Euro wrap-up

Overview

- Bunds made gains today as financial markets await the coming week's ECB announcement. In contrast, BTPs made losses as Italy's Deputy PM Salvini was reportedly undecided about holding a snap election.
- Gilts also made gains despite a larger than expected increase in UK public sector borrowing.
- All eyes in the coming week will be on the ECB policy announcement (Thursday) and confirmation of the identity of the next UK PM (Tuesday).

Chris Scicluna
+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.770	-0.017
OBL 0 04/24	-0.701	-0.015
DBR 0¼ 02/29	-0.368	-0.012
UKT 1½ 01/21	0.511	-0.016
UKT 1 04/24	0.511	-0.024
UKT 1⅝ 10/28	0.732	-0.027

*Change from close as at 4.40pm BST.
Source: Bloomberg

Euro area

A rebound in the current account surplus

A quiet end to the week for euro area economic data brought just the May balance of payments, which reported an increase of €8bn in the current account surplus to a three-month high of €30bn. The rise in the surplus principally reflected a €4bn rise in the goods trade surplus to €27bn, which related to the improved showing in exports, as well an increase in the primary income surplus as income earned abroad rose and income repatriated by non-residents fell. In the twelve months to May, however, the cumulative current account surplus came in at €323bn (2.8% of euro area GDP), some €69bn (0.2ppt of GDP) lower than the same period a year ago, reflecting the weaker net trade performance as export growth floundered but domestic demand remained relatively firm. In contrast to the recent trend, the financial account data reported a significant net inflow of capital in the euro area in May as residents were net sellers of foreign assets, but non-residents increased exposure to euro area assets. And while net purchases of debt by non-residents fell, that development seems bound to have reversed substantively over the past month or so as expectations of new ECB policy easing increased.

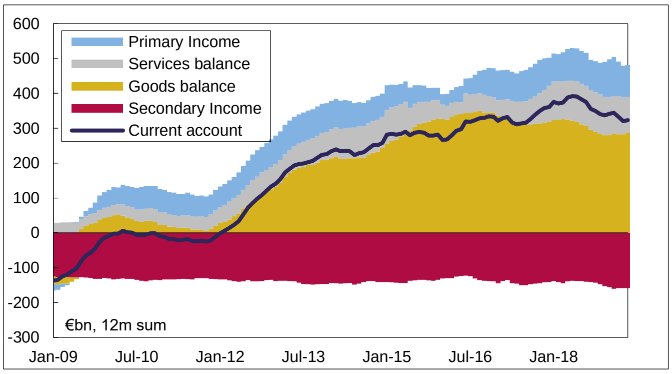
ECB is gearing up to ease policy again

The main event of the coming week in the euro area, of course, will be the ECB's latest policy announcement on Thursday. With its updated economic forecasts having suggested that headline and core inflation will likely remain below target over the coming three years, at its policy meeting last month the Governing Council extended its forward guidance to suggest that rates are expected to remain at current levels at least through the first half of 2020. In his post-meeting press conference, Mario Draghi also stated that the Governing Council "is determined to act in case of adverse contingencies". The account of that meeting added that there had been "broad agreement" that the "Governing Council needed to be ready and prepared to ease the monetary policy stance further by adjusting all of its instruments, as appropriate". So, like the Fed, the ECB appears to be gearing up to take new policy action.

July meeting likely to bring a signal of action in September

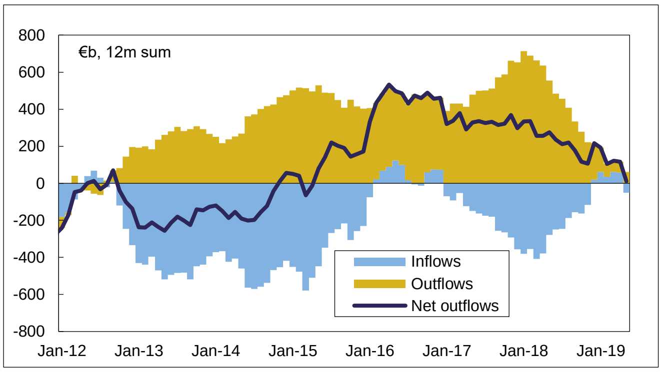
Recent comments from Governing Council members, however, left it uncertain whether they judge that the preconditions for easing policy this month have been met. Indeed, recent economic data – from the euro area and certain other major economies – have been mixed and difficult to interpret with confidence. And as last month's forward guidance did not explicitly flag the near-term possibility of a rate cut, we think the policymakers will want to wait for September before deciding what to do. Assuming they wait until then, they would also be able to calibrate precisely their policy response with updated economic forecasts that better reflect recent events. So, at the coming week's meeting, we expect the Governing Council only to make a clearer signal of the likelihood of further easing in September, rather than announce detailed new measures.

Euro area: Current account balance



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Portfolio investment



Source : Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Adjustment of all instruments possible

If and when it eases policy this month or in September, moreover, it is highly uncertain what specific form that action will take. As a rate cut of smaller magnitude would likely have little economic impact, we would expect a cut of 20bps in the deposit rate to -0.60%. At the same, to reduce the cost of the negative rate on the banks and thus maintain easy financial conditions and support economic sentiment (particularly in Germany) too, a new tiered interest rate system – such as those long adopted by the BoJ and Danish, Swedish and Swiss National Banks – would also seem likely be announced. In addition, reflecting the ECB's readiness to adjust "all of its instruments, as appropriate", and its assessment that its asset purchases provided more support to growth and inflation over the past few years than negative rates, an increase in the issue limits on the QE programme (from 33% to 50%) might also be announced as a signal of preparedness to restart net asset purchases again if necessary. Indeed, we would not be surprised if a recommencement of net asset purchases (say, a programme of €45bn per month over nine months) was announced as soon as September if the economic dataflow deteriorated between now and then and/or more substantive downside risks to the economic outlook – e.g. associated with Brexit and/or the US trade wars – looked set to crystallise. Additional net asset purchases would also add credibility to any announcement of a revamped inflation target – such as a symmetrical 2.0%Y/Y target – which a Bloomberg report yesterday suggested might now be under discussion, and which Draghi would seem bound to be asked about in Thursday's press conference.

The week ahead in the euro area and US

Beyond the aforementioned ECB announcement, the coming week's data calendar will be dominated by economic sentiment survey results for July. After a quiet start to the week with little of note due on Monday, the following day brings the flash estimate of the Commission's euro area consumer confidence index for July. Having declined to a near-two year low in December, this indicator ticked a touch higher at the start of the year before oscillating around a broadly sideways trend. And after slipping slightly in June, we expect only modest improvement in the July reading. Wednesday, meanwhile, brings the most notable release of the week in the shape of the flash July PMIs. In June, the euro area services PMI edged up to an eight-month high (53.6). But the equivalent index for manufacturing weakened a little to remain firmly in contractionary territory (47.6). And overall, the average PMIs for Q2 remained underwhelming, with the euro area composite index up just 0.3pt from Q1 to 51.8, the second-lowest level since 2014 implying GDP growth of about 0.2%Q/Q, and the equivalent quarterly PMIs for Germany (52.5) and France (51.3) suggestive of growth at the same pace. Like for consumer confidence, we expect little improvement in the flash PMIs for July. The French INSEE business climate indices are also due on Wednesday with the similar German ifo indices scheduled for release on Thursday before the ECB announcement, and the Italian ISTAT economic sentiment survey results due on Friday. Beyond the economic survey indices, the ECB's bank lending data, also due Wednesday, should be consistent with ongoing steady loan growth, led by Germany and France, at the end of Q2. In the markets, meanwhile, Italy will sell a range of regular and index-linked bonds on Friday.

A key focus in the coming week's US economic diary will be the first estimate of Q2 GDP on Friday, which is expected to report a moderation in growth of a little more than 1ppt from the rate of 3.1%Q/Q annualised in Q1. Ahead of that, there will be plenty of new data from the housing market, with existing home numbers for June and the FHFA house price indices for May on Tuesday, and new home sales figures for June on Wednesday. That day will also bring the preliminary Markit PMIs for July. And ahead of the GDP release the following day, alongside the usual weekly claims numbers, Thursday will give an update on demand at the end of Q2. In particular, advance June data for goods trade and durable goods orders are due that day, as well as wholesale and retail inventory figures for the same month. There will be plenty of regional Fed surveys scattered across the week too, starting with the Chicago Fed national activity indices for June on Monday. In the bond markets, the US Treasury will sell 2Y Notes on Tuesday, 5Y Notes and 2Y FRNs on Wednesday, and 7Y Notes on Thursday.

UK

Public borrowing higher than expected in June

Having come in lower than expected over the first two months of the fiscal year, UK public sector net borrowing was higher than expected in June, at £7.2bn (excluding public sector banks), up from £3.3bn a year earlier and the highest for the month since 2015. One reason for the increase from June 2018 was higher debt interest payments, up £2.1bn, partly due to increased payments associated with inflation-linked Gilts. However, due to weaker increases in income tax and VAT payments, which are likely to be related to the economic slowdown, growth in central government tax receipts slowed to 1.5%Y/Y, just half the rate in the OBR's full-year forecast. The higher net borrowing figure for June took the total some 33% above that in the equivalent period in FY18/19, suggesting that it is now on track for an overshoot of the OBR's full-year target of £29.3bn.

Fiscal irresponsibility to be back in vogue?

Indeed, looking ahead, a change to the accounting treatment of student loans from September will boost the measure of net borrowing this fiscal year by approximately £11bn. More significantly, all indications are that the next Prime Minister, who seems almost certain to be the populist Brexiter Boris Johnson, intends to loosen fiscal policy aggressively in the autumn Budget. With substantive tax cuts and lashings of extra public spending promised throughout the Conservative leadership campaign, fiscal irresponsibility might be back in vogue after years of austerity. However, given the Government's slender

Parliamentary majority (see below), we suspect that the most reckless and/or politically divisive measures would be blocked by the House of Commons.

OBR no-deal Brexit scenario likely too conservative

Most important for the health of the public finances, of course, will be what happens with respect to Brexit. The OBR's "Fiscal Risks Report", published yesterday, included a scenario based on the IMF's estimated impact on the economy of a no-deal Brexit that largely avoided border disruption. That scenario foresaw GDP falling by 2% by end-2020, 4% below the OBR's current baseline forecast at that point. In such circumstances, the OBR estimates that annual net public borrowing would be around £30bn a year higher than baseline from 2020-21 onwards. And that would push public sector net debt up close to 87% of GDP, almost 12ppts higher than the current baseline. In our view, like that of Chancellor of the Exchequer Philip Hammond, not least since more severe border disruption would likely ensue, the impact on GDP and the public finances would likely be far more severe if the UK was to leave the EU without a deal. Thankfully, however, yesterday's vote by MPs to limit scope for the next Prime Minister to push through a no-deal Brexit by dissolving Parliament supported our view that such a destructive outcome once the end-October Article 50 deadline passes remains unlikely.

Johnson to be confirmed as May's successor

Politics will dominate the coming week in the UK, with the announcement of the winner of the Conservative leadership election to be made on Tuesday morning. Assuming that no major scandals come to light before then, the highly divisive Boris Johnson seems bound to be confirmed as Theresa May's replacement as head of the ruling party. The following day, Theresa May will take questions in the House of Commons for the last time, after which she will head to Buckingham palace to resign formally as Prime Minister. Johnson should be confirmed as Prime Minister shortly afterwards, allowing him to deliver a first speech from Downing Street later that day, and a first statement to the House of Commons the following day. Later on Thursday, the House of Commons is scheduled to rise for summer recess, after which it is scheduled not to return to work until 3 September. To some extent, however, the Parliamentary timetable assumes that a vote of no confidence in the Government is avoided in the coming week.

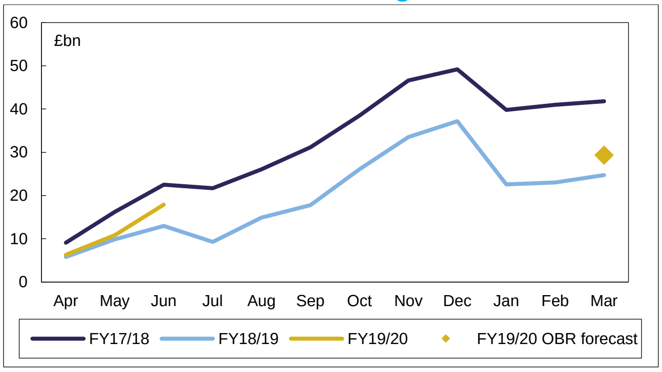
Government vulnerable to a vote of no confidence

Since Theresa May's disastrous snap election in 2017, the Conservative party has had a minority of seats in the House of Commons. Its representation has diminished further over recent months due to resignations from the party by several MPs and the removal of another MP by his constituents following a conviction for fraud. As such, even with the backing of the ten MPs from the Northern Irish DUP with whom Theresa May negotiated a "confidence and supply" deal, the Government now has a working majority of just four seats. That is set to drop to three in August following a by-election in Wales related to the recall of the disgraced fraudulent MP. So, the Government is vulnerable to a vote of no-confidence, defeat in which would likely trigger an early General Election.

Minority of Conservatives could yet bring down the Government

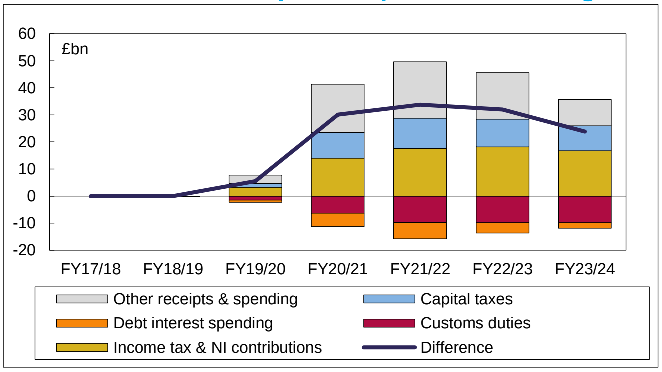
Throughout the leadership campaign, Johnson was deliberately evasive about his intentions for Brexit. However, he seemingly reduced scope for a new agreement to be reached with the EU, with the associated increased risk of a no-deal Brexit contributing to recent downwards pressure on sterling. While many Conservative MPs have been unperturbed by Johnson's behavior, a minority, including Chancellor Philip Hammond, is determined to act to prevent a no-deal Brexit. That resulted in yesterday's vote by MPs to reduce scope for the Government to force through a no-deal Brexit by proroguing Parliament. Moreover, if it was the only way prevent the UK leaving the EU without a deal, some Conservative MPs have also made clear their willingness to vote against the Government in a vote of no-confidence.

UK: Public sector net borrowing



Source: ONS, OBR and Daiwa Capital Markets Europe Ltd.

UK: No-deal Brexit impact on public borrowing*



**Increase in net public sector borrowing above OBR baseline forecast assuming a no-deal Brexit with minimal border disruption. Source: OBR Fiscal Risks Report and Daiwa Capital Markets Europe Ltd.*

Vote of no confidence unlikely before October

For a vote of no-confidence in the Government to be held in the coming week, Labour's Jeremy Corbyn would need to table the appropriate parliamentary motion by Wednesday. If the Government then lost that vote the following day, it would have two further weeks to try to win back the confidence of MPs without which a General Election would then be held in late September. If Corbyn tables his motion on Thursday, the confidence vote would come in early September, with the General Election then likely to be held just a week before the Article 50 deadline of 31 October. Since the anti-no-deal Conservatives would seem unlikely to vote against the Government until all other options to prevent the UK leaving the EU without a deal have been exhausted, however, we do not expect any confidence motion to be tabled until after the recess, and probably not before mid-October if and when all other attempts to block a no-deal Brexit have been exhausted.

The week ahead in the UK

Beyond the politics, the coming week's UK economic data calendar is extremely light. After a quiet Monday with no notable releases due, the following day's CBI Industrial Trends survey will take stock of conditions in the manufacturing sector at the start of Q3. The CBI's Distributive Trades survey, due Thursday, will likewise give a health-check on the retail and wholesale sectors in July. And between those releases, the UK Finance bank lending figures for June are due on Wednesday. In the bond market, the DMO will sell 10Y Gilts on Tuesday.

In the absence of significant news, the next edition of the Euro wrap-up will be published on 23 July 2019

Daiwa economic forecasts

	2019				2020				2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP forecasts %, Q/Q											
Euro area	0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.1	1.8	1.0	0.8
Germany	0.4	0.1	0.2	0.2	0.2	0.3	0.2	0.1	1.4	0.7	0.9
France	0.3	0.2	0.3	0.3	0.3	0.3	0.2	0.2	1.6	1.1	1.1
Italy	0.1	0.0	0.0	0.0	0.0	0.1	-0.1	-0.1	0.7	0.1	0.1
Spain	0.7	0.5	0.4	0.4	0.4	0.4	0.4	0.3	2.6	2.3	1.6
UK	0.5	-0.1	0.2	0.2	0.2	0.2	0.2	0.1	1.4	1.2	0.7
Inflation forecasts %, Y/Y											
Euro area											
Headline CPI	1.4	1.4	1.0	1.0	1.4	1.3	1.4	1.5	1.8	1.2	1.4
Core CPI	1.0	1.0	1.0	1.0	1.1	1.2	1.3	1.4	1.0	1.0	1.2
UK											
Headline CPI	1.9	2.0	1.8	1.6	1.9	1.6	1.5	1.7	2.5	1.8	1.8
Core CPI	1.9	1.7	1.7	1.7	1.8	1.9	1.8	1.7	2.1	1.7	1.8
Monetary policy											
ECB											
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.40	-0.40	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.40	-0.60	-0.60
Net asset purchases*	0	0	0	0	0	0	0	0	15	0	0
BoE											
Bank Rate %	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.75	0.50	0.50
Net asset purchases**	0	0	0	0	0	0	0	0	0	0	0

**Monthly target €bn, end of period. **Monthly target £bn, end of period. Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Euro area current account balance €bn	May	**29.7**	-	20.9	**22.4**
UK	Public sector net borrowing £bn	Jun	**7.2**	3.9	5.1	**4.5**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 22 July 2019			
			- Nothing scheduled -			
			Tuesday 23 July 2019			
EMU		15.00	Preliminary consumer confidence	Jul	-7.3	-7.2
Spain		09.00	Trade balance €bn	May	-	1.6
UK		11.00	CBI industrial trends survey - total orders (business optimism)	Jul	-15 (-)	-15 (-13)
			Wednesday 24 July 2019			
EMU		09.00	Preliminary composite PMI	Jul	52.1	52.2
		09.00	Preliminary manufacturing PMI (services PMI)	Jul	47.6 (53.3)	47.6 (53.6)
		09.00	M3 money supply Y/Y%	Jun	4.6	4.8
Germany		08.30	Preliminary composite PMI	Jul	52.2	52.6
		08.30	Preliminary manufacturing PMI (services PMI)	Jul	45.0 (55.3)	45.0 (55.8)
France		07.45	Business confidence (manufacturing confidence)	Jul	106 (102)	106 (102)
		08.15	Preliminary composite PMI	Jul	52.5	52.7
		08.15	Preliminary manufacturing PMI (services PMI)	Jul	51.6	51.9 (52.9)
UK		09.30	UK Finance loans approved for house purchase £bn	Jun	52.6	42.4
			Thursday 25 July 2019			
EMU		12:45	ECB Main Refinancing rate %	Jul	*0.00*	0.00
		12:45	ECB Marginal Lending Facility rate %	Jul	*0.25*	0.25
		12:45	ECB Main Deposit rate %	Jul	*-0.40*	-0.40
Germany		09.00	IFO business climate	Jul	97.0	97.4
		09.00	IFO current assessment (expectations)	Jul	100.3 (94.0)	100.8 (94.2)
France		11.00	Total jobseekers '000s	Q2	-	3.4
UK		11.00	CBI distributive trades survey - reported retail sales	Jul	3	-42
			Friday 26 July 2019			
France		07.45	Consumer confidence	Jul	102	101
Italy		09.00	Business confidence (manufacturing confidence)	July	- (100.6)	99.3 (100.8)
		09.00	Consumer confidence	Jul	109.5	109.6
		09.00	Hourly wages Y/Y%	Jun	-	1.4

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 22 July 2019
			- Nothing scheduled -
			Tuesday 23 July 2019
UK		11.00	Conservative party leader to be announced
		10.30	Auction: to sell £2.75bn of 0.875% 2029 bonds
		13:15	BoE's Andy Haldane due to give a speech
			Wednesday 24 July 2019
UK		-	Conservative party leader to be invited to become the new Prime Minister
			Thursday 25 July 2019
EMU		12:45	ECB monetary policy announcement
		13.30	ECB's Draghi to give post-meeting press conference
			Friday 26 July 2019
EMU		09.00	ECB publishes its Survey of Professional forecasters
Italy		10.00	Auction: to sell fixed-rate and index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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