

Euro wrap-up

Overview

- After spreads of OATs over Bunds rose to the highest levels for the year, French PM Lecornu was given until Wednesday evening to reach a new political agreement with opposition parties.
- Gilts made losses while the UK construction PMI rose to a three-month high despite ongoing caution ahead of the government's end-November Budget.
- Focus in Europe tomorrow will remain on French politics, while German factory orders data are also due.

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Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	2.000	-0.012
OBL 2.2 10/30	2.301	+0.002
DBR 2.6 08/35	2.716	+0.020
UKT 3¾ 03/27	3.986	+0.026
UKT 4% 03/30	4.152	+0.038
UKT 4½ 03/35	4.736	+0.048

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

Source: Bloomberg

Euro area

Lecornu given until Wednesday evening to reach a new deal for French political stability

Spreads of OATs over Bunds pushed up to this year's highs after French PM Lecornu resigned this morning just 27 days into his term, as his nominated cabinet faced rejection in a vote of no confidence later this week. Opposition parties bemoaned that Lecornu offered little change from his three predecessors, who had all been removed by the National Assembly. And they had a point. Most of the nominated senior ministers had been fixtures of recent failed governments. And the overall magnitude of fiscal tightening sought by Lecornu in his draft Budget for 2026 was negligibly different from that proposed by his predecessor Bayrou. Just as French markets were closing for the day, however, the Elysée announced that President Macron had decided to ask Lecornu to restart his negotiations, setting him a deadline of Wednesday evening to try to reach a new deal to "define a platform for action and stability".

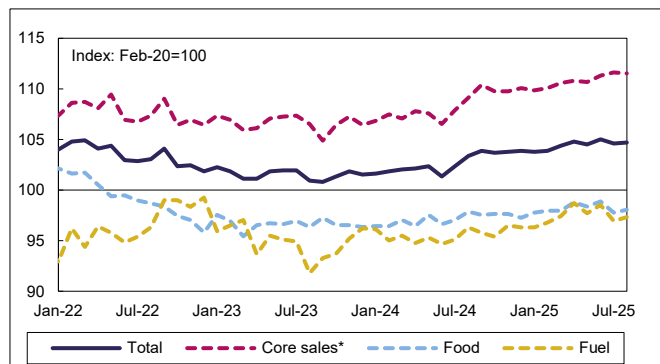
What will Macron do if Lecornu fails again?

Given Lecornu's struggles to date, and his stymied attempt to resign, the probability of success by Wednesday evening should not be considered high. So, that raises the question of how Macron might respond in the event of continued failure. He could nominate a new PM, perhaps a nominally independent technocrat, to propose an alternative budget and cabinet. But given the entrenched splits within the National Assembly and well-rehearsed arguments for and against the fiscal policy options available, the chances that an independent PM might deliver a Budget fit for purpose might be slim. So, Macron might reasonably judge that the time has come to dissolve the National Assembly and call a new election within 20-40 days. (While it represents a third feasible option, we do not expect Macron himself to fall on his sword and resign.) Notwithstanding the scope for tactical voting that might again benefit the left bloc, any new Assembly election might be expected to give the far-right National Rally (RN) the largest share of seats. But RN might also seem likely to fall short of a workable majority capable of delivering a Budget for next year. So, for the time being, the chances of emergency legislation again being required to extend this year's Budget into 2026 appear relatively high. As the French economy continues to grow and the unemployment rate remains low by historical standards, that would not spell fiscal disaster. But the budget deficit would remain above 5% of GDP next year. And following Fitch's recent action, the case would strengthen for a sovereign credit rating downgrade by another major agency before the end of this year.

Euro retail sales remain subdued over the summer, but core sales trending higher in Q3

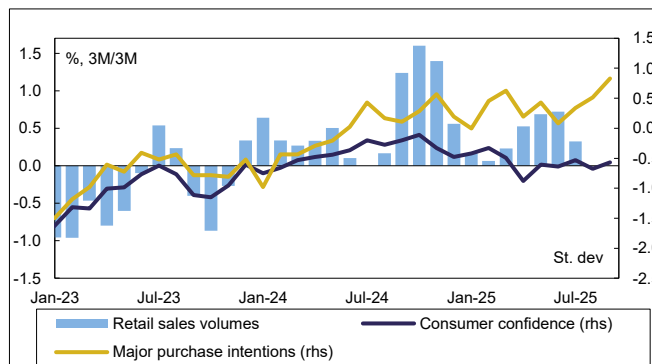
With consumer confidence subdued, food inflation still high and wage growth slowing, today's euro area retail sales data unsurprisingly suggested that household spending on goods was lacklustre over the summer. Total retail sales volumes

Euro area: Retail sales volumes



*Non-food and fuel sales. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales & consumer confidence



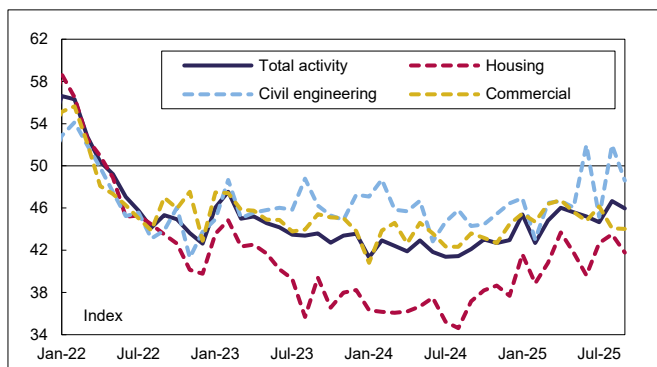
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

increased just 0.1%M/M in August following a decline in July (-0.4%M/M), held back in part by the third decline out of the past four months in Germany and Italy. Admittedly, given the positive carry over from June, this left euro area sales tracking just 0.1% below the Q2 average. But that represents a marked slowdown from sales growth of 0.7%Q/Q in Q2. The weakness over the summer principally related to spending at food stores, which in the first two months of Q3 was trending some 0.8% below the Q2 level despite a modest pickup in August. And while lower petrol prices gave support to auto fuel sales volumes in August, they too were more than 1.0% below the Q2 average. More encouragingly, core sales – i.e. non-food and fuel – were trending some 0.6% above the Q2 level despite a modest fall in August. And although the headline consumer confidence index remained range-bound in September, households were more upbeat about the outlook for their own personal finances. With purchase intentions also judged to be the most favourable in almost four years, we expect to see a pickup in sales in September. And with spending on services likely supported by strong tourism in Southern Europe, we still think that household consumption rose for an eighth successive quarter in Q3.

Construction PMIs flag ongoing woes for German and French housebuilders

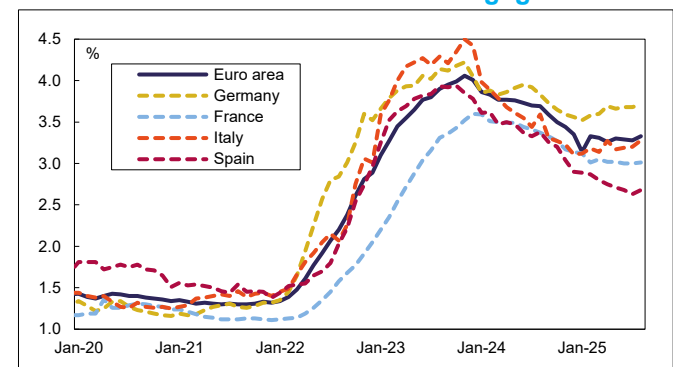
Having risen to a 3½-year high in August, the euro area construction PMIs ultimately finished Q3 on a damp note. The headline euro area activity index fell 0.6pt on the month to remain firmly in contractionary territory (46.0). And the weakness was broad-based across subsectors. Moreover, firms suggested that they continue to reduce headcount (48.7) and were the most downbeat the outlook since January (44.5) as order books continued to shrink (44.5). We caveat that the construction PMIs have not been a particularly accurate gauge of broader construction output in recent months. But that owes partly to their scope, which is limited to just Germany, France, Italy and Ireland. So, the construction PMIs are unable to account for developments in Spain, where production in the sector had initially been estimated to expand extremely vigorously in Q2, fully explaining the strong euro area growth of 2.4%Q/Q. We note, however, that this increase in Spain has been subsequently revised away, suggesting that euro area construction output in Q2 might be revised down to show a slight contraction. In any case, the decline in the PMI was principally swayed by a sharp drop in France (down 3.8pts to 42.9). Perhaps more optimistically, German constructors signalled a slower downturn (up 0.2pt to 46.2) led by a third expansionary month in four for civil engineers (51.4) buoyed by the government's infrastructure push. But the picture in the euro area's largest member states was otherwise downcast, with housebuilders in Germany and France reporting sub-40 readings. We note that, contrasting most of its peers, mortgage rates in Germany have ticked slightly higher since the start of the year, to tally with the upwards shift in Bund yields. And while house prices in Germany rose a respectable 1.1%Q/Q and 3.2%Y/Y in Q2, they were little moved in France (-0.2%Q/Q and 0.5%Y/Y). House price inflation in both countries remained well below the euro area average (1.7%Q/Q, 5.1%Y/Y), and still far weaker than the ongoing increases in Spain (4.0%Q/Q, 12.8%Y/Y) and Portugal (4.7%Q/Q, 17.2%Y/Y).

Euro area: Construction PMIs



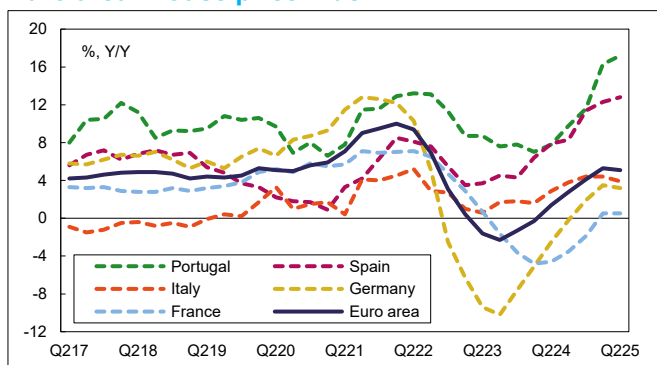
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Interest rates on new mortgages



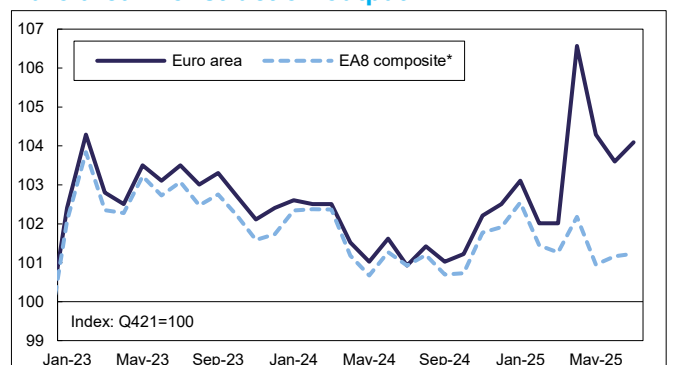
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: House price index



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output



*Composite index based on latest data from the eight-largest member states.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Preceding the release of Wednesday's industrial production figures, German factory orders in August will provide tomorrow's euro area economic data highlight. Those are widely expected to benefit from some payback following a sharper contraction in July (-2.9%M/M). But given the effects of bulk orders earlier this year, weaker demand from the US and stronger euro, we expect such a rebound will be insufficient to fully reverse the previous month's weakness. Meanwhile, French goods trade data for August are also due. Finally, the first release of euro area sector accounts for Q2 – including updates to the household savings ratio and business profit share indicators – may also be of interest.

UK

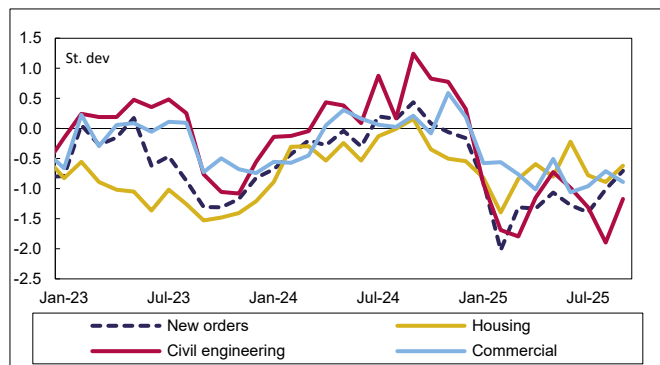
Construction PMI rises to a three-month high, but firms remain cautious ahead of Budget

Contrasting the deterioration in the September services and manufacturing PMIs, today's equivalent construction survey signalled some signs of stabilisation towards the end of the summer. In particular, the headline activity PMI rose for a second successive month in September to 46.2, a three-month high. But this still left the index more than one standard deviation below the long-run average. And having fallen to a more than five-year low in July (44.3), the quarterly index was some 2½pts below the Q2 level, implying a likely drag from the sector on Q3 GDP growth. But while the construction PMIs signalled contraction in the sector throughout the first half of this year, the ONS measure of construction activity actually rose in both Q1 and Q2. And we suspect that it rose in Q3 too. Indeed, construction output in July was supported by a marked pickup in new private and public sector work. And demand in the sector continues to be supported by lower borrowing costs and stabilisation in the property market. The improvement in the September construction PMIs reflected a pickup in the housing component to a three-month high (46.8). Despite slipping back slightly in September, the commercial activity index maintained a broadly sideways trend over the quarter. And while civil engineering was the weakest performing segment, the respective index was almost 5pts above August's near-five-year low. Firms also flagged signs of new demand for infrastructure projects, including in the energy sector, and increased planning approvals. Nevertheless, constructors' optimism about the coming twelve months remained subdued as firms expressed caution ahead of the government's November Budget announcements.

The day ahead in the UK

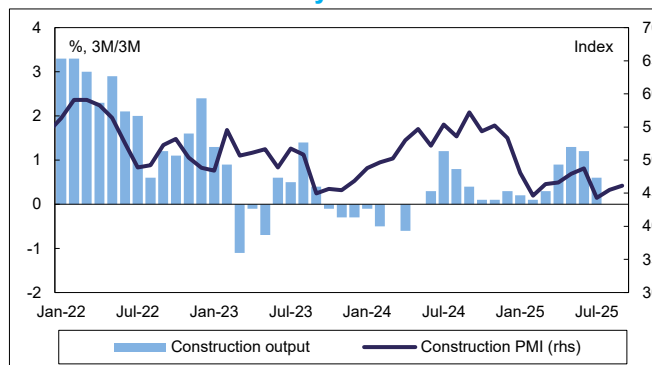
It should be a quiet day ahead for the UK, with no economic data releases or key events scheduled for Tuesday.

UK: Construction PMIs



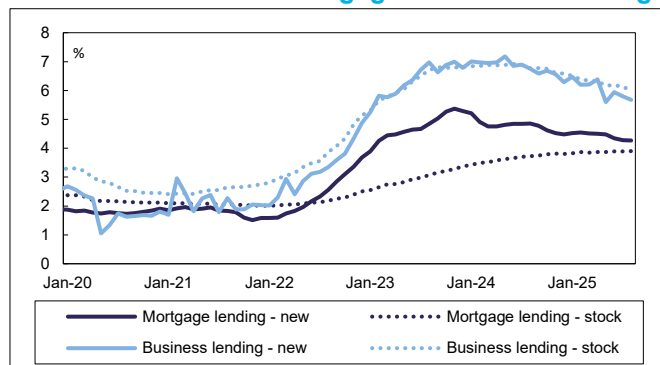
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Construction activity & PMI



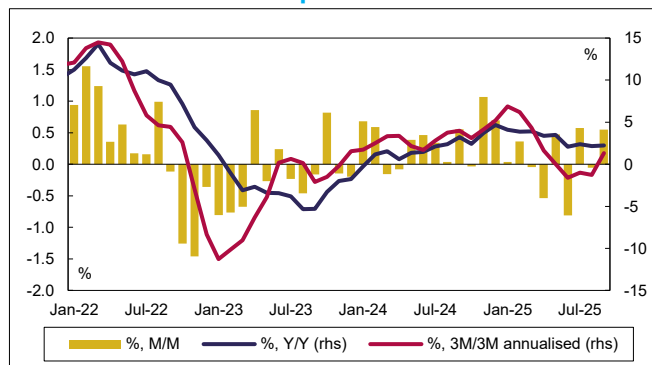
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Interest rates on mortgage & business lending



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Nationwide house prices











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
Euro area	 Retail sales M/M% (Y/Y%)	Aug	0.1 (1.0)	0.1 (1.3)	-0.5 (2.2)	-0.4 (2.1)
	 Construction PMI	Sep	46.0	-	46.7	-
	 Sentix investor confidence indicator	Oct	-5.4	-7.7	-9.2	-
Germany	 Construction PMI	Sep	46.2	-	46.0	-
France	 Construction PMI	Sep	42.9	-	46.7	-
Italy	 Construction PMI	Sep	49.8	-	47.7	-
Spain	 Industrial production M/M% (Y/Y%)	Aug	-0.1 (3.4)	0.4 (3.5)	-0.5 (2.5)	-0.4 (2.7)
UK	 Construction PMI	Sep	46.2	46.0	45.5	-



Auctions

Country	Auction
- Nothing to report -	




Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany	 07.00	Factory orders M/M% (Y/Y%)	Aug	1.2 (3.1)	-2.9 (-3.4)
France	 07.45	Trade balance €bn	Aug	-	-5.6

Auctions and events

Euro area	 17.10	ECB President Lagarde to give speech, followed by Q&A, at Business France event in Paris			
Germany	 10.30	Auction: to sell up to €4.5bn of 2.2% 2030 bonds			
UK	 10.00	Auction: to sell £1.25bn of 0.125% 2028 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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