

Euro wrap-up

Overview

- While EU leaders failed to appoint a successor to Draghi, Bunds made gains as ECB policymakers acknowledged the possible case for further easing on a day of decidedly mixed euro area economic data.
- Gilts also made gains as the UK manufacturing PMIs indicated contraction in the sector at end-Q2.
- Tuesday will see EU leaders try again to agree who should next lead the ECB, and brings data on German retail sales and UK construction.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.755	-0.003
OBL 0 04/24	-0.685	-0.020
DBR 0% 02/29	-0.358	-0.030
UKT 1½ 01/21	0.606	-0.013
UKT 1 04/24	0.614	-0.018
UKT 1½ 10/28	0.807	-0.026

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

Euro area

Lagarde in line to succeed Draghi?

After negotiating through the night, EU leaders failed to reach agreement this morning on who should next lead the EU institutions, including the ECB. They will try again tomorrow. Most notably from the perspective of the financial markets, support now appears to be seriously lacking for the hawkish Bundesbank President Jens Weidmann to take over from Mario Draghi when his term concludes on 1 November. From an economic perspective that's good news, as Weidmann previously failed to back key Draghi initiatives such as the OMT and QE programmes. Instead, there now appears to be momentum for French and/or female candidates, raising the prospect that IMF Managing Director and former French Minister of Finance Christine Lagarde might be lined up to take the role. Other credible female French candidates include OECD Chief Economist Laurence Boone. Crucially, in contrast to Weidmann, both she and Lagarde might be expected to maintain broad continuity of monetary policy from Draghi's pragmatic approach and share his commitment "to do whatever it takes" to preserve the euro. In addition, Lagarde would seem to possess the communication and political skills that are essential for the role.

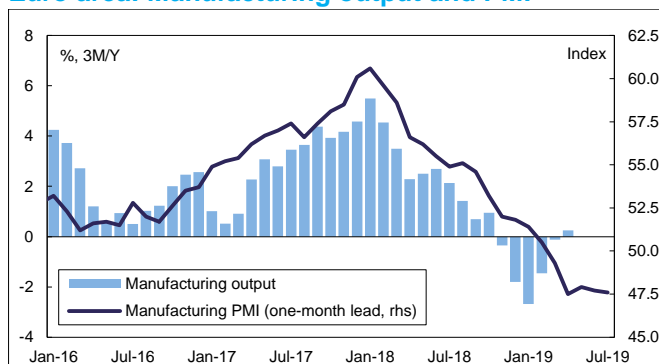
Governing Council sings from the same hymn sheet

The diminished prospect of an inappropriately hawkish successor to Draghi from November appeared to weaken the euro this morning. And the increased prospect of easier ECB policy before then similarly saw euro area bond yields fall after speeches from new ECB Chief Economist Lane, Bank of Spain Governor de Cos and Dutch Governor Knot strongly suggested that a wide majority (and perhaps a unanimity) of Governing Council members now recognise the case for easier policy. Indeed, the comments from the normally hawkish Knot were particularly striking, repackaging recent views espoused by Draghi that it was indisputable that inflation was still too low, the ECB would act if downside risks crystallised, and also that there were no significant obstacles to restarting QE if required. We would not expect a shift to QE before next year, but forecast a cut of 10bps in the deposit rate in September when the ECB's updated forecasts make clear that inflation will remain lower for longer.

Manufacturing PMIs weaker than previously thought

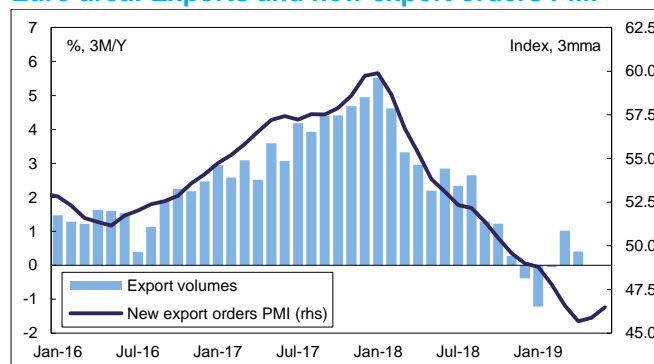
Like last week's [Commission](#) economic sentiment survey, for which the industrial confidence indicator fell to its lowest since September 2013, the persisting weakness signalled in the euro area's manufacturing sector was one of the principal disappointments of the flash June PMIs. Unfortunately, today's final manufacturing PMIs were softer still. The headline manufacturing PMIs for the euro area (47.6) and Germany (45.0) were revised down from their flash estimates, as were the respective output indices, to suggest ongoing significant contraction. And while it was consistent with modest expansion at a

Euro area: Manufacturing output and PMI



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

Euro area: Exports and new export orders PMI



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



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nine-month high, the French manufacturing PMI (52.9) was nudged lower from its preliminary estimate too. More notably, however, the Italian and Spanish indices, which were released for the first time, also fell short of expectations. In particular, Italy's headline PMI dropped 1.3pts, the most since January, to a three-month low of 48.4, with new orders and employment reportedly in significant decline. And Spain's manufacturing PMI fell a hefty 2.2pts to 47.9, the lowest in more than six years, suggesting a sudden shift into contraction in the sector for the first time since the euro crisis. Among other detail, the declines in new export orders implied by the survey suggest that declining external demand will continue to weigh heavily on industrial output in the third quarter. And with the input and output price PMIs down to their lowest since 2016, disinflationary forces from the manufacturing sector appear to have strengthened too.

Unemployment down again

While the PMIs were downbeat, today's other top-tier economic data from the euro area were more encouraging. Indeed, despite the economic slowdown, joblessness keeps falling faster than expected, with the euro area unemployment rate down in May for the second month in the past three, declining to 7.5%, 0.8ppt lower than a year earlier and 4.6ppts below the post-crisis peak, and the lowest since July 2008. The number of people out of work fell for the seventh consecutive month, by a little more than 100k, to 12.35mn, more than 1.1mn below its level a year earlier and more than 7.0mn below the post-financial crisis peak. At the country level, Italy and Spain were principally responsible for the decline in the euro area, with the unemployment rates in both countries declining 0.2ppt. So, Italian unemployment at 9.9% was the lowest since February 2012 and Spanish unemployment at 13.6% was the lowest since October 2008. Despite an increase in the national measure of joblessness in Germany, which was likely related to a definitional change, that country's unemployment rate was unchanged on the EU measure at the series low of 3.1%. And France's unemployment rate was unchanged at 8.6%, the lowest since January 2009. Looking ahead, given relatively steady expansion in construction and services, particularly in Spain, we expect the euro area unemployment rate to edge down a little further over the remainder of the year. But with firms less confident in the future, we expect business-sector wage growth to remain broadly steady, close to the 2.5%Y/Y rate of Q1, rather than accelerate markedly further. As such, the labour market seems likely to add only a modest, rather than substantive, positive impulse to core inflation next year.

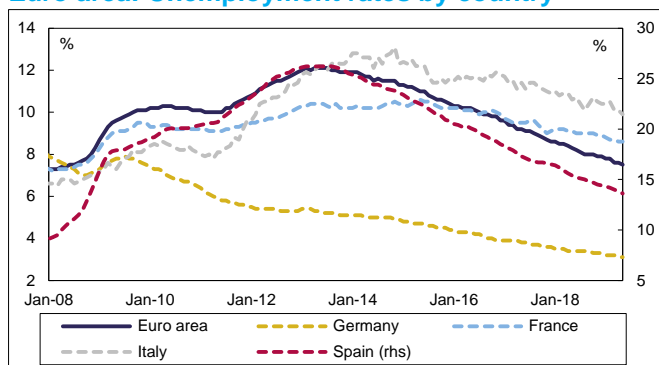
Bank lending growth remains firm

The ECB's latest bank lending figures were also upbeat, with another month of solid increases in net new loans to non-financial corporations (NFCs) and households in May. In particular, despite moderating slightly from April, net lending to NFCs was up €19.9bn (adjusted for sales and securitisations), leaving cumulative net lending over the three months to May at more than €50bn for the first time in eleven months, and growth in the stock of such loans unchanged at a healthy 3.9%Y/Y. Similarly, new lending to households remained strong in May, at €16.7bn, to leave the growth in the stock at 3.3%Y/Y, matching the strongest pace for more than a decade seen in the previous three months. At the country level, the net flow of lending to NFCs on the same basis remained firmest in Germany and France, with year-on-year growth in the former (6.7%Y/Y) the strongest for more than a decade. In contrast, lending to NFCs in Italy (-0.5%Y/Y) and Spain (-1.6%Y/Y) remained well down on a year earlier.

The day ahead in the euro area and US

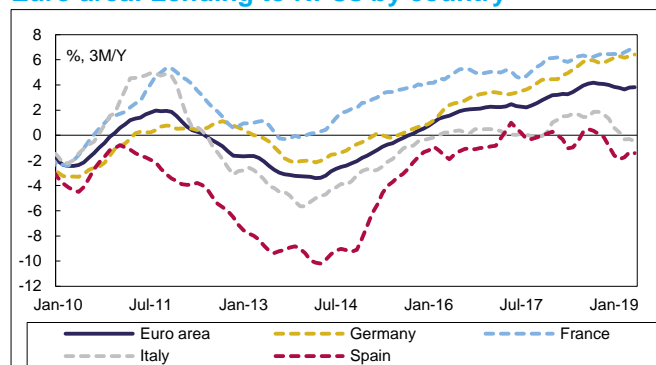
On Tuesday morning, EU leaders will resume their aforementioned efforts to try to find agreement on whom to appoint to lead the European Council, Commission, Parliament and – most notably for the markets – ECB. Datavise, Tuesday will bring German retail sales figures for May, which are expected to post a rise following a notable (albeit downwardly revised) drop of 1.0%M/M in April. Euro area producer price data for May, which should show a moderation in the annual inflation rate to the lowest in thirteen months, are also due. ECB Governing Council members Knot and Vasiliauskas will be speaking publicly. In the US, Tuesday will be a relatively quiet day with the June vehicle sales the only notable new data release. However, NY Fed President John Williams will speak publicly on the global economic and monetary policy outlook.

Euro area: Unemployment rates by country



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Lending to NFCs by country*



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

UK

Manufacturing PMI points to sharp contraction in Q2

Thanks to precautionary Brexit-related stock-building, the manufacturing sector provided a notable boost to UK economic growth in the first quarter of the year, with the near-2%Q/Q growth in the sector last higher in 1999. But output slumped 3.9%M/M in April, and surveys suggest the remainder of the quarter was a damp squib. Certainly, today's manufacturing PMI for June was particularly disappointing, with the headline index declining for the third consecutive month and by a steeper-than-expected 1.4pts to 48.0, its lowest reading since February 2013. And the weakness in the survey's output component was even more striking, with the more than 3pt drop taking the index to 47.2 the lowest reading since October 2012 and 8.5pts lower than March's recent peak. While production of intermediate and investment goods reportedly remained very weak at the end of the quarter, there was also a sharp slowdown in the consumer goods sector. Of course, weaker production in part reflects the ongoing reduction of those stocks built up last quarter. But the inventory overhang and continued Brexit uncertainty meant that UK manufacturers struggled to draw new orders too, with the relevant index falling more than 2pts to 46.6, a near-seven-year low. Looking at the quarter as a whole, the headline, output and new orders indices posted losses of 3pts or more compared with the respective averages in Q1. And with the drop in the output PMI more than offsetting the increase in Q1, today's survey suggests a marked contraction in production last quarter to provide a sizeable drag on GDP growth.

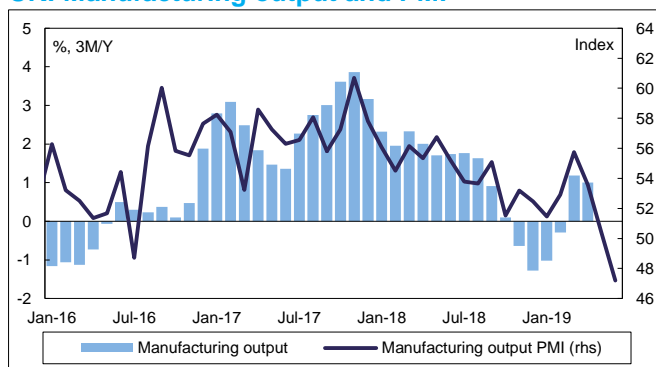
Consumer lending remains subdued

While much will depend on whether households further reduced their savings from the already historically low rate, the BoE's latest monthly lending figures might suggest that private consumption failed to provide a significant boost to growth in the second quarter. In particular, net consumer credit increased just £0.8bn in May, broadly in line with the average since mid-2018 but still near the bottom of the range of recent years. This saw year-on-year growth maintain its steady downward trend in May, easing 0.6ppt to 5.3%Y/Y, the weakest rate for five years and well below the near-11%Y/Y peak hit in late 2016. Net secured borrowing also moderated in May, with the £3.1bn increase the smallest since April 2017. While this left annual growth stable at 3.2%Y/Y, the number of mortgage approvals for house purchase eased back slightly in May (down 0.6k to 64.4k) suggesting that mortgage lending might slow further over coming months, not least as ongoing Brexit uncertainty will no doubt remain an important factor influencing household borrowing decisions.

The day ahead in the UK

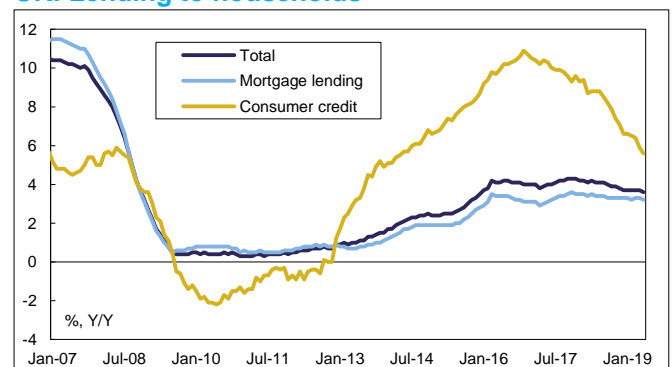
Tomorrow will bring the June PMI survey for the construction sector. Given ongoing uncertainties surrounding the Brexit outcome and recent housing market weakness, the headline construction index is likely to have remained below the key-50 expansion level for the fourth month out of the past five in June. Tomorrow will also bring the Nationwide house price index for the same month. In the markets, the DMO will issue 5Y Gilts.

UK: Manufacturing output and PMI



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

UK: Lending to households















Source: BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Final manufacturing PMI	Jun	47.6	47.8	47.7	-
	 M3 money supply Y/Y%	May	4.8	4.6	4.7	-
	 Unemployment rate %	May	7.5	7.6	7.6	-
Germany	 Final manufacturing PMI	Jun	45.0	45.4	44.3	-
	 Unemployment rate % (change 000s)	Jun	5.0 (-1.0)	5.0 (0.0)	5.0 (60.0)	-
France	 Final manufacturing PMI	Jun	51.9	52.0	50.6	-
Italy	 Manufacturing PMI	Jun	48.4	48.7	49.7	-
	 Unemployment rate %	May	9.9	10.3	10.2	10.1
Spain	 Manufacturing PMI	Jun	47.9	49.5	50.1	-
UK	 Manufacturing PMI	Jun	48.0	49.5	49.4	-
	 Consumer credit (mortgage lending) £bn	May	0.8 (3.1)	0.9 (4.2)	0.9 (4.3)	1.0 (4.1)
	 Mortgage approvals 000s	May	65.4	65.5	66.3	66.0






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	 10.00	PPI Y/Y%	May	1.8	2.6
Germany	 07.00	Retail sales M/M% (Y/Y%)	May	0.5 (2.7)	-1.0 (4.0)
Spain	 08.00	Unemployment, monthly net change 000s	Jun	-90.0	-84.1
UK	 07.00	Nationwide house price index M/M% (Y/Y%)	Jun	0.2 (0.5)	-0.2 (0.6)
	 09.30	Construction PMI	Jun	49.2	48.6

Auctions and events

Country	BST	Auction / Event
UK	 10.30	Auction: to sell £3bn of 0.625% 2025 bonds
	 15.05	BoE Governor Carney scheduled to speak in Bournemouth

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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