Euro wrap-up

Overview

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- Bunds made losses as the German government announced extra issuance for the coming quarter while euro area construction output rose at the start of Q3.
- Gilts followed the trend lower as the BoE slowed the pace of QT but left rates unchanged and signalled concerns about 'prominent' upside risks to the UK inflation outlook.
- Friday will bring retail sales, public finance and consumer confidence data from the UK, as well as an update on the French business climate.

Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	2.003	+0.008
OBL 2.2 10/30	2.302	+0.028
DBR 2.6 08/35	2.721	+0.051
UKT 3¾ 03/27	3.953	+0.003
UKT 4⅜ 03/30	4.098	+0.027
UKT 4½ 03/35	4.672	+0.048

*Change from close as at 4:45pm BST.
Source: Bloomberg

Euro area

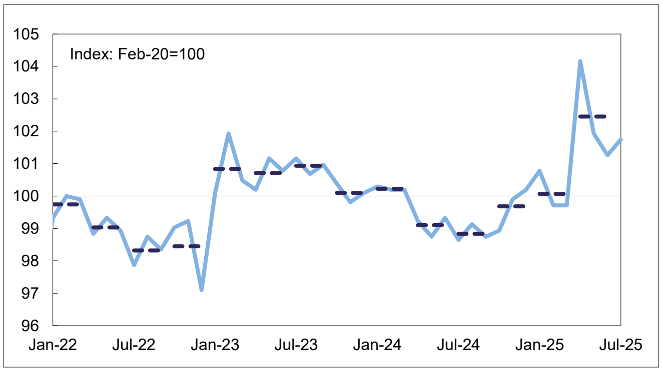
Construction activity returned to growth in July, but likely to be a drag on Q3 GDP

Construction provided non-negligible support to euro area GDP growth in Q2, with output in the sector jumping 2½%Q/Q, matching the pace in Q223 which was the strongest in a decade excluding the lockdown-distorted surge in Q320. But this was principally due to the leap in activity reported in Spain in April (>40M/M). Indeed, when excluding that country, euro area construction activity fell a little more than ½%3M/3M in June to an eight-month low. Despite an ongoing payback for the earlier strength in Spain (-4.5%M/M), today's figures reported a return to modest growth in the sector in the euro area at the start of Q3. Aggregate construction output rose for the first month in three in July, by 0.5%M/M, supported by growth in the core member states, including Germany (0.3%M/M), France (0.5%M/M), Belgium (2.2%M/M) and Austria (2.0%M/M). Growth was firmest in specialised construction (1.2%M/M), which rose to a six-month high. Civil engineering also posted a second successive increase (0.5%M/M) to reach a 17-month high. In contrast, building work fell for a third consecutive month in July (-1.4%M/M). And while this principally reflected weakness in Spain, there were also declines in the subsector in Germany and Netherlands. Due also to the substantial negative carryover from Q2, building work was tracking a noteworthy 3½% below the Q2 average. So, while civil engineering and other specialised activities provided some offset, total construction output was trending a little more than ½% below the Q2 level at the start of Q3. The sector's PMIs were more encouraging in August, with the activity index rising to a 2½ year high. And the ongoing recovery in the housing market and lower borrowing costs should support demand. But, overall, we expect the construction sector to be a modest drag on GDP growth in Q3. Looking further ahead, we note that the level of building permits remained relatively subdued heading into the summer. But in Germany they rose almost 15%Y/Y in July to a more than two-year high, hopefully pointing to a more meaningful recovery into 2026.

Germany ups plans for Bund issuance in Q4 to meet infrastructure & defence goals

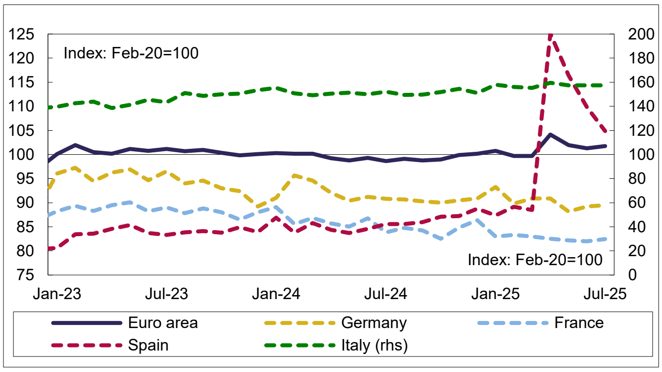
Bunds held their ground against other euro area government bonds today, despite the announcement by the German government of additional issuance for the coming quarter to fund its plans for extra spending on infrastructure and defence. In June, the German debt management agency increased its planned issuance for Q3 by a chunky €19bn to €118.5bn. Today, it announced a slightly smaller increase in issuance for Q4 of €15bn, although that similarly represented an increase of almost 20% relative to the initial plan to take the total for the quarter to €90.5bn. Slightly more of the additional borrowing in Q4 (€4.5bn) than in Q3 will be issued as extra bills in the money market. The remaining €10.5bn will be issued across the bond curve, including an extra €1bn at the 30-year maturity, again illustrating how the German government continues to have greater policy space to provide fiscal stimulus than its G7 peers. Given the extra issuance planned for Q4, German gross

Euro area: Construction activity*



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

Euro area: Construction activity by member state



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

debt sales this year will now reach about €425bn, some €45bn (almost 12%) more than originally announced at the end of 2024. Net new issuance will reach about €143bn in 2025, with a further rise to €175bn expected next year.

The day ahead in the euro area

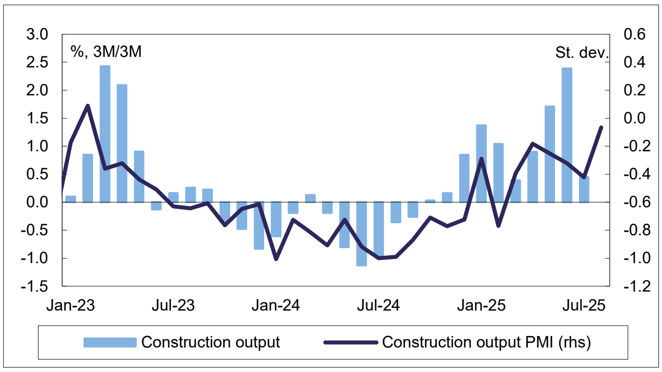
Ahead of Monday's flash PMI surveys, tomorrow's French INSEE business survey will be watched for signs of ongoing economic resilience at the end of Q3 despite heightened political uncertainty. The Bank of France measure of retail sales will also provide an update on consumer spending in August. Meanwhile, German producer price figures for August are likely to report a continued absence of underlying pipeline pressures in the factory sector over the summer.

UK

MPC leaves rates unchanged & signals concerns about "prominent" upside inflation risks

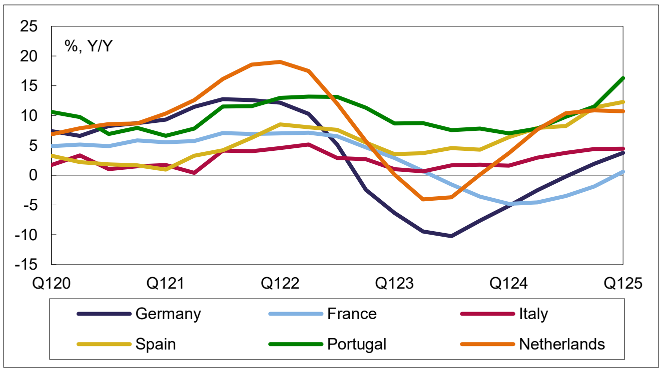
After the slimmest of majorities on the BoE's MPC voted in favour of last month's 25bps rate cut, this month's decision to leave Bank Rate unchanged at 4.0% was backed by seven out of nine members. As expected, only the external doves Dhingra and Taylor preferred a further 25bps of easing. Also predictably, the MPC left its forward guidance unchanged, repeating that a "gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate". That arguably suggests that at most one 25bp rate cut per quarter might remain reasonable for the time being. But, while it leaves open the door to possible further easing in November, the likelihood of such a cut has diminished. Reassuringly perhaps, the policy statement reiterated that underlying disinflation has "generally continued". But it also cautioned that there has been "greater progress in easing wage pressures than prices". And with inflation expected to peak this month at 4.0%Y/Y before falling back gradually to target thereafter, the MPC remains concerned about potential second-round effects. Indeed, while risks to medium-term inflation pressures remain two-sided, the minutes noted that the upside risks "remained prominent in the Committee's assessment". Moreover, the risk of a rapid loosening of the labour market was judged to have diminished, suggesting that the likelihood of an eventual undershooting of the inflation target has also declined somewhat. As such, with the MPC seemingly indicating that the risks to medium-term inflation have tilted to the upside, we think that the majority will want to wait for clear evidence that inflation has passed the peak before pulling the trigger on another rate cut. So, we now push back our expectation for the next cut in Bank Rate to February when the BoE will first incorporate the impact of the government's end-November Budget measures into its projections.

Euro area: Construction output



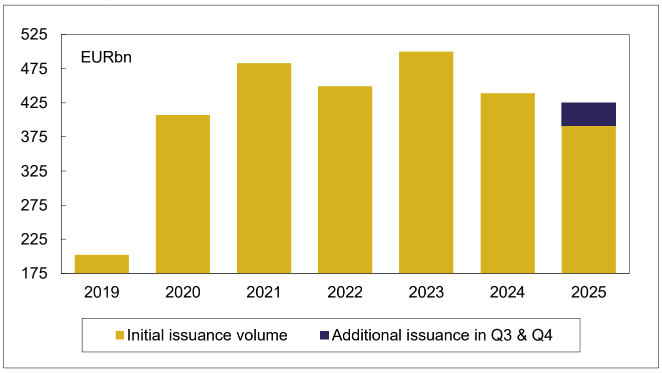
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: House price growth



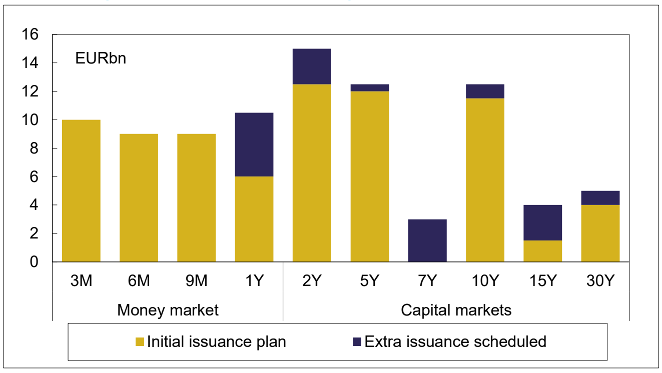
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Gross annual debt issuance



Source: German Finance Agency and Daiwa Capital Markets Europe Ltd.

Germany: Q425 issuance by tenor



Source: German Finance Agency and Daiwa Capital Markets Europe Ltd.

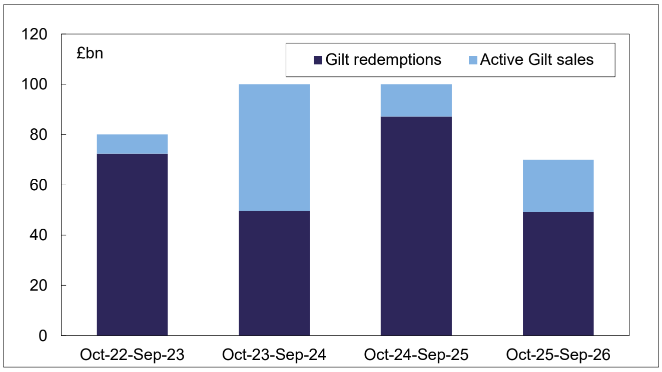
QT pace to slow by 30% to £70bn over the coming 12 months

While today's interest rate announcement was predictable, the MPC's decision on the BoE's plan for quantitative tightening (QT) was highly uncertain. In the event, the Committee agreed to slow the pace in the reduction of its bonds held for monetary policy purposes from £100bn in each of the past two 12-month periods to £70bn over the coming 12 months. That decision, which could take the level of bank reserves close to the upper range of estimates of 'ample' by this time next year, was broadly in line with the median expectation of market participants. So, it had a minimal impact on yields. Nevertheless, with redemptions set to decline from £87bn to just £49bn, the volume of active Gilt sales over the coming 12 months will increase by £8bn from the prior period to £21bn, an arguably unnecessary addition to the supply of UK sovereign bonds to the market. However, the decision was supported by seven out of the nine MPC members. Seemingly unperturbed by the risks of unforeseen adverse consequences for financial stability, Chief Economist Pill wanted to maintain the pace of QT at £100bn, which would have implied more than tripling the amount of BoE Gilt sales in the coming 12 months from the last period. At the other end of the spectrum, in line with our own view, external member Catherine Mann judged that £70bn of QT over the coming 12 months would be excessive. Mindful of the risks of placing upwards pressure on long-term yields via Gilt sales and generating volatility in short rates by reducing the level of bank reserves, she voted to leave the total volume of Gilt sales unchanged. Admittedly, to reduce the overall impact on the long end of the yield curve, the share of sales of long-dated Gilts (i.e. those of residual maturities of more than 20 years) will be cut from around one third to one fifth, which will leave the volume of such sales broadly unchanged. In contrast, the share of sales of shorter-dated Gilts (of residual maturity of 3-7 years) and medium-term Gilts (with a residual maturity of 7-20 years) will rise from one third to 40%, roughly doubling the sales volumes of such bonds.

The day ahead in the UK

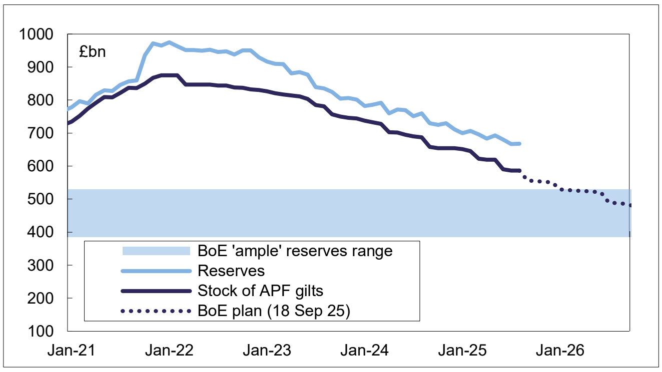
The end of the week will bring retail sales and public finance data for August, as well as the GfK consumer confidence survey for September. While the previous retail sales release revised down the strength of growth in the first half of the year, it also signalled a firmer than expected performance at the beginning of Q3. Consistent with the improvement in consumer confidence to an eight-month high, the past week's BRC retail survey pointed to a solid monthly increase in August too. But consumer confidence is expected to have deteriorated slightly at the end of the third quarter amid rising unease about possible tax hikes to come in the government's Budget announcement on 26 November. While they might well suggest that the OBR's borrowing projection remains broadly on track, the August public finance statistics will likely continue to illustrate the Chancellor's need to tighten the fiscal stance given government spending U-turns and the likelihood of a downwards revision to the OBR's forecast of productivity.

UK: BoE plan for quantitative tightening



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE reserves & stock of APF gilts



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Current account €bn	Jul	**27.7**	-	35.8	-
		Construction output M/M% (Y/Y%)	Jul	**0.5 (3.2)**	-0.3 (1.7)	-0.8 (1.7)	-0.7 (1.8)
UK		BoE Bank Rate %	Sep	**4.00**	*4.00*	4.00	-

Auctions

Country		Auction
France		sold €2.11bn of 0.75% 2028 bonds at an average yield of 2.26%
		sold €2.87bn of 2.4% 2028 bonds at an average yield of 2.34%
		sold €4.43bn of 2.7% 2031 bonds at an average yield of 2.79%
		sold €2.10bn of 3.5% 2035 bonds at an average yield of 3.22%
		sold €641m of 0.6% 2034 inflation-linked bonds at an average yield of 1.37%
		sold €448m of 0.1% 2038 inflation-linked bonds at an average yield of 1.70%
		sold €246m of 0.55% 2039 inflation-linked bonds at an average yield of 1.85%
Spain		sold €2.08bn of 2.4% 2028 bonds at an average yield of 2.212%
		sold €1.98bn of 3.2% 2035 bonds at an average yield of 3.23%
		sold €1.38bn of 4% 2054 bonds at an average yield of 4.074%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	PPI Y/Y%	Aug	-1.7	-1.5
France		07.45	INSEE business (manufacturing) confidence indicator	Sep	95 (96)	96 (96)
		07.45	Retail sales Y/Y%	Aug	-	-1.9
		07.45	Final wages Q/Q%	Q2	*0.5*	0.7
UK		00.01	GfK consumer confidence indicator	Sep	-18	-17
		07.00	Retail sales – incl. auto fuel M/M% (Y/Y%)	Aug	0.4 (0.6)	0.6 (1.1)
		07.00	Retail sales – incl. auto fuel M/M% (Y/Y%)	Aug	0.7 (1.0)	0.5 (1.3)
		07.00	Public sector net borrowing £bn	Aug	12.8	1.1

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.