Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds made gains as data for euro area retail sales and German factory orders remained consistent with a downward trend in spending on goods.
- Gilts made losses as two BoE policymakers repeated that rates might be hiked at a faster pace over coming months, while Boris Johnson's time as Prime Minister finally appeared about to end.
- Thursday will bring the account of the ECB's 9 June policy meeting and data for German industrial production in May.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.354	-0.055
OBL 1.3 10/27	0.804	-0.041
DBR 0 02/32	1.201	-0.011
UKT 1 04/24	1.716	+0.088
UKT 1¼ 07/27	1.731	+0.036
UKT 4¼ 06/32	2.088	+0.043

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

Euro area

Euro area retail sales remain subdued

Given increased opportunities for spending on services, a slump in consumer confidence and squeezed real disposable income, today's euro area retail sales figures (perhaps inevitably) suggested that household spending on goods remained subdued in the middle of Q2. Indeed, despite declining in April by 1.4%M/M, slightly steeper than previously thought, sales in May rose just 0.2%M/M, even softer than had been expected. While this left sales still more than 3% higher than the pre-pandemic level, they were little changed from a year earlier. Moreover, in the first two months of Q2, sales were trending 0.8% lower than the Q1 average, underscoring the likely contraction in spending on goods over the second quarter. Admittedly, there was a solid rise in sales at non-food stores, by 1.2%M/M, although this merely reversed the decline in April and was likely boosted by summer discounting as was evident in the latest German figures. In contrast, sales at food stores, where price pressures are particularly acute, were down for the second successive month (-0.3%M/M). Online and fuel sales were also weaker (down 0.2%M/M a piece). While some of this weakness should be offset by increased spending on services, including hospitality and tourism, the data flag concerns about momentum in overall consumption. And we certainly see little reason to expect a significant boost to spending on goods in June, suggesting that retail sales were a drag on GDP growth in Q2 for the second successive quarter.

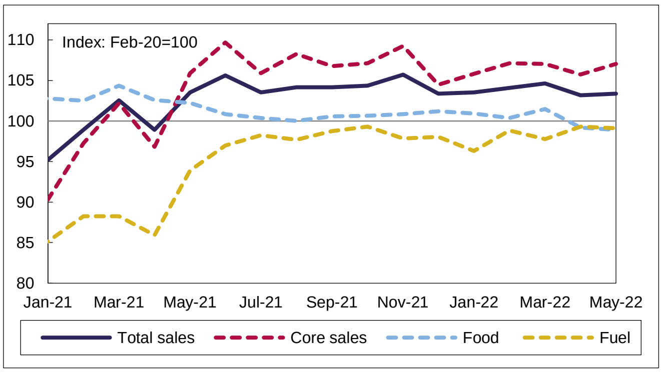
German factory orders steadier but still suggest weaker goods demand in Q2

While they marginally beat expectations, avoiding a fourth successive monthly fall, Germany's factory orders data for May also flagged the downtrend in spending on goods. Indeed, while the extent of the decline in April was smaller than previously thought at 1.8%M/M, German factory orders were effectively just flat in May, with growth of just 0.1%M/M. That left them down 3.1%Y/Y, albeit still 4.1% above the pre-pandemic level in February 2020. Excluding bulk orders, which typically contribute significant volatility to the series, orders did fall for a fourth successive month in May, by 0.9%M/M. And the underlying trend in new orders is clearly still down. Indeed, the average level of new orders in the first two months of Q2 was 4.9% below the average in Q1, highlighting a marked weakening of demand for German goods this quarter.

But motor vehicle orders stronger, and turnover suggests firmer growth in production in May

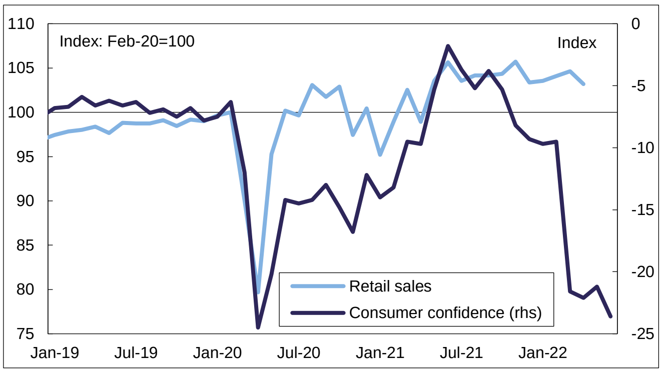
Unlike recent months, the weakness in new goods demand in May came from domestic orders, which fell 1.5%M/M in overall terms to an eight-month low, and a steep 5.1%M/M excluding bulk orders. New orders from within the euro area fell 2.4%M/M to the lowest level since October, but other foreign orders rose 1.3%M/M from April's 19-month low. By type of good, further declines in orders for intermediate (3.2%M/M) and consumer goods (4.5%M/M) were offset by a pickup in new

Euro area: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales and consumer confidence



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

orders for capital goods (up 3.3%M/M) including motor vehicles (up almost 13% to less than 5% below the pre-pandemic level, albeit still almost 15% below last year's peak). More encouragingly, looking ahead to tomorrow's production data, manufacturing turnover rose for a second month in May, up 3.2%M/M following growth of 0.6%M/M. That suggests non-negligible upside risks to the consensus forecast (currently 0.4%M/M) for industrial production growth in May.

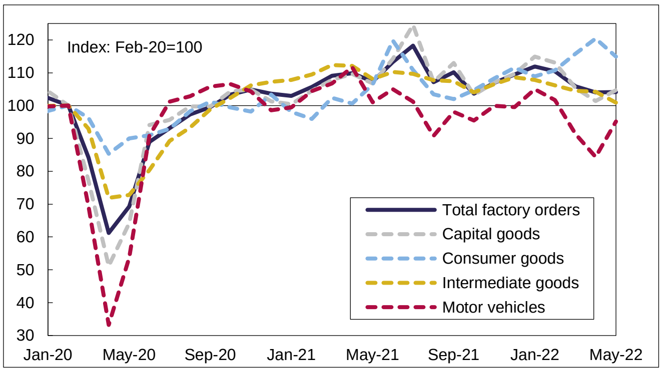
Euro area construction PMI points to a faster pace of contraction with new projects on hold

The euro area construction PMIs implied a further contraction in activity in the sector in June, with the headline activity index down for the fifth consecutive month and by 2.2pts to 47.0, the lowest level since February 2021. Negative momentum was reported in house-building (45.1), commercial work (46.3) and civil engineering (45.2) alike, with the respective indices all firmly in contractionary territory and the former the lowest since May 2020. Although firms expressed somewhat less pessimism about future activity, the new orders index fell to a sixteen-month low at just 44.4, implying a substantial decline as demand for new projects was impacted by higher costs and an increasingly challenging economic outlook. Indeed, although the survey suggested that supply-chain disruption and input price pressures had eased very slightly, they remained extremely elevated by historical standards and seem likely to maintain a limiting impact on activity for some time to come. Contrasting with the euro area aggregate index, there was a modest improvement in the German activity PMI, up 0.5pt on the month, although at 45.9 it remained at a level suggestive of significant contraction and the lowest of the member states. Admittedly, the German PMI was only marginally weaker than the equivalent French index, which slumped 4.5pts in June – the most since October 2020 – to 46.4, a ten-month low, as residential building declined sharply. But the collapse in the Italian PMI seen since Q1 was maintained in June, down a further 3.9pts to 50.4, a drop of more than 18pts since February and the lowest since January 2021, as the inflow of new work fell for the first time since May 2020.

The day ahead in the euro area

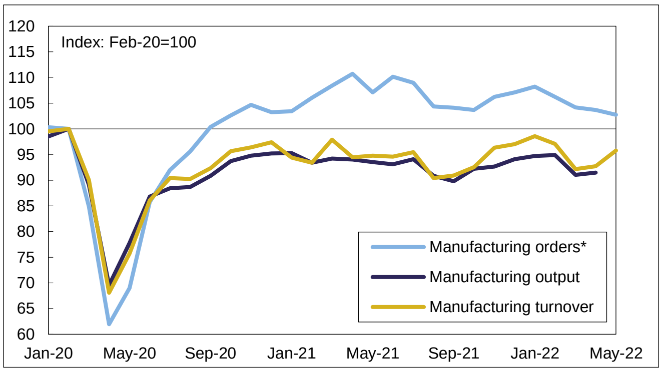
Tomorrow's release of the account from the ECB's 9 June policy-setting meeting will be of interest, although it remains to be seen if it will provide any additional noteworthy information on the Governing Council's plans for monetary policy normalisation. In particular, the Governing Council pre-committed to increasing its main interest rates by 25bps in July. And it made clear that, unless the medium-term inflation outlook in its updated projections is judged to have improved then, it will raise its key rates by a larger amount – presumably 50bps – in September. It also stated that "a gradual but sustained path of further increases" is likely thereafter, raising the likelihood of at least 50bps – and perhaps 75bps or more – of hikes in Q4 and additional tightening in 2023. Of course, in her press conference following that meeting, President Lagarde failed to offer detail on the Governing Council's intentions with respect to fragmentation risks. But faced with sharply rising spreads on

Germany: Manufacturing orders



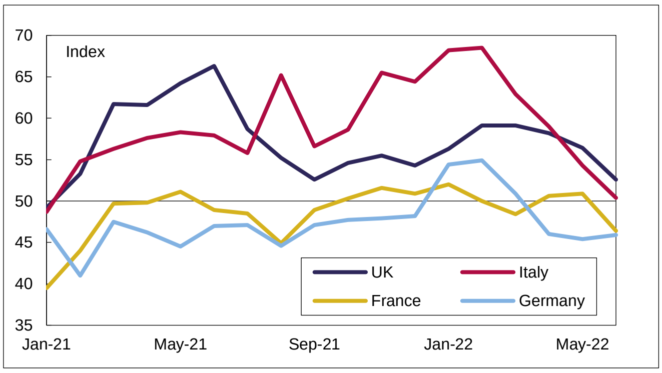
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing orders and output



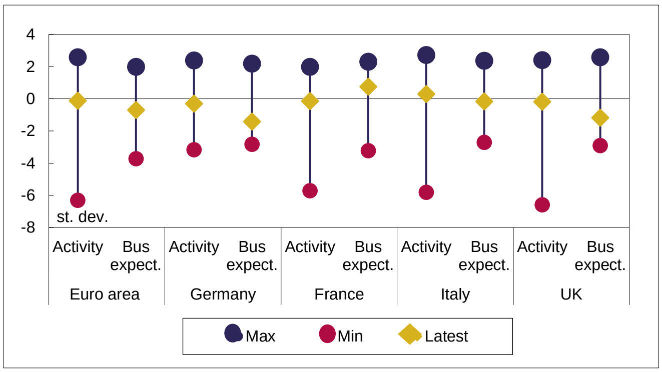
**Excluding large orders. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

Europe: Construction PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Construction PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

BTPs and other Southern European bonds, the subsequent ad hoc policy meeting on 15 June saw the Governing Council agree to commission plans for a new anti-fragmentation policy tool.

On the data front, the flow of manufacturing releases continues tomorrow, with the aforementioned figures from Germany expected to illustrate the ongoing impact of supply challenges facing the sector. Given today's turnover numbers, there are upside risks to the Bloomberg consensus forecast of an increase of 0.4%M/M in May. Irish industrial production numbers are also due tomorrow, with a rebound likely following a notable drop in April (-9.6%M/M) and likely to have a significant bearing on the euro area figure when it is published next week.

UK

Johnson near point of no return as Cabinet and party members turn against him

Having won the confidence vote among his party's MPs last month with less than 60% support, Boris Johnson's time as UK Prime Minister finally appears set to end imminently in the wake of the latest scandal related (in part) to his economy with the truth. Yesterday evening's resignation of two senior Cabinet members – Chancellor Rishi Sunak and former Chancellor Sajid Javid – over the Prime Minister's (lack of) integrity and competence was followed today by resignations of dozens of junior government members and a message from a further senior Cabinet member that he should quit. At the time of writing, another delegation of several senior Cabinet members was reportedly set to tell him to do likewise. It also appeared that Johnson would find insufficient MPs willing to fill all of the new vacancies in government left by the resignations. And a process was seemingly afoot among MPs to change the Conservative party's rules early next week to allow for a further challenge to Johnson's leadership if he doesn't resign by then. In his two parliamentary appearances today, Johnson looked like he knew that his time as PM is up. We would be surprised if he did not resign this evening.

Huge uncertainty about who will succeed Johnson and what that will mean for policy

It would be nice to think that Johnson's departure from Downing Street will bring an end to the period of chaotic, unprincipled, often-confrontational policymaking and misinformation that has been a hallmark of his term. However, the lack of obvious capable and untarnished successors among the party's MPs – illustrated by the fact that junior trade minister Penny Mordaunt is today's bookies' favourite – leaves plenty of uncertainty about the direction of policy ahead. Certainly, it remains to be seen who will win the upper hand in the forthcoming leadership election – populists and opportunists (such as Mordaunt or Foreign Secretary Liz Truss) or more traditional (perhaps reassuringly dull) conservatives such as Sunak, Javid or Defence Secretary Ben Wallace. Certainly, however, the need for the next PM to appease the populists within the party will continue to have a substantive bearing on policy, which therefore might remain lacking in economic rigour and incapable of addressing the UK's woeful post-Brexit performance of business investment and exports, or the biggest hit to real incomes in decades.

Any further fiscal loosening likely to be met by BoE with even higher rates

A big question-mark therefore relates to the near-term direction of fiscal policy, with today's replacement of Sunak as Chancellor by former Education Secretary Nadhim Zahawi having fleetingly raised the possibility of a further loosening via higher public expenditure and/or lower taxation in the autumn. While Zahawi now might seem unlikely to remain in office at the Treasury long enough to deliver a single Budget, the UK's current cyclical position of excess demand, related in part to the big hit to potential output from the twin shocks of Brexit and Covid-19, means that any further fiscal loosening would likely be judged by the BoE to add to inflationary pressures, resulting in even more monetary tightening than would otherwise be the case. Indeed, two MPC members today repeated the signal from the June MPC meeting that rates might well be hiked at a faster pace over coming months. And a 50bps hike in Bank Rate remains a strong probability for August, with further hikes also likely before year-end.

UK construction PMI falls sharply, signalling the first contraction in housing since May 2020

Far more prosaically, data-wise, today's UK construction PMI survey was downbeat, falling well short of expectations in June as output and new orders continued to slow amid heightened concerns about the economic outlook. In particular, the headline activity index fell for the third successive month and by 3.8pts – the largest monthly drop for eleven months – to 52.6, a reading that was last lower in January 2021. While the civil engineering subsector remained the most resilient (54.4), there was a marked slowdown in commercial activity – the index fell 5.5pts to 54.3 – while the collapse in housing activity continued, with the relevant PMI slipping into contractionary territory (49.3) for the first time since the onset of the pandemic in May 2020, to be some 7½pts below the Q1 average and almost 19pts lower than the peak this time last year. New orders also maintained a downward trend, with the respective index down to an eight-month low, as inflationary and recession concerns weighed on demand. And looking ahead, given also the prospect of higher interest rates over coming quarters, expectations about activity in the year ahead fell for the fifth consecutive month, to suggest that construction firms were the most downbeat since July 2020.

The day ahead in the UK

Focus in the UK tomorrow will remain firmly on politics, while economic releases are thin on the ground. Updated labour productivity figures for Q1 are due, while the Bank of England will publish its Decision Makers Panel survey. Separately, hawkish external MPC member Catherine Mann is due to speak at a forum on the rise of inflation and current global monetary policy issues.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Construction PMI	Jun	**47.0**	-	49.2	-
	Retail sales M/M% (Y/Y%)	May	**0.2 (0.2)**	0.4 (-0.3)	-1.3 (3.9)	**-1.4 (4.0)**
Germany	Factory orders M/M% (Y/Y%)	May	**0.1 (-3.1)**	-0.5 (-5.0)	-2.7 (-6.2)	**-1.8 (-5.3)**
	Construction PMI	Jun	**45.9**	-	45.4	-
France	Construction PMI	Jun	**46.4**	-	50.9	-
Italy	Construction PMI	Jun	**50.4**	-	54.3	-
Spain	Industrial production M/M% (Y/Y%)	May	**-0.2 (3.8)**	-0.5 (3.3)	2.1 (2.4)	**- (2.3)**
UK	Construction PMI	Jun	**52.6**	55.0	56.4	-

Auctions

Country	Auction
Germany	sold €4.0bn of 1.7% 2032 bonds at an average yield of 1.22%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	08.00	Industrial production M/M% (Y/Y%)	May	0.4 (-1.8)	0.7 (-2.2)
UK	09.30	Final output per hour Y/Y%	Q1	-0.8	0.7

Auctions and events

Country	BST	Event
Euro area	10.45	ECB Chief Economist Lane participates in panel on the accelerated green transition in the post-Covid era
	12.30	ECB publishes account of the 9 June policy meeting
France	09.50	Auction: 2% 2032 bonds
	09.50	Auction: 0.5% 2044 bonds
	09.50	Auction: 2% 2048 bonds
	09.50	Auction: 0.75% 2053 bonds
Spain	09.30	Auction: 5.9% 2026 bonds
	09.30	Auction: 2.55% 2032 bonds
	09.30	Auction: 1.9% 2052 bonds
	09.30	Auction: 1% 2030 index-linked bonds
	09.30	BoE publishes Decision Maker survey
	14.00	BoE's Mann scheduled to speak at forum on the rise of inflation and current global monetary policy issues

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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