Euro wrap-up

Overview

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- Bunds made gains as an investor survey suggested that confidence in the German economic outlook has softened somewhat.
- Gilts also made gains as UK GDP data for May were significantly weaker than expected.
- Wednesday will bring UK inflation figures for June, which are expected to confirm that underlying price pressures remain very subdued.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.673	+0.006
OBL 0 04/25	-0.654	-0.014
DBR 0 08/30	-0.447	-0.027
UKT 0½ 07/22	-0.113	-
UKT 0⅝ 06/25	-0.070	-0.011
UKT 4¾ 12/30	0.150	-0.035

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

Euro area

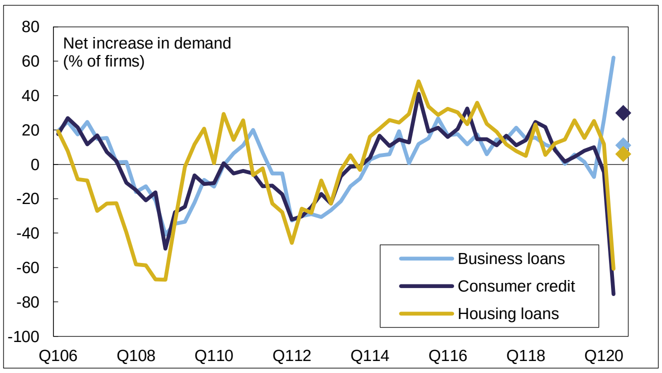
Firms' loan demand expected to normalise after Q2 surge

The latest ECB bank lending survey (BLS) predictably illustrated the ongoing significant impact of the pandemic on firms' demand for liquidity. Indeed, the survey's net balance of firms' demand for loans surged to its highest level (62%, compared with 26% in Q1) since the survey began in 2003. While the survey reported a sharp decline in funding needs for capex projects, the big increase in new loans was required to finance inventories and working capital as well as debt refinancing and restructuring. In contrast to Q1, loan demand was greater for SMEs than for larger firms, although both were at record highs. Demand was also significantly higher for short-term loans than long-term loans. Net demand increased considerably in all of the largest member states but was most marked among firms in France, Italy and Spain. And over the first half of the year as a whole, demand from manufacturers saw the biggest increase. Looking ahead, demand from SMEs is anticipated to remain well above the long-run average in Q3. But banks expect some normalisation in overall demand for business loans, with the net balance for larger firms forecast to fall back sharply. In stark contrast to the picture for bank loans, demand for consumer and housing loans reportedly fell back sharply in Q2, with the former suggesting the biggest drop on record and the latter the most since the global financial crisis. But both components are expected to recover somewhat in Q3.

Loan guarantees prevented tightening of credit standards

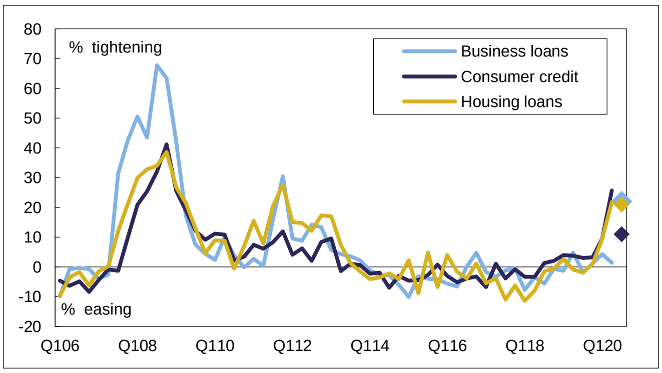
While credit standards on loans to NFCs remained broadly unchanged in Q2, this contrasted with a significant tightening during previous crises as monetary and fiscal policy initiatives – not least government loan guarantees – offered reassurance. Certainly, while demand for government guaranteed loans in Germany was lower than expected, greater take-up in other member states underpinned a notable easing in credit standards. Overall, banks reported a net easing in credit standards for short-term loans. And perhaps also reflecting the greater incentive to boost lending provided by the ECB – which in June cut the interest rate on its TLTRO-iii operations to 50bps below the deposit rate for banks that increase their lending beyond the required benchmark – there was a considerably lower number of loan applications rejected last quarter, particularly in France. In marked contrast, lending conditions tightened markedly for housing loans and consumer credit, by the most since Q411and Q109 respectively, as banks assessed increased risks associated with the economic outlook, borrowers' creditworthiness and housing market prospects. Looking ahead, banks anticipate a further, but smaller, tightening on consumer loans in Q3, but considerably tighter lending conditions on business loans as government loan schemes potentially draw to a close. Of course, banks also expressed a greater degree of uncertainty regarding the near-term outlook as the future path for the pandemic remained unclear.

ECB bank lending survey: Demand for loans*



Diamonds reflect survey forecast for the coming three months. Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

ECB bank lending survey: Credit standards*



Diamonds reflect survey forecast for the coming three months. Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

ZEW survey sees expectations soften slightly

While the initial rebound in economic activity in May appears in many member states to have surpassed expectations, some high frequency data have suggested a leveling off in momentum over the past few weeks. And today's German ZEW survey suggested that confidence in the recovery failed to improve significantly at the start of Q3. In particular, the current assessment balance increased a much smaller than expected 2.2pts in July, to -80.9, still close to historically low levels. And this merely reflected a marginal increase in the share of survey recipients assessing some normalisation, with none reporting an improvement. Moreover, there were some doubts cast about the near-term outlook, with the balance for expectations over the coming six months slipping back slightly in July. Admittedly this was down from a multi-year high recorded in June. And overall, survey participants still anticipated a gradual recovery in economic activity over the second half of the year after the marked contraction in Q2.

Euro area IP rebounds in May

There were no surprises from today's aggregate euro area industrial production figures, which showed a record increase in May of 12.4%M/M. But this still left output down 21.2% from the pre-Covid peak, and also a little more than one fifth below the level a year earlier. Within the detail, the improvement reflected a near-fivefold increase in production of motor vehicles, although output in the sector was still more than 50% below the pre-pandemic level. Strong increases in machinery (19%M/M) and electrical equipment (15%M/M) similarly left output down by almost a fifth from the peak in February. Indeed, production of pharmaceutical products was the only subsector to remain slightly higher than at the start of the year. And overall, while surveys have pointed to a further improvement in activity in June as containment measures continued to relax, we expect total output to remain well below the pre-Covid level for the foreseeable future.

The day ahead in the euro area

It should be a quiet day for euro area economic news tomorrow, with just final Italian CPI figures for June due for release. In contrast to today's German and Spanish figures – which confirmed that headline inflation rose respectively by 0.3ppt to 0.8%Y/Y and 0.6ppt to -0.3%Y/Y in June – these are expected to confirm that inflation edged further into negative territory last month, down 0.1ppt to -0.4%Y/Y, the weakest for more than four years.

UK

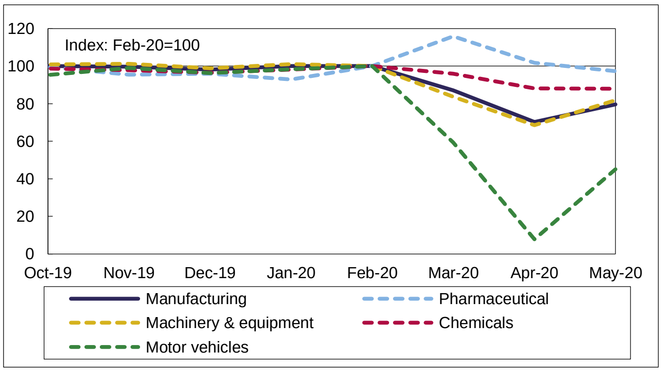
A limp rebound in GDP in May

Having been slower to get to grips with the pandemic, the UK was unable to relax its lockdown restrictions as quickly as other European countries. As a result, the rebound in UK economic activity has lagged that of its peers. Today's ONS data showed that GDP growth in May was even weaker than expected, at just 1.8%M/M following a drop of more than 20%M/M in April to be down some 24.5% from the level before the pandemic hit in February. Among the various sectors, manufacturing production rose 8.5%M/M with most sub-sectors recording positive growth. But that left it down 22.3% from February, with output of metals still down more than one quarter, machinery and equipment down about one third, and transport items down by more than half. Construction output rose a similar 8.2%M/M but that still left it down a whopping 38.8% from February. Most strikingly, growth in services was minimal at just 0.9%M/M to be 24.4% lower than the pre-pandemic level.

Massive variation across the sub-sectors

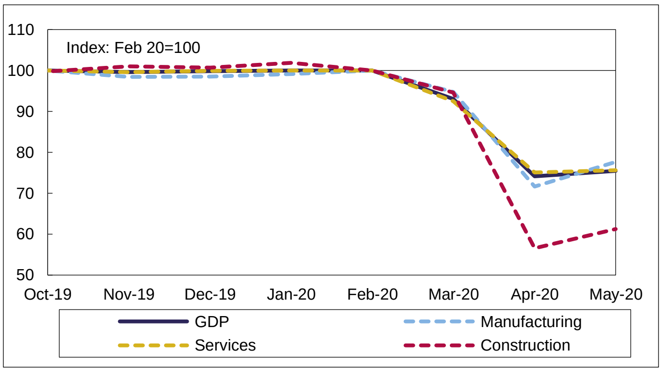
Most of the growth in services in May came from retail and supporting industries (e.g. freight transport and warehousing), as sales rebounded 12.0%M/M, albeit leaving them still some 13.1% below the February level. But constraints on other forms of activity meant that growth in many other services was still minimal or even negative again. For example, with negligible growth, the level of output in hospitality was still down more than 90% from February. Value added of arts and

Euro area: Industrial production in selected sectors



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP and selected sectoral components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

entertainments dropped a further 11.3% to be less than half the pre-pandemic level. And while health and social care output rose, it remained almost 30% below February's level as non-essential medical treatment was postponed. Of all main services sub-sectors, only public administration and defence output was above February's level in May, as government activity sought to respond to the pandemic.

Spending firmer in June

Less constrained by lockdown restrictions, early indications for June point to a stronger rebound last month, albeit one that still left total output well down on the February level and probably also continued to lag the euro area. Indeed, the BRC retail survey measure of total sales rose 3.4%Y/Y in June, the first year-on-year increase since February, as non-essential stores were allowed to reopen. Data for last month from Barclaycard reported a stronger increase in spending on essentials (+6.6%Y/Y) and a smaller drop in spending on non-essentials (-22.3%Y/Y) than in May, to leave the measure of overall spending down 14.5%Y/Y. However, according to the same survey, expenditure on hospitality and leisure remained exceptionally weak in June (down more than 70%Y/Y) as did spending on motor fuel (down by more than one third from a year earlier). Moreover, spending in department stores was still down sharply (by almost one third from a year earlier), with Barclaycard reporting survey findings that more than half of consumers continue deliberately to avoid the shops. It remains to be seen whether the government's decision to make compulsory the use of face masks in shops from 24 July will encourage more consumers to return to the High Street.

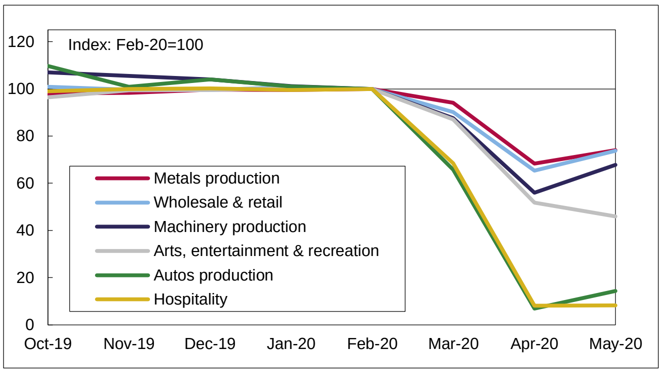
A sobering outlook for jobs, spending and rates

Today's figures strongly suggest a fall in GDP of more than 20%Q/Q in Q2 following a drop of 2.2%Q/Q in Q1. Thereafter, the profile will obviously depend critically on the path of the pandemic and the response of consumers and businesses. How the government reacts in the autumn to the blowout of the budget deficit, which the OBR's updated baseline forecast published today suggested would exceed 16% of GDP (more than £370bn) this year, will also play a role, as will the extent of the trade barriers that it imposes between the UK and EU at the end of the year. The performance of the labour market will also have a material impact, particularly the magnitude of the rise in unemployment once the Job Retention Scheme has been brought to an end in October. On the OBR's updated central scenario, the unemployment rate would peak in Q4 at 12%, which would be almost 4ppts above the highest level after the global financial crisis and also above the post-War peak reached during the mass joblessness of the Thatcher era. While it would decline gradually thereafter, it would remain above the pre-crisis level into the medium term. As such, private consumption would drop almost 14%Y/Y in 2020 and would not return to the pre-pandemic level of private consumption until 2025. And GDP would drop 12.4%Y/Y this year before rising gradually thereafter to surpass the pre-pandemic level in Q422, similarly suggesting that a vast amount of spare capacity will persist into the middle of the decade. Unsurprisingly, therefore, that financial market pricing implies that the BoE will maintain ultra-low rates for the foreseeable future, and that the next move is more likely to be down than up.

The day ahead in the UK

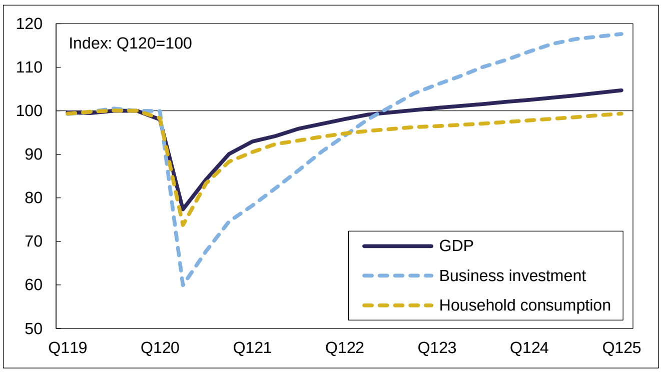
Wednesday will bring the latest UK inflation figures for June. As illustrated by today's GDP release, softer demand should have kept any upside inflationary pressures emanating from the supply side at bay. And so, while the oil price shifted slightly higher over the past month, headline inflation is expected to have moved sideways at just 0.5%Y/Y, while core inflation likely edged slightly lower from 1.2%Y/Y in May. Tomorrow will also bring the ONS house price index for May, as well as Visa's consumer spending index for June. Meanwhile, external MPC member Tenreyro will discuss the impact of Covid-19 on the economy.

UK: Output in selected sub-sectors



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: OBR central scenario



Source: OBR and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Industrial production M/M% (Y/Y%)	May	**12.4 (-20.9)**	13.2 (-19.9)	-17.1 (-28.0)	**-18.2 (-28.7)**
Germany		Final CPI (EU-harmonised) Y/Y%	Jun	**0.9 (0.8)**	0.9 (0.8)	0.6 (0.5)	-
		ZEW current situation (expectations)	Jul	**-80.9 (59.3)**	-65.0 (65.0)	-83.1 (63.4)	-
Spain		Final CPI (EU-harmonised) Y/Y%	Jun	**-0.3 (-0.3)**	-0.3 (-0.3)	-0.9 (-0.9)	-
UK		BRC retail sales monitor like-for-like Y/Y%	Jun	**10.9**	-	7.9	-
		Monthly GDP M/M% (3M/3M)	May	**1.8 (-19.1)**	5.5 (-17.4)	-20.4 (-10.4)	**-20.3 (-10.8)**
		Industrial production M/M% (Y/Y%)	May	**6.0 (-20.0)**	5.6 (-21.0)	-20.3 (-24.4)	**-20.2 (-23.8)**
		Manufacturing production M/M% (Y/Y%)	May	**8.4 (-22.8)**	6.2 (-25.1)	-24.3 (-28.5)	**-24.4 (-28.2)**
		Construction output M/M% (Y/Y%)	May	**8.2 (-39.7)**	14.0 (-37.0	-40.1 (-44.0)	**-40.2 (-44.2)**
		Index of services M/M% (3M/3M%)	May	**0.9 (-18.9)**	4.9 (-16.8)	-19.0 (-9.9)	**-18.9 (-10.7)**
		Total trade balance (goods trade balance) £bn	May	**4.3 (-2.8)**	-0.7 (-8.1)	0.3 (-7.5)	**2.3 (-4.8)**

Auctions

Country		Auction
Italy		sold €3.5bn of 0.3% 2023 bonds at an average yield of 0.3%
		sold €4.5bn of 0.95% 2027 bonds at an average yield of 0.95%
		sold €2bn of 3.1% 2040 bonds at an average yield of 1.91%
UK		sold £3.25bn of 0.125% 2026 bonds at an average yield of -0.017%
		sold £3bn of 0.375% 2030 bonds at an average yield of 0.197%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ Daiwa forecast	Previous
Italy		09.00	Final CPI (EU-harmonised CPI) Y/Y%	Jun	-0.2 (-0.4)	-0.2 (-0.3)
UK		07.00	CPI (core CPI) Y/Y%	Jun	0.5 (1.2)	0.5 (1.2)
		07.00	PPI input prices (output prices) Y/Y%	Jun	-6.3 (-1.1)	-10.0 (-1.4)
		09.30	ONS house price index Y/Y%	May	-	2.1*

Auctions and events

Country		BST	Auction / Event
Germany		10.30	Auction: €5bn of 0% 2030 bonds
UK		09.00	BoE's Tenreyro scheduled to speak at a webinar – Covid-19 and the economy
		10.00	Auction: £3.25bn of 2.25% 2023 bonds
		11.30	Auction: £1.5bn of 1.75% 2057 bonds

**Previous figure is for March 2020. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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