

Euro wrap-up

Overview

- Gilts made sizeable gains as UK GDP unexpectedly failed to grow for a second successive month and exports fell sharply in July.
- Ahead of tomorrow's ECB monetary policy decision, Bunds also made gains.
- The ECB seems bound to deliver a further cut of 25bps in the Deposit Rate to 3.50% while its updated macroeconomic projections will likely revise lower the growth outlook and foresee headline inflation to be back at target by end-2025.

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.125	-0.045
OBL 2½ 10/29	1.948	-0.040
DBR 2.6 08/34	2.094	-0.034
UKT 4½ 01/27	3.771	-0.082
UKT 4½ 07/29	3.596	-0.085
UKT 4½ 07/34	3.746	-0.072

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

UK

UK economy moved sideways for second successive month illustrating slowing momentum

While the PMIs pointed to a pickup in economic growth at the start of Q3, today's monthly GDP report suggested a loss of momentum. Indeed, the UK economy unexpectedly failed to grow for a second successive month in July. Given the surprising strength in the first half of the year, output was still up 1.2%Y/Y. And while it eased to a five-month low, growth on a three-month basis remained slightly above estimates of potential at 0.5%3M/3M, representing only a slight moderation from 0.7%Q/Q in Q1 and 0.6%Q/Q in Q2. But the level of GDP in July was just 0.1% above the Q2 average, suggesting that growth over Q3 as a whole will be significantly softer than in the prior two quarters. So, we maintain our forecast that GDP growth will slow to 0.3%Q/Q in Q3, a touch below the BoE's projection in the August Monetary Policy Report of 0.4%Q/Q.

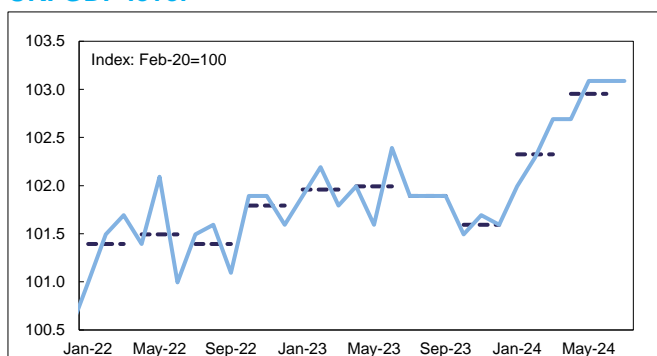
Services sector returns to modest growth, but improvement in part reflected one-offs

Within the detail, the services sector provided the only source of growth in July, with the 0.1%M/M increase reversing the decline in June and marking the sixth monthly increase in seven. This left activity in the sector up a solid 0.6%3M/3M. Growth was led by the ICT subsector thanks to a rebound in computer programming, consultancy and information services. A boost from healthcare, retail and hospitality also helped to offset a drop in professional, scientific and technical activities that appeared merely related to normal monthly volatility. Indeed, professional activities still provided the largest contribution to services growth on a three-month basis. Overall, the monthly pace of growth in services in July was well down on the average in the first five months of the year (0.4%M/M). And certain one-offs, such as the lower number of strikes in the healthcare sector and a boost to retail sales from the European football championships, flattered the data. So, despite stronger growth in household real disposable incomes, underlying momentum in the sector appears subdued.

Manufacturing and construction start Q3 in reverse as car and machinery production drop

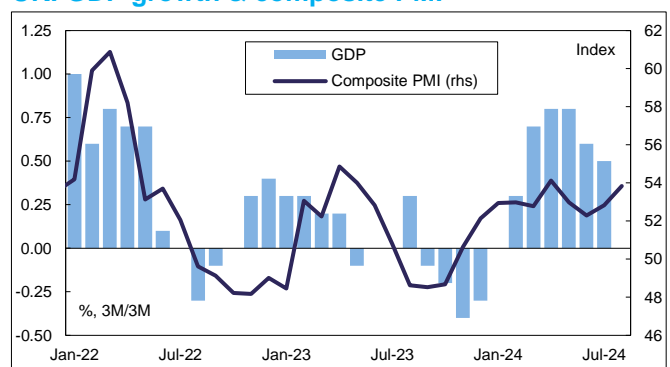
Although the manufacturing output PMI rose to a 2½-year high that month, industrial production fell 0.8%M/M in July to be down 0.1% on a three-month basis. The decline was steeper in manufacturing at -1.0%M/M and -0.3%3M/3M, leaving it still almost 6% below the pre-pandemic level, with output contracting in half of the 13 subsectors. The drop was partly driven by transport equipment, where motor vehicle production fell for the fourth month of the past five and by 3.5%M/M, as factories reportedly prepared for new models and suffered from temporary supply chain disruption. Production of machinery and equipment fell a hefty 4.7%M/M – the most since October 2021 – to a four-month low, with basic metals and electrical equipment also providing a modest drag. The PMIs had also failed to signal a pause in the construction sector, where activity

UK: GDP level*



*Dashed dark blue line represents quarterly average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite PMI



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

fell for the first month in three in July, by 0.4%M/M, reflecting declines in both new building work and repair and maintenance. However, construction activity was still up 1.2%3M/3M, the first positive growth on this basis since October 2023.

Trade deficit widens as exports fall back sharply at the start of Q3

Tallying with recent manufacturing weakness, the latest trade figures disappointed once again, with the deficit widening more than £2.0bn to £7.5bn, just shy of April's two-year high. Despite a decline in the value of imports (-1.5%M/M), exports fell the most since January 2023 (-4.7%M/M) led by a big drop in goods shipments (-10.8%M/M) related in part to chemicals and machinery. Adjusting for prices, goods export volumes were weaker still, reversing the rise the prior month, plummeting 11.5%M/M in July to be down 5.7%Y/Y. That still left them up 0.8%3M/3M, unchanged from June. But three-month growth in export volumes was well shy of the 3.9%3M/3M rise in import volumes. Excluding the distortion from precious metals, goods export volumes rose 1.4%3M/3M but imports rose 3.3%3M/3M. So, while monthly trade figures are highly volatile and subject to revisions, today's release suggests that net trade will provide a further drag on GDP in Q3.

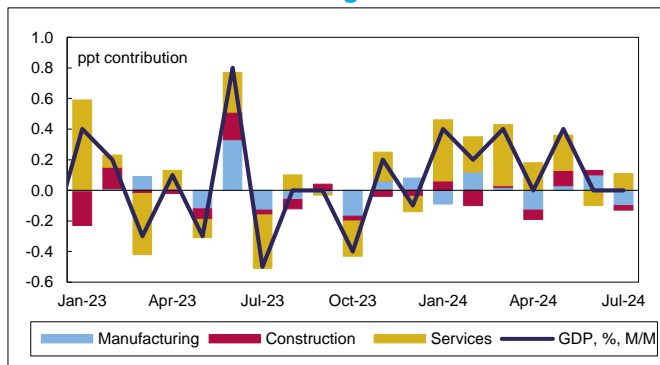
The day ahead in the UK

A quiet day ahead for UK data will bring just the RICS residential survey for August. While the headline house price balance slipped back in July, the survey signalled a pickup in sales volumes and prices over the near term. With mortgage approvals having recently ticked higher and borrowing costs lower after the BoE cut Bank Rate in early August, we expect surveyors to report an improvement in housing market conditions, including a pickup in prices, buyer enquiries and sales last month.

The day ahead in the euro area

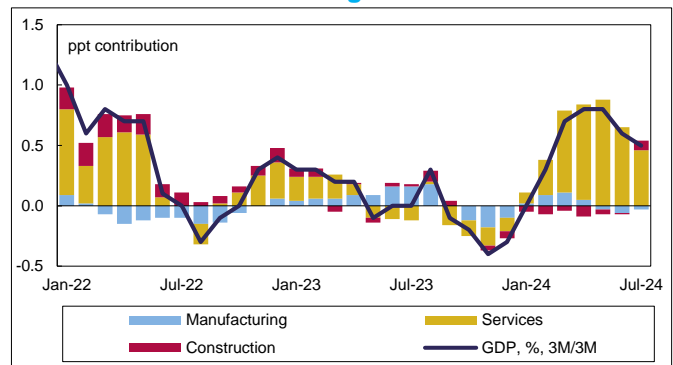
The main event in Europe tomorrow will be the conclusion of the ECB's monetary policy meeting, with the Governing Council set to confirm a further cut of 25bps in the Deposit Rate to 3.50%. The pre-agreed narrowing of the rate corridor from 18 September will also be confirmed, but the resulting 60bps cut in the Refi Rate to 3.65% will be insignificant. As the ECB's hawks remain preoccupied with lingering upside risks to inflation, the policy statement will likely repeat that rates will be restrictive for as long as necessary, and decisions will remain data dependent and hence relatively backward-looking. But the ECB's updated projections will likely nudge down the outlook for GDP. And while the core inflation profile will be revised slightly higher over the near term, the projections should still suggest that headline inflation will be back to 2.0%Y/Y by end-2025 and slightly below target by the end of the horizon. Recently, Chief Economist Lane warned of the dangers of keeping rates too high for too long, which would risk unnecessarily restraining growth, weakening the labour market and pushing inflation well below target over the horizon. As recent data point to rising downside risks to the euro area outlook, President Lagarde ought to echo such dovish sentiments in her press conference.

UK: Contributions to GDP growth



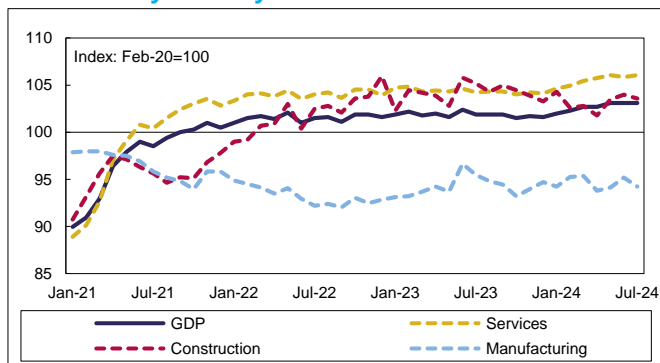
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to GDP growth



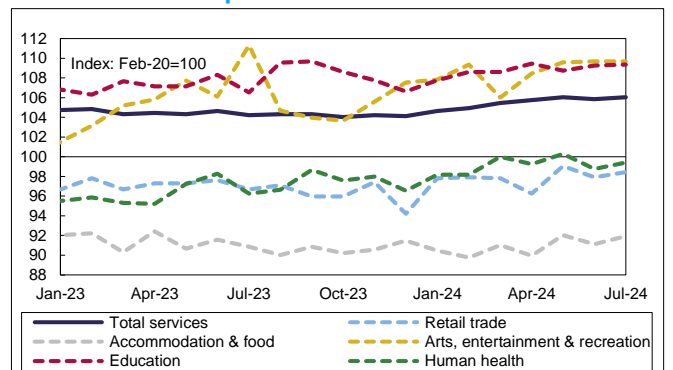
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly GDP by sector



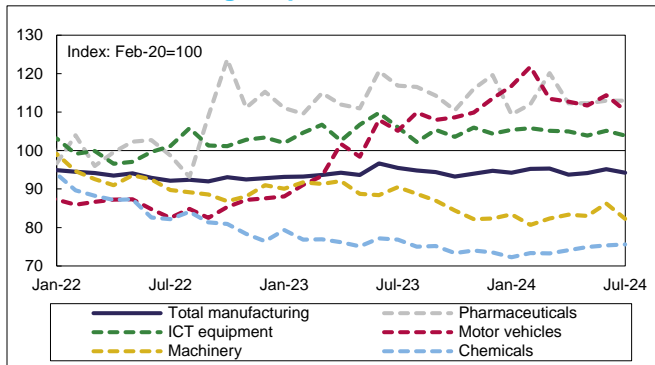
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Services output



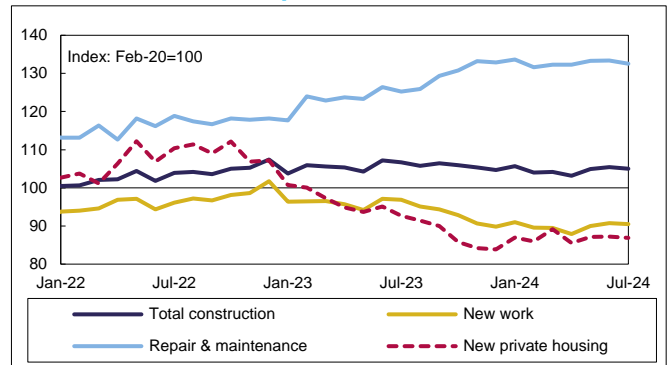
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output



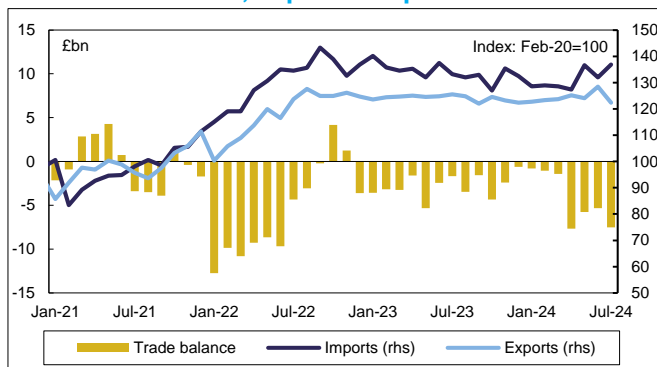
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Construction output



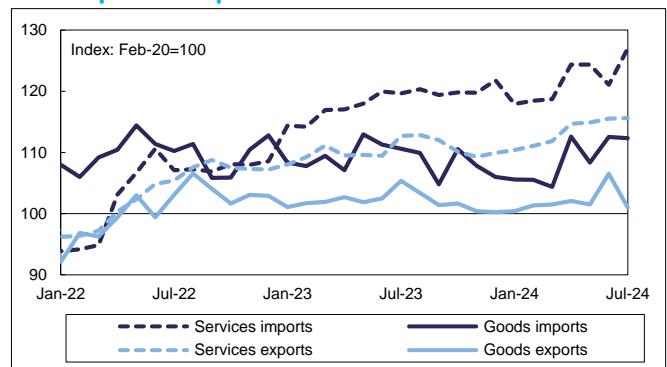
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Trade balance, export & import values



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Export & import volumes*



*Excluding precious metals. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
UK	Monthly GDP M/M% (3M/3M%)	Jul	0.0 (0.5)	0.2 (0.6)	0.0 (0.9)	-
UK	Services output M/M% (3M/3M%)	Jul	0.1 (0.6)	0.2 (0.6)	-0.1 (0.8)	-
UK	Industrial output M/M% (Y/Y%)	Jul	-0.8 (-1.2)	0.3 (-0.1)	0.8 (-1.4)	-
UK	Manufacturing output M/M% (Y/Y%)	Jul	-1.0 (-1.3)	0.2 (-0.1)	1.1 (-1.5)	-
UK	Construction output M/M% (Y/Y%)	Jul	-0.4 (-1.6)	0.5 (-0.7)	0.5 (-1.7)	-
UK	Trade (goods trade) balance £bn	Jul	-7.5 (-20.0)	-5.1 (-18.0)	-5.3 (-18.9)	-





Auctions

Country	Auction
Germany	sold €3.69bn of 2.6% 2034 bonds at an average yield of 2.11%
UK	sold £3.75bn of 4.25% 2034 bonds at an average yield of 3.757%







Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area 	13.15	ECB Deposit Rate (Refi Rate) %	Sep	<u>3.50 (3.65)</u>	3.75 (4.25)
Italy 	09.00	Unemployment rate Q/Q%	Q2	-	7.2
Spain 	08.00	Final HICP (CPI) Y/Y%	Aug	2.4 (2.2)	2.9 (2.8)
UK 	00.01	RICS house price balance %	Aug	-14	-19

Auctions and events

Euro area 	13.15	ECB monetary policy announcement			
	13.45	ECB President Lagarde holds post Governing Council meeting press conference			
	-	ECB to reduce spread between deposit and main refinancing rates to 15bps			
Italy 	10.00	Auction: to sell up to €3.5bn of 3.45% 2027 bonds			
	10.00	Auction: to sell up to €3bn of 3.45% 2031 bonds			
UK 	10.00	Auction: to sell £2bn of 0.125% 2026 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited ("DCME"). DCME is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange. DCME and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or derivatives or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of DCME and its affiliates may have positions and effect transactions in such the Securities or derivatives or options thereof and may serve as Directors of such issuers. DCME may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended only for investors who are professional clients as defined in MiFID II and should not be distributed to retail clients as defined in MiFID II. Should you enter into investment business with DCME's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

DCME has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at <http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory>. Regulatory disclosures of investment banking relationships are available at <https://daiwa3.bluematrix.com/sellside/Disclosures.action>.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Capital Markets Europe Limited retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.