Euro wrap-up

Overview

- Bunds made losses as investors took respite from recent concerns about Italian banks and post-UK referendum uncertainty.
- Gilts made losses as investors welcomed the reduction in political uncertainty following yesterday's confirmation of Theresa May as the next UK Prime Minister.
- Tomorrow brings euro area industrial production data for May, along with June's final CPI estimates from France, Italy and Spain.

Economic Research Team
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.670	+0.025
OBL 0 04/21	-0.579	+0.035
DBR 0½ 02/26	-0.094	+0.074
UKT 1¼ 07/18	0.186	+0.033
UKT 1½ 01/21	0.415	+0.055
UKT 2 09/25	0.824	+0.065

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

Euro area

Italian IP disappoints, while French business sentiment remains subdued

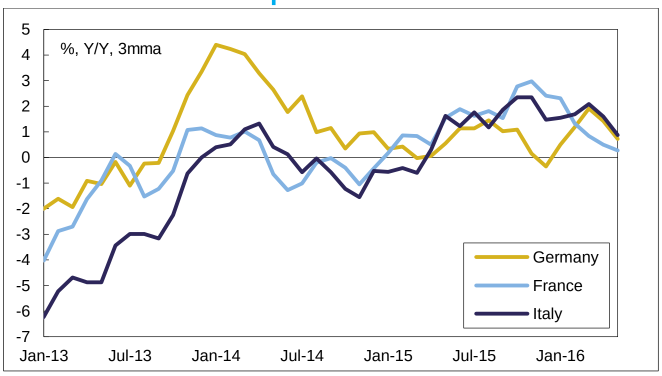
Following the disappointing May industrial production releases from Germany and France last week, the equivalent figures from Italy also came in on the soft side, with industrial output down 0.6%M/M. And with the increase in Italian IP in April a touch weaker than previously thought, the annual pace of decline (0.4%Y/Y) was the steepest since the start of 2015. Within the detail, the weakness was principally driven by a near-2%M/M drop in capital goods production, to leave the average over the first two months of the second quarter down more than 2% compared with the average in Q1 and raising some concerns over the near-term outlook for business investment. Production of intermediate and consumer goods also slipped back in May. And given the further contraction in energy output, total industrial output was on average in the first two months of Q2 0.1% lower than the average in Q1, suggesting that the sector might well have been a drag on economic growth in the second quarter. So, taken together with data from the other larger member states, we now expect Friday's release of aggregate euro area IP to report a monthly decline of about 1%M/M, which would represent the third drop out of the past four months and almost fully reverse the increase in April.

Meanwhile, the Bank of France business sentiment survey suggested that economic conditions in that country were broadly unchanged at the end of the second quarter with sub-par readings from each of the main sectors. In particular, the manufacturing-related index was unchanged at 97 in June, while the construction-related index was similarly unchanged on the month at 94. However, the services-related component edged down by 1pt to 97, with accommodation and food-related activity reportedly subdued despite the football-related rise in tourism that month. Overall, the Bank of France assessed that its indicators were consistent with French GDP growth of 0.2%Q/Q in Q2, bang in line with our own forecast.

Fiscal fines for Spain and Portugal?

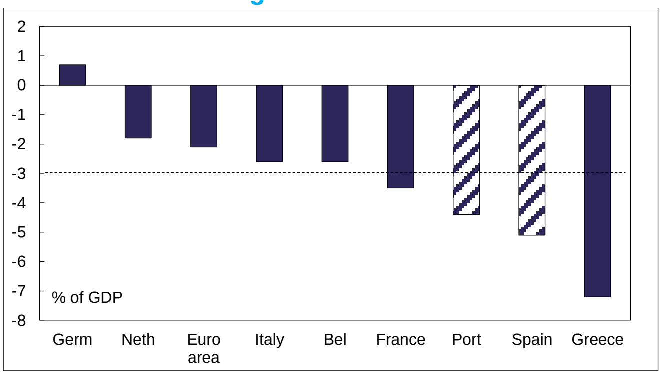
Policy-wise, today saw attention shift away from concerns about Italian banks – on which there remains no agreement on how to resolve problems of inadequate capital and excess NPLs – to fiscal matters elsewhere in Southern Europe, as the ECOFIN Council of EU Finance Ministers concluded that Portugal and Spain had not taken effective action over the past year to 'correct their excessive deficits'. Indeed, in both countries in 2015 the general government deficit remained well above the Stability and Growth Pact limit of 3% of GDP: in Portugal it reached almost 4½% of GDP while – arguably hindered by the government's lack of a parliamentary majority – in Spain it remained over 5% of GDP. And given the respective governments' repeated failures over recent years to reduce their fiscal deficits according to the targets agreed by the other Ministers, today's decision has scope to trigger sanctions, representing the first occasion outside of a bailout programme whereby the

Euro area: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: General government balance in 2015



Source: European Commission

Follow one of the WSJ's top 50 financial twitter feeds @DaiwaEurope

EU's fiscal rules could bind on a member state with any meaningful consequence. The Commission now has twenty days to recommend imposing fines, which can amount to as much as 0.2% of GDP. But Portugal and Spain can then submit 'reasoned requests' within ten days for a reduction of the fines proposed, and then the other Finance Ministers subsequently will have a further ten days to consider and then vote on whether to approve the fines. There are good political and macroeconomic reasons why this circuitous process is likely to conclude with no meaningful fines imposed. Indeed, the Slovakian Finance Minister, who currently holds the ECOFIN Presidency, suggested that we should expect 'a smart, intelligent result', which might imply an eventual agreement to impose mere symbolic fines amounting to zero.

The day ahead in the euro area and US

Aside from the aforementioned euro area industrial production release, tomorrow brings final estimates of French, Spanish and Italian CPI for June. After final German figures today affirmed that EU-harmonised CPI increased 0.2ppt to a five-month high of 0.2%Y/Y, the equivalent French and Spanish CPI rates are also expected to confirm an increase of 0.2ppt to 0.3%Y/Y and -0.9%Y/Y respectively, while Italian CPI is forecast to be unchanged at -0.3%Y/Y. Supply-wise, Germany will sell 10Y bonds, while Italy will sell bonds with various maturities.

In the US, Wednesday brings the Fed's latest Beige Book, the Federal monthly budget statement and import price figures for June. In the UST market, a 30Y bond auction will be conducted.

UK

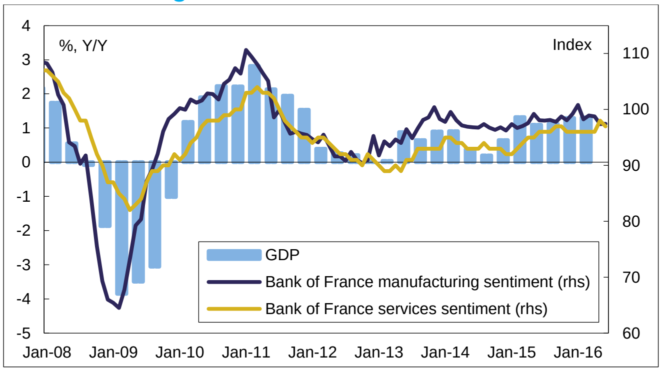
Uncertainty is set to remain high beyond May's appointment

While the confirmation that Theresa May will become Prime Minister on Wednesday evening provided some reassurance to financial markets by reducing one source of near-term political uncertainty, there remain countless key unknowns that will weigh heavily on the UK economy for the foreseeable future. While May sought to downplay speculation of a snap general election, such a plebiscite cannot be ruled out, not least since it might be convenient for the Tories to exploit the more severe leadership crisis in the (main opposition) Labour party. And while she reiterated that Article 50 would not be triggered this year to set in train the process for the UK's departure from the EU, May still insisted once again that 'Brexit means Brexit' and that the process would be launched before too long. So, lack of clarity about the future relationship between the UK and EU will last for several quarters and perhaps years to come, acting as a major disincentive to business investment. Evidence of the immediate hit to UK economic activity will likely become increasingly clear over coming months, and the weakness should be expected to be prolonged and painful.

Carney defends the BoE independence

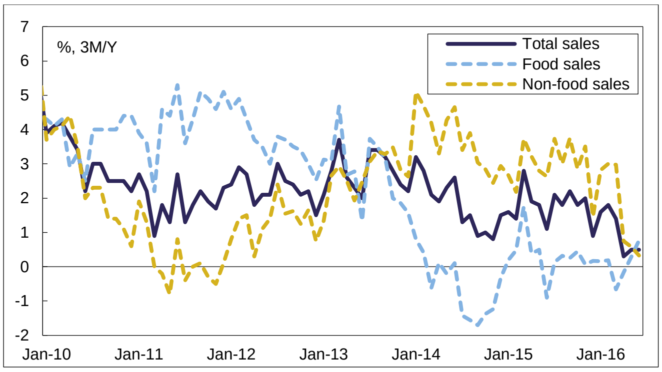
Ahead of Thursday's monetary policy announcement, today saw senior BoE officials, including Governor Carney, testify before the Treasury Select Committee on financial stability issues. The most heated exchanges related to Brexiteers' accusations of a lack of impartiality on the part of the BoE ahead of the referendum. Rightly, Carney and other FPC members firmly rejected claims made by a number of Leave campaigners that the BoE breached its independence by identifying Brexit as one of the major economic and financial risks ahead of the vote, with subsequent events confirming its analysis. Nevertheless, officials continued to suggest that UK banks are in a much stronger position than previously to withstand economic shocks, and the decision announced by the FPC last week to reduce the counter-cyclical capital buffer to zero might free up to £150bn for lending to the economy. But while he gave no explicit clues as to what to expect at Thursday's meeting, Carney hinted that the MPC might be ready to take action – presumably via a rate cut – to increase loan demand and ensure that the additional capital is put into use. Certainly, we expect Thursday to bring a cut of at least 25bps in Bank Rate to 0.25% or below.

France: GDP growth and business sentiment



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

UK: BRC-KPMG Retail sales monitor



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

Retail sales growth moderated before the referendum

With regard to new economic data, today's BRC-KPMG retail sales monitor, which principally reflected responses given before the referendum, suggested that even ahead of the vote consumers were much more cautious with their spending. In particular, on this survey's measure, retail sales increased by just 0.2%Y/Y in June, down from growth of 1.4%Y/Y in May and significantly below this year's average of 1.0%Y/Y. Over the second quarter as a whole, sales were up 0.5%3M/Y, down from growth of 1.4%3M/Y in Q1 and the softest quarterly pace since 2008. Like-for-like sales fell by 0.5%Y/Y in June, to leave them down 0.3%3M/Y, the softest quarterly reading since Q314. And looking ahead, given the significant deterioration in consumer confidence in the immediate aftermath of the referendum vote, the hit to retail spending looks set to be much more significant over coming months.

The day ahead in the UK

Wednesday should be a relatively quiet day for new economic data, with only the BoE's Credit Conditions Survey for Q2 – which was conducted before the referendum – due for release.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
Germany	Final EU-harmonised CPI Y/Y%	Jun	**0.2**	0.2	0.0	**-**
UK	BRC sales like-for-like Y/Y%	Jun	**-0.5**	-	0.5	**-**

Auctions

Country	Auction
UK sold	£0.5bn of 4% 2060 bonds (22-Jan-2060) at an average yield of 1.442%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	ECB QE net purchases €bn	Weekly	**16.1**	*18.5*	9.7	**-**
France	Bank of France manufacturing sentiment indicator	Jun	**97**	97	97	**-**
Italy	Industrial production M/M% (Y/Y%)	May	**-0.6 (-0.6)**	0.1 (1.1)	0.5 (1.8)	**0.4 (-)**

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	Industrial production M/M% (Y/Y%)	May	-0.8 (1.3)	1.1 (2.0)
France	07:45	Final EU-harmonised CPI Y/Y%	Jun	0.3	0.1
Italy	09:00	Final EU-harmonised CPI Y/Y%	Jun	-0.3	-0.3
Spain	08:00	Final EU-harmonised CPI Y/Y%	Jun	-0.9	-1.1

Auctions and events		
Country	BST	Auction / Event
Germany	10:30	Auction: To sell €5bn of 2026 bonds (15-Aug-2026)
Italy	10:00	Auction: To sell up to €2bn of 0.1% 2019 bonds (15-Apr-2019)
	10:00	Auction: To sell up to €2.5bn of 0.95% 2023 bonds (15-Mar-2023)
	10:00	Auction: To sell up to €1.25bn of 1.65% 2032 bonds (01-Mar-2032)
	10:00	Auction: To sell up to €1.75bn of 2.25% 2036 bonds (01-Sep-2036)
UK	09:30	BoE publishes Credit Conditions Survey Q2 2016
	10:30	Auction: To sell £1.25bn of 0.125% 2026 index-linked bonds (22-Mar-2026)

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

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited in the European Union, Iceland, Liechtenstein, Norway and Switzerland. Daiwa Capital Markets Europe Limited is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange and Eurex Exchange. Daiwa Capital Markets Europe Limited and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of Daiwa Capital Markets Europe Limited and its affiliates may have positions and effect transactions in such securities or options and may serve as Directors of such issuers. Daiwa Capital Markets Europe Limited may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended for investors who are not Retail Clients in the United Kingdom within the meaning of the Rules of the FCA and should not therefore be distributed to such Retail Clients in the United Kingdom. Should you enter into investment business with Daiwa Capital Markets Europe's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

Daiwa Capital Markets Europe Limited has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory. Regulatory disclosures of investment banking relationships are available at https://daiwa3.bluematrix.com/sellside/Disclosures.action.