonally adjusted basis by more than £2.6bn from June's record high to a five-month low of £7.95bn. Adjusting for relative price changes, export volumes rose 3.5%M/M while import volumes dropped 1.8%M/M to suggest that net trade made a positive contribution to GDP growth at the start of Q3.

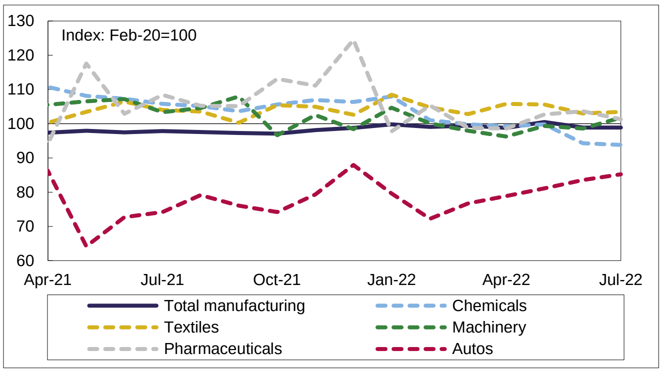
Deficit likely to hit new high over coming months as Brexit frictions and fuel prices take their toll

While improved from the prior month, the trade deficit in July was still extremely high by historical standard, being almost five times the average deficit in the two years before the pandemic. The deterioration over recent quarters reflects many factors, including the new barriers to trade related to the post-Brexit arrangements, which appear to have impeded exports to non-EU markets as well as to the EU. And, of course, the deterioration also reflects shifts in global energy prices, with the fuels deficit rising almost £500mn in July to a new series high of £5.6bn, almost seven times the average in the two years before the pandemic. With prices in forwards markets pointing to further upwards pressure on the fuels deficit over coming months, this year's marked depreciation of sterling likely to boost the value of imports before it benefits exports via the so-called J-curve effect, external demand set to be weak, and the UK government having no concrete proposals to ease the frictions imposed by Brexit, we expect the trade deficit to reach a new record high before year-end, leaving sterling vulnerable to further weakness into the New Year.

The day ahead in the UK

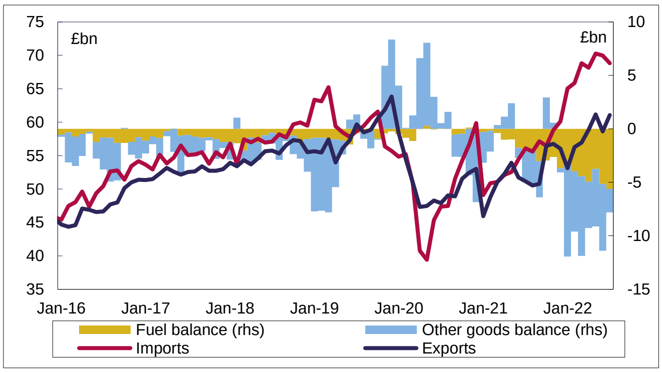
The UK data focus tomorrow will be the latest labour market figures, which will likely point to ongoing tightness in the labour market, albeit perhaps with further hints of gradual softening. For a fourth successive month, the unemployment rate is expected to remain at 3.8% in the three months to August, in line with the level at the end of 2019 ahead of the pandemic. In addition, although the number of job vacancies is likely to decline for the second successive month, it might remain little different to the number of unemployed workers. And having slowed in the three months to June, growth in nominal average weekly labour earnings is expected to pick-up again – from 4.7%3M/Y (excluding bonuses) and 5.1%3M/Y (including bonuses) – to remain above the BoE's comfort zone, albeit remaining at historically negative rates in real terms.

UK: Manufacturing output



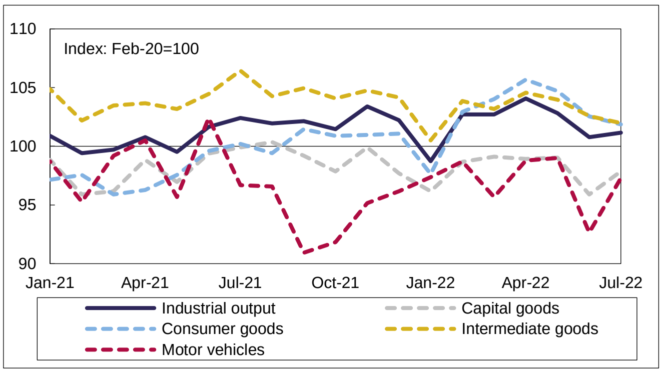
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Goods and services trade balance



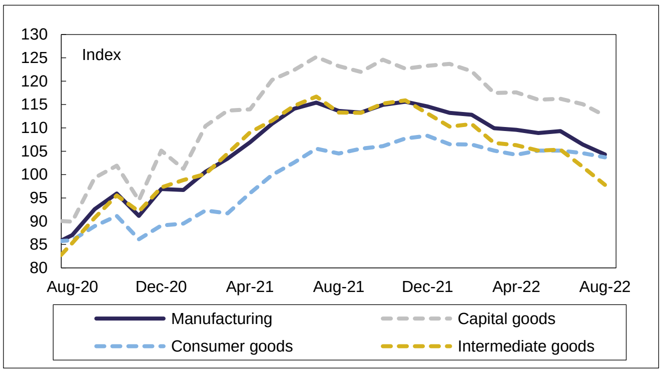
**Nominal terms. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

Italy: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Italy: ISTAT business sentiment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area

Italian IP bucked the trend in July, but manufacturing outlook weakening

Today's Italian industrial production release bucked the trend for the start of Q3, posting modest growth in July of 0.4%M/M and thus contrasting with declines recorded in the other large member states of between -0.7% to -1.6%M/M. Admittedly, this marked the first increase in three months and followed a substantial drop in June (-2.0%M/M) to leave the level 1.3% below the Q2 average. Growth was largely attributed to production of transport equipment, which accelerated 5.0%M/M after a setback in June (-6.4%M/M) to be 2.7% below the pre-pandemic level in February 2020. Indeed, output was down in ten out of the fourteen subsectors, with the most striking declines in chemicals (-4.9%M/M), coke & petroleum (-3.5%M/M) and extraction of minerals (-3.5%M/M). So, while production of capital goods rose (2.0%M/M), output of intermediate and consumer goods fell for the third consecutive month. Surveys suggest a marked deterioration in conditions in August, with ISTAT's manufacturing sentiment index down for the third consecutive month in August to its lowest level since March 2021, and confidence among intermediate goods producers at its lowest since 2020. While the manufacturing output PMI rose slightly in August, at 47.0 it remained consistent with contraction, with new orders also falling. Taken together with worsening services and construction outlooks, ISTAT today judged in its monthly economic update that activity looks set to slow over coming months.

The day ahead in the euro area

Tomorrow will bring the German ZEW investor survey for September. Like last week's Sentix survey, this is expected to signal a further deterioration in conditions at the end of Q3, with the indices for current conditions and expectations for the coming six months likely to be at levels consistent with recession. Tuesday will also see the final release of German and Spanish consumer price inflation figures for August. The preliminary German data broadly aligned with expectations, with the HICP inflation rate rising 0.3ppt to a new series high of 8.8%Y/Y. The national CPI measure of inflation also resumed an upwards trend, increasing 0.4ppt to 7.9%Y/Y, matching the post-reunification peak reached in May ahead of the implementation of the government's temporary energy-related support initiatives. Contrasting Germany, but in line with expectations, Spain's headline inflation rate eased slightly in August, by 0.4ppt to 10.3%Y/Y on the HICP measure and 10.4%Y/Y on the national CPI measure.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Industrial production M/M% (Y/Y%)	Jul	**0.4 (-1.4)**	0.0 (-0.6)	-2.1 (-1.2)	**-2.0 (-1.1)**
UK	Monthly GDP M/M% (3M/3M%)	Jul	**0.2 (0.0)**	0.3 (0.1)	-0.6 (-0.1)	-
	Industrial production M/M% (Y/Y%)	Jul	**-0.3 (1.1)**	0.3 (1.9)	-0.9 (2.4)	-
	Manufacturing production M/M% (Y/Y%)	Jul	**0.1 (1.1)**	0.3 (1.5)	-1.6 (1.3)	-
	Index of services M/M% (3M/3M%)	Jul	**0.4 (-0.2)**	0.4 (-0.2)	-0.5 (-0.4)	-
	Construction output M/M% (Y/Y%)	Jul	**-0.8 (4.3)**	0.5 (5.6)	-1.4 (4.1)	-
	Goods trade balance (excl. precious metals) £bn	Jul	**-19.4 (-19.5)**	-22.4 (-)	-22.8 (-22.1)	-

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
Economic data						
Germany		07.00	Final CPI M/M% (Y/Y%)	Aug	*0.3 (7.9)*	0.9 (7.5)
		07.00	Final HICP M/M% (Y/Y%)	Aug	*0.4 (8.8)*	0.8 (8.5)
		10.00	ZEW current assessment (expectations) balance	Sep	-52.1 (-59.5)	-47.6 (-55.3)
Spain		08.00	Final CPI M/M% (Y/Y%)	Aug	*0.1 (10.4)*	-0.3 (10.8)
		08.00	Final HICP M/M% (Y/Y%)	Aug	*0.1 (10.3)*	-0.6 (10.7)
UK		07.00	Payrolled employees, change '000s	Aug	60	73
		07.00	Unemployment claimant count rate % (change '000s)	Aug	-	3.9 (-10.6)
		07.00	ILO unemployment rate 3M%	Jul	3.8	3.8
		07.00	Employment change 3M'000s	Jul	125	160
		07.00	Average earnings including (excluding) bonuses 3M/Y%	Jul	5.4 (5.1)	5.1 (4.7)
Auctions and events						
Germany		10.30	Auction: €5.5bn of 0.40% 2024 bonds			
Italy		10.00	Auction: €2.75bn of 1.20% 2025 bonds			
		10.00	Auction: €3.25bn of 2.80% 2029 bonds			
		10.00	Auction: €1.50bn of 3.25% 2046 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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