Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds made gains as the euro area current account surplus jumped sharply thanks to a record goods trade balance, while French retail sales started Q3 in reverse.
- Gilts also made significant gains as UK public sector borrowing again missed expectations while a survey pointed to a drop in output and weakening of selling-price expectations in the manufacturing sector.
- Wednesday’s focus will be the August flash PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.074	-0.021
OBL 2.4 10/28	2.645	-0.051
DBR 2.6 08/33	2.640	-0.058
UKT 0⅝ 06/25	5.107	-0.088
UKT 1⅝ 10/28	4.669	-0.068
UKT 3¼ 01/33	4.637	-0.085

*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

French retail sales edge lower at start of Q3 despite modest uptick in consumer sentiment

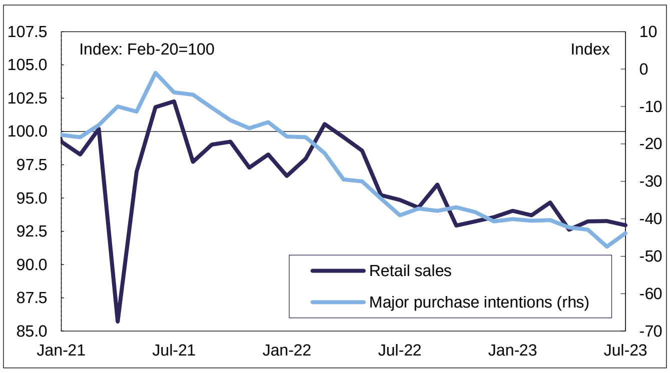
With real incomes eroded by high inflation, French household consumption has been weak over the past three quarters. In Q2, it contracted 0.4%Q/Q, as cuts in real spending on food (-2.7%Q/Q) and manufactured goods (-0.1%Q/Q) were only in part offset by increased consumption of services (0.7%Q/Q) and energy (1.7%Q/Q). Judging from today’s Bank of France retail survey, French consumption of goods declined further at the start of Q3. In particular, having been unchanged in June, the survey’s measure of retail sales volumes dropped 0.3%M/M in July to fall to a three-month low and the second-weakest level since the final lockdowns in early 2021. So, while they were only marginally below the Q2 average, retail sales volumes were also down 0.5%3M/3M and 2.0%Y/Y. Probably in part due to higher spending on eating out as well as recent record inflation in the category, the survey measure of real food sales was again particularly soft, dropping 2.6%M/M to be down 1.1%3M/3M. But while new car sales fell again, likely as payback for the rebound in the spring, spending on manufactured goods overall fell just 0.2%M/M to be down just 0.2%3M/3M. That reflected stronger sales of furniture, clothing, electronic goods, and games and toys, which all appear to have benefited from the extended summer discounting period.

The Bank of France retail survey data do not map precisely onto the official INSEE goods consumption figures. But they do provide a useful indication of the underlying trend, and a soft start to retail spending in Q3 was not unexpected. Reassuringly perhaps, with consumer inflation expectations having declined significantly over recent months, French consumer confidence picked up in July to a 14-month high suggesting an end to the weak trend might be in sight. However, consumer willingness to make major purchases improved only modestly last month, and was still at the second-lowest level since the first wave of Covid-19. So, while French consumer spending on goods might well stabilise in Q3, a meaningful return to positive growth is likely to be some way off. The August INSEE consumer confidence survey results, due one week today, should give further clues.

German producer prices point to significant goods price disinflation to come

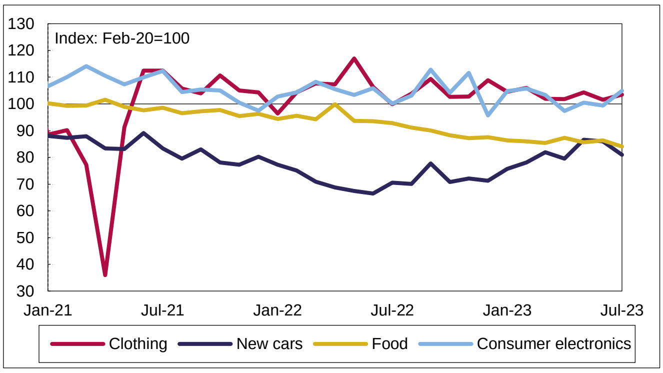
The catalyst for a resumption in growth in retail sales should be lower consumer price inflation, particularly of goods. And judging by Germany’s producer goods inflation data released yesterday, which reported a continued easing of pressures, the prospects for such a decline still look favourable. German industrial producer prices fell for the ninth month out of the past ten in July and by a much larger-than-expected 1.1%M/M. As a result, the annual rate of PPI inflation plunged 6.1ppts to -6.0%Y/Y, marking the sharpest year-on-year decline in German producer prices since the Global Financial Crisis in 2009. Inevitably, the base effect associated with the extreme surge in natural gas prices last summer was key in explaining the sharp drop. But producer energy prices also fell for a third successive month in July, by 2.5%M/M, to be down a whopping

France: Retail sales* & consumer spend intentions



*Sales volumes. Source: Bank of France, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

France: Retail sales* by selected component



*Sales volumes. Source: Bank of France, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

19.3%Y/Y in July and more than 36% below the peak last September. The annual pace of decline in electricity prices was most striking, accelerating almost 26ppts to -30.0%Y/Y.

Excluding energy, producer prices fell 0.4%M/M to the lowest level since December, helping the respective annual rate to slow 0.8ppt to 2.1%Y/Y. Reflecting better functioning supply chains and a broader easing of input cost pressures, intermediate goods prices fell for a fifth successive month and by 1.0%M/M to be down 3.4%Y/Y. In contrast, producer prices of capital goods were up 0.3%M/M and 5.5%Y/Y, still nevertheless the softest rate since Russia's invasion of Ukraine. The durable consumer goods PPI was unchanged on the month and up 5.8%Y/Y, the lowest annual rate since end-2021. And with food prices better behaved, producer prices of non-durable consumer goods were also unchanged on the month for the first time in almost two years. So, the respective annual rate slowed for a ninth successive month to 8.1%Y/Y, the least vigorous since February 2022. Tomorrow's PMIs will likely underscore that this favourable disinflation trend is set to continue over the remainder of Q3 and probably into 2024. Indeed, we currently expect euro area core goods inflation to drop from 5.0%Y/Y in July to close to 2.0%Y/Y by year-end and less than 1.0%Y/Y on average in Q124.

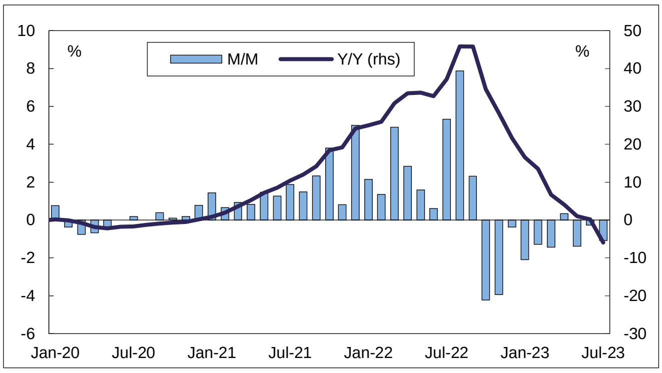
Reversal of terms of trade shock sends goods trade surplus to series high in June

The rapid disinflation of industrial goods prices reflects the marked easing in prices of imported goods, which were down 11.9%Y/Y in Germany (and a similar 10.9%Y/Y in the euro area) at end-Q2. With export prices down just 0.9%Y/Y, that also represents a significant reversal of the hugely adverse terms of trade shock experienced since the Russian invasion of Ukraine. And with that improvement, so too the euro area's external balance has markedly strengthened. Indeed, the current account surplus jumped almost €28bn in June – the most since 2015 – to €35.8bn, the highest since February 2021. And the favourable shift was led by the goods trade balance, for which the surplus on the ECB measure widened by more than €17bn to a series high of €39.3bn, a remarkable turnaround from the substantive deficits recorded between March and November last year. The services surplus also widened, albeit to a lesser extent, by €2.1bn to €7.7bn. The deficit on primary income – related to net income from interest, profits and dividends – swung significantly into surplus, improving more than €11bn to €7.7bn. And the secondary income deficit – predominantly accounted for by remittances, foreign aid and EU transfers – widened slightly (-€14.8bn). In the absence of further marked relative price shocks, and notwithstanding some downside risks associated with the appreciation of the trade-weighted euro from last autumn, we expect the trade and current account surpluses to remain in ample surplus over coming quarters.

The day ahead in the euro area

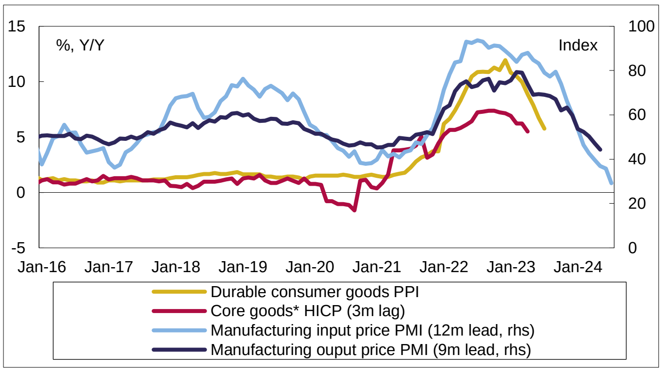
Looking ahead, tomorrow's data highlight will be the publication of the preliminary August PMIs. The euro area PMIs have weakened markedly in recent months, implying a notable deterioration in the economic outlook since the early spring. In

Germany: Industrial producer price inflation



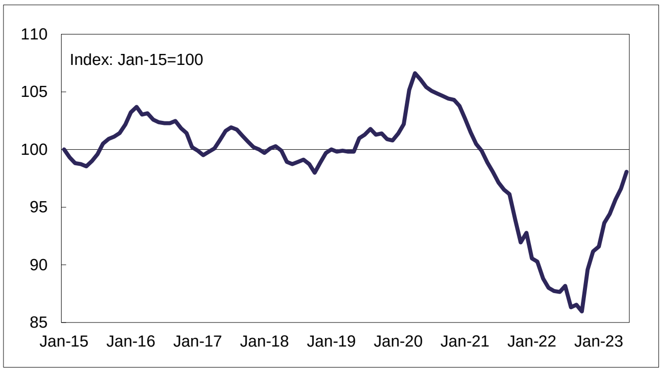
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Selected goods price indices



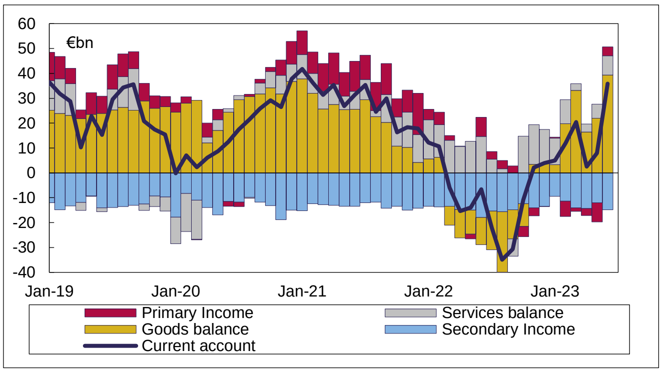
**Non-energy industrial goods prices. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Terms of trade*



**Export price index divided by import price index. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Current account & major components



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

particular, the euro area composite PMI fell for a third consecutive month in July and by 1.3pt to an eight-month low 48.6. This left the index more than 3½pts below the Q2 average and firmly in contractionary territory for the first time since Q4. At the country level, the composite PMIs for both Germany and France also fell clearly below 50 in July. The August PMIs are expected to move broadly sideways from these disappointingly soft levels, albeit also suggesting that cost pressures continue to dissipate, particularly in manufacturing. Tomorrow also brings the release of the European Commission's flash estimate of euro area consumer confidence, which is expected to edge a little higher in August – for the fifth successive month – to -14.5, still nevertheless well below the pre-pandemic level.

UK

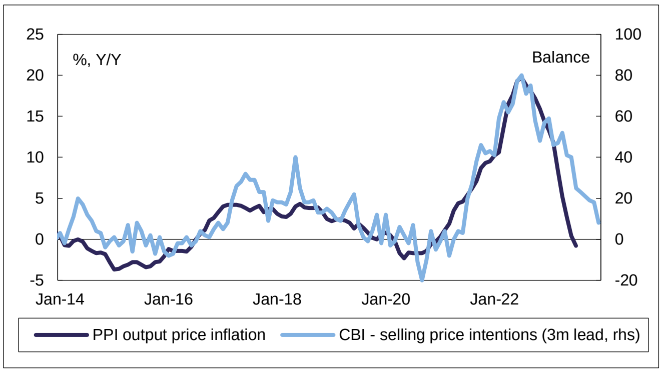
CBI survey reports drop in factory output & orders, & a further moderation in price pressures

Boosted by a sharp rebound in the auto sector (14.0%Q/Q) as supply chains were restored, and growth also registered in pharmaceuticals and metals among others, manufacturing output rose a surprisingly brisk 1.6%Q/Q in Q2 to be 6.0% above the pre-pandemic level. That growth jarred with survey evidence of a significant loss of momentum in the sector last quarter, with the adverse trends extending into the July sentiment indices too. Indeed, today's CBI Industrial Trends indices – which represented the first of the August survey results – reported that manufacturing output volumes fell the most since September 2020 in the three months to August. The weakness appeared broad-based, with output down in almost of the 17 sectors, and led by autos and other transport, mechanical engineering, paper and chemicals. While output volumes were expected to stabilise over the coming three months, total order books, and export orders, were reported to be below "normal" in August and to a greater extent than in July. Admittedly, these indices were broadly in line with their (weak) long-run averages. And they had also held up better over recent months than the manufacturing new orders PMI. The deterioration in today's CBI survey, however, suggests that the August PMIs, due tomorrow, will point to sharp declines in both output and new orders in the middle of Q3. They are also likely to report a further easing of cost pressures in the factory sector. According to the CBI survey, the net balance of survey respondents expecting to increase selling prices fell for an eighth successive month and by 10pts +8%, the lowest since February 2021.

Net borrowing continues to come in below expectations thanks to high inflation

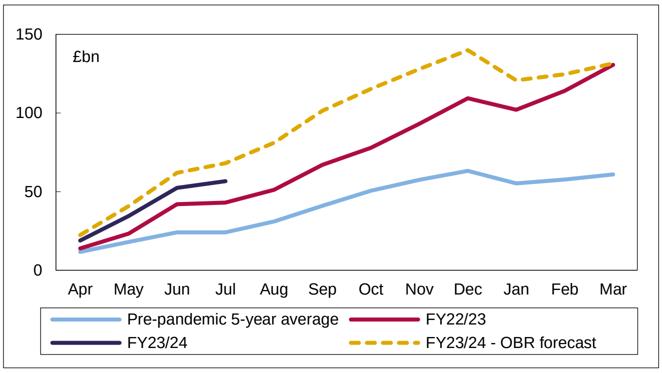
Public sector net borrowing in July again came in below market expectations and the OBR's forecast published at the time of the March Budget. In particular, net borrowing by the public sector excluding banks (PSNB ex) in July came in at £4.3bn, up £3.4bn from a year earlier. And that took the total for the first four months of this fiscal year to £56.6bn, £11.3bn or almost 17% below the OBR's forecast for the same period. Much of the improvement relative to expectations has so far come on the revenue side, which is running more than £10bn above forecast, as both VAT and income tax receipts have exceeded expectations thanks to high inflation of prices and wages. Central government expenditure is also running above the OBR's forecast largely due to increases in inflation-linked net benefit payments and staff costs. And high inflation also meant that central government debt interest payments reached a record high for July. The data for the fiscal year to-date seemingly opened the door a little wider to a tax-cutting loosening of fiscal policy ahead of the next general election, which is due by January 2025. However, we note that the high inflation – which so far has boosted government receipts more than its expenditure – also renders the government's future public spending plans for coming years far less credible. Adding to that additional pressures to come on debt interest from higher Gilt yields, and transfers from H M Treasury to the BoE to cover the Asset Purchase Facility losses associated with quantitative easing, the Chancellor is likely to have relatively limited leeway for a fiscal giveaway either in his next Autumn Statement or Spring Budget. Given the ruling Conservative party's dire public ratings, however, some opportunistic tax cuts by the next Budget seem increasingly inevitable, regardless of the fiscal arithmetic.

UK: PPI inflation & CBI price expectations index



Source: CBI, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing*



**Excluding public sector banks. Source: ONS, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

The day ahead in the UK

As in the euro area, the focus in the UK tomorrow will be the flash August PMIs. The UK's July PMIs signalled a weakening of momentum at the start of Q3, albeit with the composite activity index (a six-month low of 50.7) pointing to stagnation rather than outright contraction in GDP. Growth in services was also the softest in six months while the manufacturing output PMI suggested the sharpest drop in the sector since January. Cost pressures in services appeared to remain high by historical standards while manufacturing output prices were broadly stable. The latest survey is expected to indicate that this sluggishness continued into the middle of the quarter, with no improvement forecast in the headline August PMIs.

European calendar

Today's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
France	Bank of France retail sales Y/Y%	Jul	**-2.1**	-	-2.0	-
UK	Public sector net borrowing (ex banks) £bn	Jul	**3.5 (4.3)**	3.9 (5.0)	17.7 (18.5)	17.1 (17.9)
	CBI industrial trends survey, total orders (selling prices)	Aug	**-15 (8)**	-	-9 (18)	

Country	Auction
Auctions	
UK	sold £1.5bn of 0.75% 2033 index-linked bonds at an average yield of 0.977%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Economic data						
Germany	PPI Y/Y%	Jul	**-6.0**	-5.1	0.1	-
UK	Rightmove house price index M/M% (Y/Y%)	Aug	**-1.9 (-0.1)**	-	-0.2 (0.5)	-

Country	Auction
Auctions	
	- 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					
Euro area	09.00	Preliminary manufacturing (services) PMI	Aug	42.6 (50.5)	42.7 (50.9)
	09.00	Preliminary composite PMI	Aug	48.5	48.6
	15.00	European Commission's preliminary consumer confidence index	Aug	-14.3	-15.1
Germany	08.30	Preliminary manufacturing (services) PMI	Aug	38.6 (51.5)	38.8 (52.3)
	08.30	Preliminary composite PMI	Aug	47.8	48.5
France	08.15	Preliminary manufacturing (services) PMI	Aug	45.1 (47.5)	45.1 (47.1)
	08.15	Preliminary composite PMI	Aug	47.5	46.6
UK	09.30	Preliminary manufacturing (services) PMI	Aug	45.0 (50.8)	45.3 (51.5)
	09.30	Preliminary composite PMI	Aug	50.3	50.8
Auctions and events					
Germany	10.30	Auction: €3.0bn of 2.40% 2030 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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