Euro wrap-up

Overview

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- Bunds made modest gains as final euro area core inflation was confirmed to have temporarily fallen in July and construction output remained weak in June.
- Gilts were little changed as a downwards surprise to UK inflation in July was offset by the strongest house price inflation since 2004.
- Friday will bring UK retail sales data for July, as well as the latest consumer sentiment survey and public finance figures. Euro area balance of payments data due tomorrow.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/23	-0.754	-0.009
OBL 0 10/26	-0.742	-0.009
DBR 0 08/31	-0.483	-0.009
UKT 0$^1/_8$ 01/23	0.132	-0.008
UKT 0$^1/_8$ 01/26	0.290	-0.005
UKT 4¾ 12/30	0.567	+0.005

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

Euro area

Final inflation confirms rise in headline CPI rate, but drop in the core measure

Today's final euro area inflation figures for July predictably made no significant changes from the flash estimates, and thus confirmed the 0.3ppt increase in the preliminary headline estimate to 2.2%Y/Y, the highest for almost three years. The rise was driven principally by energy inflation, which – largely due to base effects associated with the plunge in oil prices a year ago – increased a slightly stronger-than-initially-estimated 1.7ppts to 14.3%Y/Y, the highest since August 2008 and contributing 1.3ppts to the headline rate. Bang in line with the preliminary release, food inflation increased 1.1ppts to 1.6%Y/Y, an eight-month high. Services inflation also edged higher, by 0.2ppt to 0.9%Y/Y, as more of the services industry reopened and tourism began to recover (accommodation costs rose 6.8%M/M in July, while package holidays prices rose 14.6%M/M). Despite base effects from Germany's temporary VAT cut last year, and car inflation rising a further 0.9ppt to a series high 3.4%Y/Y, , prices of non-energy industrial goods fell sharply in July, to leave inflation of such goods down 0.5ppt to 0.7%Y/Y. But this principally reflected pandemic-related changes in summer discounting this year compared with last – indeed, clothing prices declined a sizeable 11.9%M/M in July, to leave the annual rate of growth down 5.5ppts to -3.4%Y/Y. So, while core inflation moderated 0.2ppt to 0.7%Y/Y, in line with the preliminary release and consistent with the average of the preceding twelve months, this is likely to mark the trough over the near term. Indeed, when also excluding clothing and travel-related items, 'super-core' inflation actually rose 0.2ppt to 1.6%Y/Y.

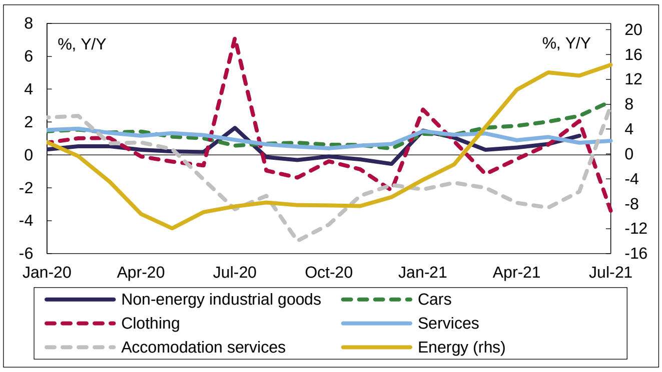
Inflation to remain above ECB's 2% target for a while before falling back

Looking ahead, the near-term outlook will likely remain volatile. The breach of the ECB's new target looks set to persist over coming months, not least as the moderation in clothing inflation last month will prove temporary. The impact of rising input costs amid supply bottlenecks might be expected to play a bigger role over the near term too. And with energy inflation expected to be temporarily boosted by higher petrol prices and services inflation likely to tick higher, we expect headline CPI to rise to 3%Y/Y this quarter and core inflation to rise above 1½%Y/Y. But not least due to base effects, we expect headline and core inflation to fall back at the start of 2022.

Construction output disappoints in June

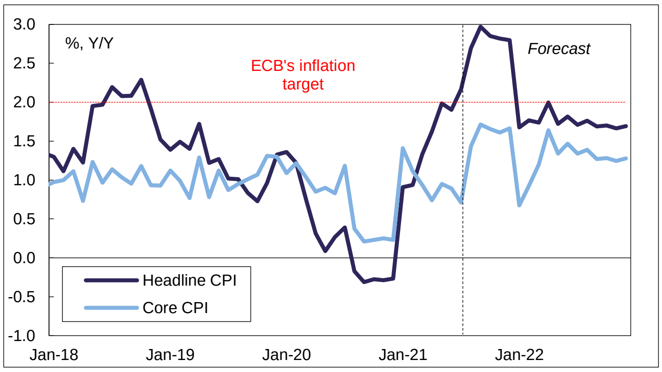
While yesterday's euro area GDP release confirmed the strong expansion in Q2, today's euro area construction figures implied only limited support from the sector during the second quarter. In particular, output fell in June for the third consecutive month and by a steeper 1.7%M/M, led by a drop in building construction (-1.9%M/M). Given the strength in output in March, this still left output 0.5% higher than in Q1, underpinned by a near-2½%Q/Q increase in Germany, while

Euro area: Selected CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Headline and core CPI forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

construction activity in France and Spain fell 1.4%Q/Q and 0.5%Q/Q respectively. But the level in June was now more than 2% lower than the pre-pandemic peak. Of course, the recent weakness to some extent will reflect ongoing supply bottlenecks affecting the sector. Indeed, while it has fallen back, confidence in the sector remains elevated by historical standards and order books are at their highest since February 2020.

The coming two days in the euro area

The euro area economic data calendar will be relatively quiet over the remainder of the week. Tomorrow brings euro area balance of payments figures for June, which in line with a modest narrowing of the goods trade balance might see the current account moderate too. Friday, meanwhile, will bring German producer prices for July. These are expected to show a further acceleration in inflation at the factory gate, with the headline PPI rate rising to 9.2%Y/Y – which would be the highest since the early 1980s – from 8.5%Y/Y previously. Higher energy prices will likely remain the driving factor.

UK

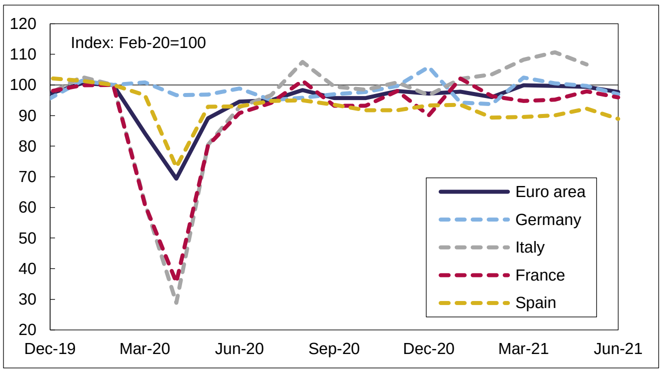
Inflation fell more than expected in July due to pandemic-related base effects

While UK inflation was expected to have moderated in July, today's data surprised on the downside, with the headline CPI rate falling 0.5ppt to 2.0%Y/Y, more than reversing the jump in June and 0.1ppt softer than the BoE had expected. While energy inflation moderated slightly (down 1ppt to 9.3%Y/Y), the drop principally reflected softer services (down 0.5ppt to 1.6%Y/Y) and non-energy industrial goods inflation (down 0.4ppt to 2.4%Y/Y). As such, core inflation also fell 0.5ppt to 1.8%Y/Y, down from the near-3½ year high in June. But the ONS attributed almost half of the moderation to base effects caused by the jump in prices last year when the economy emerged from lockdown. Certainly, the differing seasonal sales pattern was evident in the fashion industry. Discounting meant that clothing prices fell 2.2%M/M in July, compared to a more modest decline of 1.0%M/M in July 2020 (taking the annual inflation rate down 1.3ppts to 2.0%Y/Y). Prices of computer software didn't see the same increase as last year when pandemic-related demand was at its strongest, while prices of package holidays were also estimated to have declined this year compared with a rise in July last year. The hospitality component was similarly impacted by the higher base last year when the economy emerged from lockdown.

Supply bottlenecks pushing some prices higher

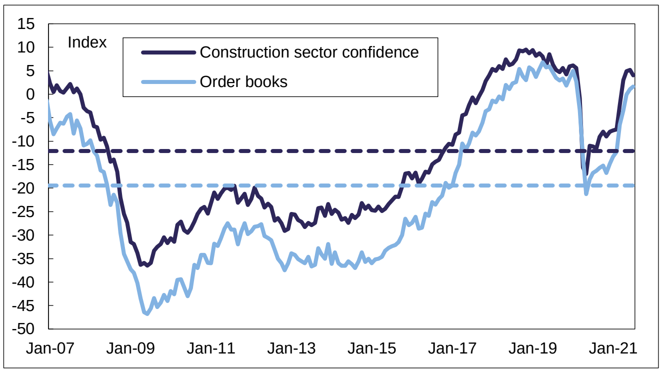
There were also some upwards price pressures in July associated with the pandemic, most noticeably the highest contribution from transport inflation (up 0.5ppt to 7.7%Y/Y) since November 2011. Indeed, prices of second-hand cars rose

Euro area: Construction output by member state



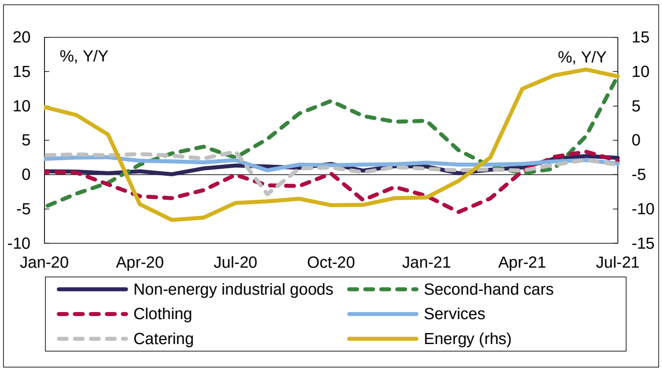
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction confidence and orders



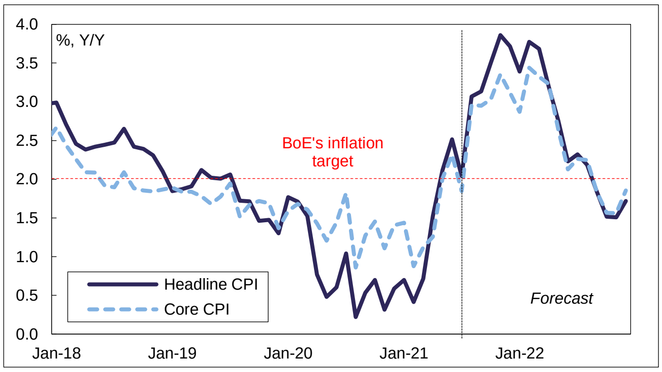
**Dashed lines represent euro era average. Source: Refinitiv and Daiwa Capital Markets Europe Ltd..*

UK: Selected CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Headline and core CPI forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

7%M/M in July to see the annual increase rate accelerate to 14.4%Y/Y the most since May 2010, seemingly reflecting increased demand following the reopening of the economy, together with the supply bottlenecks impacting production of new autos. There were also reportedly concerns about reduced supply of second-hand cars due not least to fewer one-year-old cars coming to the market because of the fall in new registrations last year. Meanwhile, the latest industrial producer price inflation figures surprised on the upside in July, with input prices of materials and fuels up for the eleventh consecutive month (0.8%M/M) to leave them almost 10% higher than a year earlier, a fraction below the decade-high reached in May. Producer output prices also rose 0.6%M/M, to leave the equivalent annual rate of inflation also up by 0.4ppt to 4.9%Y/Y, the highest rate since December 2011. Despite showing negative annual growth, transport equipment provided the largest upward contribution (2ppts) to the annual PPI rate due to weight changes implemented. While producer petroleum inflation remained elevated in July (46.6%Y/Y) this was down from May's peak of 68.4%Y/Y.

Inflation to take a step up through H221

Looking ahead, the inflation outlook in the UK remains highly uncertain. But base effects associated not least with last year's hospitality subsidies and VAT cut are likely to see headline inflation take a notable step up in August. Indeed, like the BoE, we forecast headline inflation to rise back to 3%Y/Y. Services inflation might be expected to take a further step up over the months ahead too as the economy continues to normalize and demand strengthens. And with energy and other goods inflation set to rise again in the final quarter, we expect the headline CPI rate to take a further step up before the end of the year, peaking at just under 4%Y/Y. While it will remain elevated for much of the first half of 2022, we continue to expect the headline CPI rate to fall back close to and eventually below 2.0%Y/Y in the second half of the year, as base effects from past shifts in energy and goods prices see an accelerated decline in the respective contributions.

House prices in June boosted by government incentives

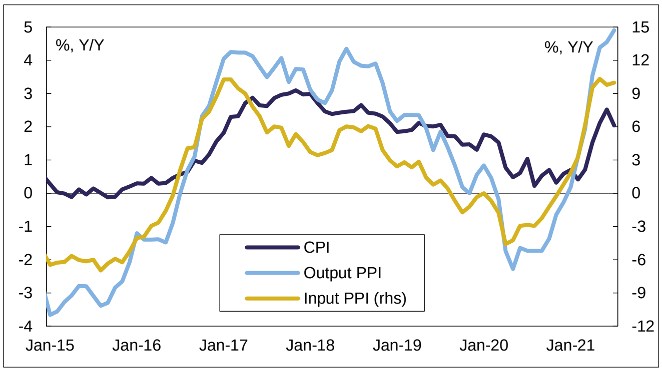
Today's ONS house price data reported a surge in growth in June to match the record high number of transactions as home buyers rushed to complete purchases before the tapering of the government's stamp duty holiday came into effect at the end of that month. Indeed, according to the ONS, the average house price jumped 4.2%M/M in June to a record high £266k. This left the annual rate of increase accelerating to 13.2%Y/Y, admittedly flattered by base effects but nevertheless the strongest since November 2004. Solid growth was seen across the country, with the North West of England and Wales again reporting the strongest growth (18.6%Y/Y), while London remained the region with weakest annual growth (6.3%Y/Y). But June might well mark the peak. While a lack of supply will likely keep prices elevated, more recent housing releases suggest that the number of new enquiries has subsequently fallen back. And the Rightmove figures published earlier in the week reported that asking prices fell for the first time this year as demand for more expensive properties slowed.

The coming two days in the UK

With no UK economic data due for publication tomorrow, the focus now shifts to Friday's retail sales report for July. The latest consumer confidence report indicating that households remained broadly upbeat at the start of Q3 and the CBI's distributive trade survey suggested that sales growth last month remained well above the long-run average. So, while spending on services seems bound to have risen last month as final restrictions were eased, retail sales of goods, including autos fuel, are expected to have risen 0.2%M/M in July, after increasing 0.5%M/M in June. That would bring the annual growth rate down to 5.8%, from 7.4%Y/Y previously, albeit leaving sales 5.9% higher than the pre-pandemic level. Friday will also bring the latest consumer confidence survey for August, as well as public sector finance figures for July.

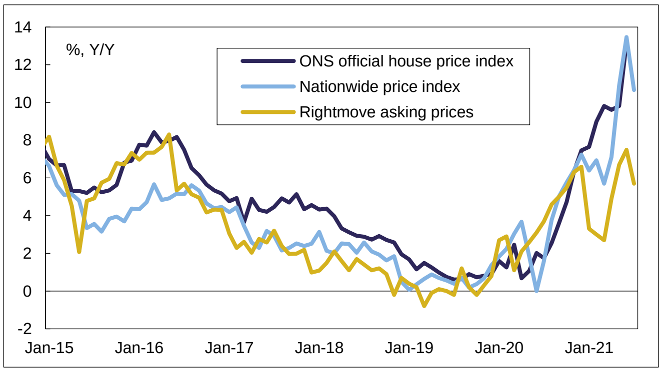
The next edition of the Euro wrap-up will be published on 20th August 2021

UK: Producer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Housing market indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final CPI (core CPI) Y/Y%	Jul	**2.2 (0.7)**	*2.2 (0.7)*	1.9 (0.9)	**-**
	Construction output M/M% (Y/Y%)	Jun	**-1.7 (2.8)**	-	0.9 (13.6)	**-0.4 (12.2)**
UK	CPI (core CPI) Y/Y%	Jul	**2.0 (1.8)**	*2.3 (2.0)*	2.5 (2.3)	**-**
	PPI output prices (input prices) Y/Y%	Jul	**4.9 (9.9)**	4.4 (9.1)	4.3 (9.1)	**4.5 (9.7)**
	House price index Y/Y%	Jun	**13.2**	-	10.0	**9.8**

Auctions

Country	Auction
Germany	sold €827mn of 0% 2050 bonds at an average yield of -0.04%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09.00	Current account balance €bn	Jun	-	11.7
Spain	08.00	Trade balance €bn	Jun	-	0.1

Auctions and events

Country	BST	Event
France	09.50	Auction: 0% 2024 bonds
	09.50	Auction: 0.5% 2026 bonds
	09.50	Auction: 1% 2027 bonds
	10.50	Auction: 0.1% 2028 index-linked bonds
	10.50	Auction: 0.1% 2029 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	PPI Y/Y%	Jul	9.2	8.5
UK	00.01	GfK consumer confidence	Aug	-7	-7
	07.00	Retail sales including auto fuel M/M% (Y/Y%)	Jul	0.2 (5.9)	0.5 (9.7)
	07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Jul	0.1 (5.8)	0.3 (7.4)
	07.00	Public sector net borrowing £bn	Jul	11.9	22.8

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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