Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds were little changed on the day despite a bigger than expected increase in German producer prices while euro area construction output data disappointed.
- Gilts followed USTs lower as a survey suggested a slight improvement in mood in the UK industrial sector.
- Friday will bring the flash PMIs and other survey results for August as well as updates on UK retail sales and public finances.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.848	-0.011
OBL 2.9 10/31	2.984	-0.004
DBR 3 08/36	3.257	-0.002
UKT 4⅜ 03/28	4.372	+0.017
UKT 4⅛ 03/31	4.598	+0.021
UKT 4¾ 10/35	5.067	+0.023

*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

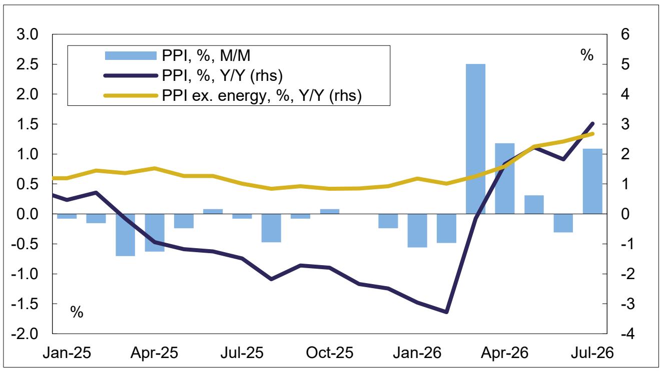
German producer prices rise more than expected in July on rebound in energy prices

Up to now, ECB policymakers are likely to have taken some comfort from the relatively restrained indirect pass-through of the energy shock to prices of other items. Certainly, pressures have been largely concentrated in the early stages of the production chain and in sectors most exposed to prices of hydrocarbons. But with wholesale oil and gas prices having shifted higher again in recent weeks, so too have risks that the indirect and second-round price effects will become steadily more pronounced and long-lasting. Indeed, today's data showed that German producer prices rose 1.1%M/M in July, almost twice the consensus forecast, to be up 3.0%Y/Y, the most in more than three years, and 4.8% since the start of the conflict at end-February. And the increase in producer prices of energy (3.4%M/M) was the biggest since March and left them at a 17-month high, more than 11% above their level at the start of the conflict. More happily, however, producer prices of intermediate goods rose just 0.1%M/M, the least in eight months. Nevertheless, they were still up more than 4% since the start of the conflict. And while producer prices of chemicals fell in July, they were still 8.7% above their level in February, with prices of chemical derivatives of hydrocarbons up more than one third on the same basis.

Producer prices of capital goods & consumer durables firm but food PPI extends downtrend

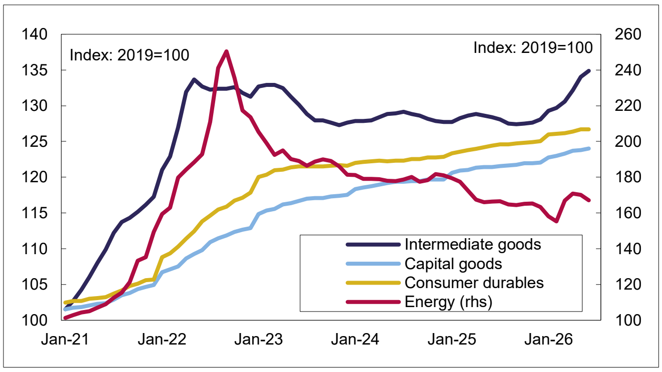
Among other major categories, prices of capital goods remained largely well-behaved, up 0.2%M/M in July to be up 1.1% since February. But that took the respective annual rate up to a two-year high of 2.3%Y/Y. And with producer prices of computers, electronic and optical equipment up 5.6%Y/Y, there was again evidence of an inflationary impact from AI-related demand. Meanwhile, producer prices of consumer durables rose 0.3%M/M, the most since January, but were still up just 0.8% since the start of the conflict and 2.0%Y/Y. Prices of motor vehicles (0.4%M/M) and furniture (0.6%M/M) also rose the most since the start of the year but were similarly still cumulatively up only around 1% since the February. And most encouragingly for households, producer prices of consumer non-durables continued to decline (-0.3%M/M and -2.3%Y/Y). The driver was the ongoing reversal of the shock to food prices of the past couple of years. Indeed, processed food prices fell 0.4%M/M in July, marking the tenth decline in the past 12 months. Overall, German food PPI inflation dropped to -4.6%Y/Y, well below the equivalent CPI rate (0.4%Y/Y) last month. That might point to the likelihood of further softening of the food CPI rate over the near term. But before long, the impact of Europe's drought on both the summer harvest and river freight costs will become increasingly evident on producer and consumer prices alike.

Germany: Producer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Producer price levels



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

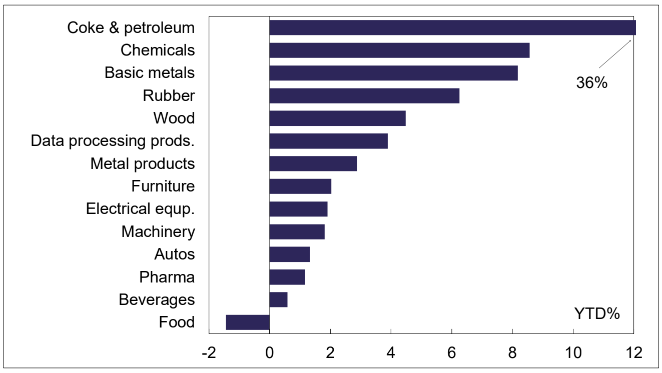
Construction output rose in Q2 but ended the quarter on soft note in part due to heatwave

Euro area construction output ended Q2 on a particularly soft note, dropping in June by a steeper-than-expected 1.3%M/M with softness in all major subsectors. Nevertheless, particularly given the positive carryover from March, construction output still rose in Q2 for the first quarter in five and by 0.6%Q/Q. Unlike the quarterly expansion in industrial production (0.9%Q/Q), construction output was unable fully to reverse the fall in Q1 (-1.0%Q/Q). The weakness in June was concentrated particularly in France (-2.9%M/M), Belgium (-1.8%M/M) and a couple of smaller countries. In the former of those, record high temperatures were a key factor, which weighed indiscriminately on housing, civil engineering and renovation activity alike. And given the soft end to the quarter, French construction output dropped for a third successive quarter in Q2 and by 1.0%Q/Q. But in Germany, thanks to strong growth in civil engineering activity on the back of the government's public infrastructure campaign, production in the sector was up 2.0%Q/Q, the most in more than two years. Unfortunately, the soft end to Q2 for the euro area as a whole represents negative carryover into Q3. And given record high temperatures in July and part of August, we expect output in the sector in France in particular to have remained weak. Cost and supply pressures, higher ECB rates and a broader tightening of financial conditions will also weigh on activity. And survey indicators, including the sector's PMIs and Commission indices, also point to continued softness. But with funding assured, German public infrastructure will remain a source of support, as increasingly should AI-related infrastructure projects. And resilient labour markets and – in the absence of persistent high inflation – recovering real incomes should in due course bolster housing activity too.

The day ahead in the euro area

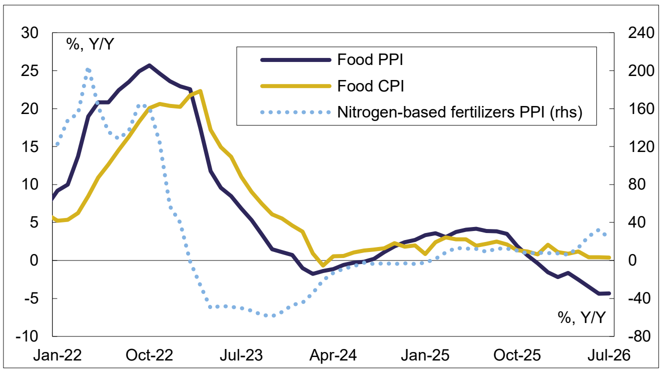
The end of the week will bring a host of surveys from the euro area, of which the August flash PMIs will be the focus. Admittedly, these indicators were a poor guide in Q2 to euro area GDP growth, which picked up to 0.4%Q/Q (and was steady at 0.3%Q/Q excluding Ireland), while the composite output PMI pared more than 2pts, slipping into slight contractionary territory (49.1). But July's survey appeared to be more consistent with the resilience of the hard data. The composite output PMI rose to 52.0, an eight-month high. Services activity (51.7) was seemingly buoyed by tourism and ICT-related activity, while manufacturers – led by Germany, as well as Italy and the Netherlands – continued to benefit from firmer orders and a slight easing of cost pressures, taking the output index to its highest level since March 2022 (52.8). Firmer momentum in German business activity was accompanied by signs of stabilisation in France, which were reassuringly validated by INSEE's more comprehensive survey. The INSEE indices, which will be released shortly before the flash PMIs on Friday, will continue to provide a valuable crosscheck, not least given August's susceptibility to revisions. Ultimately, however, the flash PMIs should sustain their stronger momentum despite obvious downside risks posed by the continuation of the conflict in the Middle East.

Germany: YTD change in producer price levels



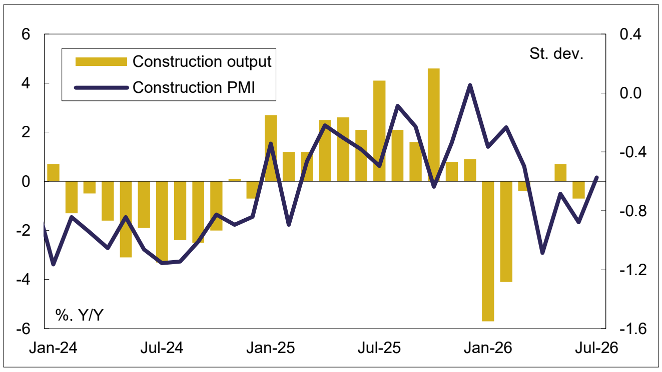
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Food CPI & PPI



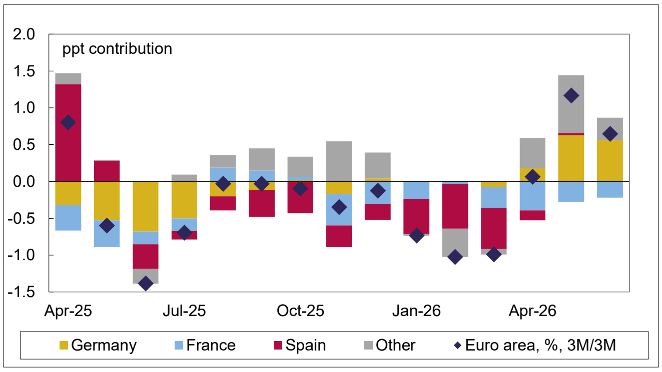
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output & activity PMI



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

Euro area: Construction output growth contributions



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Uncertainty and the rebound in auto fuel prices pose a potential headwind to consumer sentiment, which could also be reflected in tomorrow's flash Commission's reading. But having risen to a five-month high in July (-15.9), that seems unlikely to repeat its deep retrenchment at the onset of the conflict, and any drop should be modest. On the other hand, higher input price pressures pose a more obvious downside risk to the flash manufacturing output PMIs, which could be compounded by the impacts of low water levels on the Rhine on river freight. Higher consumer price inflation might also have precipitated a pickup in household inflation expectations in the ECB's latest survey. But the measure of medium-term expectations – of greater importance to policy decisions – should be little affected. And negotiated wages growth in Q2 is expected to be little changed relative to Q1 which, alongside Wednesday's labour cost and vacancy data, should give policymakers more reassurance that second-round inflationary effects will remain elusive for the time being.

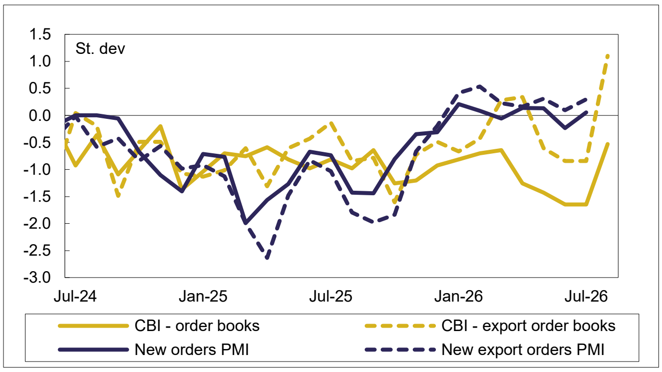
UK

The day ahead in the UK

Alongside July's retail sales figures, the August flash PMIs will also be at the center of attention in the UK on Friday. Like the euro area, July's survey showed tentative signs of firmer momentum at the start of Q3, with a near-3pt increase taking the composite output PMI to a three-month high of 52.2. That change was led by a signal of a return to expansion in the dominant services sector (52.1), boosted by ICT-related activity as well as fading political uncertainty. Weaker input price pressures and easing supply-chain strains lent some support to the manufacturing output PMI (52.9, a 22-month high). Still, new orders in the dominant services sector were less upbeat, while the composite employment index was stuck below the 50-threshold for a 21st straight month. Given recent BoE commentary, whether the latter shows some improvement in August to corroborate last week's REC jobs report will be of particular interest. But with underlying activity still underwhelming before energy prices rebounded, a slower pace of expansion seems more likely than not this month. That said, today's CBI industrial trends survey – while providing a less comprehensive read on the manufacturing sector – might raise hopes for a better reading. While the largest share of firms (43%) still reported lower production volumes over the past three months, the 25% reporting an increase was the largest for 11 months. And assessments of domestic and overseas order books were their best in 21 and 50 months respectively, led by improvements in chemicals and electrical goods. Of course, that improvement might just bring the CBI more in line with the less downbeat PMIs. And the same might be said of selling prices, although we expect Friday's flash survey to mirror at least some of the renewed pressure reported today by the CBI.

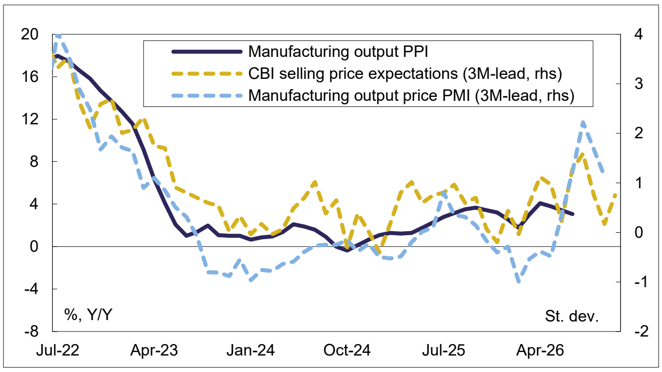
As last month's PMIs suggested, the cumulative effects of the World Cup, persistent heatwaves and improved consumer confidence suggest that further resilience in UK retail sales in July cannot be fully discounted. And given the strength of sales in May and June, a third consecutive quarter of growth in Q3 remains highly likely. However, with real incomes being squeezed by slowing wage growth and higher inflation, some payback for recent strength would appear overdue. Indeed, contrasting a bright spot in a recent CBI survey, last week's BRC retail monitor suggested that sales growth was considerably weaker, emphasising the negative effect of the heatwave on footfall and fewer big-ticket purchases. And according to the GfK consumer survey which is also due tomorrow, consumers' appetite for major purchases is likely to have remained weak in August, not least given the adverse sentiment and price effects of events in the Middle East since the last survey. On the other hand, the headline consumer confidence index might not be quite so downbeat, particularly should it receive a 'Burnham bounce'. However, tomorrow's public finances data for July will provide an overview of the challenging fiscal situation under which he now governs.

UK: Survey indicators of manufacturing orders



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

UK: Manufacturing output prices & survey indicators



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

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Construction output M/M% (Y/Y%)	Jun	**-1.3 (-0.7)**	-	0.4 (1.2)	0.2 (0.7)
Germany		PPI Y/Y%	Jul	**3.0**	2.5	1.8	-
UK		CBI industrial trends – total orders (selling prices) net % balance	Aug	**-25 (22)**	-40 (14)	-45 (11)	-

Auctions

Country		Auction
France		sold €2.72bn of 2.4% 2029 bonds at an average yield of 3.17%
		sold €3.165bn of 2.7% 2031 bonds at an average yield of 3.37%
		sold €4.315bn of 3.25% 2032 bonds at an average yield of 3.52%
		sold €2.30bn of 3% 2034 bonds at an average yield of 3.88%
		sold €425mn of 3.15% 2032 inflation-linked bonds at an average yield of 1.26%
		sold €471mn of 0.95% 2043 inflation-linked bonds at an average yield of 2.24%
		sold €492mn of 0.1% 2047 inflation-linked bonds at an average yield of 2.36%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Preliminary services (manufacturing) PMI	Aug	51.5 (51.8)	51.7 (51.9)
		09.00	Preliminary composite PMI	Aug	51.7	52.0
		09.00	ECB consumer expectations survey – 1Y- (3Y-) ahead CPI Y/Y%	Jul	-	3.0 (2.8)
		10.00	Negotiated wages Y/Y%	Q2	2.40	2.46
		15.00	Preliminary Commission consumer confidence indicator	Aug	-16.0	-15.9
Germany		08.30	Preliminary services (manufacturing) PMI	Aug	50.1 (52.1)	49.8 (52.2)
		08.30	Preliminary composite PMI	Aug	51.3	51.3
France		07.45	INSEE business (manufacturing) confidence indicator	Aug	98 (101)	97 (101)
		07.45	INSEE production (own-company production) outlook indicator	Aug	-	-10 (-1)
		08.15	Preliminary services (manufacturing) PMI	Aug	49.4 (50.0)	49.6 (49.8)
		08.15	Preliminary composite PMI	Aug	49.5	49.4
UK		00.01	GfK consumer confidence indicator	Aug	-18	-17
		07.00	Retail sales – incl. auto fuels M/M% (Y/Y%)	Jul	-0.5 (2.2)	1.0 (4.2)
		07.00	Retail sales – excl. auto fuels M/M% (Y/Y%)	Jul	-0.5 (3.3)	1.1 (5.4)
		07.00	Public sector net borrowing £bn	Jul	0.0	16.0
		09.30	Preliminary services (manufacturing) PMI	Aug	51.8 (51.5)	52.1 (51.9)
		09.30	Preliminary composite PMI	Aug	51.6	52.2

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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