

Euro wrap-up

Overview

- While the French government presented its draft budget for 2027 with its plan to reduce its budget deficit to 5% of GDP, OATs and BTPs continued to sell off while Bunds rallied hard on a flight to quality.
- Gilts rallied while the UK manufacturing PMIs suggested a softening of momentum at the end of Q3.
- Friday will bring the flash estimate of euro area inflation in September and the latest UK DMP survey of business price and wage expectations.

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Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	3.057	-0.142
OBL 2.9 10/31	3.254	-0.099
DBR 3 08/36	3.505	-0.078
UKT 4 05/29	4.797	-0.074
UKT 4½ 03/31	4.909	-0.063
UKT 4¾ 07/36	5.396	-0.027

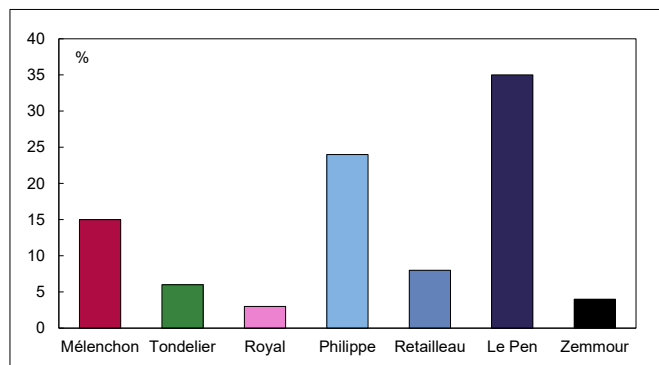
*Change from close as at 5.00pm BST.
Source: Bloomberg

Euro area

French budget aims to cut deficit to 5% of GDP but public debt to keep rising on unsustainable path

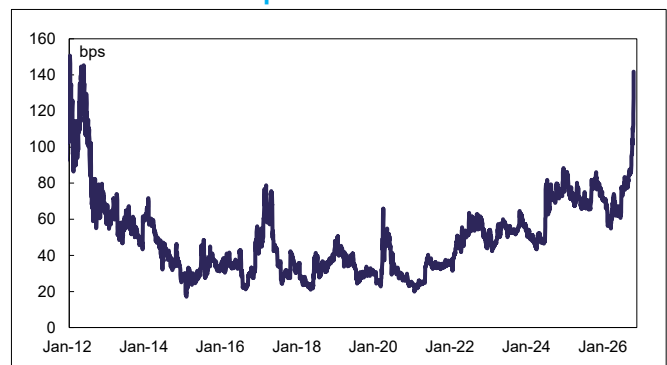
As many of the measures had been discussed in advance, there were no major surprises from today's draft French budget for 2027 when it was presented by Prime Minister Lecornu. In total, against the backdrop of weaker economic growth this year (circa 0.5%YY, roughly half the rate initially expected) and higher debt interest costs, the government aims to cut the deficit from just under 5½% of GDP this year back to 5%, matching the initial target for 2026. Without the proposed measures, amounting to about €43bn (or €54bn including other recent policies), the deficit would rise to 6½% of GDP or more. Markets appeared to take some comfort that about 60% of the adjustment should come from spending restraint. Under-indexation of pensions, cuts to the civil service salary bill, savings to budgets for healthcare, sick-leave compensation and local authorities, as well as a freeze to certain welfare payments, would bear the brunt of the savings. And despite a partial extension of last year's supposed one-off tax on large firm profits, most of the burden of higher taxes is proposed to fall on the household sector, including a reduction of allowances for higher-income pensioners and an extension to the high-income minimum-tax surcharge. But even if successfully implemented and economic growth accelerates to twice this year's rate, the French gross debt stock would still rise above 120% of GDP. And given this year's sharp upwards shift in OAT yields and a primary deficit of around 3% of GDP, the medium-term target to reduce the deficit to the 3% of limit by 2029 appears little more than wishful thinking. Anyway, given the government's lack of majority in the National Assembly, and next spring's Presidential election approaching, the budget looks unlikely to be adopted by year-end, with emergency legislation likely to be required to extend this year's budget into January for a third successive year. And eventually, the government might well have to impose a form of its 2027 budget plan via constitutional means, bypassing Assembly approval at risk of a potentially disruptive no-confidence motion.

France: Voter intentions in Presidential 1st round*



*Poll assumes Gabriel Attal does not run. Source: ifop Fiducial and Daiwa Capital Markets Europe Ltd.

France: 10Y OATs spread to Bunds

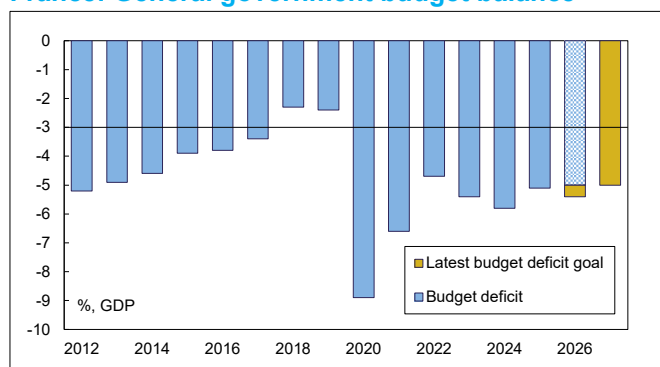


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

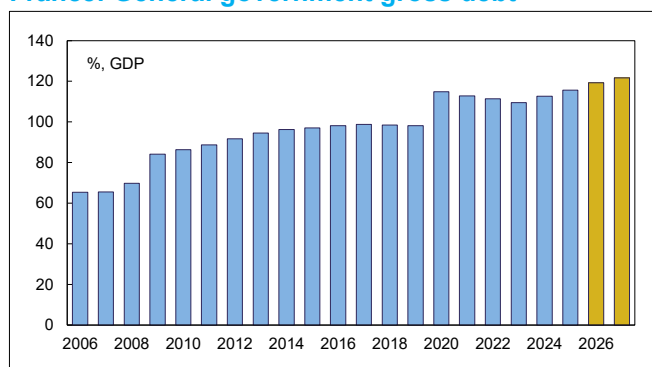
Uptrend in French spreads to be sustained amid Assembly paralysis & Presidential uncertainty

Currently, the far-right RN party of Marine Le Pen, which holds the balance of power in the National Assembly, appears disinclined to remove the government via such a no-confidence motion. So, Lecornu might yet survive the imposition of a budget via constitutional means. But the debate over the 2027 draft budget is only a sideshow ahead of the Presidential election in the spring and a likely further lower house election thereafter. And Presidential uncertainty and the likelihood that the National Assembly will remain divided and paralysed for the foreseeable future have been key drivers of the rise in OAT spreads to post-euro crisis highs over recent weeks. We see no obvious near-term catalyst for that uptrend to cease, with the 10Y spread likely to exceed 150bps before long. Le Havre Mayor Édouard Philippe remains the centre's main hope of reaching the Presidential second round. But notwithstanding a more encouraging poll published today (see chart), there

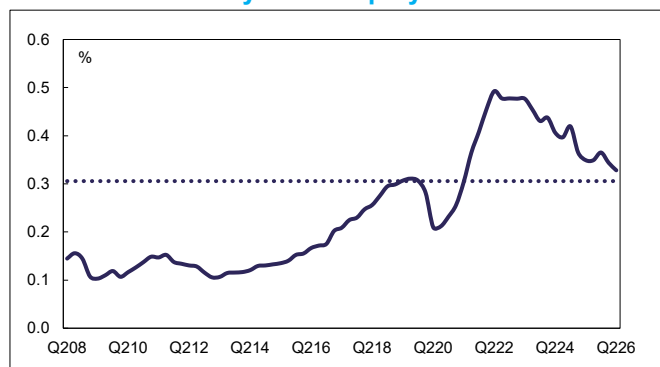
remain concerns that he could yet be beaten to that run-off by far-left Jean-Luc Mélenchon, whose ratings have been buoyed by his calls to cancel (or exchange for zero-coupon perpetuals) French government bonds held by the ECB. And even if Philippe squeezes past Mélenchon in the first round, second-round polling currently places him well behind far-right Marine Le Pen, whose economic policy continues to lack credibility despite her party's efforts to appear more business-friendly and distance itself from previous calls for Frexit. While Le Pen might recognise that the bond market will impose some constraints on her fiscal policy, we would not expect any government of hers to mimic the orthodox policies pursued by Georgia Meloni to maintain the flow of essential EU funds to Italy. Moreover, judging not least from her recent pension policies as well as her questionable fiscal arithmetic ahead of the previous Presidential election, Le Pen would seem highly unlikely to take the difficult decisions required to stabilise the government debt stock against the backdrop of rising debt interest costs and age-related spending pressures. Added to that, Le Pen's populist economic nationalism would represent a significant obstacle to efforts to make the French and euro area economies more dynamic and competitive. Indeed, under a Le Pen Presidency, the paralysis in France might seem likely to be matched by a harmful new paralysis in EU policymaking.

France: General government budget balance*


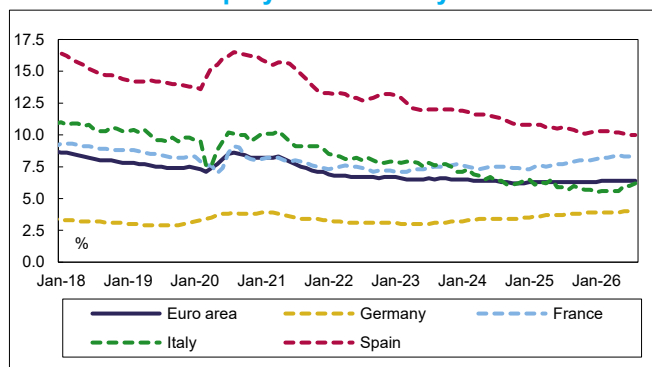
*Shaded light blue bar represents government's previous goal.
 Source: Macrobond and Daiwa Capital Markets Europe Ltd.

France: General government gross debt*


*Gold bars represent government forecast for 2026 & 2027.
 Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Vacancy to unemployment ratio*


*Dotted line is 2019 average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates by member states


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

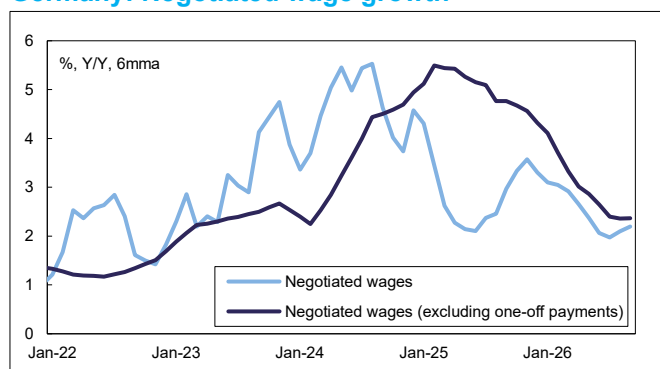
Euro area unemployment rate unchanged at 6.4%, but above the ECB's forecast

With inflation set to rise to a three-year high in September and climb further over coming months, likely peaking above 4% in Q127 to be broadly in line with the ECB's 'adverse' scenario, the ECB will raise rates again by year-end. But with indirect price pressures so far limited and few signs of labour market tightness, second-round inflation risks still look well contained. Indeed, today's data reported a third successive monthly rise in the number of unemployed in August to 11.36mn, the highest level since February 2024. While the jobless rate was unchanged at 6.4% for a seventh successive month, it was tracking 0.2ppt above the ECB's projection for Q3. Much of the rise in unemployment was concentrated in Italy and Austria and reflected higher labour participation rather than rising redundancies. Elsewhere, the German ILO unemployment rate held steady to match its highest level in a decade. More encouragingly, Spanish unemployment remained at its lowest level since spring 2008 while the French rate fell to a five-month low. But after the euro area vacancy-to-unemployment ratio already fell in Q2 to its lowest level in five years, labour slack likely increased a little further in Q3. In Germany, labour slack was reflected in still subdued negotiated wage growth in Q3 (2.3%3M/Y). And while Germany's largest union IG Metall in the past week demanded a 5% pay increase, the eventual settlement will surely be far more moderate and firms will anyway continue to absorb a large share of cost pressures in their margins.

Final manufacturing PMIs signal strongest growth since Russia's invasion of Ukraine

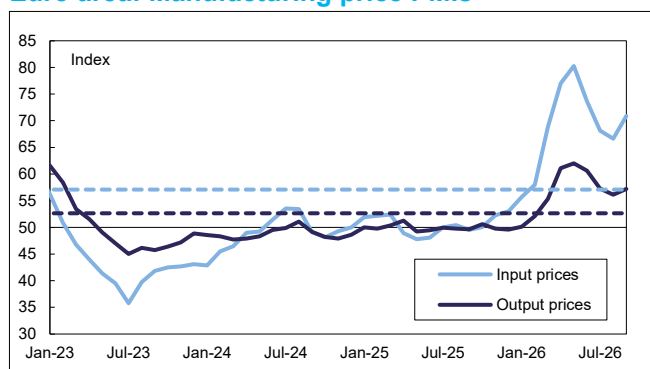
Business surveys point to some stabilisation in labour demand at the end of Q3 as signals about growth momentum improved despite the intensification of cost pressures. And today's final euro area manufacturing PMIs were even more upbeat than the flash release had suggested, indicating a cyclical upswing in the sector that should provide meaningful support to activity in Q4. Buoyed in part by stronger defence and AI-related demand, the output component (52.3) signalled the fastest expansion since Russia's invasion of Ukraine. While stocks of finished goods reportedly rose to their highest level in more than three years, the new orders index (52.5) pointed to the strongest demand growth in three years and new export orders were the best since February 2022, which should help to sustain the recovery over coming months. Among the member states, the German (56.0), Dutch (56.7) and Irish (57.8) indices suggested ongoing outperformance in the sector. But if the survey is to be believed, manufacturing output continued to stagnate in the services-dominated member states of France (50.4) and Spain (50.3) and contracted slightly in Italy (49.1).

Germany: Negotiated wage growth



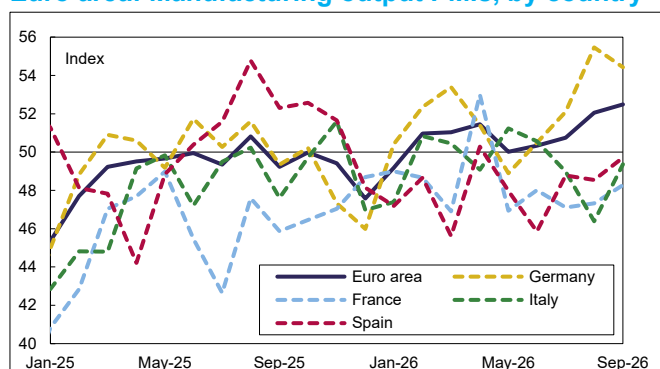
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing price PMIs*



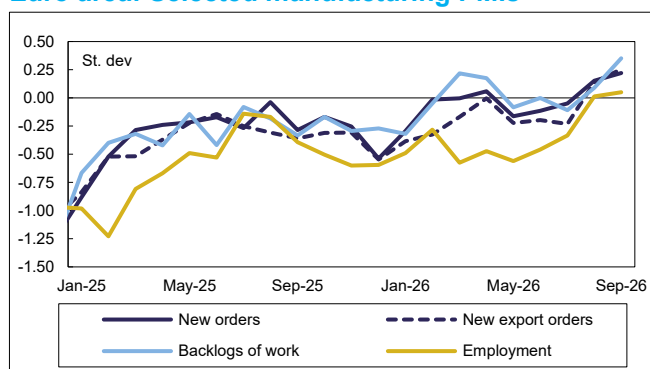
*Dashed lines represent pre-pandemic averages. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output PMIs, by country



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

Euro area: Selected manufacturing PMIs



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

The day ahead in the euro area

The key focus on Friday will be the flash euro area inflation estimates for September. Based on figures already published by the larger member states, we expect the headline HICP rate to rise 0.5ppt to a three-year high of 3.7%Y/Y, with risks skewed to the upside. With prices of auto fuel and gas having risen sharply, the increase will be energy-led, with inflation of that component set to reach the highest since early 2022. But given the persistence and intensification of the energy shock, as well as the summer heatwave, the risks to food inflation also appear skewed to the upside. Meanwhile, AI-related demand pressures could sustain upwards pressure on core goods inflation beyond August's 2½-year high (1.2%Y/Y). Reassuringly, however, with services inflation likely to remain relatively well contained, we only expect core inflation to edge back up to 2.5%Y/Y, remaining broadly within its range since the onset of the energy price shock and with scant evidence otherwise of more substantive and broader inflation persistence.

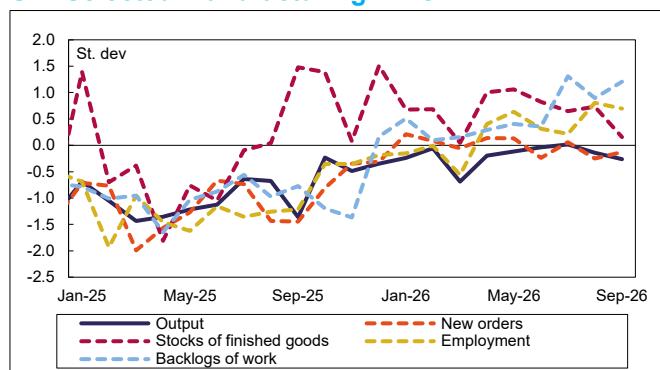
UK

UK manufacturing PMI suggests only modest growth, but firms broadly upbeat about outlook

In contrast to the euro area, the final UK manufacturing PMIs for September signalled a loss of momentum at the end of Q3 with the output index (51.5) pointing to the weakest expansion since March. Moreover, growth reportedly remained concentrated in the investment goods sector, perhaps reflecting stronger AI-related demand, while output in the consumer and intermediate goods sectors reportedly continued to contract. But although today's release indicated only modest growth

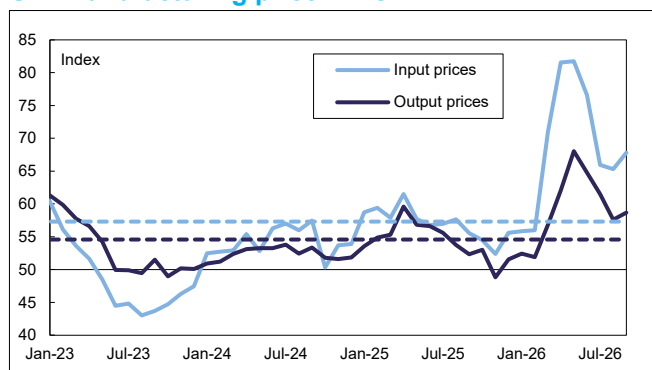
in new orders, it also suggested somewhat firmer external demand than implied in the flash release. And with manufacturers having reduced their stocks of finished goods to the lowest level in ten months, the orders-to-inventory ratio rose to the highest level since March. Perhaps as a result, firms remained broadly upbeat about the outlook for the coming 12 months and increased headcount for a sixth successive month, albeit at a slower pace than in August. Nevertheless, supply chains remained under pressure. Taken together with higher energy costs, the input price PMI (67.8) rose above the flash reading and to a three-month high. While firms still suggested that cost pressures remained less intense than at the start of the US-Iran conflict, they nevertheless reported a markedly faster pace of output price inflation than prevailed before the war.

UK: Selected manufacturing PMIs



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

UK: Manufacturing price PMIs*



*Dashed lines represent pre-pandemic averages. Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

The data focus in the UK on Friday will be the results of the BoE's latest Decision Maker Panel survey, which will provide an update on firms' price and wage growth expectations. While most MPC members were seemingly reassured by the continued absence of evidence of strengthening selling-price and wage-setting pressures in the August DMP survey to refrain from hiking Bank Rate [last month](#), the risks to September's DMP survey are undoubtedly skewed to the upside. While expectations for output prices and CPI one year ahead are expected to tick higher on the recent jump in wholesale energy prices, policy makers will pay more attention to expectations for three years ahead. In August, those expectations for CPI moved sideways at 3.8%3M/Y, still near the bottom of the range of recent years. Firms' wage expectations for the coming year were also relatively subdued in August (3.4%3M/Y), helping to dampen concerns about second-round effects.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Final manufacturing PMI	Sep	52.9	<u>52.7</u>	52.7	-
	 Unemployment rate %	Aug	6.4	6.4	6.4	-
Germany	 Final manufacturing PMI	Sep	53.9	<u>53.8</u>	54.3	-
France	 Final manufacturing PMI	Sep	50.6	<u>50.3</u>	51.1	-
Italy	 Manufacturing PMI	Sep	50.4	50.0	49.6	-
Spain	 Manufacturing PMI	Sep	51.0	50.2	49.5	-
UK	 Nationwide house prices M/M% (Y/Y%)	Sep	-0.2 (0.8)	0.1 (1.4)	0.2 (1.6)	-
	 Final manufacturing PMI	Sep	51.9	<u>52.0</u>	51.7	-

Auctions

Country	Auction
France	 sold €6.27bn of 3.7% 2036 bonds at an average yield of 4.93%
France	 sold €1.53bn of 3.8% 2037 bonds at an average yield of 4.97%
France	 sold €2.13bn of 1.25% 2038 bonds at an average yield of 5.06%
France	 sold €2.06bn of 2% 2048 bonds at an average yield of 5.4%
Spain	 sold €1.57bn of 1.45% 2029 bonds at an average yield of 3.43%
Spain	 sold €2.17bn of 3.4% 2036 bonds at an average yield of 4.176%
Spain	 sold €1.32bn of 2.9% 2046 bonds at an average yield of 4.562%
Spain	 sold €520mn of 1.15% 2036 inflation-linked bonds at an average yield of 1.96%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	 10.00	Preliminary headline (core) HICP Y/Y%	Sep	<u>3.7 (2.5)</u>	3.2 (2.4)
Italy	 09.00	Retail sales M/M% (Y/Y%)	Aug	-	-0.4 (0.8)
Spain	 08.00	Unemployment change (employment net change) 000s	Sep	-	44.4 (83.8)
UK	 09.30	DMP – 1Y ahead output price (CPI) expectations 3M/Y%	Sep	3.7 (3.2)	3.8 (3.1)

Auctions and events

Euro area	 12.30	ECB Vice President Vujčić to deliver a keynote speech to the ESRB's 10 th annual conference in Frankfurt
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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