Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds were little changed despite a disappointing German retail sales release, while BTPs significantly outperformed as Italy reportedly cut its budget deficit target to avoid disciplinary action from the Commission.
- Gilts made gains as the construction PMI fell to a decade-low and Carney spoke of increased downside risks to global and UK GDP growth.
- Tomorrow will bring final services and composite PMIs for June from the euro area and UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.760	-0.003
OBL 0 04/24	-0.688	-0.002
DBR 0¼ 02/29	-0.365	-0.008
UKT 1½ 01/21	0.528	-0.083
UKT 1 04/24	0.528	-0.092
UKT 1⅝ 10/28	0.726	-0.087

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

Euro area

German retail sales set for weak Q2

The most noteworthy data from the euro area today came in the form of a disappointing German retail sales release for May. Contrasting with an expected increase, sales declined for the second successive month and by 0.6%M/M. And while the drop in April was less severe than initially estimated, sales were still down a hefty 1%M/M that month. Nevertheless, to some extent reflecting the steady growth over the past year, sales were still up an impressive 4.0%Y/Y in May, with spending on food up more than 2½%Y/Y, non-food sales up more than 5%Y/Y and internet and mail order purchases up more than 8%Y/Y. Those annual rates were flattered somewhat by the additional working day this year compared with last. Indeed, today's release clearly suggested that household consumption has weakened considerably after a surge in the first quarter of the year – in the first two months of Q2, retail sales were 1% lower compared with the average in Q1. And this further supports our view that the acceleration in German GDP at the start of year won't be repeated in Q2: we maintain our forecast for a moderation to 0.1%Q/Q from 0.4%Q/Q in Q1.

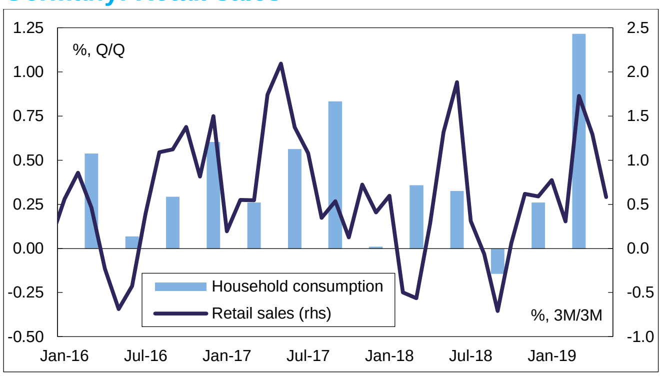
Lagarde set for ECB?

At the time of writing, there was still no outcome from EU leaders' negotiations over whom to nominate to lead the European institutions. However, reports suggested possible agreement this evening on a package that would see German Defence Minister Ursula von der Leyen succeed Jean-Claude Juncker at the Commission and French IMF Managing Director Christine Lagarde succeed Mario Draghi at the ECB Presidency. Such an outcome should be considered favourable from an economic perspective: while Lagarde is not an economist, she is internationally credible and a good communicator, she is wary of the existential risks that would threaten the euro if the ECB failed "to do whatever it takes", and would likely adopt the pragmatic approach to policy-setting favoured by Mario Draghi. Certainly, we would not expect to see a significant step-change to policy making at the ECB if she took the reins, although Chief Economist Philip Lane would play the pivotal role in determining future policy.

ECB more likely to cut in September than July

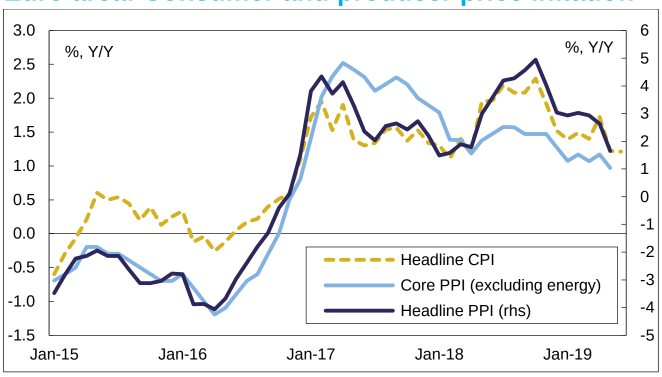
With respect to near-term policy decisions, while markets briefly reacted to a headline today that ECB policymakers see no need to rush into policy easing this month, the report should have come as no surprise. Consistent with recent comments from various Governing Council members, including Chief Economist Philip Lane, any changes in policy are likely to come if and when the ECB revises down its economic forecasts in September. This month, the ECB is more likely to simply amend the wording in its statement to make it clear that a rate cut in the autumn is possible. We would then expect the September meeting to conclude with a 10bps cut in the deposit rate to -50bps and the introduction of a tiered interest rate framework. Meanwhile, today's euro area producer price inflation figures illustrated the disinflationary pressures in the pipeline, with the headline PPI rate falling 1.0ppt in May to 1.6%Y/Y, a fifteen-month low. While this largely reflected softer energy price inflation, down 3.3ppt to 3.1%Y/Y, core PPI (excluding energy) fell 0.2ppt to 1.0%Y/Y, its lowest rate since 2016.

Germany: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer and producer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

Tomorrow will bring the final services and composite PMIs for June, for which the flash euro area headline indices rose 0.5pt to 53.4 and 0.3pt to 52.1 respectively, principally due to a better showing in France. Given the modest downward revision yesterday to the euro area manufacturing output index (down 0.3ppt from the flash to 48.5), we might well see the headline composite PMI nudged slightly lower too. In the markets, Germany will sell 5Y Bunds.

In the US, it will be a busy day for top-tier releases including the non-manufacturing ISM and services PMI surveys, weekly jobless claims numbers, ADP June employment figures, and final durable goods and trade reports for May.

UK

Construction PMI collapses

After yesterday's extremely weak manufacturing PMIs, today's construction sector survey can only be described as dire, further illustrating the damaging impact persistent political and economic uncertainties surrounding Brexit is having on the UK economy. In particular, the headline PMI slumped 5.5pts in June to 43.1, the steepest monthly drop for seven years and its lowest reading for more than a decade. The weakness was broad-based with the respective indices implying sharp falls in housing (45.1), civil engineering (41.9) and commercial activity (41.8). Against the backdrop of a Conservative leadership election that has seen the two main candidates talk up the prospects of a no-deal Brexit and propose a range of unworkable and ill-thought through fiscal policies, Markit reported that firms have adopted a more cautious approach to new construction projects with delays and reduced budgets widely cited – indeed, the new orders PMI fell 4.7pts in June to 43.3, similarly the weakest outturn since April 2009 and one consistent with marked contraction. And while construction firms reportedly reduced only slightly their workforces in June perhaps on tentative hopes that activity will recover, today's survey also suggested that optimism about the near-term outlook in the sector remained close to May's seven-month low. So, with output likely to have weighed on GDP growth in the second quarter, we see little prospect of construction providing much support through the second half of the year too.

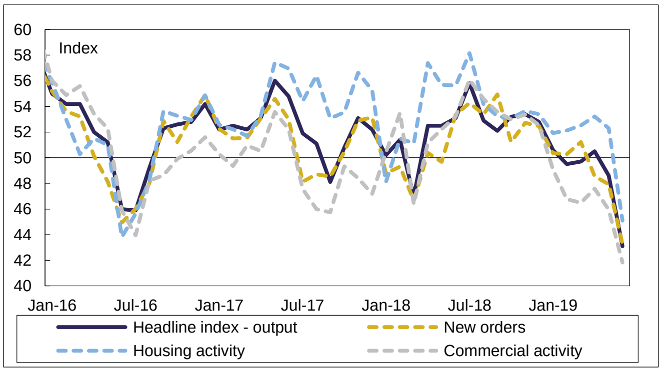
House price growth remains subdued

Weakness in the housing market was also clearly evident in the Nationwide house price index for June, which today suggested that residential property price growth remained subdued at the end of the second quarter, up just 0.1%M/M and 0.5%Y/Y, in line with the average of the first half of the year and well down the rates of the preceding five years. Once again the weakness in the second quarter was driven principally by London and the South East, with prices in the capital down compared with a year earlier for the eighth consecutive quarter. Annual price growth elsewhere in England was still modest, on aggregate broadly little changed compared with a year ago. In contrast, the housing market in Northern Ireland again outperformed in Q2, with prices up more than 5%Y/Y, while house prices rose more than 4%Y/Y in Wales. We note that house price inflation on the Nationwide survey has been weaker than that on the official ONS house price index since 2014. However, not least given persistent uncertainties surrounding Brexit, we anticipate activity in the UK housing market on aggregate to remain subdued over coming quarters. And while lower mortgage rates and a lack of new supply will limit the downside risks to prices, declines in London and the South East are likely to continue to weigh on national house price inflation unless and until Brexit is resolved in an orderly manner.

The day ahead in the UK

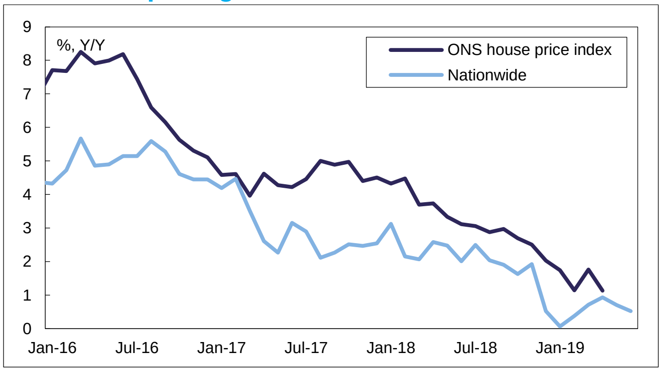
The June PMI surveys will conclude tomorrow with the services release expected to show that the headline business conditions index moved sideways at the end of Q2 at a subdued 51.0. Of course, given the downside surprise to today's construction and yesterday's manufacturing surveys, risks to this forecast would appear skewed to the downside. Certainly, we wouldn't be surprised to see the composite PMI slipping below the key-50 expansion level to add to evidence of negative GDP growth in Q2. Tomorrow will also bring the BRC's latest shop price index for June. Elsewhere, BoE Deputy Governors Broadbent and Cunliffe are scheduled to speak publicly.

UK: Construction PMIs



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

UK: House price growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		PPI Y/Y%	May	**1.6**	1.8	2.6	-
Germany		Retail sales M/M% (Y/Y%)	May	**-0.6 (4.0)**	0.5 (2.7)	-2.0 (4.0)	**-1.0 (4.6)**
Spain		Unemployment, monthly net change 000s	Jun	**-63.8**	-90.0	-84.1	-
UK		Nationwide house price index M/M% (Y/Y%)	Jun	**0.1 (0.5)**	0.2 (0.5)	-0.2 (0.6)	-
		Construction PMI	Jun	**43.1**	49.2	48.6	-

Auctions

Country		Auction
UK sold		£3bn of 0.625% 2025 bonds at an average yield of 0.62%

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	Final services PMI (composite PMI)	Jun	53.4 (52.1)	52.9 (51.8)
Germany		08.55	Final services PMI (composite PMI)	Jun	55.6 (52.6)	55.4 (52.6)
France		08.50	Final services PMI (composite PMI)	Jun	53.1 (52.9)	51.5 (51.2)
Italy		08.45	Services PMI (composite PMI)	Jun	50.0 (49.5)	50.0 (49.9)
Spain		08.15	Services PMI (composite PMI)	Jun	52.7 (51.7)	52.8 (52.1)
UK		00.01	BRC shop price index Y/Y%	Jun	-	0.8
		09.30	Services PMI (composite PMI)	Jun	51.0 (51.0)	51.0 (50.9)

Auctions and events

Country		BST	Auction / Event
Germany		10.30	Auction: to sell €4bn of 2024 bonds
UK		11.00	BoE Deputy Governor Cunliffe scheduled to speak in Lisbon
		13.15	BoE Deputy Governor Broadbent scheduled to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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