Euro wrap-up

Overview

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- Although German factory orders fell the most since 2020 and euro area retail sales also declined, Bunds followed USTs lower as some of the traditionally hawkish members of the ECB Governing Council suggested they might support a rate hike next week.
- While the UK construction PMIs remained consistent with growth in the sector, Gilts outperformed as BoE Governor Bailey stated that rates are now "near the top of the cycle".
- Thursday will bring data for German industrial production and surveys of UK labour market conditions and business price expectations.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.101	+0.083
OBL 2.4 10/28	2.657	+0.075
DBR 2.6 08/33	2.652	+0.045
UKT 0⅝ 06/25	5.216	-0.027
UKT 1⅝ 10/28	4.801	+0.014
UKT 3¼ 01/33	4.532	+0.014

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

Euro area

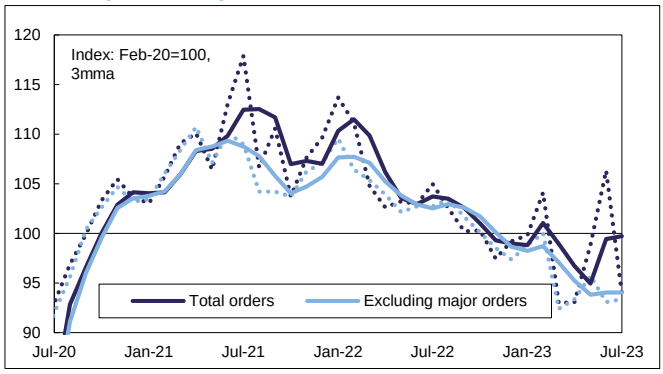
Sharp drop in German orders in July reflects payback for strength in Q2

At face value, today's German factory orders data added to the steady flow of negative news out of the manufacturing sector, highlighting the strong likelihood that production will be a drag on economic growth this quarter. Indeed, factory orders fell a steeper-than-expected 11.7%M/M in July – the largest monthly drop since in the initial pandemic wave in April 2020 – to be down 10.5%Y/Y and more than 20% below the peak two years ago. However, the weakness largely reflected payback for the exceptionally strong cumulative growth of more than 14% over the prior two months. And total orders were still up 3.1%3M/3M, the strongest three-month growth rate since February 2022. The marked volatility over recent months was principally related to bulk and exceptional large-scale orders. Most notably, orders in the aerospace subsector had enjoyed a temporary surge in May and June, rising cumulatively by almost 400% over the two months, before falling back by 66%M/M in July to return close to the average level of the past couple of years. Similarly, there were also double-digit monthly percentage declines in July in data processing, electronic and optical products, electrical equipment, and metal products. But there was also a modest rise in new orders for motor vehicles, reflecting increased overseas demand, to leave them up marginally on a three-month basis for the first time since February. And when excluding major items, German factory orders rose 0.3%M/M in July, albeit leaving them down 1.3%3M/3M. Notwithstanding potential ongoing volatility related to bulk orders, the near-term outlook remains clouded by weaker demand both at home and overseas, with the ifo indices and PMIs suggesting that new orders fell in August at the steepest underlying rate since the initial pandemic slump in April 2020.

Decline in German turnover points to a second successive fall in manufacturing production in July

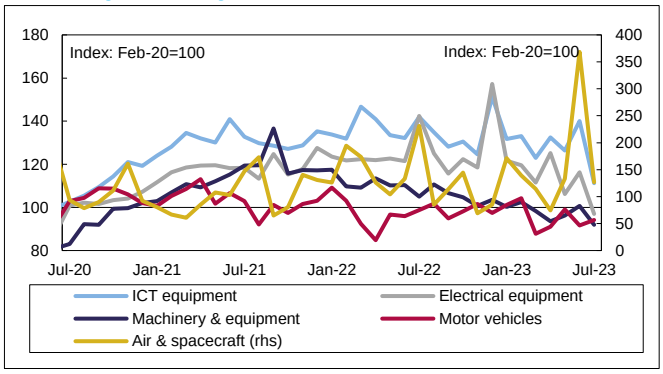
While significant backlogs of work and easing in supply constraints supported a recovery in manufacturing output at the start of the year, the subsequent weakening in demand meant that it contracted in Q2 (-0.6%Q/Q) by the most in a year. And while total orders trended higher, today's manufacturing turnover figures suggest that production started the third quarter on the back foot. In particular, turnover fell for a second successive month in July, by 1.0%M/M, to leave it up just 1.4%Y/Y and still 2½% below the pre-pandemic level. So, while truck toll mileage moved broadly sideways in July, today's turnover figures strongly suggest that tomorrow's German industrial production figures will report another decline, with the risks to the Bloomberg consensus forecast (-0.4%M/M) skewed to the downside. And with business gas usage even weaker than a year earlier and more than 20% below the average level between 2018 and 2021, production in the energy-intensive sectors might well have fallen further too.

Germany: Factory orders*



Dotted lines represent unsmoothed data. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders in selected subsectors



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

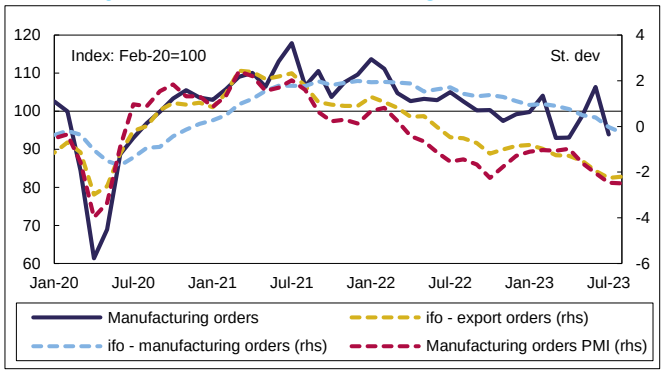
Retail sales fall slightly in July but appear on track for growth over Q3 as a whole

Broadly in line with expectations, euro area retail sales volumes fell slightly in July, down 0.2%M/M. The volume of sales over prior months was, however, revised upwards, e.g. real-terms growth in June is now estimated at 0.2%M/M, 0.5ppt stronger than previously thought. As a result, the annual real rate beat expectations, coming in at -1.0%Y/Y, unchanged from the upwardly revised figure June and thus matching the best reading since September. Moreover, the volume of sales in July was slightly above the Q2 average. And strikingly, real sales growth on a three-month basis rose for the third successive month to 0.5%3M/3M. That marked the strongest three-month expansion since December 2021, suggestive of a re-emergence of positive momentum as real disposable incomes benefited from firmer wage growth, high employment and slowing inflation. Indeed, despite the drop in consumer confidence in August, real retail sales appear on track for positive growth for the second successive quarter in Q3. By category, the fall in sales volumes in July was due to weakness in the fuel category, likely reflecting the steady rise in petroleum prices that month, while real sales of food and core items both rose 0.5%M/M. And looking through the monthly volatility, core sales volumes were up a solid 0.7%3M/3M, while food sales edged higher (0.1%3M/3M) but fuel sales took a sizeable step down (-1.5%3M/3M). Online and mail order sales were significantly firmer too, up 2.2%3M/3M. Given rising prices, in value terms, nominal retail sales were down 0.1%M/M in July but still up 1.1%3M/3M and 3.8%Y/Y.

Construction PMIs point to ongoing contraction amid collapse in housing activity

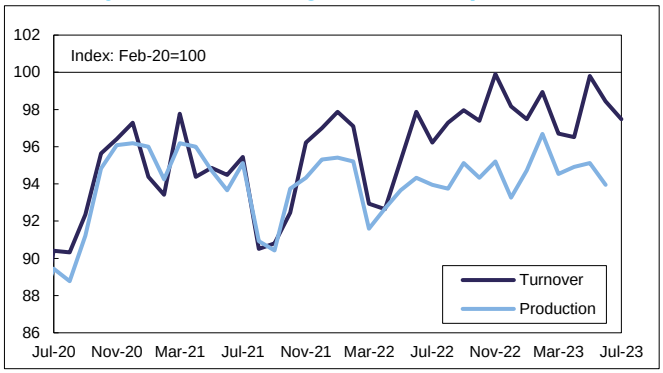
Consistent with the manufacturing and services PMIs, today's construction survey suggested that conditions remained challenging in the face of higher borrowing costs associated with the ECB's aggressive policy tightening and the uncertain economic outlook. Indeed, while the euro area's headline activity index edged only slightly lower in August, at 43.4 it marked the sixteenth consecutive month in 'contractionary' territory and implied the steepest drop in output this year. Given declining house prices, higher mortgage interest rates and still subdued consumer confidence, the weakness was once again most acute in the housing sector, whereby the activity index dropped 3.6pts to 35.7, the lowest reading since early 2010 barring the collapse during the first Covid-19 lockdown. Like in the manufacturing survey, the deterioration was most striking in Germany, where the housing index fell to 30.0, the lowest since February 2010, while the equivalent French index (33.6) was the weakest since May 2020. Although the implied drop in housing activity in Italy (46.6) was relatively modest and civil engineering was reportedly the firmest in six months, the commercial activity PMI in that country was the weakest of the member states to raise concerns about business capex. The underlying weakness in total construction was led by a steeper decline in new orders. As such, firms scaled back both purchases of inputs and staff headcount in August, with German construction companies cutting jobs at the fastest pace since May 2020.

Germany: Selected manufacturing order indices



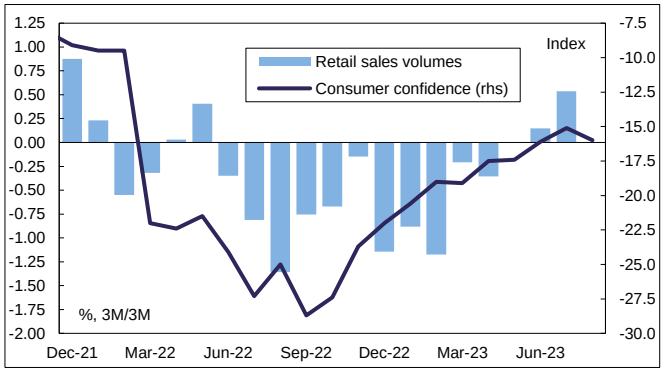
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing turnover & production



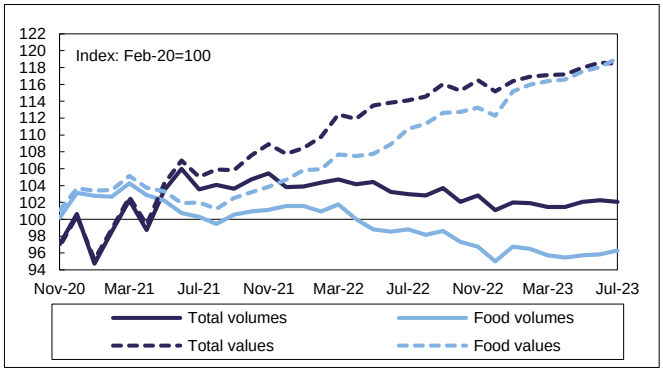
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales & consumer confidence



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

Euro area: Retail sales volumes & values



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

One focus on Thursday will be the aforementioned figures for German industrial production in July. Surveys point to a significant drop in factory sector activity. Indeed, the manufacturing output PMI fell more than 2½pts that month to 41, the lowest since the global financial crisis in 2009 bar the initial wave of pandemic. So, with today's data having shown that new factory orders fell 11.7%M/M and turnover in the sector fell 1.0%M/M, we now think that German manufacturing production also declined as much as 1%M/M. Having dropped by 2.8%M/M in June, construction output seems likely to have rebounded somewhat in July despite downbeat sentiment in that sector. However, that seems unlikely to prevent a third successive monthly fall in industrial production, following the decline of 1.5%M/M in June.

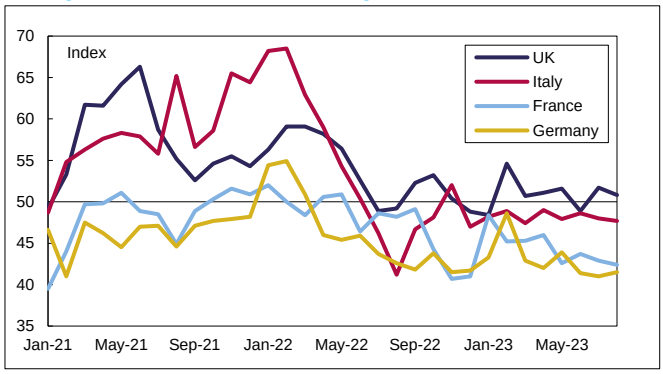
Thursday will also bring the first euro area national accounts for Q2. The updated figure for GDP is likely to confirm the current growth estimates of 0.3%Q/Q and 0.6%Y/Y. However, there is a possibility of a downside revision, not least in light of the 0.1ppt increase in the estimated quarterly pace of decline in Italy (to -0.4%Q/Q). The first estimates of the main expenditure components are likely to point to modest growth in household and government consumption, with inventories and net trade also providing support. Construction investment certainly will have weighed on overall capex. Other new data due tomorrow include figures for French trade and Italian retail sales in July, and French payrolls and wages in Q2.

UK

Construction PMI remains above 50, but masks ongoing downturn in housing activity

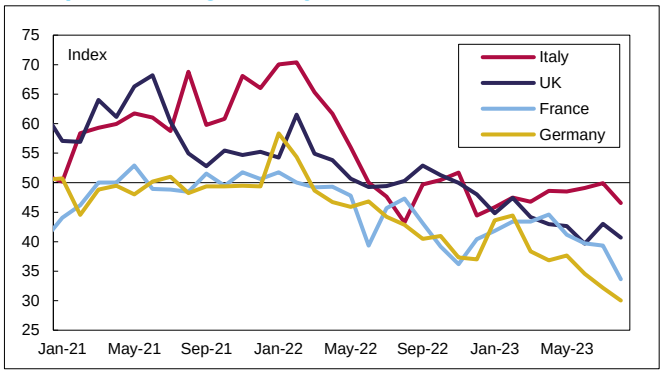
While the UK manufacturing and services PMIs were consistent with contraction over the summer, today's equivalent construction survey suggested that activity continued to hold up relatively well in August despite the dampening effect of the wet weather and higher borrowing costs. Indeed, the headline construction activity index fell a smaller-than-expected 0.9pt to 50.8, supported by ongoing growth in commercial building and civil engineering. But like in the euro area, the survey continued to present a particularly gloomy assessment for house building, with the respective activity index falling 2.3pts to 40.7, implying the second-sharpest contraction since May 2020, with respondents citing cutbacks to new housing projects. And given the steady rise in interest rates and falling house prices, there appears little prospect for a rebound in activity in the sector over the near term. Indeed, despite ongoing growth in commercial and infrastructure activity, the survey suggested that new orders fell for a second month out of the past three and at the steepest pace for more than three years. As such, growth in sub-contractor usage weakened in August, leading to the biggest rise in contractor availability since the start of 2010. Construction firms also expressed greater caution about the outlook for the coming twelve months, as concerns about higher borrowing costs and the downturn in the housing market weighed on expectations.

Europe: Construction activity PMIs



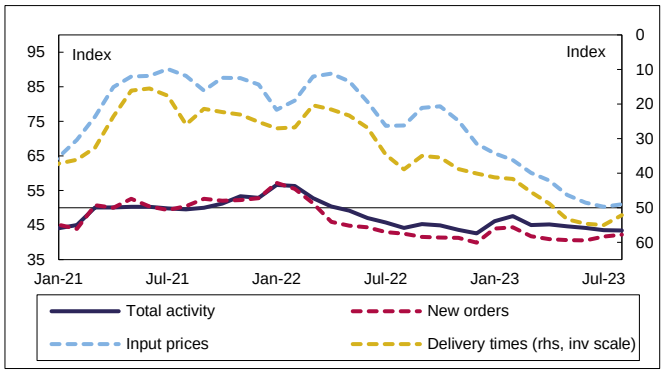
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Housing activity PMIs



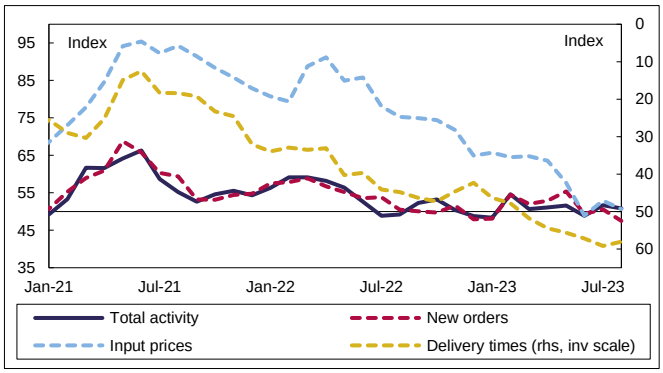
Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



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

UK: Construction PMIs



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

The day ahead in the UK

Thursday will bring the latest REC report on jobs and BoE Decision Maker Panel (DMP) survey results. The REC survey is likely to point to a continued loss of momentum in the labour market, with moderating demand for workers, increased staff availability and somewhat less pressure on starting salaries. The principle focus of the DMP survey will be business inflation expectations after the July survey reported that one-year ahead CPI inflation expectations fell 0.3ppt to 5.4%Y/Y while three-year ahead expectations dropped 0.4ppt to 3.3%Y/Y.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Construction PMI	Aug	**43.4**	-	43.5	-
	Retail sales M/M% (Y/Y%)	Jul	**-0.2 (-1.0)**	-0.1 (-1.2)	-0.3 (-1.4)	0.2 (-1.0)
Germany	Factory orders M/M% (Y/Y%)	Jul	**-11.7 (10.5)**	-4.0 (-3.9)	7.0 (3.0)	7.6 (3.3)
	Construction PMI	Aug	**41.5**	-	41.0	-
France	Construction PMI	Aug	**42.4**	-	42.9	-
Italy	Construction PMI	Aug	**47.7**	-	48.0	-
UK	Construction PMI	Aug	**50.8**	50.5	51.7	-

Auctions

Country	Auction
Germany	sold €4.1bn of 2.6% 2033 bonds at an average yield of 2.63%
UK	sold £4.0bn of 4.5% 2028 bonds at an average yield of 4.803%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	Final GDP Q/Q% (Y/Y%)	Q2	*0.3 (0.6)*	0.0 (1.1)
	10.00	Final employment Q/Q% (Y/Y%)	Q2	*0.2 (1.5)*	0.5 (1.6)
Germany	07.00	Industrial production M/M% (Y/Y%)	Jul	-0.5 (-2.1)	-1.5 (-1.7)
France	07.45	Trade balance €bn	Jul	-	-6.7
Italy	09.00	Retail sales M/M% (Y/Y%)	Jul	-	-0.2 (3.6)
UK	09.30	BoE DMP 1 year ahead CPI expectations Y/Y%	Aug	5.0	5.4

Auctions and events

France	09.50	Auction: To sell 3% 2033, 1.25% 2038 and 3.0% 2054 bonds
Spain	09.30	Auction: To sell 1.3% 2026, 3.55% 2033 and 1.9% 2052 bonds
	09.30	Auction: To sell 1.0% 2030 index-linked bonds
UK	00.01	REC/KPMG report on jobs
	09.30	BoE to publish Decision Maker Panel Survey results

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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