Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds were little changed as euro area CPI rose back above zero while late reports suggested the ECB is considering relaxing the rules governing its QE programme to ensure it can meet its purchase targets.
- Gilts made gains, with 10Y yields below 90bps for the first time, as Carney stated that the BoE will probably ease monetary policy over the summer.
- Tomorrow brings final manufacturing PMIs for June from various euro area member states and the UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.651	+0.002
OBL 0 04/21	-0.561	-0.003
DBR 0½ 02/26	-0.131	-0.005
UKT 1¼ 07/18	0.121	-0.090
UKT 1½ 01/21	0.375	-0.082
UKT 2 09/25	0.892	-0.057

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

UK

Political drama ramps up further

The political vacuum at the top of Government remains a long way from being filled. Today's launch of bids for the leadership of the ruling Conservative Party laid bare the disarray in the pro-Leave camp, with Michael Gove launching his own campaign, while Boris Johnson, whose celebrity status had been instrumental in helping the Leave side win the referendum and had previously been considered bookmakers' favourite for the job, pulling out of the race. Gove – seemingly with the backing of notorious "*powers that be"* within the media – decided that Johnson doesn't have what it takes to be Prime Minister (something that most sane commentators have realised for years), so threw his own hat into the ring (despite having previously said that he himself is less equipped than even Gordon Brown was to be PM).

But the front runner now seemingly is current Home Secretary Theresa May. While she was nominally in favour of remaining in the EU, she hardly spoke at all during the referendum campaign. And at her leadership campaign launch today she made all of the right noises to attract pro-Leave MPs and Tory Party members, arguing that, under her leadership, there would be no going back on leaving the EU and that ending free movement of workers would not be negotiable. At the same time, however, she said that she would not invoke Article 50 until the UK's position is clear, suggesting that it might not be invoked this year, and possibly not until well into next. At the same time she claimed to rule out a snap General Election which, if she does win in early September, would perhaps remove one further possible political uncertainty to add to the already large mountain of them facing the UK. But that would also mean that she would face a House of Commons composed of at least two-thirds of members that are against leaving the EU. Coupled with growing legal opinion that triggering Article 50 will require the assent of Parliament, that raises the possibility that, while MPs are still likely to permit Article 50 being triggered given the result of the referendum, their full endorsement may well come wrapped in all sorts of conditionality, possibly including the requirement for a full government paper to be prepared setting out its negotiating aims and perhaps even the possibility of holding a second referendum when the details of any deal are known.

Economy did OK in run up to referendum…

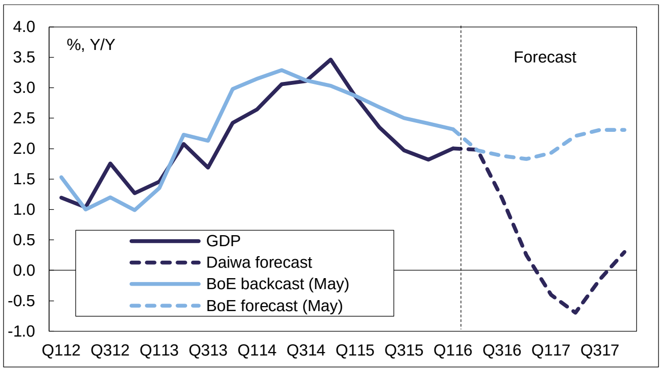
All the while the political uncertainty remains so elevated, the more the economy will be suffering. It actually looks as though the economy went into the referendum in not too bad shape. While the final Q1 GDP figures today confirmed growth of 0.4%Q/Q, down from 0.7%Q/Q at the end of 2015, economic data for the months leading up to the EU referendum have generally been firmer than expected. Indeed, figures from the services sector, also released today, showed a 0.6%M/M increase in activity in April, leaving the three-month on three-month growth rate falling by just 0.1ppt to 0.5%. We expect growth to have been unchanged at 0.4%Q/Q in Q2 as a whole.

UK Economic forecasts

		Q216	Q316	Q416	2016	2017
GDP growth (%, Y/Y)	Daiwa	2.0	1.2	0.2	1.4	-0.2
	BoE*	2.0	1.9	1.8	2.0	2.3
CPI inflation (%, Y/Y)	Daiwa	*0.3*	*0.7*	*1.2*	*0.7*	*2.1*
	BoE*	*0.4*	*0.8*	*0.9*	*0.6*	*1.5*

**May 2016 Inflation Report.*
Source: BoE and Daiwa Capital Markets Europe Ltd..

UK: GDP forecasts



Source: BoE and Daiwa Capital Markets Europe Ltd.

…but outlook grim

However, the economic outlook has been transformed markedly for the worse by the referendum result. There are any number of reasons to expect a much weaker growth profile and recession in the coming quarters. We expect a sharp contraction in investment due to the hit on business confidence and significantly lower consumption growth as real incomes get squeezed both by rising inflation resulting from the sharp depreciation in sterling (which we expect to fall further from here) but also rising unemployment as firms adjust workforces downwards. And while net trade will benefit from falling imports on the back of the drop in domestic demand, weaker sterling is unlikely to boost exports significantly, not least given the uncertainty over the UK's future trading arrangements. Against this backdrop, we see GDP shrinking by 0.4%Q/Q in Q3, followed by contractions in both Q4 and Q117. And while we expect growth to return thereafter, it will be lacklustre, weighed down by continued political uncertainty and downward pressure on real incomes. Despite the anticipated weaker growth, we have nonetheless raised our inflation forecast to reflect the impact of the fall in sterling. We now expect inflation to rise back above the BoE's target in the second quarter of next year (see table for full forecast). But, as Mark Carney indicated in a hastily-arranged speech today, the BoE will ignore this one-off shock, instead concentrating on the demand hit, and loosening policy accordingly, cutting Bank Rate aggressively (but possibly not to zero), probably as soon as next month. And he also indicated that in August, when the MPC will have a new full set of forecasts, further policy action could occur then, presumably via an increase in asset purchases.

Current account leaves sterling vulnerable

The risks to our forecast are weighted to the downside. In particular the political uncertainty could have a bigger impact on investment than we anticipate. This is particularly true for investment from overseas, where uncertainty about whether the UK will continue to maintain access to the Single Market, a key reason why the UK has the second largest stock of foreign direct investment in the world, is likely to see firms freeze investment plans. That would obviously be bad for growth. But, as other data today showing that the UK ran a current account deficit of 6.9% of GDP in Q1 demonstrated, it is also potentially dangerous for sterling given the UK's need for large inflows of foreign capital to pay its way. When added to the fact that political risk has risen sharply, expectations about the future path of sterling have become more negative and interest rates have fallen, attracting the required foreign capital is going to be much more difficult post-referendum. That, we think, points to a further required downward adjustment in sterling, which we see falling a further 10% at least over coming months.

The day ahead in the UK

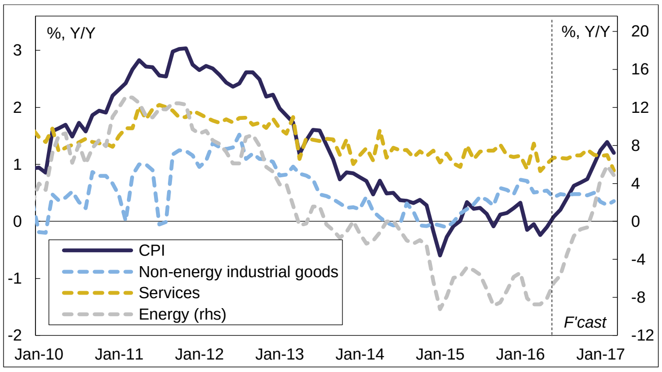
The end of the week sees the release of manufacturing PMI for June. The survey was conducted before the EU referendum and, therefore, it will not reflect the first business reaction to the Brexit vote. Nevertheless, the headline indicator is likely to have remained low, only slightly above 50.

Euro area

Inflation back above zero

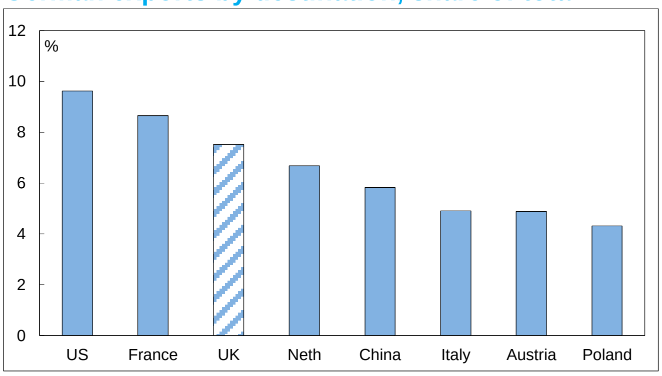
As we expected, according to today's flash estimate, euro area CPI rose 0.2ppt to 0.1%Y/Y in June, the highest since January. The increase was partly due to movements in the oil price, which reached a seven-month high earlier in the month, and so energy prices fell at their lowest annual rate since the start of the year. Services inflation ticked up 0.1ppt to 1.1%Y/Y, the highest since March. But inflation of non-energy industrial goods fell 0.1ppt to a nine-month low of 0.4%Y/Y. And so, while the narrowest core measure of inflation (which excludes energy, food, alcohol and tobacco prices) edged higher to a three-month

Euro area: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

German exports by destination, share of total*



**Twelve months to February 2016.*
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

high, at just 0.9%Y/Y it remained consistent with an absence of any meaningful price pressure. And with euro area economic growth likely to be slightly weaker than over recent quarters as Brexit uncertainty weighs, although we expect headline CPI to rise close to 1%Y/Y by year-end as the impact of past declines in energy prices eventually wear off, we also expect it to remain below 1.5%Y/Y throughout 2017 as services and non-energy goods price inflation remains subdued.

German economic growth to lose momentum on Brexit uncertainty

The latest German economic data suggested again that the euro area's largest member state was in relatively good shape before the referendum result. Retail sales rose more than expected in May, up 0.9%M/M in May following a shallower dip than previously thought in April of 0.3%M/M. That still left average sales in the first two months of Q2 still some 0.6% below the Q1 average, consistent with a notable softening of growth in consumer spending and GDP in the second quarter following a strong start to the year. Nevertheless, with unemployment falling further in June to a new post-reunification low and recent wage settlements relatively generous, we expect consumer spending to resume its role as the principal driver of German economic growth in coming quarters. However, with Germany's business confidence typically highly sensitive to global economic risks, and the UK accounting for about 7½% of its goods exports – the third highest of all countries after the US and France – we expect the contribution to GDP growth from business investment and net trade to weaken over the near term. And so, we have revised down our full-year German economic growth forecasts to below 1½% in both 2016 and 2017.

The day ahead in the euro area and US

The week will end with the final manufacturing PMIs for June: according to the flash estimate, the euro area headline manufacturing PMI rose 1.1pts to a six-month high of 52.6, leaving the average for Q2 at 51.9, a touch firmer than in Q1. May unemployment data are also due for release and expected to show a further 0.1ppt drop in the euro area jobless rate to 10.1%, the lowest since July 2011. In the US, the June manufacturing ISM indices and May construction spending data are due.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Flash CPI estimate Y/Y%	Jun	**0.1**	*0.1*	-0.1	**-**
	Flash core CPI estimate Y/Y%	Jun	**0.9**	*0.9*	0.8	**-**
Germany	Retail sales M/M% (Y/Y%)	May	**0.9 (2.6)**	0.6 (2.5)	-0.9 (2.3)	**-0.3 (2.7)**
	Unemployment change `000s (rate %)	Jun	**-6 (6.1)**	-5 (6.1)	-11 (6.1)	**-**
France	Preliminary EU-harmonised CPI Y/Y%	Jun	**0.3**	0.3	0.1	**-**
	Consumer spending M/M% (Y/Y%)	May	**-0.7 (2.2)**	0.0 (2.5)	-0.1 (2.5)	**- (2.8)**
Italy	Preliminary EU-harmonised CPI Y/Y%	Jun	**-0.3**	-0.2	-0.3	**-**
Spain	Current account balance €bn	Apr	**2.6**	-	0.8	**0.9**
UK	GfK consumer confidence survey	Jun	**-1**	*-3*	-1	**-**
	GDP – third release Q/Q% (Y/Y%)	Q1	**0.4 (2.0)**	*0.4 (2.0)*	0.6 (2.1)	**-**
	Index of services M/M% (3M/3M%)	Apr	**0.6 (0.5)**	0.2 (0.4)	-0.1 (0.6)	**-0.3 (-)**
	Current account balance £bn	Q1	**-32.6**	-28.0	-32.7	**-34.0**

Auctions

Country	Auction
Italy sold	€2.5bn of 0.45% 2021 bonds (01-Jun-2021) at an average yield of 0.33%
	€2.5bn of 1.6% 2026 bonds (01-Jun-2026) at an average yield of 1.35%
	€1.75bn of 2023 floating-rate bonds (15-July-2023) at an average yield of 0.57%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Final manufacturing PMI	Jun	52.6	51.5
		10.00	Unemployment rate %	May	10.1	10.2
Germany		08.55	Final manufacturing PMI	Jun	54.4	52.1
France		08.50	Final manufacturing PMI	Jun	47.9	48.4
Italy		08.45	Manufacturing PMI	Jun	52.4	52.4
		09.00	Unemployment rate %	May	11.7	11.7
Spain		08.15	Manufacturing PMI	Jun	52.0	51.8
UK		09.30	Manufacturing PMI	Jun	50.1	50.1

Auctions and events			
Country		BST	Auction / Event
EMU		08.15	ECB's Cœuré scheduled to speak in Paris

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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