Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest gains at the long end as the final June PMIs suggested a widespread softening of growth, while BTPs rallied as the European Commission decided not to discipline Italy.
- Gilts made gains as the UK services PMIs added to evidence of a drop in GDP in Q2.
- Thursday will bring data for euro area retail sales and UK car registrations.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.758	+0.006
OBL 0 04/24	-0.689	+0.001
DBR 0¼ 02/29	-0.384	-0.017
UKT 1½ 01/21	0.503	-0.021
UKT 1 04/24	0.493	-0.032
UKT 1⅝ 10/28	0.691	-0.031

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

Euro area

Despite stronger services, composite PMIs suggest Q2 GDP slowdown

While Monday's final manufacturing PMIs for June were weaker than previously thought, today's final services indices suggested a slightly stronger end to the second quarter for the sector, which remains the principal source of economic growth. With modest revisions made to the flash estimates, the headline indices for the euro area (53.6), Germany (55.8) and France (52.9) were confirmed at the highest for the eight, nine and seven months respectively. And the figures for Italy (50.5) and Spain (53.6), released for the first time, were the best since March. So, despite the ongoing struggles in the manufacturing sector, the composite PMIs improved slightly too. But given the weakness over the previous two months, the average PMIs for Q2 as a whole remained underwhelming, e.g. with the euro area composite index up just 0.3pt from Q1 to 51.8, the second-lowest since 2014 implying GDP growth of about 0.2%Q/Q, bang in line with our forecast. The equivalent quarterly PMIs for Germany (52.5) and France (51.3) suggested growth at the same rate. The average composite PMI in Spain (52.4), however, was the weakest since 2013, and suggested a moderation in growth of 0.3ppt to 0.4%Q/Q in Q2. And after Italy's GDP returned to growth for the first time in three quarters in Q1, albeit by a paltry 0.1%Q/Q, the composite PMI for Q2 (49.8) implies a renewed modest contraction of 0.1%Q/Q.

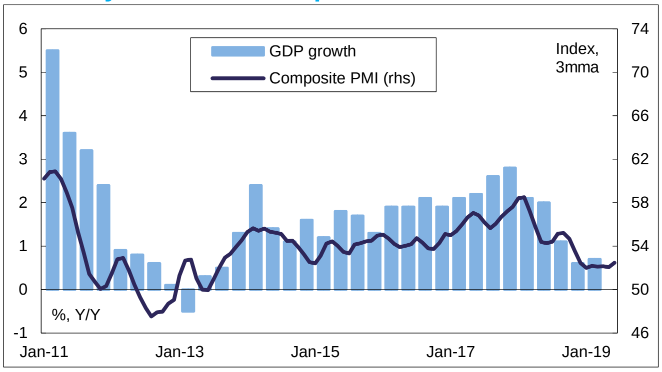
EP highly likely to endorse Lagarde

As suggested earlier in the day, EU leaders yesterday evening confirmed their preferred nominations to lead the institutions, with IMF Chair Lagarde getting the nod to succeed Draghi. Her appointment, however, will still need to be approved by Finance Ministers (surely a done deal) and the European Parliament (somewhat less of a formality). Despite her lack of central banking experience, her time spent at the French Ministry of Finance and IMF – including an important role in resolving the euro crisis – should more than compensate, providing relevant experience to meet the requirements of the EU Treaty and also demonstrating her credibility and communication skills. Moreover, gender issues – long a bone of contention for MEPs – should help secure her European Parliamentary approval. So, we fully expect Lagarde to start as ECB President on 1 November.

Lane key to policy outlook

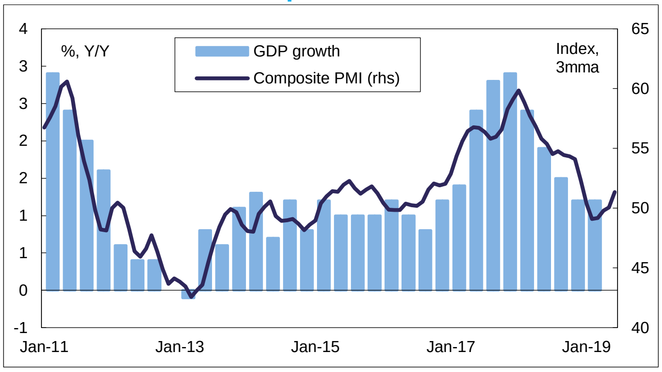
As we previously noted, Lagarde should maintain broad continuity from Draghi's pragmatic and instinctively dovish approach to policy, with a willingness to use unconventional measures and "do whatever it takes" to preserve the euro. Chief Economist Philip Lane, however, will play the key role in formulating policy from now on. As he made clear in a speech at the start of this week, Lane judges that the full range of different monetary pools used recently by the ECB – including forward guidance,

Germany: GDP and Composite PMI



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

France: GDP and Composite PMI



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

negative rates, liquidity support and QE – has worked in a complementary manner to boost GDP growth and inflation significantly (the latter by about 0.4ppt last year). So, while we currently expect just a rate cut and tiering to be announced in September, we do not rule out amendments to the ECB's asset purchase programme also being agreed before Lagarde can take up her new role.

BTPs rally as Commission pulls its punches

The removal of the tail risk of a more hawkish ECB President gave support to euro area periphery bonds today. And BTPs outperformed yet again, with 10Y yields down to 1.61% the lowest since October 2016 as the European Commission decided not to launch a formal disciplinary procedure against Italy. The decision responded to the Government's pledge, set out in a new letter to the Commission from Prime Minister Conte and Finance Minister Tria, to reduce the 2019 deficit target from the recently raised 2.4% of GDP back to the original plan of 2.04%. The reduction will be achieved partly by a recently legislated commitment not to spend certain funds originally allocated to (but unspent on) the Government's flagship basic income and early retirement schemes. The letter also restated "a commitment to achieve a structural improvement" in the fiscal position in 2020. However, with economic growth set to remain minimal, and political pressures for the repeal of the currently legislated VAT hike and additional fiscal largesse, we very much doubt that the 2020 Budget will be fit for purpose. So, we expect the next European Commission to judge that a formal procedure is merited after all.

The day ahead in the euro area and US

The main data focus tomorrow will be euro area retail sales figures for May. While expectations are for sales to have broadly reversed April's 0.4%M/M decline, the weaker than expected outturn from Germany earlier this week suggests that risks to this forecast are skewed to the downside. Supply-wise, France and Spain will sell bonds with various maturities. Meanwhile, ahead of Friday's payrolls report, tomorrow will be quiet in the US with markets shut for the Independence Day holiday.

UK

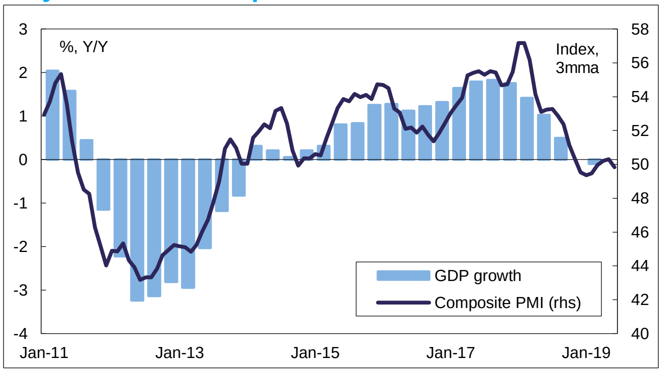
PMI signals a near-stagnating services sector

Today's services PMI concluded a trio of gloomy surveys this week, which implied a notable deterioration in economic conditions at the end of Q2 and further supported our view that GDP contracted last quarter. In particular, the headline services activity index fell a larger-than-expected 0.8pt in June to 50.2, a three-month low and consistent with near-stagnation in the sector. And against the backdrop of sluggish domestic demand and heightened Brexit uncertainties, firms reported a drop in demand for new work, with the relevant PMI back below the key-50 level for the fifth month out of the past six. Optimism about growth prospects for the year ahead also slipped back. As such, it was somewhat surprising to see services firms report an acceleration in job growth last month, with the survey's employment component up 1.8pts to 53.6, a near-two-year high.

Composite PMI consistent with GDP contraction

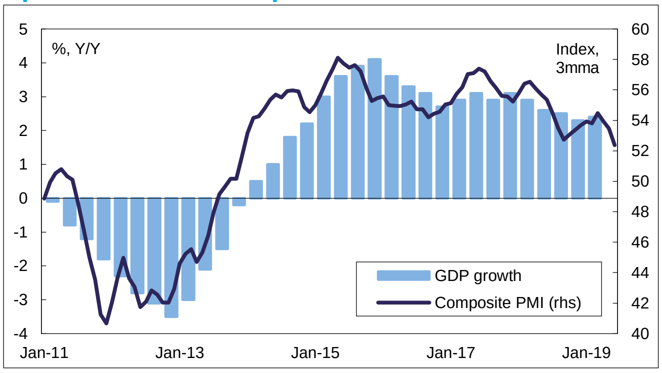
Taken together with the marked decline in the manufacturing output PMI in June (down 3.2pts to 47.2, a near-decade low), the composite PMI fell 1.2pts to 49.7, the first sub-50 reading since the post-2016 referendum slump and the second-lowest level since April 2009. And combined with the implied contraction in the construction sector, the all-sector PMI fell a steeper 1.5pts to 49.2. So, over the second quarter as a whole, today's survey implied a decline in GDP of 0.1%Q/Q, bang in line with our own forecast for Q2, and a marked slowdown from the 0.5%Q/Q expansion in Q1. Moreover, a further deterioration in new orders amid persistent Brexit uncertainties would suggest that GDP growth will remain subdued in the second half of the year too.

Italy: GDP and Composite PMI



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

Spain: GDP and Composite PMI



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

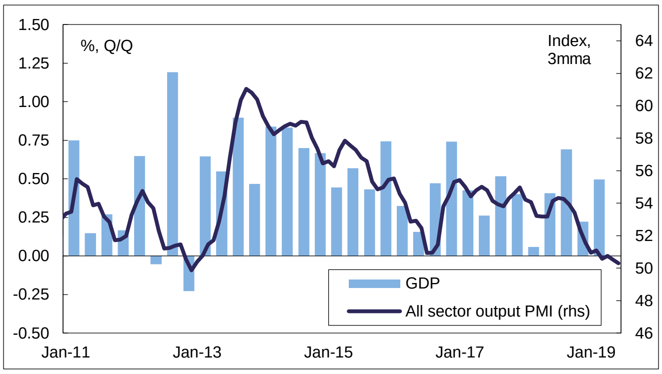
Diminishing price pressures

Today's survey also indicated a moderation in price pressures at the end of the second quarter, with the composite output price PMI falling 1.3pts in June to 52.3, a near-three-year low. The BRC's latest shop price index, also published today, suggested that retail price inflation fell sharply in June too, with the headline rate down 0.9ppt to -0.1%Y/Y, the first decline since October. With food price inflation unchanged at 1.8%Y/Y, the fall was fully accounted for by lower non-food inflation, which fell 1ppt to -1.2%Y/Y, the steepest drop for eleven months. With economic growth and underlying price pressures weakening against the backdrop of increased political uncertainty as well as a loss of momentum in other major economies, dovish comments yesterday by BoE Governor Carney were no surprise. And while the recent notable increase in the market-implied probability of a cut in Bank Rate by year-end to close to 50% likely in good part reflects perceptions of an increased probability of a no-deal Brexit due to the political posturing of Conservative leadership contenders, we certainly would not rule out a rate cut even if – as we expect – such a disorderly outcome is avoided.

The day ahead in the UK

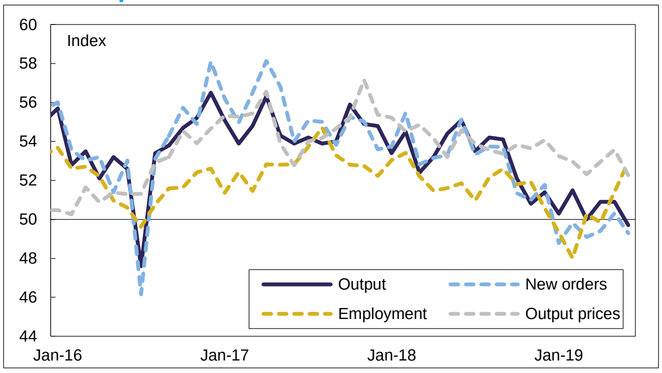
Tomorrow will provide an update on consumer spending, with new car registrations figures for June set to report another weak showing at the end of Q2 as household confidence remains fragile in the face of continued political and economic uncertainty.

UK: GDP and All-sector PMI



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

UK: Composite PMIs



Source: Markit, 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		Final services PMI (composite PMI)	Jun	**53.6 (52.2)**	53.4 (52.1)	52.9 (51.8)	-
Germany		Final services PMI (composite PMI)	Jun	**55.8 (52.6)**	55.6 (52.6)	55.4 (52.6)	-
France		Final services PMI (composite PMI)	Jun	**52.9 (52.7)**	53.1 (52.9)	51.5 (51.2)	-
Italy		Services PMI (composite PMI)	Jun	**50.5 (50.1)**	50.0 (49.5)	50.0 (49.9)	-
Spain		Services PMI (composite PMI)	Jun	**53.6 (52.1)**	52.7 (51.7)	52.8 (52.1)	-
UK		BRC shop price index Y/Y%	Jun	**-0.1**	-	0.8	-
		Services PMI (composite PMI)	Jun	**50.2 (49.7)**	51.0 (51.0)	51.0 (50.9)	-
Auctions							
Country		Auction					
Germany sold		€3.2bn of 2024 bonds at an average yield of -0.66%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		10.00	Retail sales M/M% (Y/Y%)	May	0.3 (1.6)	-0.4 (1.5)
UK		09.00	New car registrations Y/Y%	Jun	-	-4.6
Auctions and events						
Country		BST	Auction / Event			
France		09.50	Auction: to sell 0.5% 2029 bonds			
		09.50	Auction: to sell 1.25% 2034 bonds			
		09.50	Auction: to sell 1.5% 2050 bonds			
Spain		09.45	Auction: to sell 0.15% 2023 bonds			
		09.45	Auction: to sell 0.6% 2029 bonds			
		09.45	Auction: to sell 2.70% 2048 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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