Euro wrap-up

Overview

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- Bunds weakened despite a sharp drop in German manufacturing output in July and a moderation in euro area wage growth, with markets focused instead on the far-right AfD's victory in the Saxony-Anhalt election.
- While UK Chancellor Healey signalled that his Budget in October would emphasise fiscal restraint, Gilts also made losses.
- Tuesday will bring German goods trade data and a UK retail survey, while BoE MPC members will testify on monetary policy before the Treasury Select Committee.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.996	+0.053
OBL 2.9 10/31	3.126	+0.048
DBR 3 08/36	3.382	+0.045
UKT 4 05/29	4.567	+0.040
UKT 4⅛ 03/31	4.668	+0.037
UKT 4⅞ 07/36	5.172	+0.040

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

Euro area

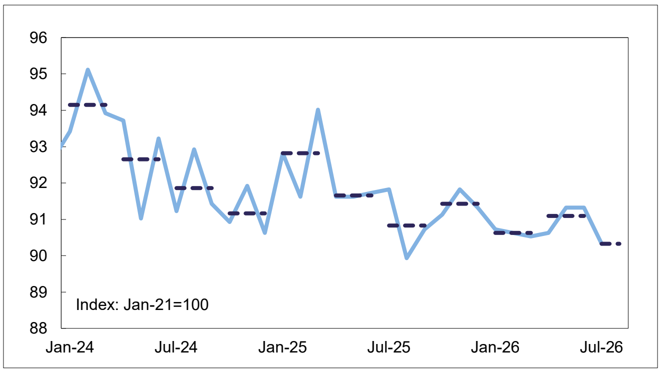
German manufacturing temporarily drops to lowest level since 2010 (outside 1st Covid lockdown)

Despite survey evidence of strengthening manufacturing momentum at the start of Q3 and factory orders pointing to a continued recovery in demand, Germany's industrial production figures for July were unexpectedly weak, with total output falling 1.1%M/M to the lowest level in 11 months. Indeed, manufacturing production fell a more pronounced 2.3%M/M, the sharpest monthly decline in 11 months, to its lowest level since 2010 outside the initial Covid lockdown. The weakness was principally driven by autos (-9.2%M/M), reportedly weighed by a single multi-week factory shutdown to install new equipment for EV production. But activity in several energy-intensive sectors also softened as wholesale energy prices rose again, while chemicals production (-2.9%M/M) faced the added challenge of disruption to Rhine river freight due to exceptionally low water levels. Nevertheless, today's report was not entirely downbeat. Strong AI-related investment appeared to continue to support solid growth in ICT and electrical equipment production. Meanwhile, the government's expanding defence and infrastructure programmes were reflected in another jump in output of explosives, while production of railway rolling stock rose to its highest level in more than three decades. Fiscal policy was also reflected in the latest construction figures, with civil engineering activity rising 1½%M/M to a fresh series high. Meanwhile, a surge in electricity generation in July (4.7%M/M) was underpinned by increased wind and solar power production.

Outlook for manufacturers brightens while order backlogs point to production growth ahead

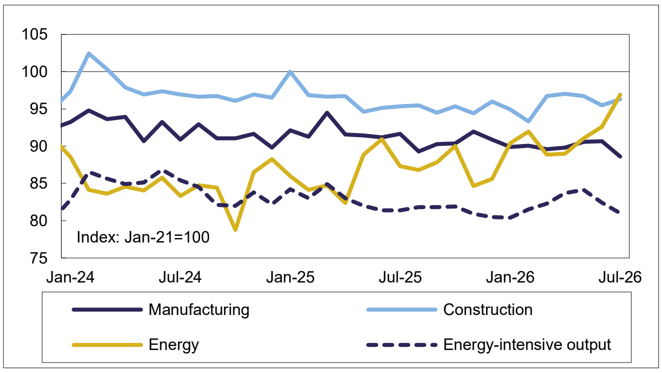
Despite persistent headwinds from higher costs and freight disruption, surveys suggest that the drop in German manufacturing output will be a temporary blip rather than mark the start of a renewed sustained downturn. Certainly, in August, the output PMI signalled the fastest expansion in 4½ years, while the ifo survey suggested that expected production over the coming three months was the strongest since March 2023. Today's Sentix survey also indicated that investors view current economic conditions in Germany to be the most favourable since mid-2023. With supply constraints related to geopolitical tensions showing signs of easing, the outlook for German manufacturing production appears increasingly promising. In June, manufacturers' order books were equivalent to more than 8½ months of production, with backlogs particularly elevated in the electrical and ICT equipment subsectors and continuing to trend higher in non-auto transport equipment. One notable area of weakness, however, remains the auto sector amid ongoing challenges from Chinese competition and shifting consumer preferences. Indeed, while Germany's auto association VDA noted that the decline in production in August (-4%Y/Y) was also partly attributable to a shift in the timing of maintenance shutdowns this year, output over the first eight months of the year was still down 4%YTD/Y. And while new car registrations rose in August, this was driven by foreign brands.

Germany: Industrial output*



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

Germany: Industrial output in key sectors

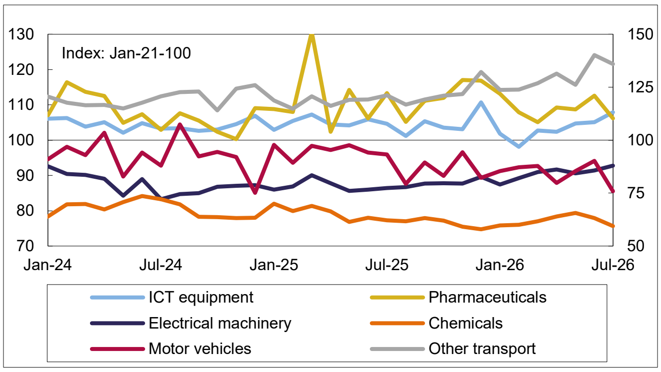


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area GDP growth in Q2 revised up to the strongest pace in four years

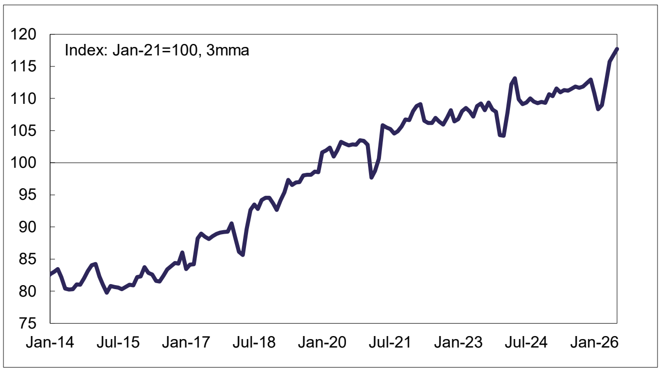
Despite hints that euro area economic activity lost momentum at the start of Q3, today's updated national accounts data brought a significant upwards revision to GDP growth in Q2. As we suggested following Friday's Irish release, aggregate euro area output is now estimated to have risen 0.6%Q/Q, 0.2ppt stronger than previously thought and the fastest pace in four years. As a result, economic output was up 1.2%Y/Y in Q2, broadly in line with estimates of the euro area's potential growth rate. Today's revision was entirely due to the impact of the questionable figures from Ireland, whose double-digit quarterly increase in GDP accounted for roughly half of euro area growth. Nevertheless, with the exception of France, today's release confirmed a broad-based expansion across the large member states, with solid growth in Germany (0.3%Q/Q), Italy (0.2%Q/Q) and the Netherlands (0.4%Q/Q) alongside ongoing outperformance in Spain (0.6%Q/Q) and Portugal (0.8%Q/Q). When excluding Ireland, euro area GDP rose 0.3%Q/Q, matching the pace in Q1 and a rate exceeded only once in more than two years. That underlying growth rate was also 0.2ppt stronger than assumed in the ECB's June baseline macroeconomic projections.

Germany: Manufacturing output by subsector



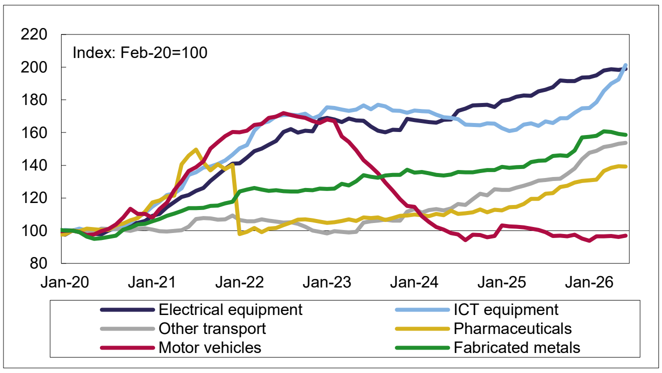
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Civil engineering output



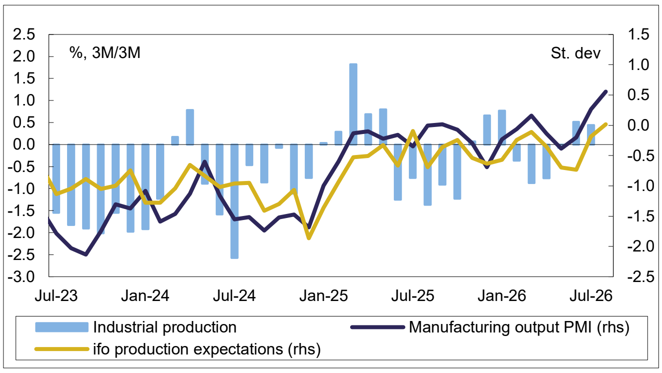
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing order backlogs



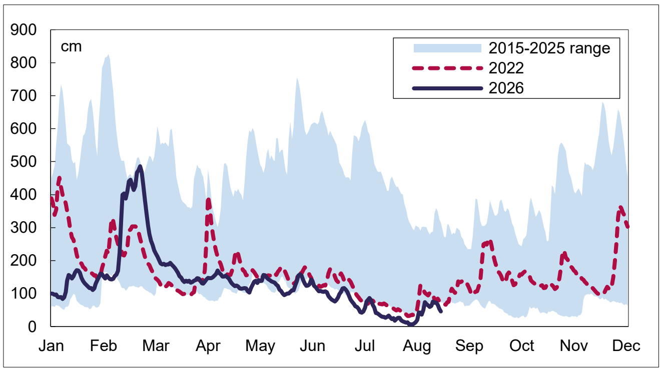
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Industrial output & survey indices



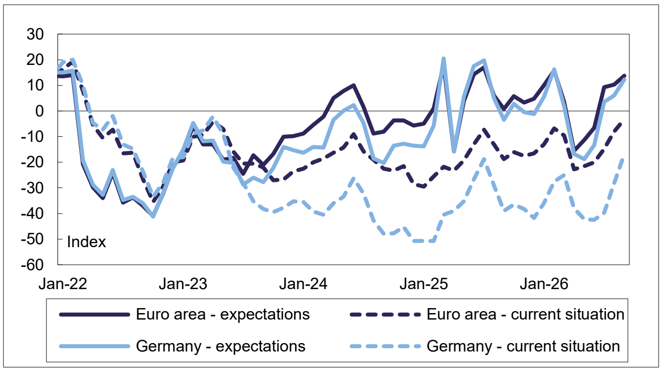
Source: ifo, S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Rhine water levels*



**Rhine levels at Kaub.*
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area & Germany: Sentix survey indices

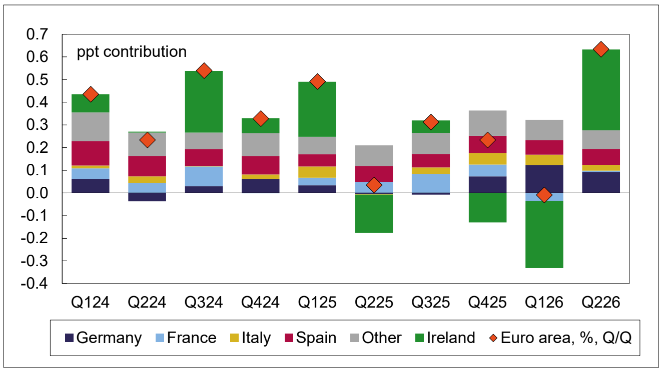


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Domestic demand remained resilient despite weakness in private capex

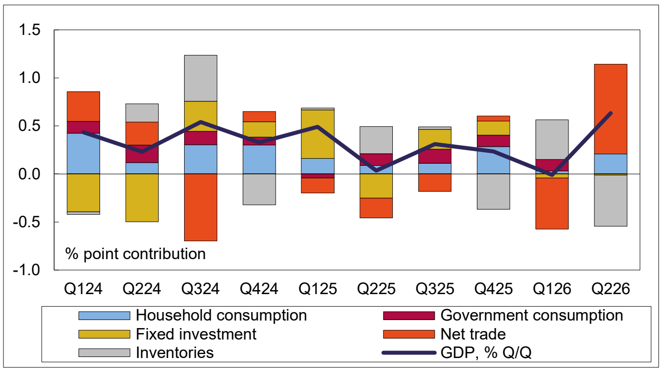
Unsurprisingly, the Irish distortion had a meaningful impact on the euro area expenditure breakdown. Exports recorded their strongest increase in 5½ years (3.4%Q/Q), and while imports rose for a third consecutive quarter, net trade nevertheless contributed a substantial 0.9ppt to GDP growth. Partly offsetting that boost, inventories acted as a drag. But final domestic demand expanded for a fourth consecutive quarter. Having slowed in Q1 as consumer confidence weakened, household consumption growth accelerated to 0.4%Q/Q, marking an eleventh successive quarter of expansion. By contrast, government consumption growth eased to 0.2%Q/Q, its softest pace in five quarters. Fixed investment edged down again (-0.1%Q/Q), with declines in housebuilding and spending on transport and machinery equipment offsetting continued infrastructure-related activity, likely including data-centre development. Looking ahead, the return to growth in firms' unit profits and continued demand for AI-related investment should support private capital spending, reinforcing the case for an upward revision to the ECB's growth projections this year. But while stronger economic activity might raise concerns about inflationary pressures, policymakers are also likely to take comfort from the further moderation in employee compensation growth, which slowed to a near five-year low of 3.3%Y/Y in Q2. Although slightly above the ECB's expectations, wage growth remains markedly softer than in the period immediately following the 2022 energy shock, underscoring the likelihood of far smaller second-round effects on inflation than during that earlier episode.

Euro area member states: Contribution to GDP



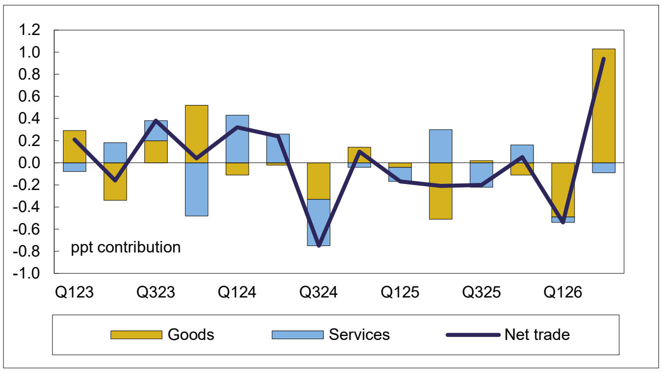
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & expenditure contributions



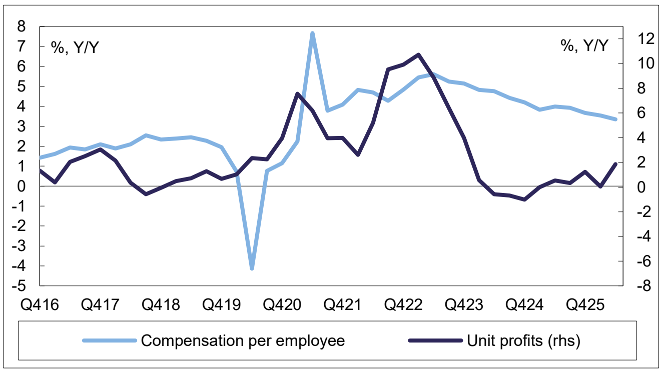
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to net trade



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unit profits & employee compensation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

While the strength of euro area goods exports last quarter – at 4.5%Q/Q, the sharpest pickup in 16 years besides the initial post-lockdown Covid rebound in 2020 – was clearly exaggerated ed by Ireland (16.9%Q/Q), they also rose firmly in Germany (2.6%Q/Q) and France (4.1%Q/Q). Goods trade data from those member states, due Tuesday, will provide an update as to whether that positive trend was sustained at the start of Q3. Admittedly, the softness of today's IP data doesn't pose a particularly good omen. And transportation might have been disrupted by the low water levels on Europe's waterways, most notably the Rhine. But surveys including the PMIs have at least remained upbeat in their assessment of overseas demand, suggesting that payback for recent strength might not be forthcoming.

The day ahead in the UK

With the BoE's pre-meeting quiet period fast approaching, policymakers' testimony to the House of Commons' Treasury Select Committee on Tuesday will perhaps be the last opportunity for communication before next Thursday's announcement on Bank Rate and future Gilt sales. Naturally, Governor Bailey's comments will be of most interest. His quotes from Jackson Hole did not signal any imminent shift in his monetary policy prescription, emphasising that second-round effects have been 'relatively muted' so far. He will likely reiterate that point once more, while remaining non-committal about future decisions. However, whether more recent developments in wholesale energy markets induce a less dovish tone from himself, or either Deputy Governor Dave Ramsden or Alan Taylor – both of whom also voted to leave Bank Rate unchanged in July – could offer clues as to the overall tone of September's policy statement. External MPC member Megan Greene, on the other hand, is likely to signal at least implicitly her intention to vote for a 25bps hike again. Datawise, the BRC's retail monitor will provide insights into consumer spending in August. Retail footfall might have benefitted from cooler temperatures later in the month. But given the jump in shop prices reported by a separate BRC survey, on a price-adjusted basis we expect another sluggish signal regarding broader sales volumes.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	GDP - third estimate Q/Q% (Y/Y%)	Q2	**0.6 (1.2)**	*0.6 (1.1)*	0.0 (0.5)	- (0.6)
	GDP - government expenditure Q/Q%	Q2	**0.2**	0.3	0.6	-
	GDP - fixed investment Q/Q%	Q2	**-0.1**	0.0	-0.3	-0.2
	GDP - household consumption Q/Q%	Q2	**0.4**	0.3	0.3	0.1
	Employment - second estimate Q/Q% (Y/Y%)	Q2	**0.1 (0.5)**	*0.1 (0.5)*	0.1 (0.5)	-
	Sentix investor confidence indicator	Sep	**5.1**	1.7	0.9	-
Germany	Industrial production M/M% (Y/Y%)	Jul	**-1.1 (-1.6)**	0.2 (0.0)	0.2 (-0.1)	0.0 (-0.5)
Spain	INE house price index Q/Q% (Y/Y%)	Q2	**3.4 (12.2)**	-	3.5 (12.9)	-

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/ *Daiwa forecast*	Previous
Germany	07.00	Trade balance €bn	Jul	15.8	15.3
France	07.45	Trade balance €bn	Jul	-	-5.8
UK	00.01	BRC retail monitor - like-for-like sales Y/Y%	Aug	-	1.0

Auctions and events

Country	BST	Event
Germany	10.30	Auction: to sell up to €750mn of 2.3% 2033 green bonds
	10.30	Auction: to sell up to €750mn of 2.6% 2041 green bonds
UK	14.15	BoE Governor Bailey & Ramsden, Greene & Taylor to testify on July's MPR before Treasury Select Committee

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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