Euro wrap-up

Overview

- Bunds made gains as Italian Euroscepticism returned to prominence and euro area consumer confidence deteriorated.
- Gilts also made gains even as one more member of the BoE's MPC voted for a rate hike at its latest policy meeting.
- Friday will bring the flash euro area PMIs for June.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/20	-0.668	-0.033
OBL 0 04/23	-0.310	-0.047
DBR 0½ 02/28	0.331	-0.046
UKT 2 07/20	0.725	+0.002
UKT 0¾ 07/23	1.030	-0.010
UKT 4¼ 12/27	1.274	-0.023

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

Euro area

Italian Eurosceptics generate market volatility once again

While yesterday's 'policy panel' in Sintra saw major central bank governors, including Draghi, flag the risks to the economic outlook from US-China trade tensions, today brought a reminder of the significant political risks persisting within the euro area. In particular, BTPs sold off sharply once again as Italy's parliament appointed two prominent Eurosceptics, Alberto Bagnai and Claudio Borghi, as chairs of the Senate's finance committee and lower house budget committee respectively. While Finance Minister Tria was subsequently forced again to insist that the government did not wish to leave the euro, the appointments provide a reminder of the inconsistency of the coalition's policy programme with the requirements of the single currency. Certainly, we remain highly sceptical of the government's intentions, not least with respect to fiscal policy.

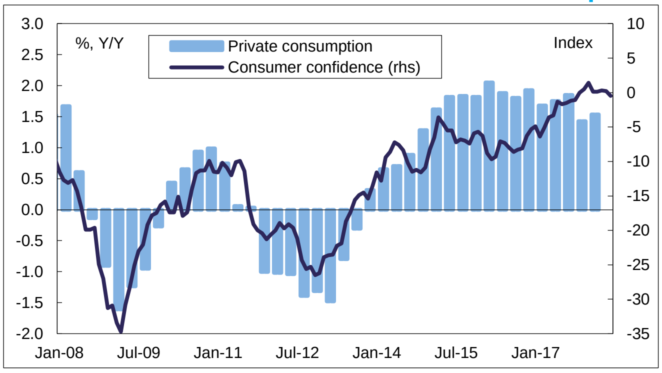
Consumer confidence takes a step down

We suspect that heightened political uncertainty and associated market volatility will weigh on economic sentiment over the near term. Indeed, having remained relatively elevated over recent months even as business sentiment deteriorated, today's flash euro area consumer confidence indicator for June fell by the most since January to reach the lowest level since October. At -0.5, however, the index remains well above the long-run average and – consistent also with ongoing firm job creation – suggests continued steady (if not particularly vigorous) growth in consumption in the euro area as a whole. We will have to wait for the final estimate and national breakdown, to be published next Thursday, to see from where the deterioration in consumer confidence emanated. But there seems good reason to believe that it will have been concentrated in countries (e.g. Italy, Spain and/or Germany) where politics remain turbulent.

But French business sentiment stabilises

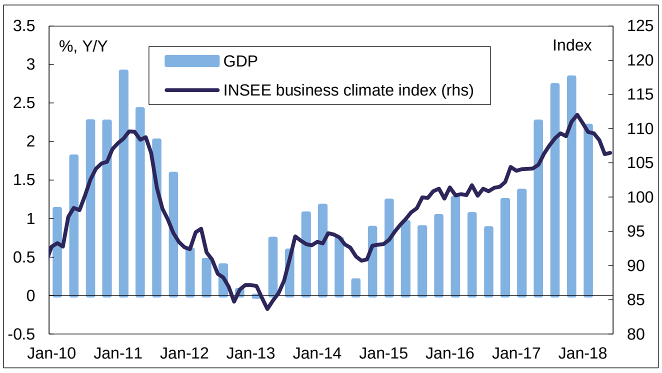
Indeed, ahead of the release tomorrow of the flash PMIs for June, perhaps reassuringly, the latest INSEE business survey from France – where, despite ongoing industrial unrest, politics remains much less volatile – was consistent with a stabilisation of business sentiment at the end of Q2. Having declined in each of the first five months of the year, the composite business climate indicator was unchanged at 106, still well above its long-term average and thus consistent with ongoing relatively firm economic expansion. Sentiment was stable in manufacturing and services, and edged higher in construction and retail, and thus continued to register above-average levels in every sector. Moreover, the survey's employment climate indicator also picked up to a four-month high of 110, well above its long-term average, similarly with favourable labour market conditions reported in every sector.

Euro area: Consumer confidence and consumption



Source: Thomson Reuters & Daiwa Capital Markets Europe Ltd.

France: GDP and business climate



Source: Thomson Reuters & Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

The week is set to come to an end with the most notable euro area data release of the week – the aforementioned flash PMIs for June. The euro area composite PMI fell in May to 54.1, the lowest level since November 2016 albeit one that was still suggestive of a rate of GDP growth of around 0.4-0.5%Q/Q in Q2. Given the escalation of concerns about the policy intentions of the new Italian government and associated financial market volatility, as well as the change in Spanish government, renewed uncertainty about Merkel's future and increase in trade-war fears, a further deterioration in the PMIs might be expected in June, most likely led by the manufacturing sector. Friday will also bring the final French GDP figures for Q1, which are set to confirm the (downwardly revised) previous estimate of 0.2%Q/Q, down from 0.7%Q/Q in Q4. Final French wages growth figures for Q1 are also due.

In the US, the week will end uneventfully, with only the flash June Markit manufacturing and service sector PMIs, which typically attract much less market attention than their European counterparts, scheduled for release.

UK

BoE plays the waiting game

The BoE inevitably left Bank Rate unchanged at 0.5%, although one extra MPC member (Chief Economist Andy Haldane) voted for a hike to leave it 6-3 in favour of the status quo. All members were more confident that the slowdown in GDP in Q1 was temporary, with activity rebounding in Q2 in line with the BoE's projections. Specifically, the MPC highlighted the strength of retail sales in April and May. The more hawkish members highlighted a pick-up in unit wage costs, and an increase of about 0.5ppt in wage settlements compared to last year. The MPC's key forward guidance was not materially amended from last month – i.e. while monetary tightening is still expected to be required over the forecast horizon, there was no additional signal (as was used last September) of the likelihood of a hike at the next meeting. So, while the views of only two MPC members need to shift to achieve a rate hike in August, on balance we still expect no hike before November at the earliest, although this looks to be a close call. The MPC itself acknowledges the "value in seeing how the data evolved from here". Accordingly, we suspect that key to the August decision will be the May wage data and the June retail sales numbers (both released in mid-July). Because of changes to the way GDP numbers are released, the MPC will not have sight of the Q2 GDP data by that meeting, although it will have seen a monthly estimate, a new gauge, for May (to be published on 10th July). And while the MPC made only the vaguest reference to the implications of rising trade tensions and the Brexit process, they remain key downside risks to the outlook.

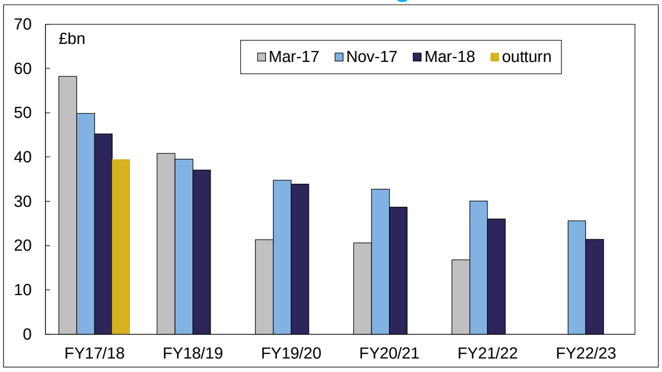
QE guidance revised

As far as QE is concerned, the MPC changed its view, and would now be ready to reduce the stock of its purchased assets if and when Bank Rate reaches around 1.5%, compared to the previous guidance of around 2%. This reflects the recognition that Bank Rate could be cut further than it previously thought when it first set that guidance before the Brexit vote. As far as we're concerned, the decision is academic – we simply do not expect Bank Rate to reach 1.5% at any time for the foreseeable future. Indeed, with UK economic growth firmly in the slow lane, more QE at some point looks more likely than any eventual shrinkage of the BoE balance sheet.

May averts Brexit rebellion – for now

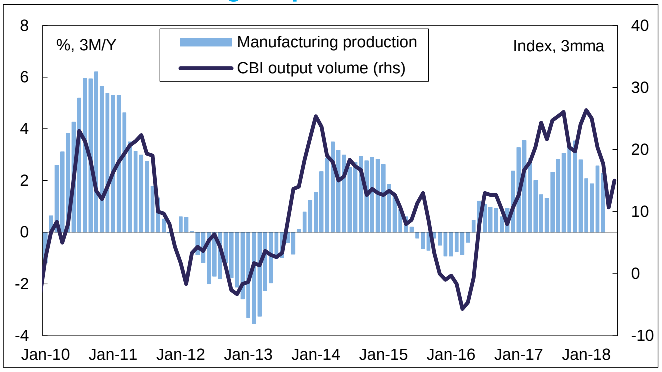
The bill that forms the legal groundwork for the UK to leave the EU yesterday got the go-ahead from MPs to become law. That's after May narrowly averted what would have been the worst parliamentary defeat of her premiership. After a few minor last-minute concessions, MPs in the House of Commons voted 319 to 303 to discard an amendment that would give them a

UK: Public sector net borrowing



Source: Thomson Reuters & Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output



Source: Thomson Reuters & Daiwa Capital Markets Europe Ltd.

meaningful vote on a Brexit deal, and potentially, direct the latter stages of negotiations. The compromise centres on a written statement from the government which contains the key line "it is open to MPs to table motions and debate matters of concern and that, as is the convention, parliamentary time will be provided for this". This vague reference has already been subject to several interpretations. In theory, it allows MPs, at the discretion of the Common's Speaker to have a vote on strategy in the event no deal is reached. But equally, the Speaker could decide not to allow them to have any vote, let alone a "meaningful" one. The proposed amendment, Brexiteers feared, would have allowed pro-remain colleagues to seek to prolong negotiations and ultimately stay in the EU, rather than exit without a deal. This was the second such amendment in as many weeks to be defeated, and staves off an imminent political crisis. But May's victories have been characterised by panicked last-minute compromises and a reluctance to openly confront rebels. That promises more drama next month, when a key amendment to a separate bill, governing membership of a customs union, is finally due to be voted on.

Fiscal risks loom

May's Chancellor, Philip Hammond, meanwhile had some much-needed welcome news on the state of the public finances. Borrowing in May came in lower than the market expected, at £5.0bn in May, compared to £7.0bn in the 2017. Moreover, revisions to previous months' data pushed the deficit for FY17//18 down by £1bn to £39.5bn, the lowest figure since FY2001/2, and almost £20bn better than the OBR forecast a year ago. Even with these revisions, the deficit in the first two months of this FY was 26% lower than a year ago, confirming that the public finances started this period on firmer footing. The improvement reflected higher tax receipts (particularly from income tax, probably due to robust employment growth) and smaller interest payments on the back of lower yields. But this encouraging snapshot has been overshadowed by questions over the future path of fiscal policy. May has promised a spending boost for the health service in England, which amounts to an increase of about £20.5bn by FY2023/24. May's initial claim that this would be partially funded by a "Brexit dividend" was met with widespread derision, not least as Brexit is officially forecast to dampen GDP growth (and hence receipts) and as the UK will continue to make "divorce payments" to the EU for many years. She was forced to concede that the bulk will come from a greater tax burden. Hammond is expected to set out detailed plans of how he intends UK tax-payers to contribute "a bit more in a fair and balanced way" in his Autumn Budget – but has already signalled his intention to stick to the fiscal rule and maintain debt reduction. With such a large sum to find, such measures will risk his party's pre-election pledge to reduce taxes. Possible targets include increasing employee and employer National Insurance rates by 1% (which would raise £8.5bn a year) or freezing personal tax thresholds and allowances (which would raise about £3.5bn). Hammond is expected to make further reference when he addresses bankers at the annual Lord Mayor's Mansion House dinner in the City tonight.

Manufacturing respite may be short-lived

Following a weak patch in recent months, the CBI Industrial Trends Survey, released on Wednesday, pointed to a rebound in manufacturing activity. The factory orders balance jumped to +13 in June from May's -3, far above market expectations and the highest level since January. Growth was broad-based, with the CBI registering that output rose in the vast majority of sub-sectors, most notably in food and drink manufacturing and mechanical engineering. However, the recovery might be short-lived, with the output expectations balance softening to a three-month low of +18. Indeed, even with the latest rebound in orders, it is clear from this survey and official data that growth in this sector has shifted to a lower pace compared to last year, raising fears that uncertainty about the Brexit landscape may already mean UK companies are being ousted from the global supply chain. The CBI, which has been persistent in asking for more clarity over the future relationship with the EU, warned that Brexit and rising trade tensions threaten future growth in the manufacturing sector. Meanwhile, the prices balance fell to an 11-month low of +13, consistent with a more benign inflation outlook, despite the recent rise in crude oil prices.

The day ahead in the UK

No significant economic data are scheduled for release on Friday. BoE Governor Carney and Chancellor Hammond's words at the Mansion House dinner this evening, however, will, as every year, be scrutinised for clues on the future path of monetary and fiscal policy respectively. But equally, their visions for the UK's financial services in the Brexit era at this crucial point will likely attract much attention.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Consumer confidence	Jun	**-0.5**	0.0	0.2	**-**
France	Business sentiment indicator (manufacturing confidence)	Jun	**106 (110)**	106 (108)	106 (109)	**- (110)**
Spain	Trade balance €bn	Apr	**-3.1**	-	-0.8	**-**
UK	Public sector net borrowing excluding interventions £bn	May	**5.0**	6.3	7.8	**6.9**
	BoE bank rate%	Jun	**0.5**	*0.5*	0.5	**-**

Auctions

Country	Auction
France sold	€2.4bn of 0% 2021 bonds (30-Jul-2021) at an average yield of -0.46%
	€1.9bn of 3% 2022 bonds (25-Apr-2022) at an average yield of -0.34%
	€4.2bn of 2024 bonds (25-Mar-2024) at an average yield of 0.03%
	€814mn of 1.85% 2027 index-linked bonds (25-Jul-2027) at an average yield of -0.993%
	€519mn of 0.1% 2028 index-linked bonds (01-Mar-2028) at an average yield of -0.809%
	€376mn of 0.1% 2047 index-linked bonds (25-Jul-2047) at an average yield of -0.18
Spain sold	€2bn of 0.35% 2023 bonds (25-Feb-2023) at an average yield of 0.336%
	€1.2bn of 1.6% 2025 bonds (30-Apr-2025) at an average yield of 0.699%
	€743.5mn of 2.35% 2033 bonds (30-Jul-2033) at an average yield of 1.83%
	€1.1bn of 5.15% 2044 bonds (31-Oct-2044) at an average yield of 2.353%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	PPI M/M% (Y/Y%)	May	**0.5 (2.7)**	0.4 (2.5)	0.5 (2.0)	**-**
UK	CBI Industrial Trends Survey, total orders	Jun	**13**	2	-3	**-**

Auctions

Country	Auction
Germany sold	€1bn of 2.5% 2044 bonds (04-Jul-2044) at an average yield of 1.06%
UK sold	€1.25bn of 0.125% 2028 inflation-linked bonds (10-Aug-2028) at an average yield of -1.709%

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	Preliminary manufacturing PMI	Jun	55.0	55.5
	09:00	Preliminary services PMI (preliminary composite PMI)	Jun	53.7 (53.9)	53.8 (54.1)
Germany	08:30	Preliminary manufacturing PMI	Jun	56.2	56.9
	08:30	Preliminary services PMI (preliminary composite PMI)	Jun	52.2 (53.4)	52.1 (53.4)
France	07:45	GDP – third estimate Q/Q% (Y/Y%)	Q1	0.2 (2.2)	0.2 (2.2)

Auctions

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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