Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds were little changed today as financial markets took respite from the post-referendum volatility and the Commission's economic sentiment survey was consistent with expansion in the euro area in Q2.
- Gilts were also little changed as EU leaders made clear that UK access to the Single Market would require acceptance of free movement.
- Datawise, tomorrow brings the flash euro area CPI estimate for June, alongside the final reading of UK Q1 GDP and balance of payments data.

Emily Nicol +44 20 7597 8331

Mantas Vanagas +44 20 7597 8318

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.653	+0.007
OBL 0 04/21	-0.561	-
DBR 0½ 02/26	-0.128	-0.016
UKT 1¼ 07/18	0.201	+0.008
UKT 1½ 01/21	0.452	-
UKT 2 09/25	0.946	-0.016

*Change from close as at 4.30pm BST.
Source: Bloomberg

UK

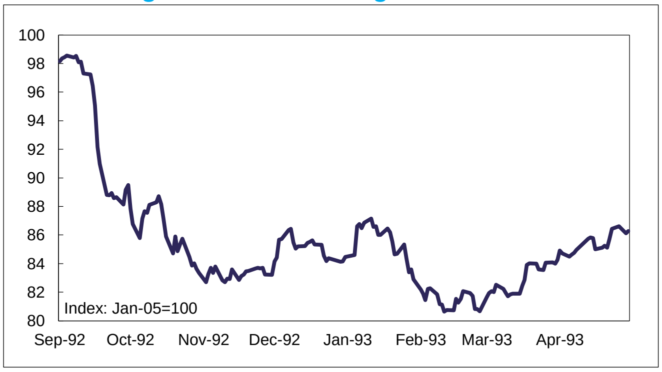
Markets have calmed down for now

After the violence of the moves over the first two trading days following the referendum result, yesterday and today saw some sense of calm being restored in financial markets. However, if history is any indication, downward pressure on sterling might be expected to resume in coming weeks and months. For example, following its ejection from the ERM and initial steep fall, sterling staged a not insignificant rally. But that did not last and the trough (which was about 20% lower against the dollar than where the initial rally occurred and 15% lower in trade-weighted terms) was not reached until five months later. Certainly, uncertainty over the UK's future looks set to be more persistent and profound this time than in the immediate aftermath of the ERM debacle, while the economy seems bound to slip into recession over coming months and remain subject to new shocks for a lengthy period thereafter, with corresponding downside risks for UK assets.

EU leaders set out initial position on future relationship with the UK

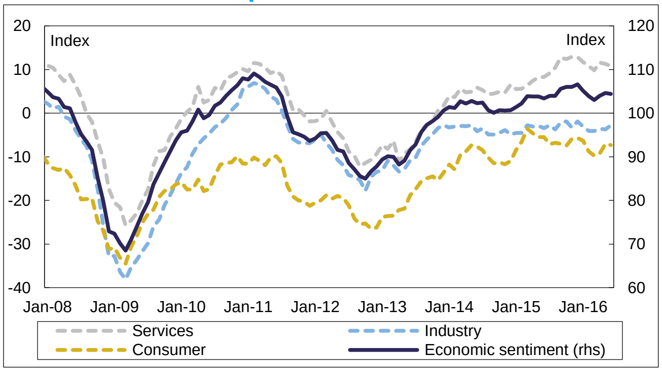
The meeting of the European Council proceeded today without David Cameron or any other UK representative as leaders of the remaining 27 EU member states gathered to discuss the EU's response to the outcome of the referendum. There the first concrete evidence emerged that the UK's path out of the EU will not be as smooth as the Leave camp implied before the referendum. For example, senior EU politicians made clear that the negotiations cannot start until Article 50 is triggered, and that they expect to see this happening very soon after a new Prime Minister is appointed in the UK. In addition, the UK is not going to get any sort of special deal – Single Market access will require the acceptance of all freedoms, including the free movement of people. Both of these positions are, of course, hugely problematic for the Leave side, which has predicated its entire hopes on informal negotiations before triggering Article 50 and being able to maintain Single Market while imposing controls on immigration. So, there is now an impasse, not least as the Conservative Party commences its process to elect a new leader by the start of September. And after that there may well be a snap General Election, delaying further the real work of starting the process of getting the UK out of the EU in earnest and merely prolonging the political uncertainty. All the while, of course, the economy and markets will suffer – yesterday saw Siemens announce that it is suspending a planned £310mn investment in Hull while both Toyota and Honda indicated that there is a good chance that they would eventually leave the UK if Single Market Access is not maintained, a position repeated by Vodafone. This Brexit stuff is probably years away from being resolved.

UK: Sterling effective exchange rate



Source: BoE

Euro area: ESI components



Source: Thomson Reuters, European Commission and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

Tomorrow marks the official start of the Tory leadership election, which will determine who will succeed David Cameron as the next Prime Minister. The full list of candidates will be clear tomorrow after the deadline for posting nominations, with bookmakers making Leave campaign leader Boris Johnson and Remain supporter Theresa May the favourites to make it to the final round of voting among party members. With regard to monetary policy and/or financial stability, BoE Governor Mark Carney is scheduled to make a speech tomorrow at 16.00 BST. On the data front, the final estimate of Q1 GDP looks set to confirm growth of 0.4%Q/Q that quarter. Meanwhile, Q1 current account figures and the GfK consumer confidence survey are also due, with the former likely to have remained a key source of vulnerability at close to £30bn (about 6% of GDP) and the latter likely to show a fall in consumer confidence ahead of the referendum.

Euro area

ESI consistent with ongoing economic expansion in Q2

With various national sentiment surveys having signalled that certain euro area member states had lost some growth momentum at the end of the second quarter, it was no surprise to see the Commission's latest consumer and business confidence surveys report a modest deterioration in June. Indeed, while German consumers were more upbeat about conditions, with the GfK's headline index unexpectedly rising for the third consecutive month to an eleven-month high of 10.1 on the back of the generous recent wage settlement round, the Commission's survey confirmed that overall consumer confidence in the euro area softened slightly at the end of Q2, with the relevant index affirmed at the flash estimate that had fallen 0.3pt to -7.3 in June. And perhaps associated with this weaker consumer sentiment, there were also declines in the retail- and services-related components, with the former at its lowest level in a year, while the latter fell to a three-month low. With firms in the construction sector also less upbeat, it was only thanks to a pickup in the industrial-related component which rose to its highest in six months that the overall Economic Sentiment Indicator (ESI) – which is arguably the most reliable guide to GDP growth in the euro area – didn't fall further. Overall, the euro area ESI fell just 0.2pt in June to 104.4, to leave the average for the second quarter close to that of the previous five quarters and therefore broadly consistent with our view that GDP growth moderated to about 0.3%Q/Q in Q216.

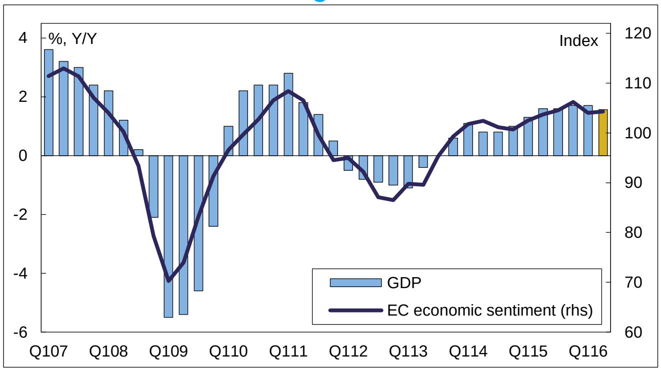
Risks to the near-term outlook skewed to the downside

Of course, this survey was conducted ahead of last week's UK referendum. And we expect the uncertainty generated by that vote to weigh on confidence across the EU in coming months. Indeed, as the UK goes into recession economic growth in the euro area will be affected, most notably via exports and investment. Draghi reportedly informed EU leaders yesterday that he expects the UK's decision to reduce euro area GDP growth by a cumulative 0.3-0.5ppt over the coming three years. We anticipate the direct impact to be somewhat higher at about 0.5-0.75ppt, with a much larger drag to ensue if copycat political instability comes to the fore in the euro area.

German and Spanish inflation rises slightly

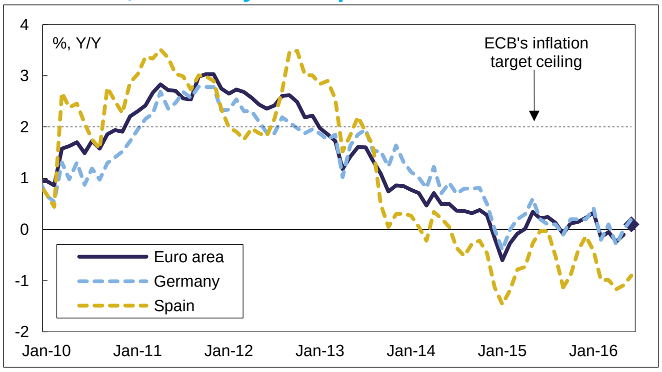
Uncertainties over near-term growth prospects will do little to ease concerns about the weakness of the outlook for inflation, which was anticipated to remain well below the ECB's target over the coming couple of years even ahead of the UK referendum. This notwithstanding, preliminary inflation data out of Germany and Spain today reported a modest pickup at the end of Q2. In particular, the German EU-harmonised CPI rate increased 0.2ppt to 0.2%Y/Y, the highest since January. According to the detail provided with the national measure, CPI was boosted by firmer services inflation, while the annual pace of decline in energy prices moderated to a five-month low. Meanwhile, Spain's EU-harmonised CPI rate also rose

Euro area: ESI and GDP growth*



**Q216 GDP figure is Daiwa forecast.*
Source: Thomson Reuters, ECB and Daiwa Capital Markets Europe Ltd.

Euro area, Germany and Spain: Headline CPI*



**German and Spanish figures are on EU-harmonised basis. Euro area June figure is Daiwa forecast. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

by 0.2ppt to -0.9%Y/Y in June. So, assuming tomorrow's French and Italian data align with expectations of increases of 0.2ppt to 0.3%Y/Y and 0.1ppt to -0.2%Y/Y respectively, we expect the aggregate euro area CPI figure – also due for release on Thursday – to rise 0.2ppt to 0.1%Y/Y the first positive reading since January, with the core CPI rate expected to rise 0.1ppt to 0.9%Y/Y.

The day ahead in the euro area and US

Aside from the aforementioned euro area flash CPI estimate, tomorrow brings German unemployment numbers for June, along with German retail sales and French consumer spending figures for May. Supply-wise, Italy will sell regular and floating-rate bonds. Meanwhile, in the US, it should be a quiet day for economic news with just weekly jobless claims figures due for release, while the Fed's Bullard is due to speak in London.

European calendar

Today's results						
Economic data						
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Economic sentiment indicator	Jun	**104.4**	104.7	104.7	**104.6**
	Services (industrial) sentiment	Jun	**10.8 (-2.8)**	11.0 (-3.4)	11.3 (-3.6)	**- (-3.7)**
	Final consumer confidence	Jun	**-7.3**	-7.3	-7.0	**-**
Germany	GfK consumer confidence survey	Jul	**10.1**	9.8	9.8	**-**
	Preliminary EU-harmonised CPI Y/Y%	Jun	**0.2**	0.2	0.0	**-**
Spain	Preliminary EU-harmonised CPI Y/Y%	Jun	**-0.9**	-1.0	-1.1	**-**
UK	Nationwide house price index M/M% (Y/Y%)	Jun	**0.2 (5.1)**	0.0 (4.9)	0.2 (4.7)	**-**
	Net consumer credit (net lending secured on dwellings) £bn	May	**1.5 (2.8)**	1.5 (2.2)	1.3 (0.3)	**- (0.1)**
	Mortgage approvals `000s	May	**67.0**	65.3	66.3	**66.2**
Auctions						
Country	Auction					
- Nothing to report -						

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	Flash CPI estimate Y/Y%	Jun	*0.1*	-0.1
	10.00	Flash core CPI estimate Y/Y%	Jun	*0.9*	0.8
Germany	07.00	l sales M/M% (Y/Y%)	May	0.6 (2.5)	-0.3 (2.3)
	08.55	Unemployment change `000s (rate %)	Jun	-5 (6.1)	-11 (6.1)
France	07.45	Preliminary EU-harmonised CPI Y/Y%	Jun	0.3	0.1
	07.45	Consumer spending M/M% (Y/Y%)	May	0.0 (2.5)	-0.1 (2.5)
Italy	10.00	Preliminary EU-harmonised CPI Y/Y%	Jun	-0.2	-0.3
Spain	08.00	Current account balance €bn	Apr	-	0.8
UK	00.05	GfK consumer confidence survey	Jun	*-3*	-1
	09.30	GDP – third release Q/Q% (Y/Y%)	Q1	*0.4 (2.0)*	0.6 (2.1)
	09.30	Index of services M/M% (3M/3M%)	Apr	0.2 (0.4)	-0.1 (0.6)
	09.30	Current account balance £bn	Q1	-28.0	-32.7

Auctions and events		
Country	BST	Auction / Event
Italy	10.00	Auction: To sell up to €2.5bn of 0.45% 2021 bonds (01-Jun-2021)
	10.00	Auction: To sell up to €2.5bn of 1.6% 2026 bonds (01-Jun-2026)
	10.00	Auction: To sell up to €1.75bn of 2023 floating-rate bonds (15-July-2023)s
UK	16.00	BoE Governor Carney due to give speech at BoE

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope