Euro wrap-up

Overview

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- Bunds made modest losses even as euro area consumer confidence weakened to its lowest level in three months.
- Gilts made larger losses as UK public borrowing again exceeded expectations in August to run well above OBR forecast.
- On Wednesday, the focus will be on the flash September PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	3.219	+0.014
OBL 2.9 10/31	3.293	+0.013
DBR 3 08/36	3.459	+0.007
UKT 4 05/29	4.776	+0.029
UKT 4⅛ 03/31	4.838	+0.021
UKT 4⅞ 07/36	5.237	+0.027

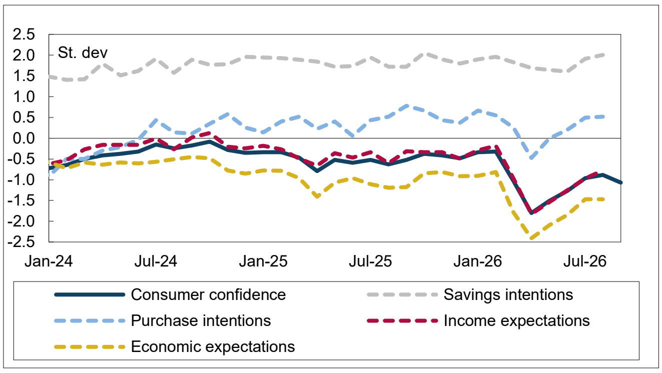
*Change from close as at 5.00pm BST.
Source: Bloomberg

Euro area

Consumer confidence unsurprisingly weakens in the face of higher energy prices

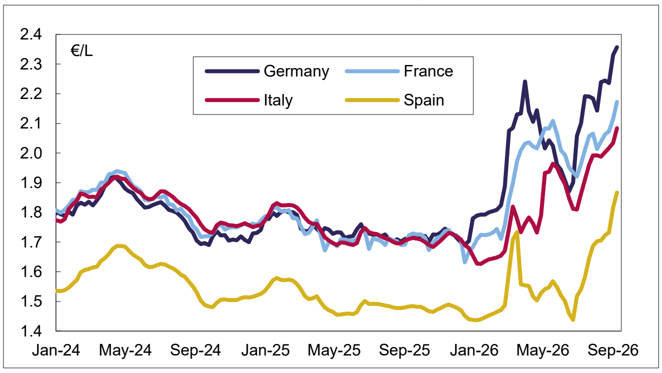
While the euro area economy has so far proved resilient to the energy price shock, and surveys continued to point to growth over the summer, the Commission's flash estimate of euro area consumer confidence in September weakened. Indeed, the headline index fell for the first month in five and by a larger-than-expected 1pt to -16.5, its lowest level since June and more than one standard deviation below the long-run average. While still some 4pts above the recent low in April, the deterioration was perhaps unsurprising given the renewed squeeze on disposable income from higher energy prices and the tightening of financial conditions following the ECB's second rate hike in three months. However, with aggregate petrol prices in the region having risen in 11 of the previous 12 weeks and on average up 5% from the end of August so far this month, some European governments have recently announced new or extended support measures to cushion the impact on households. In Germany, excise duties on gasoline and diesel will be reduced from 1 October through year-end, before a temporary cap on pump prices is introduced in January. And the Italian government will exempt road tax from 14.5mn cars to provide a partial offset to higher fuel costs. Happily, the limited evidence available from member states so far this month suggests that higher energy prices might not have yet exerted a marked restraint on consumer spending. Indeed, today's Dutch consumer survey reported that willingness to make major purchases strengthened to its highest level since March. And we continue to expect household consumption to offer support to GDP growth in both Q3 and Q4, albeit with growth below the 0.4%Q/Q rate in Q2. Nevertheless, as ECB Chief Economist Lane noted in an interview reported today, this second energy shock poses a greater risk of feeding through into broader price pressures. And a prolonged period of elevated energy costs through the autumn would more severely squeeze real incomes, posing greater downside risks to growth and upside risks to inflation alike.

Euro area: Consumer confidence indices*



**Shows flash consumer confidence estimate for September*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Weekly petrol prices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

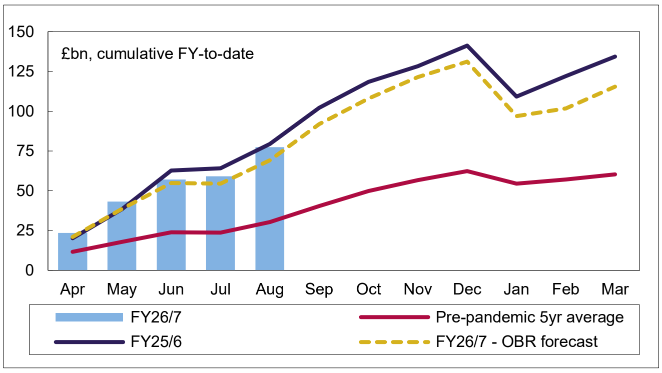
The principal focus in the euro area on Wednesday will be the flash PMIs, which will provide a signal on private sector activity at the end of Q3. Overall, we see the risks to the flash activity indices skewed slightly to the downside. Recent drivers – concentrated amongst German manufacturers and Southern European services – could be difficult to sustain and the rise in global energy prices over the summer seems bound to reassert pressure on firms' input prices and potentially selling prices too. However, those risks are unlikely to detract from the wider picture of improving underlying growth momentum. Indeed, while the headline composite output PMI merely sidestepped in August, at 52.0, it still matched the fastest expansion since last November, almost 3pts better than the Q2 average. Consistent with firmer demand, the employment index also suggested that hiring was its firmest in 10 months (50.8) while new export orders reportedly rose for the first month in 4½ years. Those improvements principally reflected the aforementioned boost from German manufacturing, whose own expansion led the euro area manufacturing output PMI to its highest level since the 2022 energy shock (53.3). And though the services activity indices in the core member states questionably slipped further into contraction territory, contrasting the signals from national surveys, the effect on the euro area index (51.6) was compensated for by strength elsewhere. In addition to the flash PMIs, a speech in the evening by ECB Chief Economist Lane might also be of interest.

UK

Public borrowing again exceeded expectations in August to run well above OBR forecast

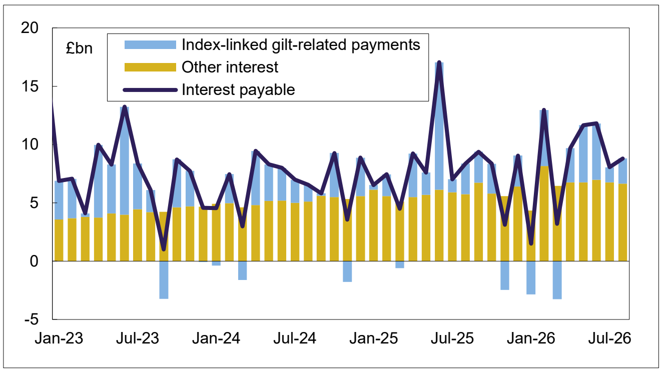
According to the GfK survey, UK consumer confidence rose during the summer back to the top of the range since Russia's invasion in early 2022. While the summer sunshine might have helped, a key driver seems to be optimism in new Prime Minister Andy Burnham, as his Labour Party has re-established a lead over the populist right-wing Reform in most opinion polls since he succeeded Keir Starmer. But while the GfK survey also reported improved sentiment in the outlook for incomes and increased willingness to spend – which tallies with continued strength in retail sales in August – the forthcoming government budget announcement on 28 October represents a significant downside risk. Certainly, as illustrated by today's public finances data for August, there will be no scope for substantive giveaways to further buoy sentiment and accelerate consumer spending. Net public sector borrowing in August reached £18.3bn, once again exceeding expectations as well as the level a year earlier. As a result, cumulative borrowing in the first five months of the fiscal year reached £77.3bn, down just £2bn from the same period in FY25/6 and a chunky £8.1bn above the OBR's forecast despite stronger-than-expected economic activity.

UK: Public sector net borrowing



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

UK: Central government debt interest



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

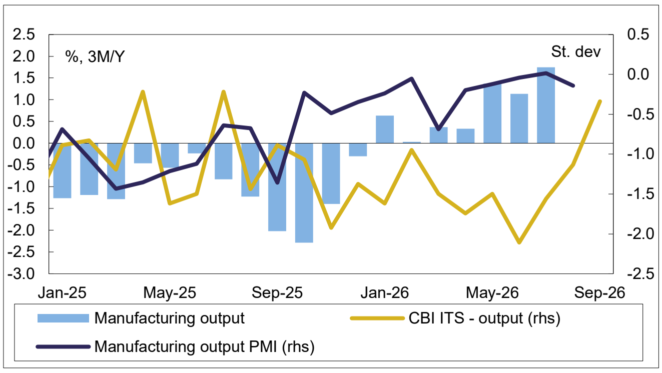
Debt interest & social payments eroding more than half of government's fiscal headroom

With government revenues from corporation tax, personal income tax and National Insurance Contributions slightly exceeding expectations, the overshoot in public borrowing relative to the OBR's forecast this fiscal year primarily reflects the continued struggle with public expenditure control. Indeed, central government expenditure in the fiscal year to August was £7.4bn above the OBR's forecast with more than half of that excess explained by the continued overshoot of spending on welfare benefits and higher debt interest on inflation-linked Gilts. Some of that miss can also be explained by higher government investment, which is excluded from its binding fiscal rule to achieve a surplus or balance on the current budget by FY29/30. But the current budget deficit in the five months to August still reached £51.9bn, almost £5bn above the OBR's forecast, thus already representing a non-negligible erosion of the £24bn of headroom estimated by the OBR in March. The BoE's decision to suspend Gilts sales over the remainder of this fiscal year will at least avoid the costs associated with the respective losses on those holdings over coming months. But with debt interest payments set to remain higher for longer and likely to exceed previous expectations over the horizon, and Burnham having made several new spending and tax commitments since taking office, more than half of the headroom identified in March has likely been eroded. With the government's credibility in public expenditure control low, speculation inevitably persists that the government will next month announce further revenue-raising measures, many of which would be expected to land on the household sector. And coupled with increases in household energy prices to come at the start of October and again in January, the consumer mood should still be expected to take a turn for the worse along with the weather before autumn has passed.

CBI survey signals improved manufacturing conditions at end-Q3

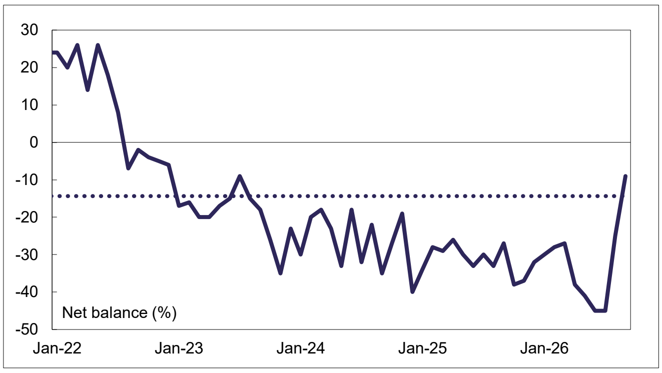
Ahead of tomorrow's flash September PMIs, today's CBI industrial trends survey provided an update on manufacturing conditions at the end of Q3. While the survey has offered a poor guide to the official manufacturing output data since the start of the year, which have shown a steady uptrend, today's results were more encouraging. Among other things, the survey's measure of output volumes in the three months to September suggested the slowest pace of contraction in fourteen months. Indeed, the weighted balance improved markedly, to -4% from -17% in August and a recent low of -33% in June. Moreover, the share of firms reporting higher output volumes over the past three months was last greater in June 2024, with growth reported in autos and other transport equipment, as well as mechanical engineering and chemicals. Firms were more optimistic about the near-term outlook too, with the share expecting output to decline over the coming three months falling to the lowest since March. That was supported by a further notable improvement in orders, with the net balance (-9%) reaching the highest level in almost three years and the share of firms judging them to be above normal for the time of year (27%) the highest since November 2022. Meanwhile, although stock levels were viewed as broadly adequate, they were at their lowest level in more than two years and well below the long-run average. However, reports today that operations at three chemical plants in Northern England will be suspended due to high gas prices highlight the risks that elevated energy costs pose to manufacturing activity in the near term. Moreover, while the CBI survey pointed to a further easing in expectations for average selling price inflation, those expectations remained above the long-run average and could rebound in coming months if and when persistently high cost pressures are passed through supply chains.

UK: Manufacturing output & survey indices



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

UK: CBI survey – order book levels*



**Dotted line represents long-run average.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

As in the euro area, September's flash PMIs will also provide the highlight for UK markets on Wednesday. And also like the euro area, the UK survey has also become less downbeat over the summer. A further pickup in the dominant services sector last month took the composite output PMI to a four-month high (52.5), leaving the index trending more than 2pts above its Q2 average thus far in Q3. Of course, policymakers will be cautious not to overinterpret the signals from the PMIs in isolation, given their poor guide to recent GDP data and the relatively subdued level. But the minutes from this week's MPC meeting showed that monetary policymakers are at least more mindful about signs of ongoing resilience. And at least as far as manufacturing is concerned, today's CBI survey (see above) suggests that conditions in the sector continue to improve. Activity aside, the employment and price PMIs will also be closely watched, particularly after the former provided another tentative sign of stabilising labour demand in August while the latter will no doubt reflect the recent acceleration in energy costs.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary Commission consumer confidence indicator	Sep	**-16.5**	-16.0	-15.5	-
UK		Public sector net borrowing £bn	Aug	**18.3**	15.5	1.8	2.0
		CBI industrial trends - total orders (selling prices) net % balance	Sep	**-9 (12)**	-	-25 (22)	-

Auctions

Country		Auction
Germany		sold €3.735bn of 2.9% 2031 bonds at an average yield of 3.28%
UK		sold £4.75bn of 4.625% 2032 bonds at an average yield of 4.843%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK		Rightmove house prices M/M% (Y/Y%)	Sep	**0.7 (-0.8)**	-	-2.0 (-1.0)	-

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
Euro area		09.00	Preliminary services (manufacturing) PMI	Sep	51.4 (52.6)	51.6 (52.7)
		09.00	Preliminary composite PMI	Sep	51.7	52.0
Germany		08.30	Preliminary services (manufacturing) PMI	Sep	49.9 (54.0)	49.7 (54.3)
		08.30	Preliminary composite PMI	Sep	51.8	51.8
France		08.15	Preliminary services (manufacturing) PMI	Sep	48.3 (51.0)	48.0 (51.1)
		08.15	Preliminary composite PMI	Sep	48.7	48.5
UK		09.30	Preliminary services (manufacturing) PMI	Sep	52.0 (51.5)	52.5 (51.7)
		09.30	Preliminary composite PMI	Sep	52.0	52.5

Auctions and events

Country		BST	Event
Euro area		17.30	ECB Chief Economist Lane to deliver lecture on 'Monetary Policy in the Euro Area' at the ICMB, Geneva
Germany		10.30	Auction: to sell up to €1bn of 3.4% 2047 bonds
		10.30	Auction: to sell up to €1bn of 2.9% 2056 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.