Euro wrap-up

Overview

- Bunds rallied as the flash euro area PMIs signalled an increasing likelihood that GDP is now contracting, while consumer confidence also deteriorated.
- Gilts also made big gains as the flash UK PMIs also surprised significantly on the downside to flag the prospect of a drop in GDP this quarter.
- Thursday will bring new survey results for French business confidence and UK retail sales.

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Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	2.948	-0.126
OBL 2.4 10/28	2.510	-0.135
DBR 2.6 08/33	2.512	-0.127
UKT 0⅝ 06/25	4.936	-0.171
UKT 1⅝ 10/28	4.478	-0.191
UKT 3¼ 01/33	4.463	-0.174

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

Euro area

Flash euro area PMIs signal an increasing likelihood of contraction in Q3

While euro area economic activity returned to moderate growth in Q2 (0.3%Q/Q), surveys suggest that the recovery momentum weakened as the quarter progressed. And having taken a further turn for the worse at the start of Q3, today's flash August PMIs implied significant additional deterioration in economic conditions this month, raising the likelihood that a contraction in euro area GDP is well underway this quarter. Certainly, the euro area's headline composite activity PMI fell well short of expectations in August, down for the fourth consecutive month and by 1.6pts to 47.0, the lowest since November 2020. And when excluding the height of the pandemic, August marked the weakest reading since April 2013 and left the composite PMI trending so far in Q3 more than 3½pts below the Q2 average and a level that before the pandemic would have been consistent with a contraction in GDP of between 0.2-0.3%Q/Q.

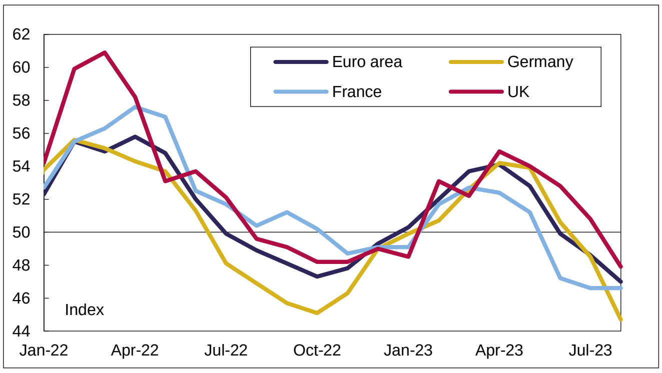
Services activity PMI falls into contractionary territory for first time this year

As has been the case for the past eighteen months, the weakness remained more pronounced in the factory sector. Despite a modest uptick in August, the manufacturing output index (43.7) was the second-lowest for eleven years when excluding the first wave of pandemic. But the deterioration in the composite PMI this month was driven by the services sector, for which the activity index declined for the fourth consecutive month, by 2.6pts to 48.3, the first sub-50 'contractionary' reading this year, to the weakest since February 2021 and for more than a decade when excluding the pandemic period. Demand continued to worsen this month too, with the survey implying the steepest pace of decline in the flow of new orders (44.9) since late 2020, with domestic and external demand a drag on both manufacturing and services. Moreover, against the backdrop of a sharp drop in firms' backlogs of work and increasing pessimism regarding the outlook over the coming twelve months, the employment PMI (50.3) suggested the softest jobs growth since February 2021.

A striking slump in Germany's composite PMI amid ongoing weakness in France

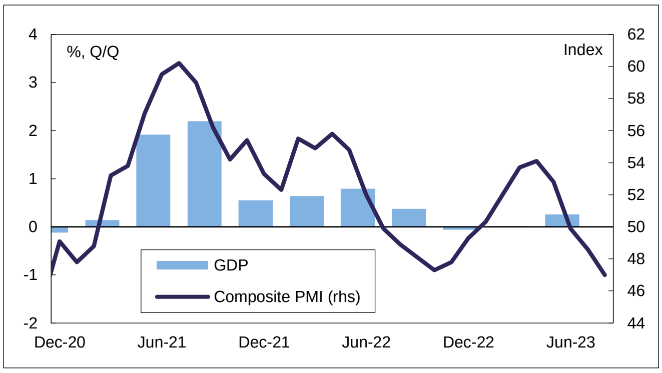
Within the limited country detail provided in today's surveys, there was a striking slump in economic activity implied by Germany's composite PMI, which fell a whopping 3.8pts in August, the most for almost two years, to 44.7, the lowest since the global financial crisis when excluding the initial Covid-19 lockdown period. Indeed, a steeper pace of decline in manufacturing (down 1.3pts to 39.7) was accompanied by a contraction in services activity (down 5pts to 47.3) for the first time in eight months. And reflecting destocking, a reluctance to invest and squeezed household and corporate budgets, new orders fell further in August, with the respective PMI (40.6) the lowest since April 2009 when excluding the first three months of the pandemic. While the French composite PMI was unchanged in August, at 46.6, it still marked the joint-weakest since

Europe: Composite output PMIs



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMIs & GDP growth



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

November 2020. Moreover, there was a further deterioration in the services sector, for which the activity index fell 0.4pt to 46.7, the lowest since February 2021. That offset a further increase in the manufacturing output index (45.8) to a five-month high. According to S&P Global, the decline in activity across the rest of the region was less severe, but nevertheless implied the first contraction since December amid an ongoing decline in manufacturing and stagnation in services.

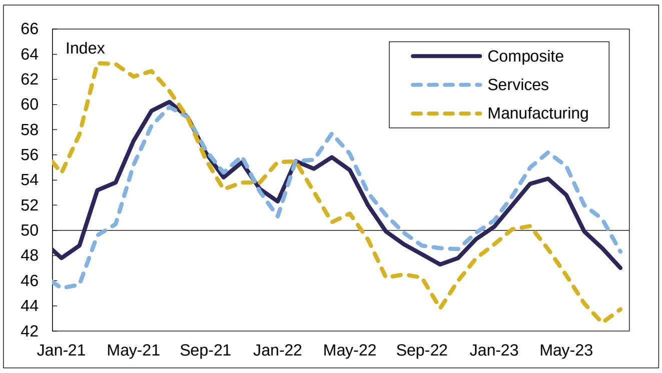
Services input cost pressures stronger, output price rises in the sector still stubbornly high

While the rapidly weakening economic momentum strengths the case for the ECB to pause its tightening cycle at its September policy-setting meeting, developments in the survey's price indices this month will be a reminder that this is not yet a done deal. Indeed, while the euro area services output prices PMI edged slightly lower to 55.9, the softest for almost two years, it was still roughly 6pts above the long-run average. Moreover, the services input cost PMI rose for the first month in six (up 1.5pts to 62.5), with survey respondents generally attributing the deterioration to rising wage pressures. However, while the manufacturing input cost PMI jumped 3.6pts in August, this merely reversed the drop in July, and at 39.4 the index was still well below the long-run average (56.3). And while the manufacturing output price PMI also ticked slightly higher in August (46.0), this too remained well below average reflecting the ongoing dampening effect of fading supply constraints and weakening demand.

Wage growth still firmly above the long-run average but consumer confidence softens

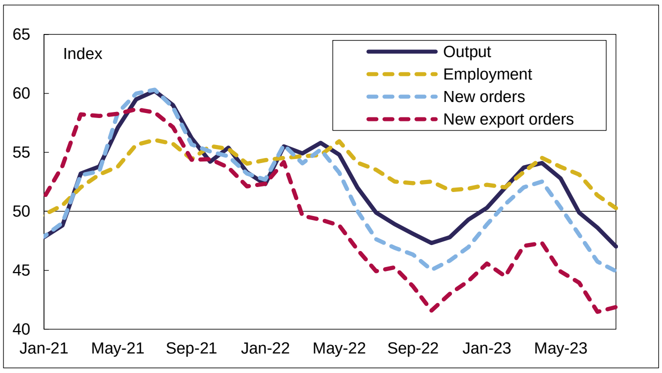
The Governing Council hawks might also judge that recent developments in negotiated wages merit another rate hike next month. According to today's ECB figures, the annual rate of negotiated wage growth eased only very marginally in Q2, by 0.1ppt to 4.3%Y/Y. (Indeed, to two decimal places, growth slowed just 0.02ppt to 4.34%Y/Y). This rate is more than double the long-run average, and also roughly double the average rate in 2019 ahead of the pandemic. And the readings for the first two quarters of the year are the two strongest on the series in three decades. Of course, actual annual nominal wage growth will have been softer in Q2 than the negotiated wage figure and negative in real terms. And while the unemployment rate is likely to remain close to a record low over the near term, and inflation is expected to fall back further, real disposable income growth will likely remain relatively subdued for the time being. Certainly, consumers do not appear overly encouraged – the Commission's preliminary euro area consumer confidence indicator for August, also published today, fell for the first time in five months, by 0.9pt to -16.0. Admittedly, this merely largely reversed the improvement in July to leave it still some 12½pts above last year's trough. But we expect the detail of this survey, which will only be published with the final release on 30 August, to suggest that consumers are reticent to loosen their purse strings. Certainly, the Dutch consumer confidence survey, for which the headline index also declined 1pt on the month, saw households' willingness to make major purchases ease to a five-month low.

Euro area: Activity PMIs



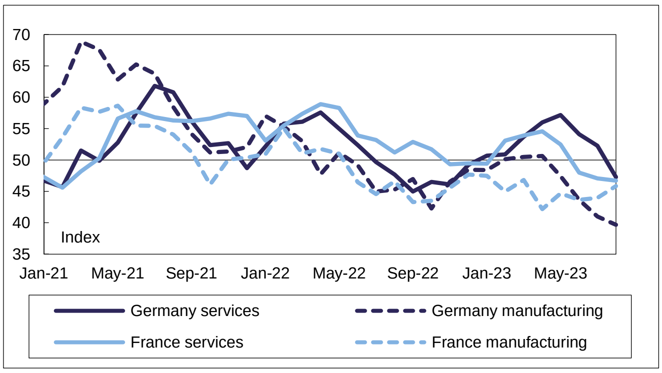
Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

Euro area: Selected composite PMI components



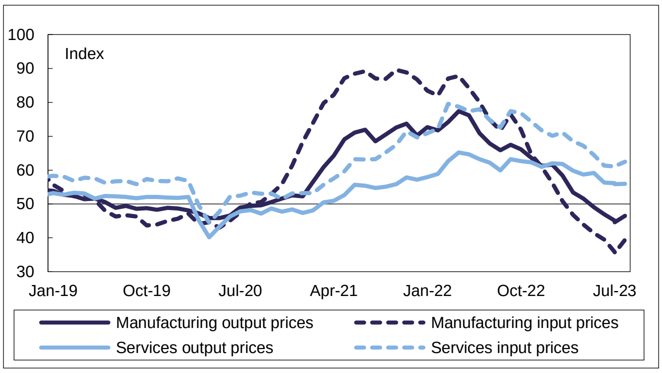
Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

Germany & France: Activity PMIs



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

Euro area: Price PMIs



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Thursday will bring the French INSEE business survey for August, which has painted a less gloomy picture of French business conditions over recent months and arguably offered a better guide to French GDP growth. Indeed, the headline business sentiment index is expected to have moved sideways for the third consecutive month, at 100, bang in line with the long-run average.

UK

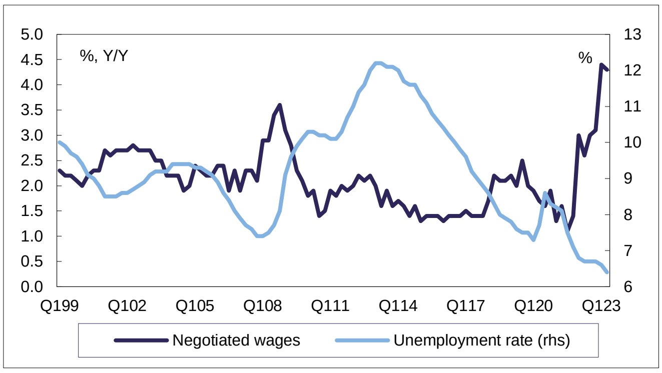
UK flash PMIs disappoint in August, signalling contraction over the summer

Like in the euro area, the UK's flash PMIs disappointed expectations in August, signalling a further marked weakening in economic momentum over the summer. In particular, the composite output PMI fell for the fourth consecutive month and by the most in fifteen months, by 2.9pts to 47.9, the lowest since the lockdown in January 2021 and the post-Brexit referendum slump in July 2016 when excluding the height of the pandemic. Indeed, the composite PMI in the first two months of Q3 (49.4) was trending some 4½pts below the Q2 average and consistent with a drop in GDP of about 0.2%Q/Q this quarter. The deterioration in conditions was broad based. The services activity index was down a further 2.8pts in August to 48.7, matching the two-year low recorded in January, while the manufacturing output index dropped 3.9pts to 43.3, a twelve-month low. This reflected a second-successive decline in new orders as the impact of higher borrowing costs and soft external demand took their toll. Indeed, demand for services reportedly fell for the first time since January and new factory orders were the weakest May 2020 and the global financial crisis when excluding the initial pandemic period. As such, the survey suggested that manufacturers continued to cut jobs in August and run down inventories at the fastest pace since 2009. So, while services providers continued to add slightly to headcount, the composite employment PMI (50.4) fell to a five-month low.

Price PMIs more encouraging, but cost pressures persist in services

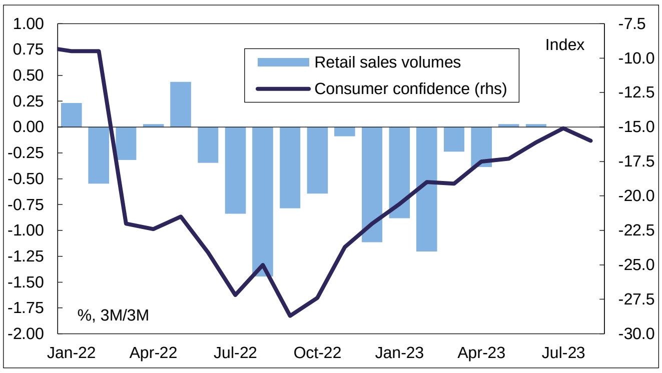
The combination of improved supply and weaker demand continued to ease manufacturers cost burdens. The input cost PMI (42.8) in the sector dropped to the lowest since January 2016 and a level more than 13pts below the long-run average, while the output prices index (48.9) suggested deflation in the sector for the first time since early 2016. Given the MPC's concerns over the stickiness in services inflation, there was also a welcome slowing in the survey measure of prices charged in the sector in August, with the respective index falling more than 3pts to 56.2, a 28-month low. Admittedly, it remained more than

Euro area: Negotiated wages & unemployment rate



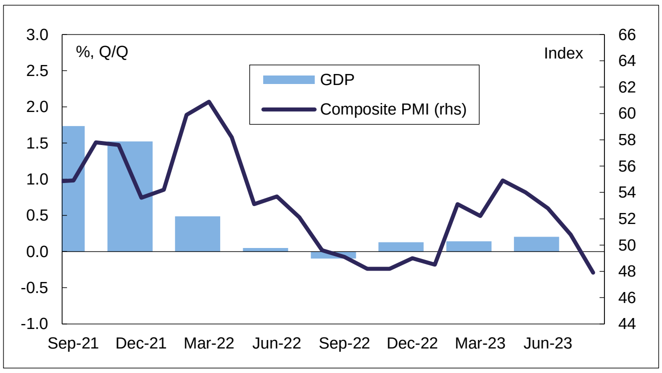
Source: ECB, Refinitiv Datastream & Daiwa Capital Markets Europe Ltd.

Euro area: Consumer confidence & retail sales



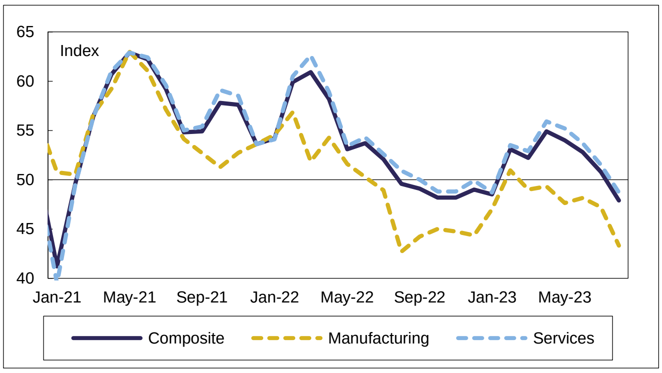
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Composite PMI & GDP growth



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

UK: Activity PMIs



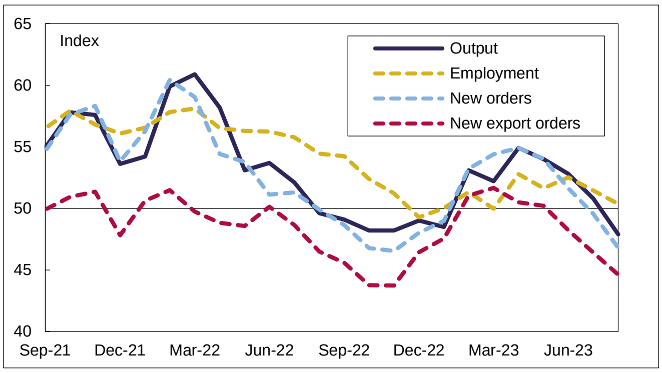
Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

3½pts above the long-run average. And the deceleration in input costs in the sector was more marginal amid reports of persistent wage pressures, with the respective index down just 0.9pt to 68.4, some 9pts above the long-run average. So, despite the sluggishness of economic activity, the PMIs' signal of ongoing cost pressures in services, as well as the further big upside surprise in the latest official wage numbers and still-sticky core inflation, we continue to expect the BoE to raise Bank Rate by 25bps on a further two occasions this cycle.

The day ahead in the UK

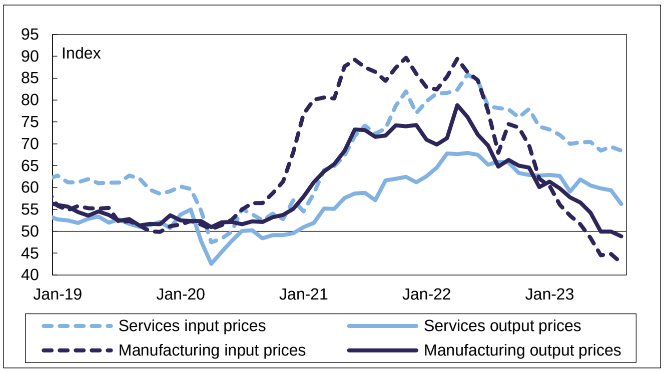
The flow of sentiment surveys continues in the UK tomorrow, with the CBI distributive trades survey set to provide an update on retailing conditions in August. Having dampened demand in July, inclement weather conditions are likely to have impacted activity on the High Street again this month. So, despite a recent pickup in household real disposable incomes thanks to strong wage growth, we expect the CBI's headline retail balance to suggest that sales remained down compared with a year earlier.

UK: Selected composite PMIs



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

UK: Price PMIs



Source: Refinitiv Datastream, S&P Global & Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary manufacturing (services) PMI	Aug	**43.7 (48.3)**	42.6 (50.5)	42.7 (50.9)	-
		Preliminary composite PMI	Aug	**47.0**	48.5	48.6	-
		European Commission's preliminary consumer confidence	Aug	**-16.0**	-14.3	-15.1	-
Germany		Preliminary manufacturing (services) PMI	Aug	**39.1 (47.3)**	38.6 (51.5)	38.8 (52.3)	-
		Preliminary composite PMI	Aug	**44.7**	47.8	48.5	-
France		Preliminary manufacturing (services) PMI	Aug	**46.4 (46.7)**	45.1 (47.5)	45.1 (47.1)	-
		Preliminary composite PMI	Aug	**46.6**	47.5	46.6	-
UK		Preliminary manufacturing (services) PMI	Aug	**42.5 (48.7)**	45.0 (50.8)	45.3 (51.5)	-
		Preliminary composite PMI	Aug	**47.9**	50.3	50.8	-

Auctions

Country		Auction
Germany		sold €2.4bn of 2.40% 2030 bonds at an average yield of 2.53%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France		07.45	INSEE business (manufacturing) confidence	Aug	100 (99)	100 (100)
UK		11.00	CBI distributive trades survey, reported retail sales	Aug	-15	-25

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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