Euro wrap-up

Overview

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- Bunds were little changed as the final July PMIs suggested that euro area economic growth was well maintained heading into the third quarter.
- Gilts were also little changed despite revisions to the July PMIs suggesting that the UK economy has weakened even more than previously thought.
- Thursday is highly likely to see the BoE ease monetary policy in an attempt to mitigate the adverse near-term impact of the Brexit referendum on UK economic activity.

Daily bond market movements

Bond	Yield	Change*
BKO 0 09/18	-0.594	-
OBL 0 10/21	-0.484	-0.004
DBR 0 08/26	-0.035	+0.001
UKT 1¼ 07/18	0.196	+0.001
UKT 1½ 01/21	0.354	-0.014
UKT 2 09/25	0.800	-0.008

*Change from close as at 4.35pm BST.
Source: Bloomberg

Euro area

PMIs revised up to signal solid start to Q3

The euro area economic dataflow remains favourable, most notably with no discernible impact in the July surveys from the marked deterioration in sentiment in the UK seen following the Brexit referendum. After the European Commission's euro area economic sentiment survey, released last week, showed an improvement in the headline index in July to a six-month high, today brought an upwards revision to the euro area composite PMI to 53.2, similarly the highest level since January – albeit in practice only slightly stronger than the readings of the preceding five months – to signal a steady start to the third quarter. Like the final manufacturing output PMI published at the start of the week which matched June's six-month high, the services activity PMI was also better than the preliminary reading although it merely ticked up slightly from June's more than one-year low. Overall, the survey suggested the likelihood of a continuation of euro area economic growth into the third quarter close to the 0.3%Q/Q rate seen in Q2. And with the euro area composite new orders index also edging down only marginally from the previous month to a level only very slightly below its average for the first half of the year, the PMIs suggest that steady growth should continue over the near term too. The relevant PMIs also suggested encouragingly that employment picked up at the fastest rate in more than six years while deflationary pressures eased by the most in ten months.

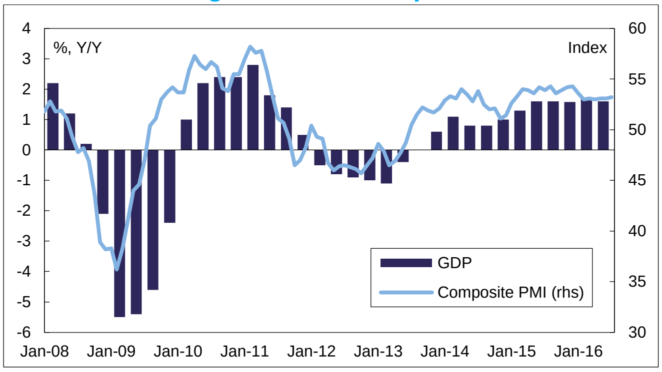
Germany leading the way

Among the member states, with firmer output growth reported by its manufacturers and services firms alike, Germany's composite PMI was comfortably ahead of the pack, confirmed at 55.3, the highest level so far this year, to give hopes of an acceleration at the start of the third quarter. Elsewhere, the results were somewhat less encouraging. While the French PMIs improved across the board, and the composite index was revised a touch higher to 50.1, that still indicated merely a stable rather than growing economy. Perhaps unsurprisingly, although it contrasted with improvements in the country's Commission sentiment indices, Italy's headline index fell back to the bottom half of the range of the past year but remained consistent with modest growth. But the biggest drop was recorded in Spain, where the composite PMI fell 2pts to 53.7, the lowest level since 2013. Nevertheless, as illustrated by the strong labour market data released yesterday which showed the steepest drop in joblessness in July in almost twenty years, as well as evidence of a strong summer for the tourism sector, there seems to be little reason to panic about a sudden marked loss of growth momentum: we currently forecast a moderation of Spanish GDP growth from 0.7%Q/Q in Q2 to a still respectable 0.5%Q/Q in Q3.

A weaker quarter on the High Street in Q2

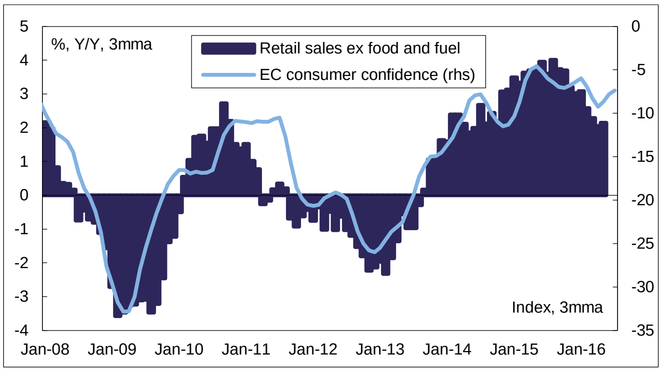
While the PMIs gave cause for cautious optimism about the current quarter, the latest euro area retail sales data aligned with muted expectations, suggesting that Q2 saw the softest growth on the High Street in six quarters. In particular, not least due

Euro area: GDP growth and composite PMI



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

Euro area: Retail sales and consumer confidence



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

to declines in Germany and France, overall euro area retail sales were merely flat in June to leave them up just 0.1%Q/Q in Q2 as a whole. We are not overly alarmed, however, with the weakness in the latest month due partly to a sharp drop in sales of automotive fuel (down more than 1%M/M), and food sales growth also little better than flat. Indeed, stripping out those erratic items and looking at the quarter as a whole, 'core' retail sales in Q2 rose 0.3%Q/Q, in line with GDP growth and – while less than half the rate of Q1 – matching the performance of Q415. And given that consumer confidence continues to hold up well and the labour market continues gradually to improve, we expect overall retail sales growth to pick up in the third quarter, and consumption to offer continued support to GDP growth too.

The day ahead in the euro area and US

Thursday is set to be exceptionally quiet for new economic data from the euro area with Greek unemployment figures for May arguably the most notable new release. In the bond markets, France and Spain will sell regular and inflation-linked bonds with a range of different maturities. In the US, ahead of Friday's payrolls report, Thursday brings the usual weekly jobless claims data and Challenger job cut numbers along with final June durable goods orders figures.

UK

Service PMIs confirm flash reading showing sharpest drop on record

In contrast to the downward revision to the manufacturing PMI earlier this week, today's final release of the services PMI for July confirmed its flash reading of 47.4. This nonetheless marked the largest drop on record, of almost 5pts, and pointed to the steepest monthly decline in activity in the services sector since 2009. Within the detail, only the business expectation index saw a notable upward revision from the flash estimate, nonetheless dropping almost 9pts from the June reading, while other major components were little changed and continued to signal a sharp loss of momentum. For example, the level of the new business indicator, which fell 6.7pts to 45.7 in July, pointed to a reduction in incoming new business for the first time since the end of 2012, while the outstanding business indicator, down 2.2pts on the month, was below 50 for the fourth consecutive month. Meanwhile, the final employment index was bang on 50, suggesting that companies stopped expanding their workforces for the first time in three and a half years. So overall, today's survey pointed to a sharp contraction in services activity at the start of Q3. When coupled with the weak manufacturing reading, the composite PMI, which was revised 0.2pts lower from the flash estimate, was down by 5pts on a month to 47.7. Overall, the July PMIs, if sustained at this level for the remainder of the quarter, were consistent with a decline in GDP in Q3 of 0.4%Q/Q.

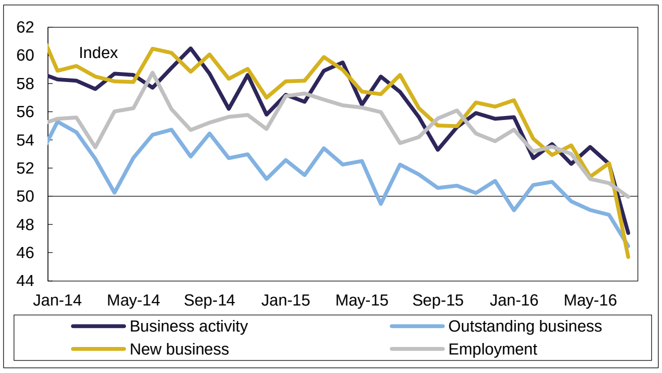
Retail prices signal a modest increase in inflationary pressures

While GDP is set to contract in Q3 and most likely beyond, the sharp depreciation in sterling that followed the referendum has dramatically changed the near-term outlook for inflation, with CPI now likely to rise above 2.5%Y/Y next year. And the BRC Nielsen retail price index released today brought early evidence of that effect starting to feed through, albeit within an environment where deflation has been the norm for several years. The headline rate of inflation on this measure rose in July from -2.0%Y/Y to -1.6%Y/Y, the highest in eleven months. The pick-up reflected weaker non-food deflation, which was up by 0.6ppt to -2.2%Y/Y, while food inflation remained unchanged at -0.8%Y/Y. Looking ahead, we would expect inflation on this measure to trend higher over coming months. But the extent to which it rises will be restrained by continued intense competition on the High Street along with the weakening of demand in response to the deterioration in consumer confidence and a dampening of real household disposable income growth.

The day ahead in the UK

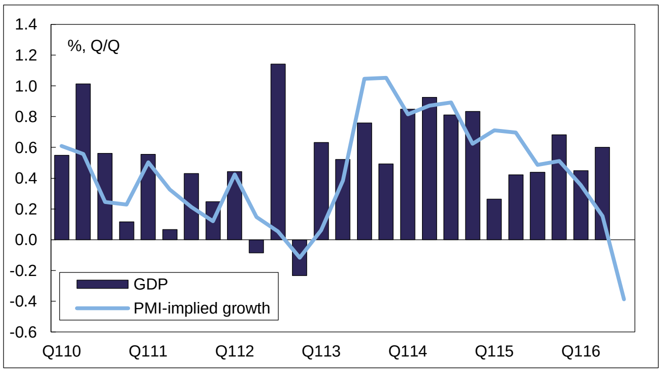
All eyes tomorrow will be on the BoE monetary policy announcement due at midday. The post-meeting statement issued following the mid-July meeting made clear that 'most members of the Committee expect monetary policy to be loosened in

UK: Services PMIs



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

UK: GDP and PMIs*



**July PMIs represent Q316 reading. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

August', with the precise size and nature of the stimulus to be guided by the updated forecasts that will be available for the meeting. Given the subsequent marked deterioration in various economic indicators, including the PMIs, we expect to see a cut in Bank Rate of 25-40bps, which is likely to be accompanied by credit/quantitative easing measures, including at least £25bn of gilt purchases and an amendment/extension of the Funding for Lending Scheme. And while the BoE's accompanying Inflation Report will revise up the profile for inflation over the forecast horizon, the outlook for GDP growth will be much weaker than the Bank forecast three months ago. And it is the outlook for growth, rather than a transitory pick-up in inflation, that will determine the BoE's actions.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Final services PMI (final composite PMI)	Jul	**52.9 (53.2)**	52.7 (52.9)	52.8 (53.1)	**-**
	Retail sales M/M% (Y/Y%)	Jun	**0.0 (1.6)**	0.0 (1.8)	0.4 (1.6)	**-**
Germany	Final services PMI (final composite PMI)	Jul	**54.4 (55.3)**	54.6 (55.3)	53.7 (54.4)	**-**
France	Final services PMI (final composite PMI)	Jul	**50.5 (50.1)**	50.3 (50.0)	49.9 (49.6)	**-**
Italy	Services PMI (composite PMI)	Jul	**52.0 (52.2)**	51.0 (52.4)	51.9 (52.6)	**-**
Spain	Services PMI (composite PMI)	Jul	**54.1 (53.7)**	55.2 (54.5)	56.0 (55.7)	**-**
UK	BRC shop price index Y/Y%	Jul	**-1.6**	-	-2.0	**-**
	Final services PMI (final composite PMI)	Jul	**47.4 (47.5)**	47.4 (47.7)	52.3 (52.5)	**-**

Auctions

Country	Auction
Germany sold	€4bn of 2018 zero-coupon bonds (14-Sept-2018) at an average yield of -0.6%

Source: German debt agency, Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		09:00	New car registrations Y/Y%	Jul	-	-0.8
		12:00	BoE bank rate %	Aug	*0.25*	0.50
		12:00	BoE asset purchase target £bn	Aug	*400*	375

Auctions and events

Country		BST	Auction / Event
EMU		09:00	ECB publishes Economic Bulletin
France		09:50	Auction: To sell 5.75% 2032 bonds (25-Oct-2032)
		09:50	Auction: To sell 0.5% 2026 bonds (25-May-2026)
		09:50	Auction: To sell 4.75% 2035 bonds (25-Apr-2035)
		10:50	Auction: To sell 1.85% 2027 index-linked bonds (25-Jul-2027)
		10:50	Auction: To sell 3.4% 2029 index-linked bonds (25-Jul-2029)
Spain		09.30	Auction: To sell 6% 2029 bonds (31-Jan-2029)
		09.30	Auction: To sell 0.75% 2021 bonds (30-Jul-2021)
		09.30	Auction: To sell 0.55% 2019 index-linked bonds (30-Nov-2019)
UK		12:00	Monetary policy announcement and MPC minutes
		12:00	BoE publishes Inflation Report

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.