Euro wrap-up

Overview

- Bunds and other euro area government bonds made gains as a report suggested that the ECB is studying a revamp of its inflation goal.
- Gilts were little changed despite an upside surprise to the latest UK retail sales data and as the House of Commons voted to limit the next Prime Minister's ability to force a no-deal Brexit.
- Friday will bring updates on the euro area balance of payments and UK public finances.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.750	-0.003
OBL 0 04/24	-0.684	-0.011
DBR 0¼ 02/29	-0.354	-0.019
UKT 1½ 01/21	0.530	-0.006
UKT 1 04/24	0.535	-0.001
UKT 1⅝ 10/28	0.759	+0.001

*Change from close as at 4.00pm BST.
Source: Bloomberg

Euro area

ECB to "revamp" its inflation goal?

While there were no economic data of note released in the euro area today, the euro weakened and euro area government bonds received support from a Bloomberg report stating that the ECB staff have "begun studying a potential revamp of their inflation goal". While the ECB failed to confirm the story, the account of last month's Governing Council meeting noted that "should the environment of too low inflation continue to prevail, considerations of a more strategic nature might be warranted…to reinforce the credibility of the ECB's monetary policy and support the achievement of a sustained adjustment in inflation to its inflation aim." So, today's Bloomberg report, which further raised hopes that the ECB will soon step up its efforts to boost inflation, looked credible.

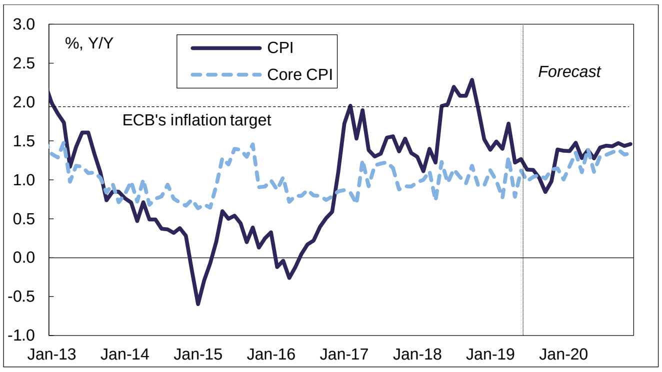
Inflation target review long overdue

Since 2003, the ECB's self-imposed target has specified that the Governing Council should aim to achieve inflation "of below, but close to, 2%" over the medium term. In his Sintra speech last month, Draghi noted how that formulation had been designed to imply "a stronger commitment than a standard inflation-targeting regime" in order to cement lower inflation expectations given the region's previous history of high inflation. However, since the Global Financial Crisis, rather than being too high, inflation in the euro area has been excessively low. Core inflation has averaged just 1.0%Y/Y over the past five years, and remained just 1.1%Y/Y in June, far away from target. And with the diminished prospect of above-target CPI, financial market measures of inflation expectations have fallen to record lows, e.g. the 5Y5Y inflation forward swap rate was today close to 1.30%, only about 16bps above its record low reached last month. So, a recalibration of the inflation target, perhaps alongside an overarching review of ECB policy (as was recently proposed by Bank of Finland Governor Olli Rehn), seems long overdue.

A symmetric target seems necessary, but not sufficient

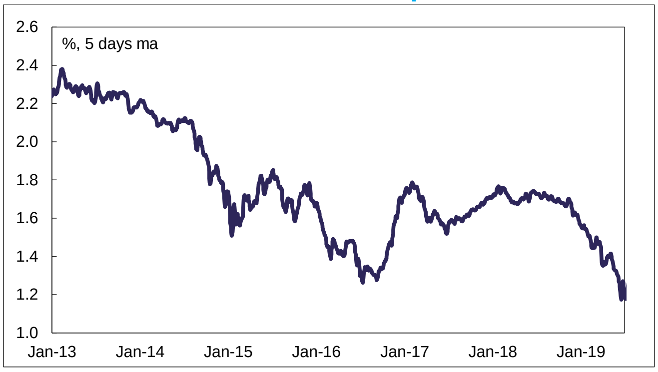
Since 2014, Mario Draghi has insisted that the ECB's inflation aim is "symmetrical", with sub-target inflation just as undesirable as above-target inflation. But unless the "symmetrical" nature of the target is specified explicitly in the Governing Council's stated objective, some financial market participants will doubt the ECB's commitment. So, with inflation expectations so low, a reformulation of the target to make clear the symmetricality of the aim – perhaps also with an unambiguous central target of 2.0%Y/Y in line with global norms, rather than "below, but close to, 2%" – would seem desirable. But unless the ECB's commitment is credible – i.e. the ECB is judged capable of achieving such a target on a sustained basis – inflation

Euro area: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro 5Y5Y Inflation forward swap rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

expectations will remain too low. The struggles of the Fed in being able to achieve its own inflation target provide grounds for scepticism in the ECB's abilities, particularly as the US has seen stronger GDP growth, lower unemployment and more active fiscal policy than the euro area. Nevertheless, if the reformulation of its target was accompanied by extra large-scale easing, such as a new asset purchase programme, the ECB's inflation-boosting credentials would be enhanced. We note, however, that the Fed's own strategic review of its policy framework is not scheduled to be completed until early 2020. And so, it remains to be seen quite how long a review at the ECB – if it is being conducted at all – might take. It is perfectly feasible that final decisions will be taken by the Governing Council under Christine Lagarde rather than Mario Draghi.

The day ahead in the euro area and US

The week should end on a quiet note with the ECB's balance of payments figures for May and German producer price data for June most notable among the new releases tomorrow. In the US, the week will end with the preliminary University of Michigan consumer sentiment survey results for July, which are expected to report a modest improvement in confidence following a dip in June.

UK

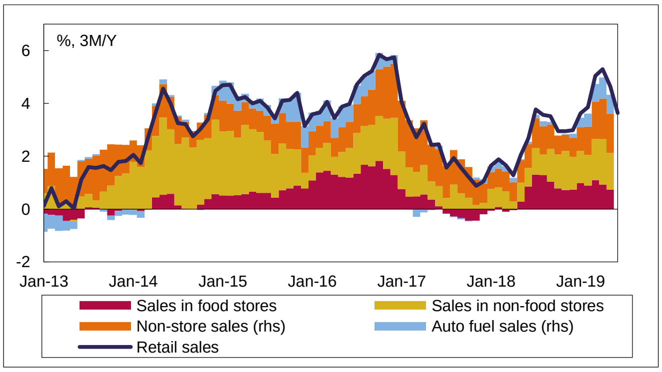
Retail sales rebound in June

While surveys had suggested another weak month for spending at the end of Q2, today's official UK retail sales data reported a surprise rebound in June. Following two consecutive monthly declines, the total volume of retail sales rose 1.0%M/M (0.9%M/M excluding auto fuel) to be up 3.8%Y/Y (3.6%Y/Y excluding auto fuel). While sales of food merely inched higher, non-food store sales rose a firm 1.7%M/M, with spending at household goods stores up 1.9%M/M and clothes stores up 1.2%M/M. And while sales at department stores maintained a downtrend, other stores (typically small and/or independent) saw sales rise a particularly firm 3.2%M/M. On-line sales slipped back on the month but were still up a strong 9.0%Y/Y. Overall, despite the soft start to the quarter, total retail sales rose 0.7%Q/Q in Q2. While that marked a slowdown from growth of 1.6%Q/Q in Q1, it does point to an ongoing positive contribution to GDP growth from household consumption last quarter. Looking ahead, some consumers are likely to feel uneasy as the end-October Article 50 deadline approaches. However, others might stockpile or bring forward big-ticket purchases to mitigate risks of a no-deal Brexit. And so, we expect steady growth in household spending in the third quarter, supported not least by the ongoing solid rate of increase in real disposable income.

The day ahead in the UK

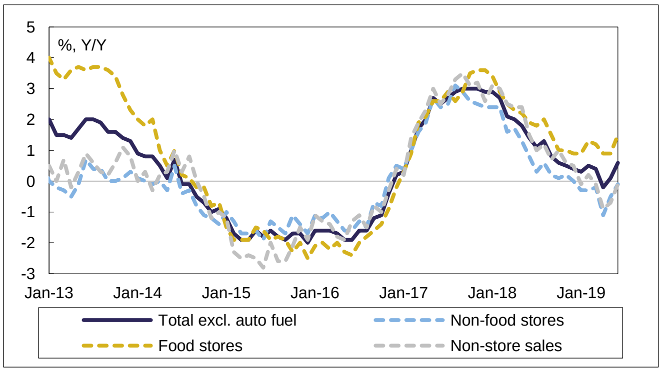
It should be a relatively uneventful end to the week for economic news from the UK, with the June public finances data the only notable release. While public sector net borrowing in April and May was up slightly on its levels in the same months last year, it was also on track to fall short of the OBR's full-year forecast by roughly £1½bn, possibly implying scope for very modest fiscal loosening in the autumn budget. However, in their campaigns to succeed Theresa May as Prime Minister, both candidates – the populist favourite Boris Johnson and the underdog Jeremy Hunt – pledged substantive tax cuts and extra public spending with few indications of how it would paid for, implying extra borrowing of tens of billions of pounds each year. And of course, the health of the public finances will partly depend on what happens with respect to Brexit. A scenario published today by the OBR in its "Fiscal Risks Report" suggested that annual net public borrowing would be around £30bn a year higher than its current baseline forecast from 2020-21 onwards.

UK: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Retail sales deflators



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
UK		Retail sales including fuel M/M% (Y/Y%)	Jun	**1.0 (3.8)**	-0.3 (2.6)	-0.5 (2.3)	**-0.6 (2.2)**
		Retail sales excluding fuel M/M% (Y/Y%)	Jun	**0.9 (3.6)**	-0.2 (2.6)	-0.3 (2.2)	**-0.4 (2.0)**

Auctions

Country		Auction
France		sold €2.75bn of 0% 2022 bonds at a yield of -0.69%
		sold €3.22bn of 2.25% 2022 bonds at a yield of -0.69%
		sold €2.78bn of 0% 2025 bonds at a yield of -0.44%
		sold €320mn of 0.1% 2028 index-linked bonds at a yield of -1.02%
		sold €786mn of 0.1% 2029 index-linked bonds at a yield of -1.01%
		sold €388mn of 0.1% 2036 index-linked bonds at a yield of -0.69%
Spain		sold €1.29bn of 0.05% 2021 bonds at a yield of -0.047%
		sold €1.22bn of 0.25% 2024 bonds at a yield of -0.205%
		sold €1.46bn of 1.95% 2030 bonds at a yield of 0.461%

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	Euro area current account balance €bn	May	-	20.9
UK		09.30	Public sector net borrowing £bn	Jun	3.9	5.1

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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