Euro wrap-up

Overview

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- While euro area core inflation fell back, longer-dated Bunds made modest losses after Executive Board member Schnabel reiterated that the ECB would not necessarily use the full €1.35trn envelope of the PEPP programme.
- Gilts were little changed as revised data revealed that the hit to GDP in Q1 was bigger than previously thought, but MPC member Haldane emphasised that the drop in Q2 will be less than the BoE had previously expected.
- Tomorrow will bring final European manufacturing PMIs, new car registration figures from various member states and German unemployment numbers.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.705	-
OBL 0 04/25	-0.708	+0.001
DBR 0 08/30	-0.465	+0.010
UKT 0½ 07/22	-0.089	-0.005
UKT 0⅝ 06/25	-0.057	-0.001
UKT 4¾ 12/30	0.170	+0.007

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

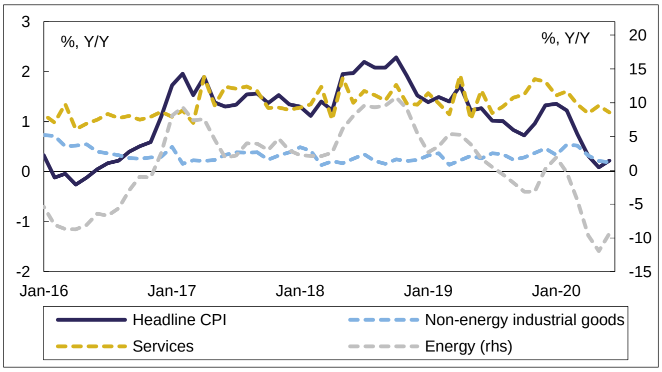
Rise in inflation in June due entirely to energy

According to the flash estimate, euro area CPI inflation rose 0.2ppt in June to 0.3%Y/Y. As had been suggested by yesterday's equivalent data from Germany and Spain, the cause of the increase was energy inflation, which rose 2.5ppts to -9.4%Y/Y as the roughly 30% increase in euro-denominated oil prices fed through to high prices of gasoline and electricity. In contrast, food inflation eased 0.3ppt to a three-month low of 3.1%Y/Y. Inflation of non-energy industrial goods was unchanged at 0.2%Y/Y (and dropped to a fifteen-month low to two decimal places). And services inflation edged back down 0.1ppt to 1.2%Y/Y, matching the bottom of the range of the past twelve months. As a result, the annual rate of core CPI dropped 0.1ppt to a thirteen-month low of 0.8%Y/Y. There remain concerns about the quality of these inflation figures. But with lockdown measures having eased, prices of only 11% of items in the inflation basket had to be imputed by the statisticians in June, only one half of the equivalent share in May and about one third of the share in April. And with demand well below the pre-pandemic level, there should be no doubt that underlying inflation remains highly subdued and at the bottom of the range of the past few years.

Inflation set to remain sub-target over the horizon

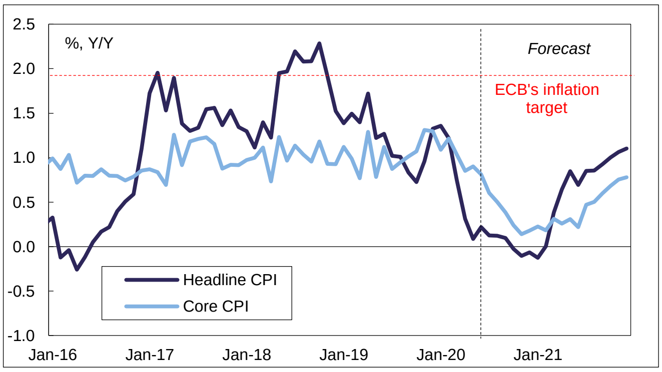
While they have picked up over recent weeks, energy prices will continue to subtract significantly from headline inflation over coming months. And we expect firms, particularly in retail, hospitality and leisure, to have to offer sizeable discounts to try to attract custom even as they are able to reopen. Moreover, as a significant share of workers currently furloughed will likely become permanently unemployed, we expect wage growth to weaken significantly, further weighing on domestically generated inflation, particularly in services. So, despite the extra costs faced by firms as they are forced to maintain social distancing practices – which will likely act as a further disincentive to hire staff over coming months – disinflationary pressures will persist. We expect core inflation later this year to drop to series lows. And the broad trend in headline inflation over coming months is likely to be sideways. From next Spring onwards, energy prices will cease to act as a drag. But with a significant negative output gap set to persist into the medium term, like the ECB we expect underlying inflation to remain well below the ECB's aim of below but close to 2.0%Y/Y well into the medium term. While Executive Board member Schnabel today repeated that the ECB might not necessarily use the full €1.35trn PEPP envelope, we continue to expect the Governing Council to increase its asset purchase target, probably by at least a further €500bn, before year end. And it will also likely maintain net asset purchases well into 2022.

Euro area: CPI inflation – major components*



*May-20 figures are flash estimates. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: CPI inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

French consumption still sub-par despite surge in May

French figures for consumer spending on goods in May beat expectations, revealing record monthly growth of 36%M/M. Perhaps inevitably as non-essential retailers reopened last month, the improvement was widespread, with spending on clothing and autos leaping the most on the month albeit from particularly weak levels. Indeed, spending on the former was still down by 17% from February while spending on transport goods was still roughly one quarter below the pre-pandemic level. This contrasted with spending on household equipment – and furniture in particular – which more than doubled in May back to the pre-Covid level. On the whole, however, the level of manufactured goods consumption remained relatively low in May, as did fuel consumption. Indeed, with food the only category to see spending above its level of February (4%), overall consumption on goods remained down 7% from the pre-pandemic level in May, to leave it on average so far in Q2 more than 15% below the Q1 average.

The day ahead in the euro area and US

Turning to the day ahead, tomorrow brings the publication of the final manufacturing PMIs for the euro area, Germany and France as well as additional member state indices, including Italy and Spain. Like the flash release and yesterday's Commission economic sentiment survey, these are expected to point towards a stabilisation of economic conditions following the initial deep contraction after the Covid outbreak rather than any vigorous expansion in June. Indeed, the flash euro area manufacturing PMI rose to 46.9, from 39.4 in May. In terms of hard data, tomorrow sees the release of German retail sales for May which are expected to show a jump, but not enough to reverse the drop recorded over the previous two months. Of course, that cumulative decline in Germany in March and April – of about 9% - was far smaller than in the other large euro area member states. Meanwhile, Germany's labour market figures are expected to report a further notable increase in the number of jobless workers to leave the unemployment rate rising to 6.5% in June, which would be the highest since H115. Elsewhere, we will also see the release of figures for new car registrations in June from various member states. Meanwhile, ECB Executive Board member Panetta is due to speak publicly.

In the US, the latest FOMC minutes will be published, together with a number of top-tier economic data releases, including the ISM manufacturing index, vehicle sales numbers and the ADP employment report, all for June, as well as construction spending figures for May.

UK

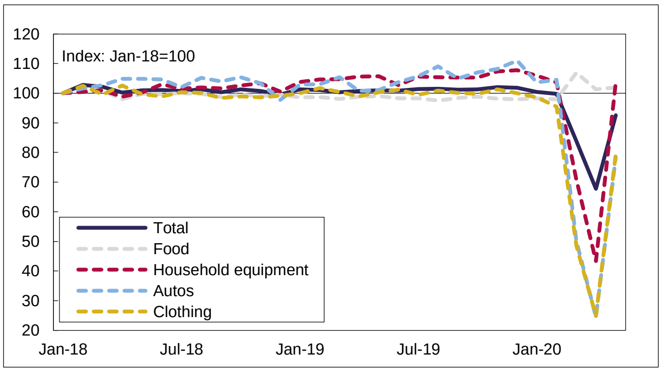
Hit to Q1 GDP larger than initially estimated, but Q2 not as bad as BoE feared

The initial hit to the UK economy from the pandemic lockdown was larger than expected, but the subsequent rebound in activity appears to be somewhat stronger than envisaged by the BoE. Today's updated figures showed that economic output dropped 2.2%Q/Q in Q1, 0.2ppt more than previously thought, to be down 1.7%Y/Y. The quarterly decline was a touch sharper than during the worst quarter of the global financial crisis and was thus the steepest since Q379. Of course, the magnitude of this drop will be dwarfed by Q2, for which we currently forecast a record contraction of 17%Q/Q. And in a speech today, BoE Chief Economist Haldane suggested that Bank staff now-casts imply a similar pace of decline to that envisaged by our own forecast. If correct, the resulting cumulative fall over Q1 and Q2 of about 20% would still be some 7ppts less than envisaged in the BoE's May Monetary Policy Report scenario. And with that implying firmer momentum heading into the second half of the year, that was a key one reason why Haldane voted (albeit on his own) against the £100bn increase in BoE asset purchases at the MPC's meeting earlier this month.

Household savings ratio up to four-year high

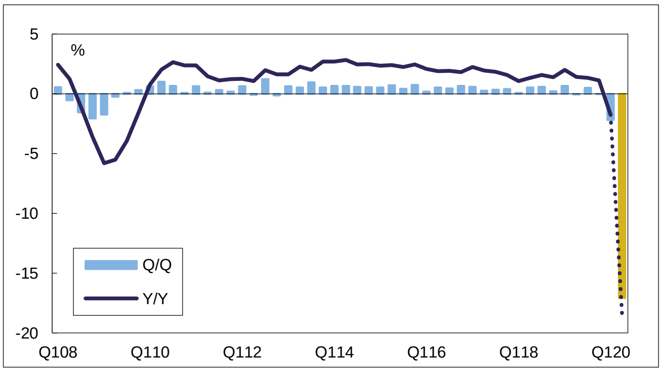
The rebound in activity from May onwards has been led by consumer spending. However, that follows an extreme collapse in April. And today's detail on the Q1 GDP report showed that the fall in private consumption was 1.2ppt sharper than originally

France: Consumer spending*



Consumer spending on goods. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: GDP growth*



Q220 is Daiwa forecast. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

thought, with the drop of 2.9%Q/Q also the worst since 1979. But with employee compensation having risen 1.1%Q/Q, the most in five quarters, lower spending in Q1 was matched by a sharp rise in the households' saving ratio, up 2ppts to a four-year high of 8.6%. With expenditure having subsequently contracted at a much sharper pace, household bank deposits increased by a record amount in May adding to evidence of a further increase in the saving ratio in the current quarter. While that might suggest scope for a swift rebound in spending over coming quarters, we expect overall savings to remain relatively elevated, partly due to the heightened uncertainty about the outlook. At the same time, the ongoing hit to the labour market will leave many of the least well-off households particularly cash-constrained. And as support under the Job Retention Scheme is phased out from August, many furloughed workers will eventually be made redundant and will struggle to find new jobs elsewhere.

Johnson public investment pledge a damp squib

Meanwhile, government spending also fell more steeply than previously thought in Q1 (-4.1%Q/Q), weighed not least by lower output of education and healthcare services. And gross fixed investment was revised down slightly too (-1.1%Q/Q), with business capex (-0.3%Q/Q) now judged to have fallen for the sixth quarter out of the past nine. As persisting uncertainty over the future trade relationship between the UK and EU will continue to weigh on investment in manufacturing while the pandemic will continue to weigh on investment in services, we certainly do not expect a swift rebound in business capex for several quarters to come. And despite suggestions within his circle that he would support large-scale additional fiscal stimulus, PM Boris Johnson today committed to increase public investment by only about 0.25% of GDP, suggesting that government spending will fail to provide an engine for recovery either.

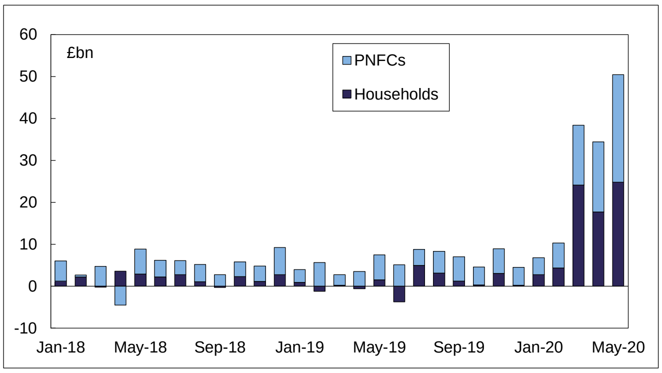
Current account deficit widened on special factors

Like other components of demand, trade volumes fell sharply in Q1 too, with exports down 13.5%Q/Q and imports down 9.4%Q/Q. And today's data also revealed that the UK's current account deficit widened substantially last quarter, by almost £12bn, to £21.1bn, or 3.8% of GDP (up from 1.7% of GDP the prior quarter). Excluding shifts in non-monetary gold and other precious metals, however, the underlying current account deficit narrowed slightly to 3.6% of GDP, well within the recent range, despite a wider deficit on primary income as UK earnings on foreign investment dropped sharply in response to lockdowns elsewhere. We expect the underlying deficit to remain close to this level over coming quarters too.

The day ahead in the UK

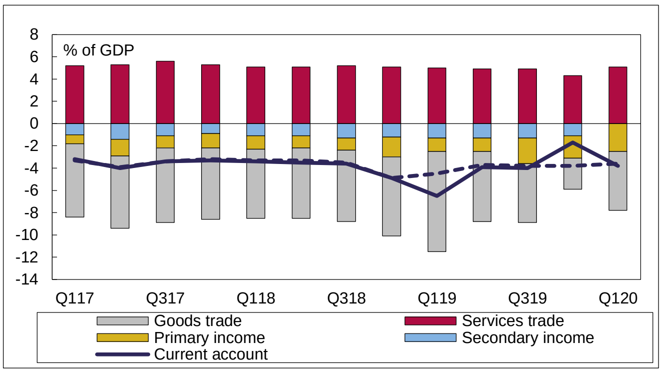
Tomorrow sees the release of the final manufacturing PMI survey for June, which is expected to reveal that activity stabilised this month but without significant momentum, with the headline index rising to 50.1, from 40.7 in May. The Nationwide house price index is expected to show that residential property prices continued to fall amid extremely weak demand. In addition, the BRC shop price index will likely report ongoing disinflationary pressures in June, as retailers lowered prices to attract customers. In other news, external MPC member Haskel will speak at an event while, in the markets, the DMO will auction 2028 and 2050 Gilts.

UK: Deposits held by households and PNFCs*



Monthly flows of sterling deposits. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Current account balance*



Dashed line represents current account balance excluding precious metals. Source: ONS and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Flash CPI (core CPI) Y/Y%	Jun	**0.3 (0.8)**	0.3 (0.9)	0.1 (0.9)	-
France		Preliminary CPI (EU-harmonised CPI) Y/Y%	Jun	**0.1 (0.1)**	0.4 (0.5)	0.4 (0.4)	-
		Consumer spending M/M% (Y/Y%)	May	**36.6 (-8.3)**	30.0 (-13.5)	-20.2 (-34.1)	**-19.1 (-32.7)**
Italy		Preliminary CPI (EU-harmonised CPI) Y/Y%	Jun	**-0.2 (-0.4)**	-0.2 (-0.3)	-0.2 (-0.3)	-
Spain		Final GDP Q/Q% (Y/Y%)	Q1	**-5.2 (-4.1)**	-5.2 (-4.1)	0.4 (1.8)	-
UK		Lloyds business barometer	Jun	**-30**	-	-33	-
		Final GDP Q/Q% (Y/Y%)	Q1	**-2.2 (-1.7)**	-2.0 (-1.6)	0.0 (1.1)	-
		Current account balance £bn	Q1	**-21.1**	-15.0	-5.6	**-9.2**

Auctions

Country		Auction
Germany		sold €2.5bn of 0% 2027 bonds at an average yield of -0.62%
Italy		sold €3bn of 1.85% 2025 bonds at an average yield of 0.68%
		sold €1.25bn of 2023 floating rate notes at an average yield of 0.56%
		sold €2.2bn of 1.65% 2030 bonds at an average yield of 1.28%
		sold €1.3bn of 0.95% 2030 bonds at an average yield of 1.2%

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 manufacturing PMI	Jun	46.9	39.4
Germany		07.00	Retail sales M/M (Y/Y%)	May	3.5 (-3.4)	-6.5 (-6.4)
		08.55	Final manufacturing PMI	Jun	44.6	36.6
		08.55	Unemployment change '000s (rate %)	Jun	110 (6.5)	238 (6.3)
France		08.50	Final manufacturing PMI	Jun	52.1	40.6
Italy		08.45	Manufacturing PMI	Jun	47.6	45.4
		17.00	New car registrations Y/Y%	Jun	-	-49.6
Spain		08.15	Manufacturing PMI	Jun	45.4	38.3
UK		00.01	BRC shop price index Y/Y	Jun	-	-2.4
		07.00	Nationwide house price index M/M% (Y/Y%)	Jun	-0.8 (1.1)	-1.7 (1.8)
		09.30	Final manufacturing PMI	Jun	50.1	40.7

Auctions and events

Country		BST	Auction / Event
EMU		08.45	ECB's Panetta scheduled to speak
UK		10.00	Auction: £3bn of 0.125% 2028 bonds
		10.00	Auction: £2.25bn of 0.625% 2050 bonds
		12.00	BoE's Haskel scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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