Euro wrap-up

Overview

- Bunds were little changed as the ECB left policy unchanged.
- Gilt yields were also little changed as one external member of the BoE's MPC suggested that she was in no hurry to ease monetary policy.
- Friday brings flash July PMIs from the euro area, Germany, France, and, most notably, the UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.621	+0.005
OBL 0 10/21	-0.492	+0.006
DBR 0 08/26	-0.010	+0.001
UKT 1¼ 07/18	0.170	-0.009
UKT 1½ 01/21	0.396	-0.009
UKT 2 09/25	0.842	+0.008

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

Euro area

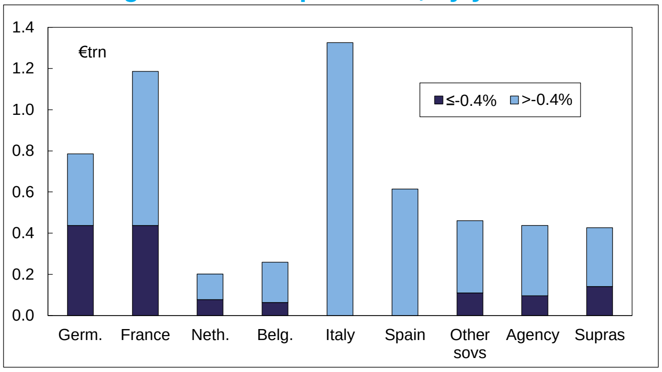
ECB meeting a non-event for policy

Following the BoE's decision last week to leave policy unchanged, it was no surprise that the ECB's Governing Council meeting today was also a non-event policy-wise with officials content to wait until September – when they will have new updated forecasts and will have had more time to evaluate the impact of its most recent easing measures – before deciding whether to act again. Notwithstanding his exhortations that government action is taken promptly to address concerns about NPLs (ostensibly in Italian banks), Draghi made clear the ECB's broad satisfaction that euro area financial markets have been resilient to the heightened uncertainty and volatility generated by the UK referendum, and judged credit conditions to remain conducive to economic recovery and rising inflation. Indeed, while he acknowledged that GDP growth in Q2 was probably weaker than in the first quarter, he also suggested that, at this stage, inflation was likely progressing in line with the ECB's previous baseline forecast. Nevertheless, he acknowledged that the risks to the outlook were skewed to the downside and restated the Governing Council's readiness, willingness and ability to act further – including via introducing additional flexibility into the conduct of the asset purchase programme – if the ECB's updated forecasts suggest that would be necessary. Since we expect the ECB to revise down its economic outlook when those projections are finalised, we also continue to expect the Governing Council in September to agree to extend the end of the asset purchase programme by a further six months to September 2017. And with yields of -0.40% or lower still preventing the ECB from buying more than €1.3trn of sovereign, agency and supranational bonds otherwise eligible to purchase under the QE programme, we also expect it to consider amendments to ensure that it can continue to buy assets at the targeted rate of €80bn per month.

A surprise improvement in French business sentiment

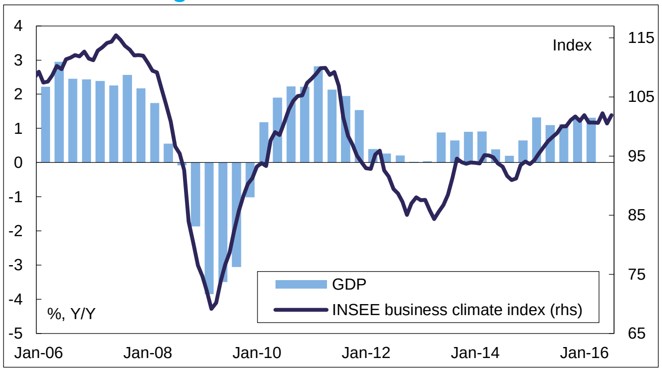
Of course, there is only very limited economic survey evidence available so far to provide an indication to the ECB of the initial economic impact from the Brexit vote. While the ZEW survey released earlier in the week suggested that investors have suddenly taken a much dimmer view of the economic outlook, yesterday's flash estimate of consumer confidence in July saw only a modest drop to a level still slightly above the average for the first half of the year. In addition, today's French INSEE business sentiment survey showed a surprise improvement in confidence in July, with the headline business climate indicator back up above its long-run average to 102, matching May's high for the year to-date. The improvement was widespread across sectors, with the manufacturing index edging back up in line with the average for the first half of the year; the construction index inching up to the highest since 2012 (albeit still below the long-run average); and the indices for retail trade and other services reporting the largest gains with both rising above the respective long-run averages. It remains to be seen however, whether demand for certain services – particularly in the hospitality and tourist industry – will be impacted by the Bastille Day atrocity in Nice. For now, we retain our forecasts of French GDP growth of 0.2%Q/Q in each of the second, third and fourth quarters of 2016.

Bonds eligible for ECB purchase, by yield*



**Bonds meeting all criteria for eligibility, except minimum yield, under the ECB Public Sector Purchase Programme.*
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

France: GDP growth and business climate



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

Friday's economic focus in the euro area will be the flash PMIs which, despite today's improved INSEE survey, are expected to signal a modest weakening in business activity from June in the euro area, Germany and France. Most notably, the euro area composite PMI is expected to decline to its lowest level since 2014 suggesting a slowdown in economic growth in the third quarter. Also due are Italian retail sales and industrial sales and orders figures for May. In the US, the flash manufacturing PMI will be the only release of note.

UK

Consumption remained strong in Q2 despite referendum uncertainty

Although many companies warned that Brexit would likely have negative consequences for business and jobs, figures from the retail sector suggest that British consumers had little concern about those risks ahead of the EU referendum. Indeed, while June's data showed a 0.9%M/M drop in sales, that merely reversed the increase of the same magnitude the previous month while the second quarter had kicked off with one of the strongest months of sales in the past few years. So, the underlying trend looks to have remained strong. Indeed, all major sales categories posted strong annual gains with the exception of clothing, which fell back sharply after a very strong showing in May. And so, the overall annual growth rate in sales slowed to 4.3%Y/Y to match the average of the past twelve months, and the increase of 1.6%Q/Q in Q2 was the highest since the end of 2014, suggesting that consumption continued to grow at a firm pace. While surveys suggest that consumer confidence has deteriorated since the referendum, it is too soon to find any hard evidence that the referendum has hit retail activity in July.

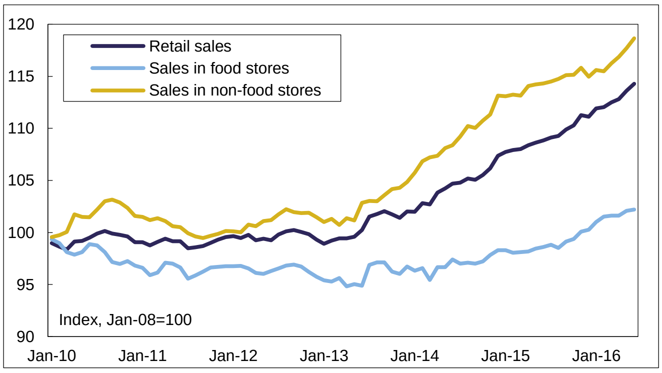
Fiscal consolidation was off-track before the referendum

The latest public finance figures suggested that public sector net borrowing was £7.8bn in June to leave total borrowing over the first three months of FY16/17 down just £2.3bn and about 8%YTD/Y. Bearing in mind that at the time of the last Budget the OBR expected the deficit to fall by almost £20bn (more than 23%) over the course of this fiscal year, the government's fiscal consolidation efforts already appeared to be off-track by the time of the referendum. Looking ahead, as economic activity weakens we expect public borrowing to start to rise again not least given the likely hit to government revenues, particularly via lower stamp duty on property transactions as well as weaker-than-anticipated corporate and income tax proceeds. So, Prime Minister Theresa May's confirmation this week that the Government is abandoning its plan to balance the budget by the end of the current Parliament will avoid an undesirable and unnecessary significant pro-cyclical tightening. Nevertheless, May's suggestion yesterday that the Tory mantra of "living within your means" will remain a central principle of the Government's policy-making suggests that meaningful fiscal stimulus will be unlikely if and when the economic fundamentals deteriorate.

The day ahead in the UK

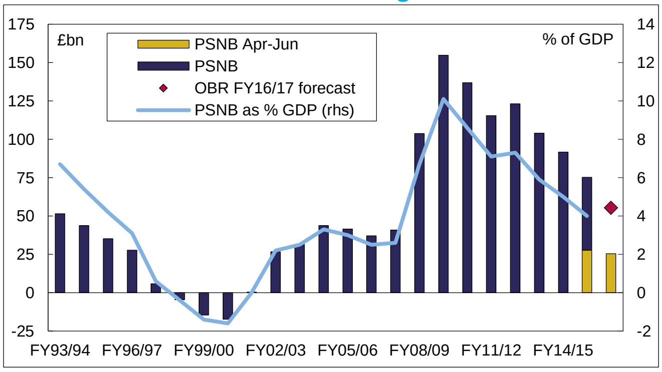
Tomorrow will bring a special one-off release of flash UK PMIs for July, which should provide the most comprehensive evidence so far of how UK businesses are reacting to the Brexit shock. The headline indices for both services and manufacturing are expected to fall into (mild) recessionary territory to below 49 from more than 52 previously, while the more forward-looking indicators might be expected to show a more significant drop, signalling an uncomfortable economic outlook ahead.

UK: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing*



**Excluding public sector banks. Source: ONS and OBR*

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	ECB refinancing rate %	Jul	**0.00**	*0.00*	0.00	-
	ECB deposit rate %	Jul	**-0.40**	*-0.40*	-0.40	-
	ECB asset purchase target €bn	Jul	**80**	*80*	80	-
France	Business confidence indicator (production outlook)	Jul	**102 (3)**	99 (-)	100 (1)	-
Spain	Trade balance €bn	May	**-0.9**	-	-0.6	-
UK	Retail sales excluding petrol M/M% (Y/Y%)	Jun	**-0.9 (3.9)**	-0.6 (4.8)	1.0 (5.7)	**0.9 (5.2)**
	Retail sales including petrol M/M% (Y/Y%)	Jun	**-0.9 (4.3)**	-0.6 (5.0)	0.9 (6.0)	**- (5.7)**
	Public sector net borrowing excluding interventions £bn	Jun	**7.8**	9.5	9.7	**9.9**

Auctions

Country	Auction
France sold	€2.5bn of 0% 2019 bonds (25-Feb-2019) at an average yield of -0.48%
	€2.7bn of 0% 2021 bonds (25-May-2021) at an average yield of -0.33%
	€1.8bn of 4.25% 2023 bonds (25-Oct-2023) at an average yield of -0.14%
	€0.8bn of 0.1% 2025 index-linked bonds (01-Mar-2025) at an average yield of -0.74%
	€0.4bn of 0.7% 2030 index-linked bonds (25-Jul-2030) at an average yield of -0.56%
	€0.3bn of 1.8% 2040 index-linked bonds (25-Jul-2040) at an average yield of -0.36%
Spain sold	€1.7bn of 0.25% 2019 bonds (31-Jan-2019) at an average yield of -0.072%
	€0.9bn 0.75% 2021 bonds (30-Jul-2021) at an average yield of 0.227%
	€0.5bn of 2.9% 2046 bonds (31-Oct-2046) at an average yield of 2.275%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	08:00	Preliminary manufacturing PMI	Jul	52.0	52.8
	08:00	Preliminary services PMI (preliminary composite PMI)	Jul	52.3 (52.5)	52.8 (53.1)
Germany	08:30	Preliminary manufacturing PMI	Jul	53.4	54.5
	08:30	Preliminary services PMI (preliminary composite PMI)	Jul	53.2 (53.6)	53.7 (54.4)
France	08:00	Preliminary manufacturing PMI	Jul	48.0	48.3
	08:00	Preliminary services PMI (preliminary composite PMI)	Jul	49.5 (49.2)	49.9 (49.6)
Italy	09:00	Industrial sales M/M% (Y/Y%)	May	-	2.1 (0.1)
	09:00	Industrial orders M/M% (Y/Y%)	May	-	1.0 (-11.3)
	10:00	Retail sales M/M% (Y/Y%)	May	-0.2 (1.0)	0.1 (-0.5)
UK	09:30	Preliminary manufacturing PMI	Jul	48.7	52.1
	09:30	Preliminary services PMI (preliminary composite PMI)	Jul	48.8 (49.0)	52.3 (52.4)

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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