

# Euro wrap-up

## Overview

- OATs outperformed on signals that a deal on a draft French Budget for 2026 was within reach, while Bunds also made gains as German IP slumped in August.
- Shorter-dated Gilts made modest losses, while data suggested that the UK government borrowing was less than previously thought but remained higher than the OBR's forecast.
- Thursday will bring the latest data for German goods trade and Irish IP, as well as the account from the ECB's September policy-setting meeting.

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### Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	1.979	-0.019
OBL 2.2 10/30	2.267	-0.027
DBR 2.6 08/35	2.676	-0.031
UKT 3% 03/27	3.993	+0.017
UKT 4% 03/30	4.149	+0.006
UKT 4½ 03/35	4.711	-0.008

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

## Euro area

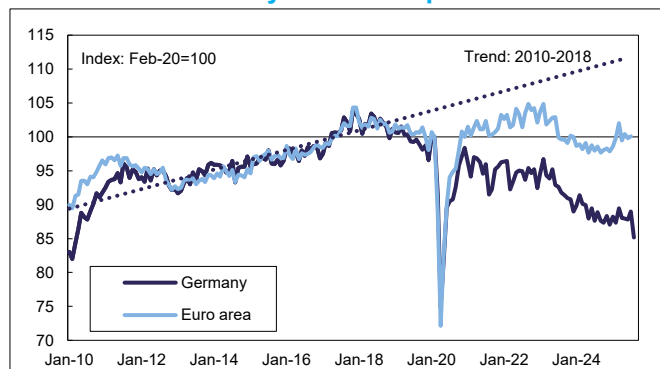
### Hopes of French Budget deal rise, but pension reform fudge would fuel fiscal sustainability risks

Ahead of Macron's self-imposed deadline of this evening, OATs (and BTPs) outperformed other euro area government bonds today on signals that a deal on a draft French Budget for 2026 might be within reach. At the time of writing, there was still no confirmation of a conclusive agreement. However, it was clear that dilution or temporary suspension of the 2023 pension reform had become a precondition for any eventual deal. That reform had sought to progressively raise the minimum retirement age from 62 to 64 years of age by the end of this decade, while also increasing the contribution period for eligibility to full entitlements. The Socialists, their left-wing allies, as well as the far-right RN have long had the reform in their crosshairs. And the relatively small near-term fiscal cost of the concession – perhaps 'only' €500mn next year and a further €3bn in 2027 – made it a topic ripe for negotiation in the current impasse, particularly given its close association with the President. Notably too, comments from certain protagonists in the talks also suggested that a consensus had been reached to target a reduction in the budget deficit from 5.4% of GDP this year to less than 5% of GDP, if not perhaps as far as the 4.7% of GDP figure sought last week by PM Lecornu. Even if a deal along those is reached today, actual delivery of the target would still be consistent with a further rise in the stock of gross government debt to above 115% of GDP, as well as being subject to implementation risk. And given that the costs of the move could rise well above €10bn per year by the next decade, any suspension of the 2023 pension reform would add to concerns about longer-term French fiscal sustainability.

### German IP slumps in August as car production disrupted by summer shutdowns

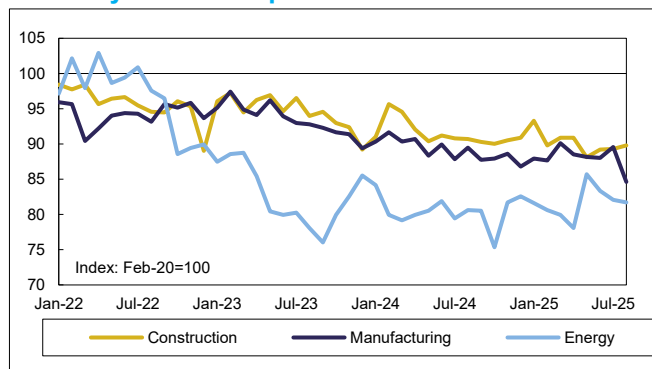
While a pullback in German industrial production in August was widely expected after solid growth in July (1.3%M/M), today's data disappointed. Total output slumped 4.3%M/M – the most since March 2022 after Russia's invasion of Ukraine – to fall to the lowest level for more than 15 years when the first Covid-19 lockdown period is excluded. The weakness was led by autos, production of which plunged 18.5%M/M – similarly the most since spring 2022 – to be trending so far in Q3 some 5% below the Q2 average. But that decline was in part due to the timing of summer maintenance as well as transitions to new car models. Excluding motor vehicles, production fell a little less than 2%M/M, nevertheless still the steepest drop since late-2022. Among other items, after a temporary bounce in July and following the marked front-running of US tariffs earlier in the year, there were also sizeable declines in production in other export-oriented subsectors, including machinery (-6.2%M/M), pharmaceuticals (-10.3%M/M) and computer, electronic and optical products (-6.1%M/M). Indeed, apart from machinery and basic metals, output from all key manufacturing subsectors was tracking below the Q2 level. Energy production also fell for a third successive month in August to be down a little more than ½% so far in Q3. And while construction activity rose for a third month (0.6%M/M), it was trending broadly sideways from Q2.

### Euro area & Germany: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### Germany: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

## Surveys point to a rebound in IP in September, and more meaningful recovery into the new year

While [factory orders](#) point to weak underlying demand for German goods throughout Q3, manufacturing output seems bound to have rebounded in September as operations resumed at car factories. That would also be consistent with signals from Germany's auto industry association (VDA), which showed that domestic production rose 2%Y/Y last month after falling more than 20%Y/Y in August. Incoming car orders were also up 10%Y/Y, with a 3%Y/Y rise in orders from abroad. Moreover, the September ifo survey suggested the brightest near-term car production outlook for two years. While that survey also implied a slight deterioration in the overall manufacturing business climate last month, it was still considered to have improved over the third quarter. And the quarterly expectations balance was the strongest for 3½ years, consistent with the signal from the output PMI. Nevertheless, the rebound in industrial production in September would need to be more than 5.0M/M to avoid a contraction over the quarter as whole. As such, the risks that GDP failed to grow again in Q3 appear to have risen. But we still expect to see a pickup in momentum in Q4 before a steady acceleration through 2026.

## The day ahead in the euro area

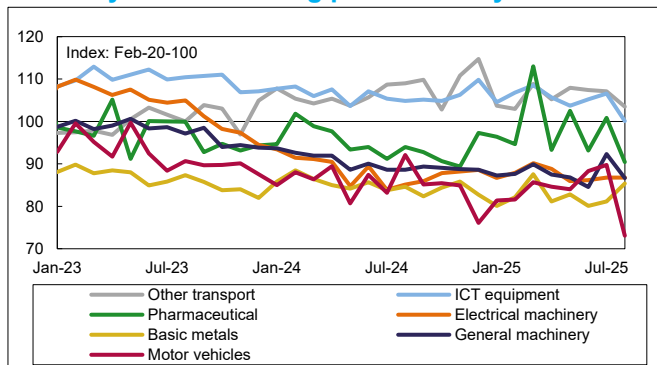
The release of the ECB's account of the September monetary policy meeting will mark Thursday's main event. The Governing Council elected to leave the key rates unchanged, having judged that the risks to the growth outlook had become 'more balanced' after resilience in the first half of the year and the passing of peak uncertainty. And with the disinflation process having essentially run its course, Lagarde reiterated that policy was in a 'good place'. We expect the account to reinforce that sentiment, whilst also highlighting the two-sided risks which could call the ECB back into action sooner than expected. On the economic data front, German goods trade data for August are also due. Recent months have seen German exports gradually retreat from March's recent high on weaker shipments to the US. While the absence of usually timelier US trade data obstructs early assessments of that trend, the effects of pre-tariff stock-building Stateside are likely to have continued serving as a headwind.

## UK

## Government borrowing less than previously thought but still running well above OBR forecast

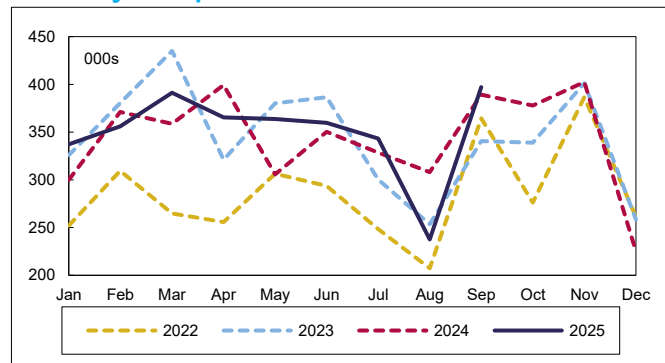
The ONS today published an unscheduled update on UK government borrowing this year and last, as the public finance data became the latest set of statistics to be struck by errors. This time around the finger of blame was pointed at HMRC as inaccuracies had been discovered in their estimates of VAT receipts. As we flagged when the [August data](#) were published on 19 September, the non-negligible overshoot of net public borrowing relative to the OBR's forecast in part related to lower-than-expected VAT revenues, which was thought might have been related to the composition in spending. But while today's

### Germany: Manufacturing production by sector



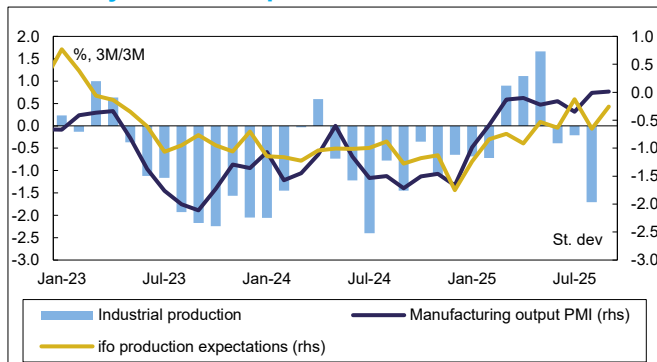
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### Germany: Car production



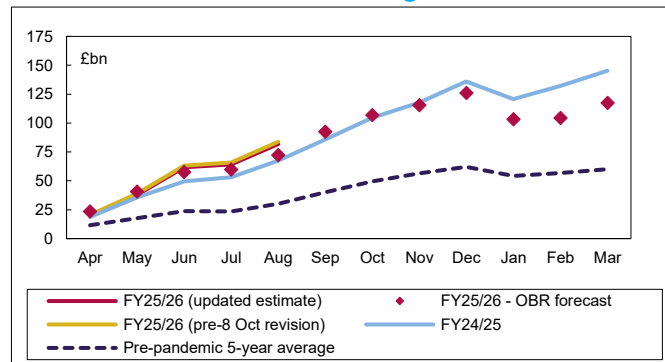
Source: VDA, Macrobond and Daiwa Capital Markets Europe Ltd.

### Germany: Industrial production & sentiment indices



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

### UK: Public sector net borrowing







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

revelations suggest that net borrowing was slightly smaller than previously estimated, it does little to alter the Chancellor's challenge. Indeed, net borrowing in the first five months of the current financial year was merely £2bn less than previously estimated at £81.8bn, still more than £14bn on a year ago and £9.4bn above the OBR's forecast. The downwards revision to the estimate of borrowing in FY24/25 was also marginal at £1bn. Of course, every little helps the Chancellor ahead of her Budget on 26 November. But the £2bn saving this year represents only a very modest dent in the overall amount of fiscal tightening that will be required to appear on track to meet the government's fiscal rules. Indeed, given the government's earlier U-turns on spending reforms, the strong likelihood of a downwards revision to the productivity assumption, and the residual overshoot that in part reflects higher local government borrowing than anticipated, the overall fiscal tightening to be announced in November's Budget could still need to reach close to £30bn to allay market and OBR concerns.





## The day ahead in the UK

Having trended lower in seven of the past eight months amid heightened uncertainty – most recently pertaining to potential tax hikes to come in November's budget – the RICS residential market survey will provide an update on housing market activity last month. Elsewhere, external MPC member Catherine Mann is due to add to her comments last week, being scheduled to speak on consumption at an event organised by the Resolution Foundation.

## European calendar

Today's results						
Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany 	Industrial production M/M% (Y/Y%)	Aug	<b>-4.3 (-3.9)</b>	-1.0 (-0.9)	1.3 (1.5)	-
Auctions						
Country	Auction					
Germany 	sold €853m of 2.6% 2041 bonds at an average yield of 3.06%					
	sold €733m of 3.25% 2042 bonds at an average yield of 3.08%					
UK 	sold £5bn of 4% 2029 bonds at an average yield of 4.095%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		BST	Release	Period	Market consensus/ <i><u>Daiwa forecast</u></i>	Previous
Germany		07.00	Trade balance €bn	Aug	15.0	14.8
UK		00.01	RICS house price balance %	Sep	-18	-19
Auctions and events						
Euro area		12.30	ECB to publish monetary policy account of 10-11 September Governing Council meeting			
UK		09.30	MPC external member Mann to give speech at Resolution Foundation event on 'Explaining the consumption gap', London.			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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