# Euro wrap-up

## Overview

**Chris Scicluna**
+44 20 7597 8326

**Mantas Vanagas**
+44 20 7597 8318

- Bunds were little changed despite data confirming that euro area core inflation in June was weaker than previously thought.
- Gilts made gains as the June UK inflation figures surprised on the downside.
- Thursday will bring UK retail sales figures, also for June.

**Daily bond market movements**

| Bond | Yield | Change* |
|---|---|---|
| BKO 0 06/20 | -0.630 | -0.001 |
| OBL 0 04/23 | -0.300 | -0.001 |
| DBR 0½ 02/28 | 0.341 | -0.003 |
| UKT 2 07/20 | 0.738 | -0.011 |
| UKT 0¾ 07/23 | 0.986 | -0.035 |
| UKT 4¼ 12/27 | 1.223 | -0.035 |

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

# Euro area

### Core inflation revised (slightly) lower

Today's final estimates of euro area inflation in June brought minimal revisions from the flash release. Headline CPI inflation was left unchanged at 2.0%Y/Y, up 0.1ppt from May and the highest since February 2017. As foreshadowed by the preliminary readings, the increase was due principally to non-core items: energy inflation rose almost 2ppts to 8.0%Y/Y, the highest since the start of 2017, while food inflation rose 0.2ppt to 2.7%Y/Y, the most since 2013. In line with the initial estimate, inflation of non-energy goods also rose from May, up 0.1ppt to 0.4%Y/Y, close to its average for the past year, while a drop of 0.3ppt in services inflation to 1.3%Y/Y was also confirmed. But the net impact of all of the revisions was to reduce core inflation by 0.1ppt from the flash estimate to 0.9%Y/Y, a touch below the average of the past year. This reflected rounding: to three decimal places, the downwards revision was tiny, from 0.963%Y/Y to 0.947%Y/Y. However, the change was sufficient to reinforce the impression that the upwards trend in underlying inflation, so long-awaited by the ECB, remains elusive.

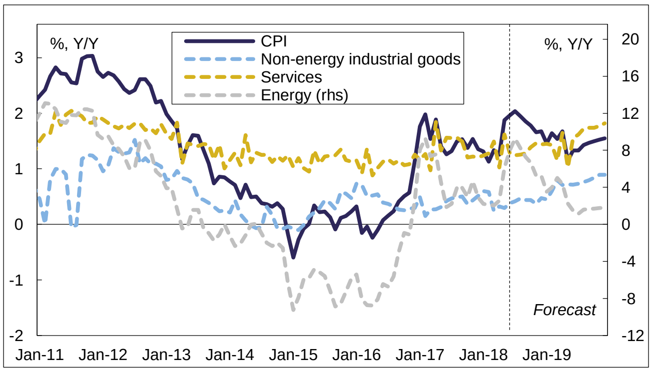
### Inflation to fall back over coming months

Looking ahead, we expect energy inflation to remain elevated for another couple of months before easing back gradually on account of base effects, with a similar profile (albeit from a lower level) anticipated for food inflation. At the same time, we expect core inflation to pick up gradually, not least as higher wage growth feeds through to services inflation. However, today's figures are a reminder than the inflationary impulse from the tightening labour market is likely to be felt only very slowly. In the absence of marked euro depreciation, we still expect core inflation to average little more than 1.0%Y/Y over the coming twelve months. And our central forecast sees headline CPI trending lower from August onwards to less than 1½%Y/Y by the middle of next year, before picking up again from late summer 2019 on. So, with notable downside risks to that outlook, there is a non-negligible probability that the ECB will have to put back the timing of its first rate rise beyond September 2019.

### Construction rebound continues

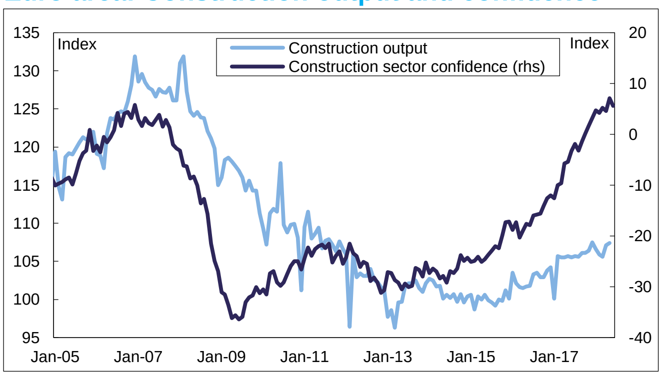
After weather-related weakness in the first quarter of the year, euro area construction activity has rebounded in Q2. Following April's (revised) leap of 1.4%M/M, the most in more than one year, construction sector output rose a further 0.3%M/M in May, to a level 1.6% higher than a year earlier. That took the average level in the first two months of Q2 1.1% above the Q1 average, with growth seen in both building and civil engineering activity on this basis. At the country level, however, growth has been concentrated particularly in Germany, where the average level in the first two months of the quarter was 2.5% above that in Q1. Looking ahead, fundamental drivers for the sector remain favourable, with steady (if not scintillating) economic growth, higher property prices, rising bank loan supply and demand, and historically low interest rates all supportive of

**Euro area: CPI inflation**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

**Euro area: Construction output and confidence**




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

construction activity. And despite the recent weakening of momentum in other sectors (particularly manufacturing), with surveys suggesting that confidence and order levels remain highly elevated by historical standards, we expect construction output to maintain its moderate uptrend, led by Germany, over coming quarters.

## The day ahead in the euro area and US

The remainder of the week should be uneventful for economic data from the euro area with no top-tier releases due on Thursday and just German producer price data for June and the ECB's balance of payments report for May due on Friday. In the markets, France and Spain will sell a range of bonds on Thursday.

In the US, Thursday will bring the usual weekly claims numbers along with the July Philly Fed survey results, while Friday will be free of top-tier economic data.

# UK

## Core inflation down below 2%Y/Y

Ahead of the next MPC meeting at the start of August, this week's UK data releases are being closely watched for any hints on whether economic indicators warrant a tightening in monetary policy. In this regard, today's inflation figures for June failed to make a compelling argument one way or the other. The headline CPI rate surprised on the downside coming in at 2.4%Y/Y, 0.2ppt lower than expected and unchanged from May. Consistent with the upwards trend in oil prices in recent months, energy CPI accelerated 2.8ppts to 8.6%Y/Y. But this impact on headline inflation was offset by weakness in core components. Clothing and footwear prices, for example, fell the most on a monthly basis since 2012, perhaps as the early arrival of hot weather this year meant that the usual summer discounting period was brought forward. And partly as a result, overall non-energy industrial goods inflation eased by 0.4ppt to 1.3%Y/Y, a level last seen in Q117.With services prices continuing to rise at an unchanged pace of 2.3%Y/Y, this left the core CPI rate easing 0.2ppt to 1.9%Y/Y, the first sub-2% reading in fifteen months. We expect the very gradual downwards trend to be maintained in the second half of 2018, with the core rate likely to moderate closer to 1½%Y/Y by year-end.

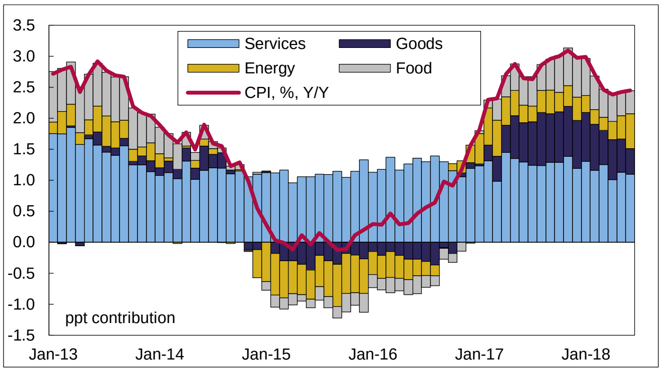
## Dilemma for the MPC

Looking at Q2 as a whole, it was only thanks to a jump in energy prices that the annual pace of inflation, 2.4%Y/Y, matched the BoE's latest forecast published in May. Meanwhile, the core rate dropped sharply, from 2.5%Y/Y in Q1 to 2.0%Y/Y. Of course, the diminishing effect of past sterling depreciation is one of the factors driving inflation lower, but it is not clear that domestic inflationary pressures are working in the opposite direction to the extent the BoE previously expected. For example, yesterday's data on pay growth were also hardly indicative of rising upward pressure on prices, with headline pay growth easing to the lowest rate this year, and the 3M/3M annualised rate for regular wages moving sideways at 2.5%. Of course, when making the monetary policy decision on 2 August, the MPC members will have to weigh this information against the decent economic activity indicators seen of late, in particular the elevated pace of employment growth and evidence of a likely rebound in GDP growth to about 0.4%Q/Q in Q2, twice the rate of Q1. In this regard, tomorrow's retail sales figures will provide additional insights into how private consumption fared in Q2. For now, however, we maintain our expectations of a Bank Rate rise in two weeks' time, although uncertainty surrounding this decision and the overall path of monetary policy going forward has arguably increased following today's data release.

## May safe for now

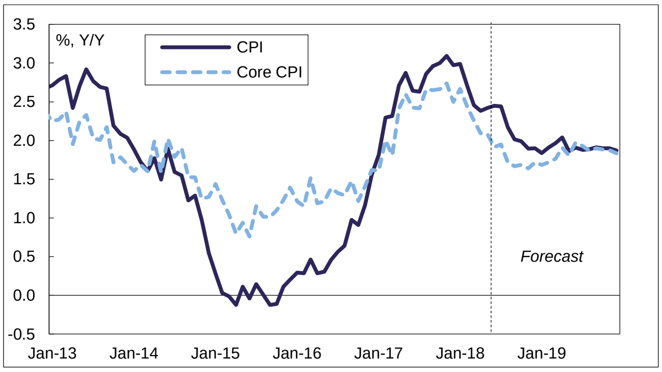
The latest political news, however, would seem to have lowered the bar to a near-term rate hike. Certainly, Theresa May's job as Prime Minister looks to be safe (for now) after her government narrowly won a vote preventing a clause that would have required the UK to remain in a customs union with the EU. After heated debate, accusations of dirty tricks and outright threats,

### UK: CPI inflation




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

### UK: Inflation forecast




*Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

the amendment proposed by the pro-Remain faction was defeated by 307 votes to 301. Had it been upheld, the amendment would have upturned May's negotiating strategy, and posed a serious risk to her already shaky leadership. (The government was, however, defeated on a separate amendment, which requires the UK to remain in the European medicines regulatory network.) Overall, the events of the last few days mean that the proposal to be taken to Brussels for discussions on the future relationship with the EU has been watered down by concessions made to Brexiters, and it is this group that clearly now has the political upper hand. And with the probability of a damaging 'no deal' Brexit non-negligible – and indeed probably having increased by the events of the past week – Theresa May stated today that seventy 'technical notices' will be published in August and September setting out how businesses and households might prepare for such a scenario.

## The day ahead in the UK

The aforementioned June's retail sales figures will round off this week's top-tier releases. A sharp bounce back in sales in the previous two months was enough to ensure spending rose 0.9%3M/3M in May, underpinning an initial estimate of GDP growth of 0.2%3M/3M for the same period. Recent surveys from the BRC and the CBI suggest the pace of spending growth moderated in June due to consumers having already largely completed their purchases of summer gear after the early arrival of hot weather. Nevertheless, England's unexpectedly prolonged participation in the football World Cup is likely to have ensured a decent pace of sales performance too in June.

# European calendar

**Today's results**

**Economic data**

| Country | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | **Revised** |
|---|---|---|---|---|---|---|
| EMU | Construction output M/M% (Y/Y%) | May | **0.3 (1.8)** | - | 1.8 (1.8) | **1.4 (1.2)** |
| | Final CPI (final core CPI) Y/Y% | Jun | **2.0 (0.9)** | *2.0 (1.0)* | 1.9 (1.1) | **-** |
| UK | CPI (core CPI) Y/Y% | Jun | **2.4 (1.9)** | *2.6 (2.1)* | 2.4 (2.1) | **-** |
| | Input (output) PPI Y/Y% | Jun | **10.2 (3.1)** | 10.1 (3.2) | 9.2 (2.9) | **9.6 (3.0)** |
| | UK House price index Y/Y% | May | **3.0** | 3.7 | 3.9 | **3.5** |

**Auctions**

| Country | Auction |
|---|---|
| Germany sold | €822mn of 1.25% 2048 bonds (15-Aug-2048) at an average yield of 1.02% |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

**Tomorrow's data releases**

**Economic data**

| Country | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|
| UK | 09:30 | Retail sales excluding auto fuel M/M% (Y/Y%) | Jun | 0.1 (3.7) | 1.3 (4.4) |
| | 09:30 | Retail sales including auto fuel M/M% (Y/Y%) | Jun | 0.2 (3.5) | 1.3 (3.9) |

**Auctions and events**

| Country | BST | Auction / Event |
|---|---|---|
| France | 09:50 | Auction: to sell 0% 2021 bonds (25-Feb-2021) |
| | 09:50 | Auction: to sell 0% 2024 bonds (25-Mar-2024) |
| | 10:50 | Auction: to sell 0.1% 2025 index-linked bonds (01-Mar-2025) |
| | 10:50 | Auction: to sell 0.7% 2030 index-linked bonds (25-Jul-2030) |
| | 10:50 | Auction: to sell 0.1% 2047 index-linked bonds (25-Jul-2047) |
| Spain | 09:30 | Auction: to sell 0.35% 2023 bonds (30-Jul-2023) |
| | 09:30 | Auction: to sell 2.35% 2033 bonds (30-Jul-2033) |
| | 09:30 | Auction: to sell 5.9% 2026 bonds (30-Jul-2026) |
| | 09:30 | Auction: to sell 1.4% 2028 bonds (30-Jul-2028) |
| UK | 10:30 | Auction: to sell bonds £2bn of 1.75% 2057 bonds (22-Jul-2057) |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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