

Euro wrap-up

Overview

- Bunds were little changed as a survey signalled a notable deterioration in investor expectations regarding the euro area economic outlook.
- Gilts were also little changed despite an upside surprise to the latest UK inflation figures.
- Wednesday's data focus will be euro area consumer confidence and the UK labour market.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.646	+0.004
OBL 0 04/21	-0.564	-0.002
DBR 0 08/26	-0.030	-0.013
UKT 1¼ 07/18	0.173	+0.003
UKT 1½ 01/21	0.392	-0.012
UKT 2 09/25	0.807	-0.019

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

Euro area

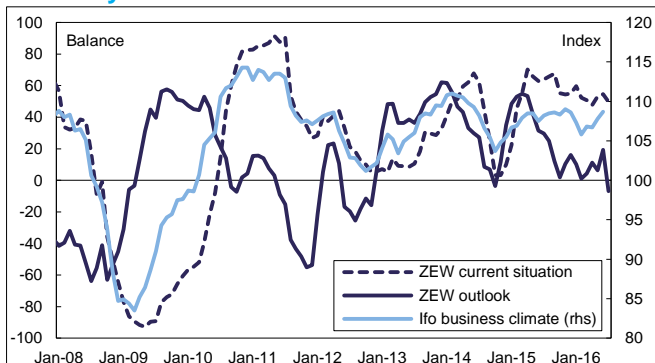
Investors pessimistic about the outlook

The first of the euro area sentiment surveys focussed solely on the period following the UK referendum result – the ZEW survey of investor sentiment released today – signalled a significant knock to confidence with respect to the economic outlook. According to this survey, investors' assessment of current conditions in the euro area declined slightly to the lowest level in a year, while their assessment of current conditions in Germany slipped to the second lowest in seventeen months, albeit still a level consistent with ongoing steady expansion. However, the declines in the indices of expected future conditions were more marked, with the German measure posting the largest monthly drop since the euro crisis to the lowest level since late 2012, and the euro area figure plummeting by the most in any single month on the series to the lowest level since the peak of the euro crisis and middle of the recession four years ago. Perhaps reassuringly given their more limited deterioration, the ZEW current conditions indices typically provide a more reliable guide to economic growth than the outlook measures, and so there is no need to panic. We expect the other major euro area surveys, such as the Commission's flash consumer confidence index (due tomorrow) and the flash PMIs (due Friday) similarly to show a deterioration in household and business sentiment, albeit not to such a dramatic extent, to suggest a slowing of economic growth (rather than recession) in the second half of 2016.

Bank lending conditions ease further

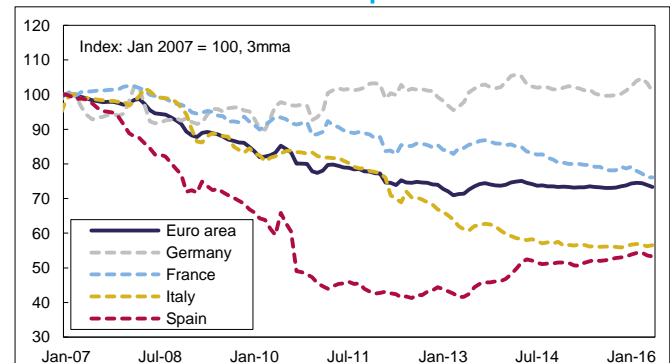
Replies to the latest ECB bank lending survey, also released today, were submitted both before and after the UK referendum, and so the full results might not accurately reflect current conditions. Nevertheless, the ECB might take some heart from their findings that supply conditions for loans to businesses and households continued to improve over the past quarter. However, the detail of the survey suggested some cause for caution with competitive pressures by far the principal cause of easier credit conditions and one consequence being a further narrowing of margins for banks. Moreover, while loan demand was also reported to have increased further, the main contributing factor with respect to lending to businesses was M&A activity, with the contribution of fixed investment declining again. While banks' access to debt markets and securitisation improved, their access to money markets deteriorated. And banks reported that they were responding to regulatory changes by, among other things, reducing exposures to riskier loans. Overall, the survey suggested that recent modest bank lending growth – approximately 1½%Y/Y in May – is set to be maintained, with risks now perhaps biased to the downside to match the skew in economic risks related to Brexit and heightened concerns about Italian banks.

Germany: Business confidence indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.



Construction output likely contracted in Q2

Finally, in terms of 'hard' data, today's construction numbers added to evidence of a weaker second quarter for economic growth. With retail sales and industrial output figures having already signalled subdued activity in April and May, today's figures revealed a fourth consecutive decline in construction output in May. In particular, the drop of 0.5%M/M, reflecting declines in each of the three largest member states and in civil engineering and building activity alike, left the average level of construction output in Q2 so far down 1.75% from Q1 suggesting strongly that the sector subtracted from euro area economic growth in Q216 for the first time in three quarters. Looking through the month-to-month volatility, however, the broad trend in the sector remains effectively flat, just as it has been for the past four years (see chart).

The day ahead in the euro area and US

As the latest ECB Governing Council meeting gets underway, Wednesday will bring the Commission's flash estimate of euro area consumer confidence in July together with the region's balance of payments figures for May. Consumer confidence is expected to fall back close to the average level for the first half of the year suggesting ongoing moderate growth in household spending, while the euro area's current account surplus is expected to slip back from April's record high of more than €36bn. Additionally, in the bond markets, Germany will sell 5Y Bunds. In the US, it will be a quiet day with no top-tier economic data due for release and no UST auctions scheduled.

UK

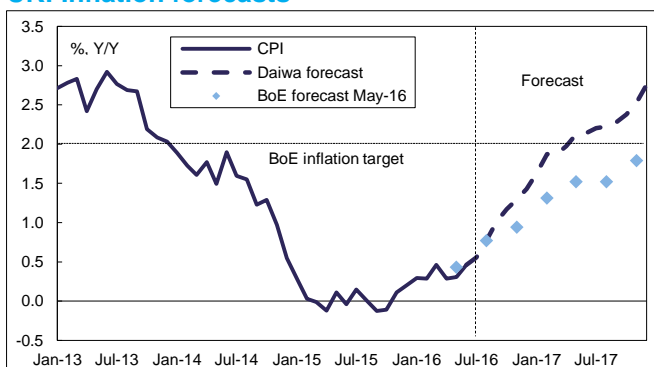
Inflation is set to rise above the 2% target next year

Exceeding expectations, today's CPI figures for June showed that inflation increased 0.2ppt to 0.5%Y/Y to equal its highest level since the end of 2014. The core rate increased by the same margin, to 1.4%Y/Y. The biggest contribution to inflation in the latest month came from transport, and, in particular, air fares, which showed the steepest May-June increase on record of 10.9%M/M. Air fares and other transport prices tend to be very volatile, and therefore, they seem likely at some point, at least in part, to reverse, exerting some downward pressure on the CPI. However, given the sharp depreciation in sterling since the referendum, the outlook for inflation has now changed fundamentally and, looking ahead, that effect on higher import prices looks set to dwarf all other movements in specific CPI items. Against this backdrop, and notwithstanding the fact that we expect GDP to fall over the near term, we now expect inflation to rise towards 1.5%Y/Y by the end of this year, and then exceed the BoE's target of 2.0%Y/Y in Q217. And if sterling depreciates further in line with our expectations, CPI inflation will be on track to exceed 3.0%Y/Y at some point, most likely in 2018.

House price growth remained steady before the EU vote

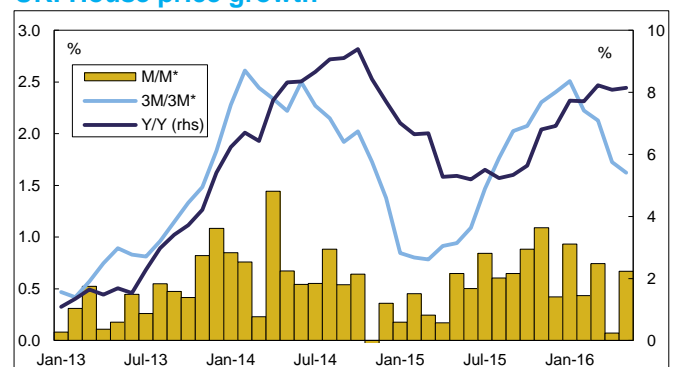
While Brexit risks have been quick to crystallize in funds related to the commercial real estate sector, and last week's RICS survey suggested some impact already on transactions and price expectations in the residential property market, it is likely to be some time before the full impact on house prices feeds through. Indeed, despite the marked increase in Stamp Duty tax on higher value properties the previous month, and uncertainty ahead of the referendum, today's ONS/Land Registry index suggested that momentum in the housing market was firm and steady in May. Indeed, house price inflation remained at 8.1%Y/Y, only a touch below the sixteen-month high of 8.2%Y/Y reached in March. And despite the expectations of near-term house price falls reported in the RICS survey, certain other evidence suggests that the impact of Brexit on the market so far has been far from catastrophic. According to Rightmove data compiled from both pre- and post-referendum periods, house asking prices fell by 0.9%M/M in the latest month, not dramatically out of line from changes in the same month in recent years

UK: Inflation forecasts



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

UK: House price growth*



*Seasonally adjusted.





Source: Land Registry, ONS and Daiwa Capital Markets Europe Ltd.

although this still left the annual rate at 4.5%Y/Y, the lowest in more than a year. And quoted agents suggested a return to business-as-usual after the referendum. We are not quite so sanguine and believe that the RICS survey likely reflects the more reliable guide to the housing market, which seems more likely to deteriorate as other sectors of the economy weaken. In that respect, yesterday's Deloitte CFO survey – which reported that optimism among large firms worsened markedly after the Brexit vote with more than 80% of respondents suggesting they plan to cut back on investment and recruitment – does not augur well.

The day ahead in the UK

The flow of major UK economic data continues tomorrow with the latest figures from the labour market. Not least given the high uncertainty ahead of the EU referendum, employment growth in May looks set to have been little changed from the rather moderate 55k3M/3M rate in April to leave the headline three-month unemployment rate at 5.0% for a third consecutive month. Wages growth is expected to pick up, with headline average weekly earnings expected to have increased by 2.3%3M/Y, up from 2.0%3M/Y in April albeit still well down on the peak rate of 3.0%3M/Y recorded last year.



European calendar

Today's results						
Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Construction output M/M% (Y/Y%)	May	-0.5 (-0.8)	-	-0.2 (-0.4)	-0.3 (-1.0)
Germany	 ZEW current assessment balance (expectations)	Jul	49.8 (-6.8)	51.8 (9.0)	54.5 (19.2)	-
UK	 CPI (core) Y/Y%	Jun	0.5 (1.4)	<u>0.4 (1.2)</u>	0.3 (1.2)	-
	 House Price Index Y/Y%	May	8.1	<u>7.5</u>	8.2	8.1
Auctions						
Country	Auction					
- Nothing to report -						

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
EMU	 ECB QE net purchases €bn	Weekly	16.3	17.0	16.1	-
UK	 Rightmove house price index M/M% (Y/Y%)	Jul	-0.9 (4.5)	-	0.8 (5.5)	-

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/ <i>Daiwa forecast</i>	Previous
EMU	09:00	Current account balance €bn	May	-	36.2
	15:00	Preliminary consumer confidence	Jul	-8.0	-7.3
Italy	09:30	Current account balance €bn	May	-	4.7
UK	09:30	Average earnings incl. bonuses (excl. bonuses) 3M/Y%	May	2.2 (2.3)	2.0 (2.3)
	09:30	ILO unemployment rate 3M%	May	5.0	5.0
	09:30	Employment change 3M/3M '000s	May	60	55
	09:30	Claimant count rate % (changed 000s)	Jun	2.2 (4.0)	2.2 (-0.4)

Auctions and events

Country	BST	Auction / Event
Germany	10:30	Auction: To sell €5bn of 2021 zero-coupon bonds (08-Oct-2021)
UK	10:30	Auction: To sell £1.5bn of 4.25% 2039 bonds (07-Sept-2039)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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