

Euro wrap-up

Overview

- While German industrial production data surprised to the upside on a surge in construction activity, shorter-dated Bunds made gains as investor concerns about France returned to the fore.
- Gilts made sizeable losses on a quiet day for UK economic news.
- Thursday will bring German trade data, alongside UK housing market and credit conditions surveys and the account of the ECB's September policy meeting.

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Daily bond market movements

Bond	Yield	Change
BKO 3 12/28	3.037	-0.064
OBL 2.9 10/31	3.218	-0.027
DBR 3 08/36	3.471	-0.004
UKT 4 05/29	4.847	+0.034
UKT 4½ 03/31	4.970	+0.049
UKT 4¾ 07/36	5.443	+0.069

*Change from close as at 4:45pm BST.

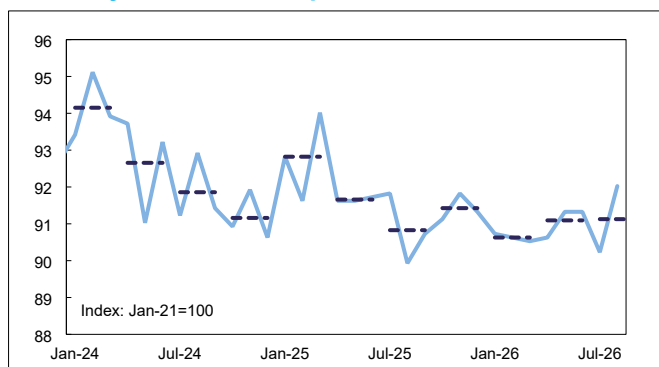
Source: Bloomberg

Euro area

German industrial output jumped in August as construction activity surged

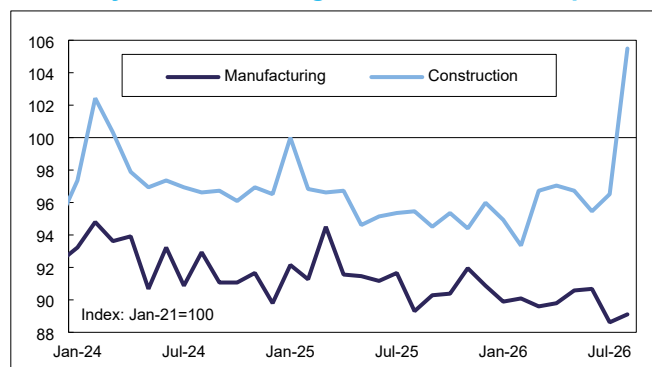
Despite headwinds from higher energy costs and low Rhine river levels, today's German industrial production data significantly beat expectations, at least on the surface. Total output jumped 2.0%M/M in August to the highest level since March 2025, just before Trump's Liberation Day tariff announcement, while the annual growth rate (2.3%Y/Y) accelerated to the strongest in almost four years. However, having fallen sharply at the start of Q3, this left industrial output trending merely sideways from the Q2 level. Moreover, the strength in August was flattered by a questionably strong outturn from construction, where activity rose 9.3%M/M, the most since 2012 outside of the post-Covid lockdown surge in March 2021. While this in part reflected the firmest growth in house-building in six months and a third successive increase in civil engineering activity to a new series high, there was a double-digit monthly rise in 'specialized' work. Although some payback is likely in September, construction output in the first two months of the quarter was tracking also 5% above the Q2 average, suggesting a welcome boost to GDP growth in Q3. In contrast, however, manufacturing production rose a more modest 0.6%M/M, only partially reversing the decline of more than 2% in July. As a result, manufacturing output in the first two months of the quarter was trending more than 1½% below its Q2 level, illustrating the downside risks to GDP in Q3 and reinforcing our expectation that German GDP growth slowed markedly from H126.

Germany: Industrial output*



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

Germany: Manufacturing & construction output

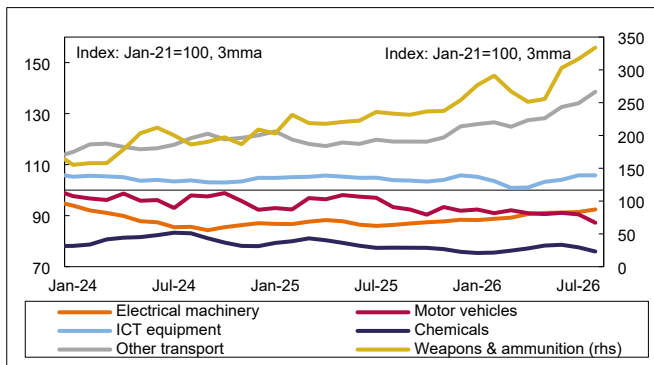


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Energy-intensive subsectors continuing to struggle, but AI- & defence-related output booming

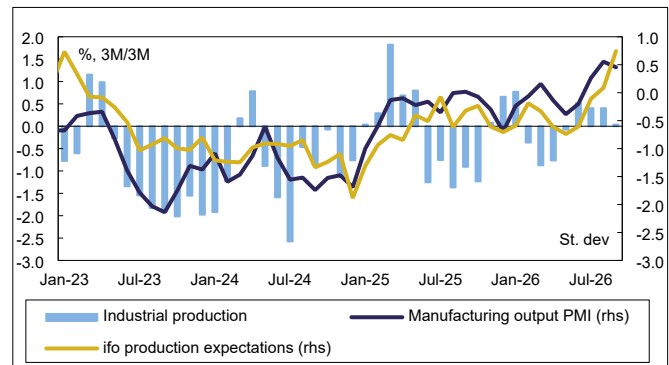
Perhaps unsurprisingly given rising wholesale energy costs, the rebound in manufacturing output was constrained by further weakness in energy-intensive subsectors. Paper production fell to a fresh series low in August, while chemicals production dropped to its lowest level since early 1994 excluding the temporary slump at end-2022. Today's release also appeared to show an ongoing deterioration in car manufacturing, where output fell (-5.4%M/M) to the lowest level since March 2022. However, this was affected by more extensive maintenance shutdowns that month than in recent years. And despite these sector-specific drags, today's data still contained some encouraging signs. Most notably, aerospace continued to support the broader transport equipment sector over the summer, with output rising to a record high. Meanwhile, the government's expanding defence programmes were again reflected in a further jump in production of weaponry and ammunition. Output of electrical and machinery equipment also rose to the highest levels in almost three years and nine months respectively. And while ICT equipment output edged lower in August, it trended around 2% above its Q2 level supported by continued strong demand for AI-related investment.

Germany: Manufacturing output, by subsector



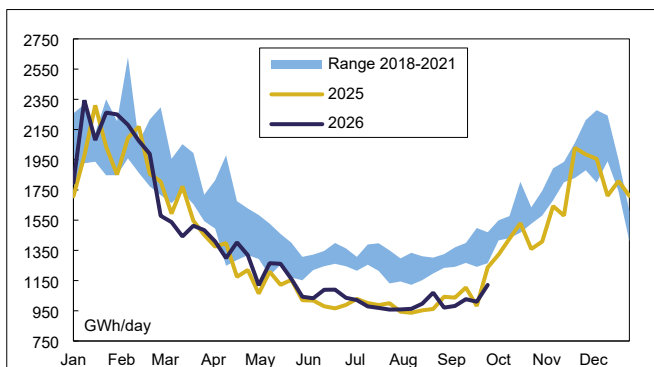
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output & survey indices



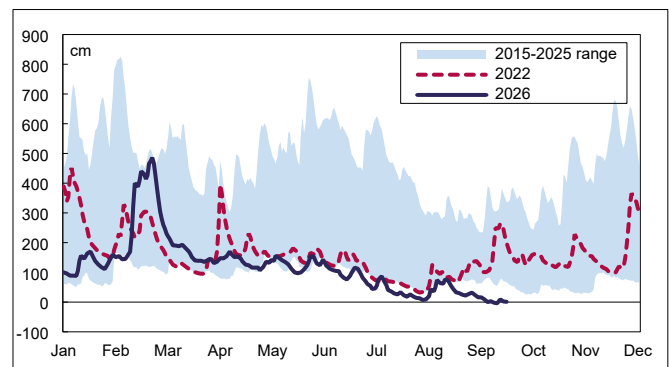
Source: S&P Global, ifo Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Industrial gas consumption



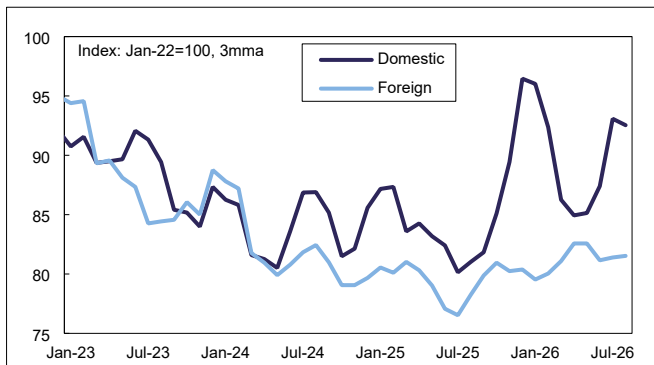
Source: Bundesnetzagentur and Daiwa Capital Markets Europe Ltd.

Germany: Rhine river level*



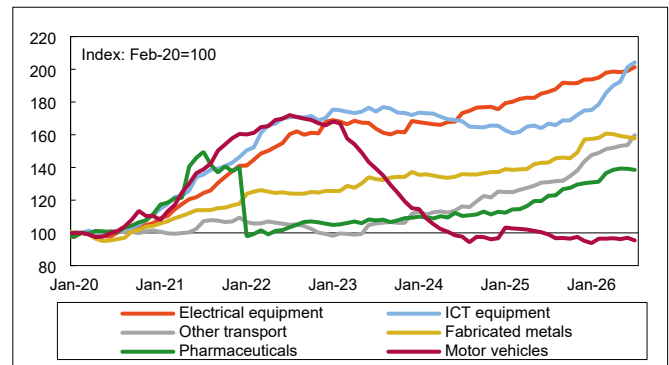
*Kaub crossing. Rhine River gauge levels are measured using a fixed historical baseline, rather the actual depth of the river water. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: New factory orders



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing order backlogs



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Surveys point to manufacturing bounce back in Q4 and into 2027

While headwinds persist and low industrial gas consumption points to an ongoing downtrend in energy-intensive subsectors, surveys suggest that the slowdown in German manufacturing over the summer should prove temporary. In September, the output PMI signalled one of the fastest expansions in 4½ years, while the ifo survey indicated that expectations for production over the coming three months were the most upbeat since January 2023. So, with new demand having risen significantly over recent months, the outlook for German factory output appears encouraging. Indeed, manufacturers' order books were equivalent to nine months of production at the start of Q3, with backlogs particularly elevated in the electrical and ICT equipment subsectors and continuing to trend higher in non-auto transport equipment. One area of weakness, however, remains the auto sector, reflecting ongoing challenges from Chinese competition and shifting consumer preferences. Nevertheless, Germany's auto association VDA reported that domestic orders rose 4%Y/Y in September. And orders for domestically produced battery electric vehicles surged almost 80%Y/Y, suggesting that the recent dominance of foreign produced new car registrations may become less pronounced over coming quarters.

The day ahead in the euro area

Tomorrow will bring German goods trade data for August. Following the decline in export values in July, surveys suggest that shipments rebounded over the summer as foreign orders continued to rise. But with import values likely to have jumped sharply due to higher imported energy costs and payback for the plunge in July, the trade surplus is expected to have narrowed slightly from July's near-two-year high of €21.1bn. Thursday will also bring the account of the ECB's September policy-setting meeting, at which the Governing Council raised rates for second time this cycle to 2.50%. The policy statement had struck a notably more hawkish tone than in July, and it will be interesting to see if the account reveals any early discussion of the case for a back-to-back hike in October. Of course, subsequent market stress and the significant tightening in financial conditions have greatly reduced the likelihood of additional policy tightening later this month.

The day ahead in the UK

While yesterday's UK construction PMIs signalled a modest improvement in activity and new orders in September, they were still consistent with contraction in the sector. The latest RICS residential survey, due tomorrow, is also expected to confirm that homebuyer demand remained subdued at the end of Q3 amid ongoing downward pressure on house prices. With swap rates having risen sharply over recent months and geopolitical uncertainty remaining elevated, the BoE's quarterly credit conditions survey is expected to show that lending standards tightened further in Q3 and are expected to tighten again in Q4. And while credit flows to households and businesses have held up over the summer, lenders may anticipate weaker demand over coming months. Thursday will also bring the REC/KPMG report on jobs, which has pointed to improved labour demand over recent months, contrasting with the ongoing declines reported in the monthly payroll numbers. Aside from the data, various BoE policymakers are due to speak publicly, including Governor Bailey and Deputy Governor Lombardelli, as well as long-standing hawks Chief Economist Pill and Green.

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	2.0 (2.3)	0.4 (0.7)	-1.1 (-1.6)	-1.2 (-1.8)
France 	Trade balance €bn	Aug	-6.1	-	-6.7	-6.6

Auctions

Country	Auction
Germany 	sold €1.91bn of 3.3% 2033 bonds at an average yield of 3.36%
UK 	sold £1.0bn of 0.125% 2028 bonds at an average yield of 4.842%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany 	07.00	Trade balance €bn	Aug	19.0	21.1
UK 	00.01	RICS house price balance %	Sep	-30	-28

Auctions and events

Euro area 	12.30	ECB to publish monetary policy account of 09-10 September meeting			
UK 	00.01	REC/KMPG Report on Jobs			
	09.30	BoE to publish quarterly Credit Conditions Survey			
	10.15	BoE's Green scheduled to give speech in South Africa			
	11.30	BoE Chief Economist Pill scheduled to give speech in London			
	13.15	BoE Governor Bailey scheduled to give speech in Turkey			
	14.00	BoE Deputy Governor Lombardelli scheduled to give speech in Coventry			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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