

Euro wrap-up

Overview

- Bunds followed USTs higher while euro area industrial production data disappointed despite ongoing AI- and defence-related demand.
- While UK GDP figures beat expectations again, Gilts also made gains.
- Friday will bring euro area goods trade data for August and final inflation estimates for September.

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Daily bond market movements

Bond	Yield	Change
BKO 3.0 12/28	3.093	-0.027
OBL 2.9 10/31	3.208	-0.043
DBR 3 08/36	3.410	-0.055
UKT 4 05/29	4.882	-0.019
UKT 4½ 03/31	4.964	-0.033
UKT 4½ 07/36	5.373	-0.050

*Change from close as of 5.00pm BST.

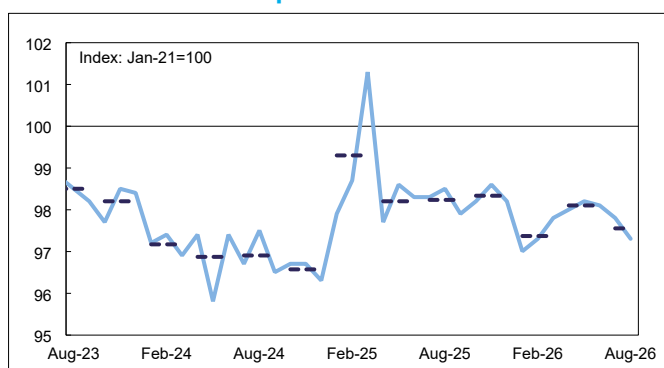
Source: Bloomberg

Euro area

Euro area IP on track to drag on GDP growth in Q3, despite ongoing AI- & defence-related demand

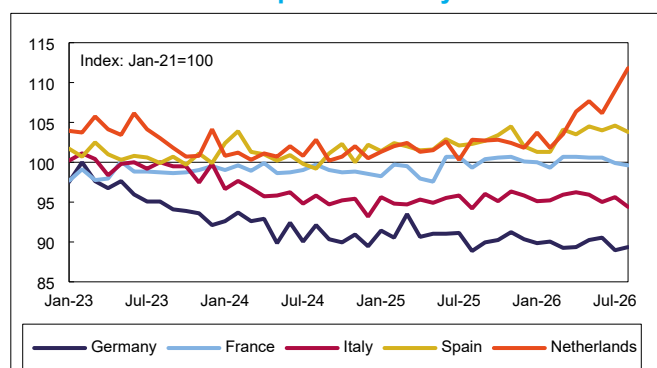
While surveys have pointed to positive manufacturing growth momentum over the summer, supported in part by German government projects and the global AI investment surge, today's euro area industrial output figures for August disappointed. Output fell for a third consecutive month and by 0.5%M/M, the most since January, leaving production down 1.1%Y/Y and tracking more than ½% below the Q2 average. The decline in manufacturing was larger still, more than offsetting continued strength in energy production during the summer heatwave. Admittedly, the manufacturing weakness was exaggerated by a second successive drop in autos production to the lowest level since March 2022 due to seasonal shutdowns. Disruption to river freight from low water levels, alongside elevated energy costs, also seemingly weighed on chemicals production, which fell to the weakest level since the global financial crisis. But despite another steep decline on the month, pharmaceuticals production remained almost 9% higher on a three-month basis. And while ICT equipment output also slipped back following strong gains earlier in the quarter, its underlying upward trend remained firmly intact. There were also signs of continued strength in other investment-related sectors, with production of general machinery and electrical equipment up to their highest levels since late 2023, while output of ammunition and military vehicles continued to trend around record highs. Those tailwinds should continue to provide support to manufacturing output over the coming months. Indeed, order backlogs continue to rise in Germany, while surveys point to firmer growth ahead. So, while high input costs and supply constraints in certain subsectors, notably data-processing equipment, will remain headwinds, we continue to expect manufacturing to return to growth in Q4 following a modest contraction in Q3.

Euro area: Industrial production*



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

Euro area: Industrial production by member state



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

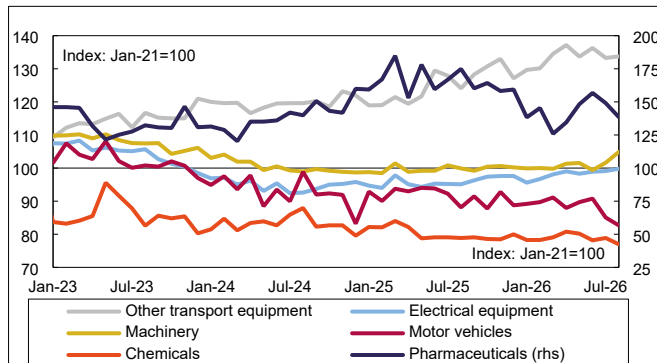
The day ahead in the euro area

September's final euro area inflation data will provide one focus of Friday's European dataflow. According to the flash reading, headline inflation rose by more than expected, jumping from 3.2%Y/Y in August to a three-year high of 3.8%Y/Y. Despite the proximity of that number to a downwards revision (3.76%Y/Y to 2 decimals places), we expect Friday's release to affirm the preliminary estimates. Indeed, final HICP figures from the largest member states have been little revised, and today's French figures were discreetly firmer. Still, the accompanying detail should confirm that energy inflation, and auto fuels in particular, were the predominant driver of that increase. They should also show that the uptick in food inflation from its five-year low was at least partly attributed to fresh-food categories such as fruit and vegetables, reflecting the impact of recent heatwaves and rising input costs. Moreover, indirect energy effects are

likely to justify a modest rebound in services inflation via often-volatile holiday-related items like package holidays and transport services. But, reassuringly, broader inflation pressures seem unlikely to emerge. And since non-energy industrial goods inflation softened a touch, core inflation merely edged back up to 2.5%Y/Y, remaining within the range it has trended over the past five months.

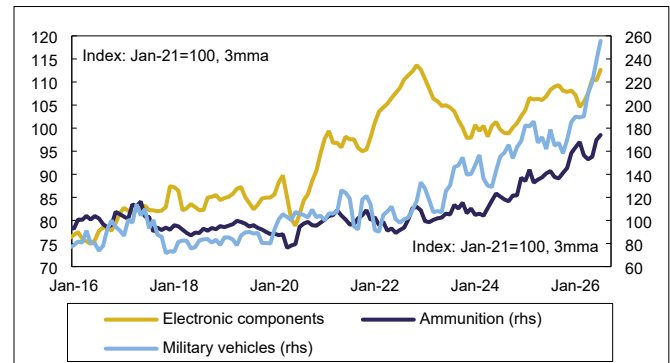
Meanwhile, euro area goods trade figures will also be of interest. While the euro area trade surplus rose to a modest five-month high in July, unfavourable swings in commodity prices as well as a significant widening in the bilateral deficit with China points towards a narrower surplus – or perhaps even a deficit – in August. The data will likely be used by the European Commission to justify the imposition of new quotas on imports from China in sectors such as machinery and chemicals on top of those announced last weekend on hybrid electric vehicles.

Euro area: Manufacturing output, by sector



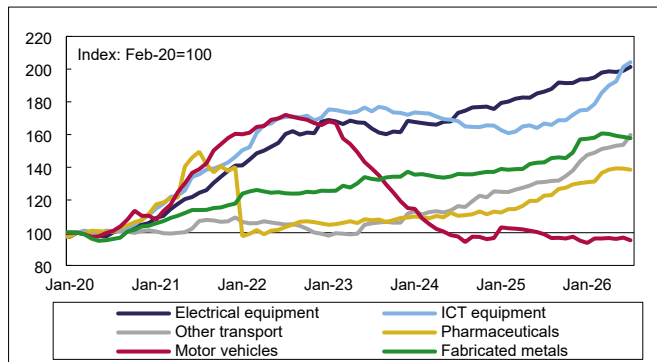
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: AI- & defence-related output



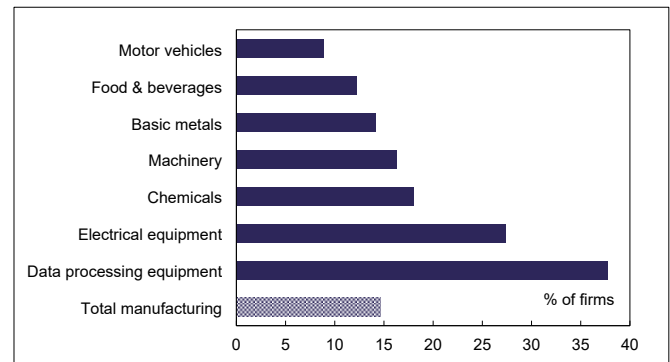
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing order backlogs



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ifo survey - material shortages*



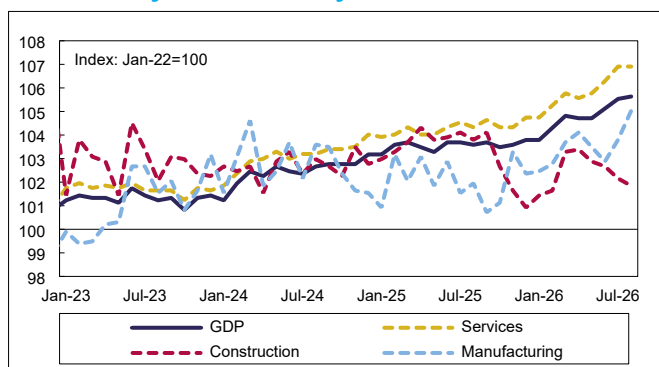
*Share of firms reporting material shortages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK

GDP again beat expectations in August, set to match fastest quarterly expansion since Q122

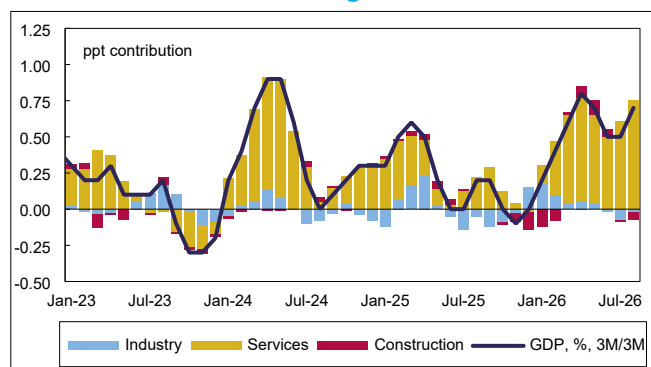
Despite higher wholesale energy prices and persistent geopolitical uncertainty, today's monthly GDP data suggest that the UK economy sustained its strong performance of H126 over the summer months, giving additional cover to the BoE to raise rates for the first time since 2023 at its November MPC meeting. Against expectations of a modest decline, economic output rose for a third consecutive month in August, by 0.1%M/M. This lifted the quarterly pace by 0.2ppt to 0.7%3M/3M, while the annual growth rate accelerated to a near-four-year high of 2.1%Y/Y. Of course, the monthly data are often subject to revision. And with GDP having contracted in only one of the past ten months, we would expect some payback in due course. Nevertheless, we have revised higher our forecast for GDP growth in Q3 to 0.7%Q/Q, which would match the fastest pace since Q122. Notably too, it would be a chunky 0.6ppt above the BoE's projection published in July and 0.4ppt above its forecast as recently as the September MPC meeting. Up to now, MPC policymakers have viewed underlying momentum as softer than the headline data suggest. But repeated upside growth surprises increasingly point to greater resilience than previously anticipated, suggesting that it is now overdue for the BoE to revise its view of underlying momentum. Certainly, economic activity looks capable of withstanding one or two rate hikes over the near term.

UK: Monthly GDP levels by sector



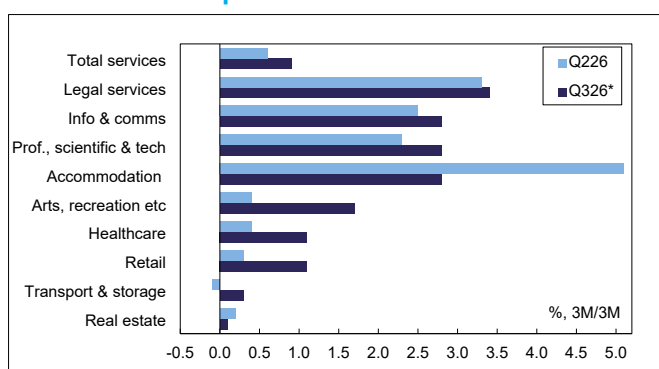
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to GDP growth



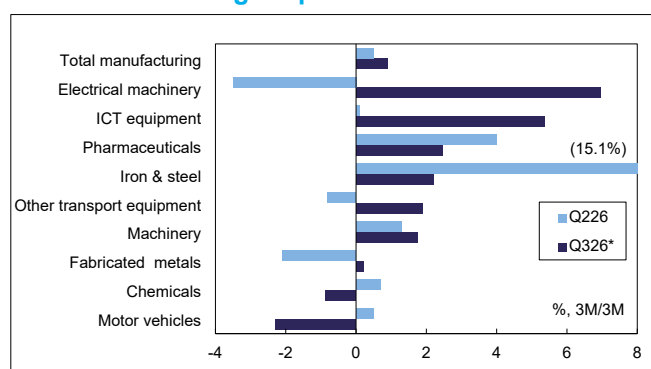
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Services output in selected subsectors



*Q326 figure is based on July & August data. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output in selected subsectors



*Q326 figure is based on July & August data. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

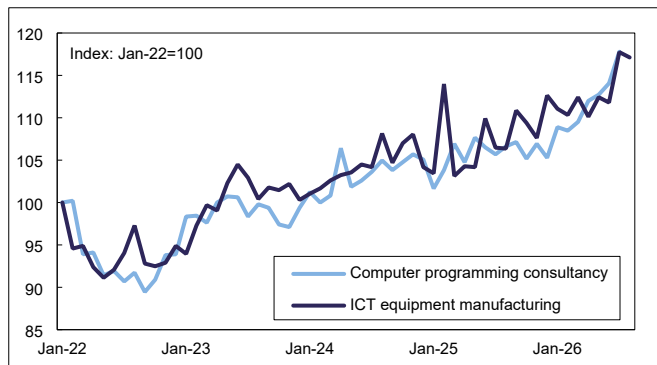
AI-related demand providing a meaningful boost to activity

While services activity was flat in August, weighed by weaker output from consumer-facing sectors, this followed three months of solid growth. As such, services output still accelerated 0.9%3M/3M, matching the fastest pace since January 2022. Moreover, the detail offered further evidence that AI-related activity has become an increasingly important source of UK growth. Computer programming, consultancy and related activities expanded for a sixth consecutive month to stand some 13% above the level at the start of the year and contributed 0.32ppt to three-month GDP growth alone. Scientific R&D activity also rose to its highest level since early 2023, while legal services reached a record high, with those two sectors together adding a further 0.4ppt to quarterly growth. Signs of the AI boost were also evident in manufacturing, where production of electrical equipment rose to the highest level in six months. And while output of ICT equipment slipped back on the month, it was still up 3.5%3M/3M. Together with rebounds in basic metals, pharmaceuticals and motor vehicles, that supported the strongest monthly growth in manufacturing output (1.2%M/M) in nine months. Nevertheless, this merely left factory output trending broadly sideways on a three-month basis, while a drag from the mining sector pushed total industrial production down 0.2%3M/3M. In part reflecting higher building costs and rising mortgage rates, construction activity was weaker still, falling for a fourth successive month in August to be down 1%3M/3M. And new private residential output slumped to the lowest level since late-2015 outside of the first Covid-19 lockdown.

Trade figures suggest that net exports are on track to boost GDP growth in Q3

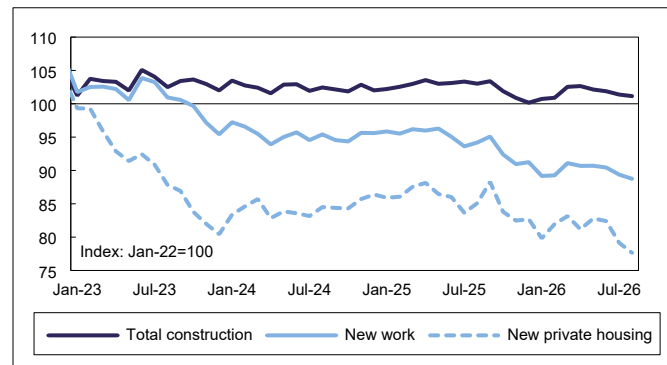
Despite the recent recovery in manufacturing output, the UK's trade performance remained mixed over the summer. Excluding precious metals, underlying goods export values fell £0.9bn (-1.1%M/M) in August, while imports declined a steeper £1.2bn (3.5%M/M). The export weakness was concentrated in trade with the EU, where shipments fell more than 7%M/M, reflecting lower exports of machinery and transport equipment, non-ferrous metals and crude oil. Underlying goods imports also fell back in August in part due to payback for the prior month's surge in machinery and transport equipment imports from outside the EU, associated with strong Chinese car imports. Lower energy prices also weighed on both export and import values. Meanwhile, exports of services slightly outpaced imports for the first month in four, to push the surplus close to a record high. And given increased shipments of precious metals, total export values were broadly flat in August following a sharp rise at the start of Q3. Overall, total exports in July and August were tracking 1% above the Q2 average, while imports were down more than 2%. And adjusting for changes to prices, the data point to the likelihood of a positive contribution from net trade to GDP growth in Q3 after a solid contribution in Q2.

UK: AI-related output



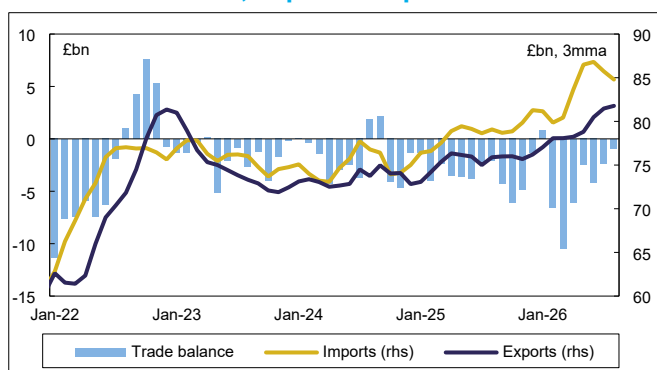
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Construction output



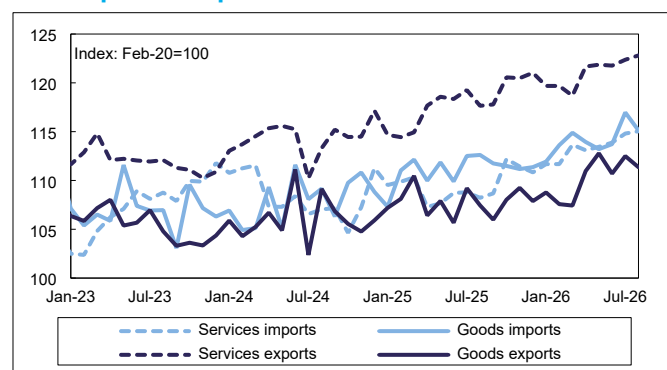
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Trade balance, export & import values



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Export & import volumes*



*Excluding precious metals. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

In the absence of top-tier economic data, UK markets will be left to digest comments from BoE Governor Andrew Bailey at an event in Bangkok on Friday. The further signs of strength in today's GDP data imply that he is unlikely to downplay the likelihood of a hike in November.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Industrial production M/M% (Y/Y%)	Aug	-0.5 (-1.1)	<u>-0.5 (-0.7)</u>	-0.1 (0.0)	-0.3 (-0.3)
France	 Final HICP (CPI) Y/Y%	Sep	3.4 (3.1)	<u>3.4 (3.0)</u>	2.6 (2.4)	-
UK	 Monthly GDP M/M% (3M/3M%)	Aug	0.1 (0.7)	-0.1 (0.5)	0.4 (0.4)	- (0.5)
	 Services output M/M% (3M/3M%)	Aug	0.0 (0.9)	-0.1 (0.7)	0.4 (0.6)	0.5 (0.7)
	 Industrial output M/M% (Y/Y%)	Aug	0.8 (1.6)	-0.1 (0.7)	0.2 (0.6)	0.3 (0.8)
	 Construction output M/M% (Y/Y%)	Aug	-0.2 (-1.8)	0.0 (-2.1)	0.1 (-2.5)	-0.5 (-1.9)
	 Trade (goods trade) balance £bn	Aug	-0.9 (-18.0)	-4.2 (-21.9)	-3.5 (-21.0)	-2.3 (-19.3)

Auctions

Country	Auction
France	 sold €2.041bn of 2.7% 2031 bonds at an average yield of 4.01%  sold €2.337bn of 0% 2031 bonds at an average yield of 4.10%  sold €3.691bn of 3.25% 2032 bonds at an average yield of 4.16%  sold €3.931bn of 3.5% 2033 bonds at an average yield of 4.41%  sold €335mn of 3.15% 2032 inflation-linked bonds at an average yield of 1.83%  sold €570mn of 0.55% 2039 inflation-linked bonds at an average yield of 2.87%  sold €345mn of 1.8% 2040 inflation-linked bonds at an average yield of 2.71%
Spain	 sold €2.4bn of 2.35% 2029 bonds at an average yield of 3.313%  sold €1.841bn of 2.6% 2031 bonds at an average yield of 3.482%  sold €1.195bn of 3.55% 2033 bonds at an average yield of 3.713%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany	 Wholesale prices M/M% (Y/Y%)	Sep	1.9 (8.7)	-	0.9 (6.8)	-
Spain	 Final HICP (CPI) Y/Y%	Sep	5.0 (4.9)	<u>5.0 (4.9)</u>	4.6 (4.3)	-

Auctions

Country	Auction
Germany	 sold €1.141bn of 3.4% 2047 bonds at an average yield of 3.80%  sold €747mn of 2.9% 2056 bonds at an average yield of 3.80%
UK	 sold £5bn of 4.625% 2030 bonds at an average yield of 4.945%

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	Final headline (core) HICP Y/Y%	Sep	<u>3.8 (2.5)</u>	3.2 (2.4)
	 10.00	Trade balance €bn	Aug	-	5.0
Italy	 10.00	Final HICP (CPI) Y/Y%	Sep	<u>4.1 (4.2)</u>	3.2 (3.3)

Auctions and events

UK	 03.00	BoE Governor Bailey to speak in a fireside chat at the IIF annual meetings in Bangkok
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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