Euro wrap-up

Overview

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- Bunds made further losses as ECB Board member Isabel Schnabel made the case for another big rate hike in September and acknowledged the possibility that QT might be discussed too.
- Gilts also made losses on a quiet day for economic news from the UK.
- Friday will bring data for German producer prices and UK retail sales, consumer confidence and public borrowing.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.722	+0.019
OBL 0 04/27	0.910	+0.025
DBR 0 02/32	1.091	+0.013
UKT 1 04/24	2.389	+0.028
UKT 1¼ 07/27	2.158	+0.028
UKT 4¼ 06/32	2.299	+0.015

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

Euro area

Schnabel makes clear that ECB's concerns about inflation outweigh its fears of recession

After a period of relative quiet since it raised rates by 50bps on 21 July, communication from the ECB resumed today with a clear hawkish message. Most notably, key Executive Board member Isabel Schnabel – who led the pivot of the Governing Council towards accelerated monetary policy normalisation over past quarters – underscored the strong likelihood of another sizeable rate hike next month. Admittedly, in an interview with Reuters, she acknowledged that risks of recession had risen. But Schnabel took comfort in the resilience of certain sectors, not least tourism, that have been benefiting from pent-up demand. She also noted the historically low level of unemployment and high level of vacancies, which suggest that firms might hoard labour in the downturn. And, unsurprisingly, she suggested that the ECB would be far more concerned about the increasingly broad-based nature of the inflation surge. Among other things, she noted the recent quick pass-through from energy prices to producer and consumer prices. She cautioned how euro weakness could magnify the impact of the energy price shock. And flagging survey evidence, she warned that a de-anchoring of inflation expectations could prevent high inflation from abating even in the event of recession.

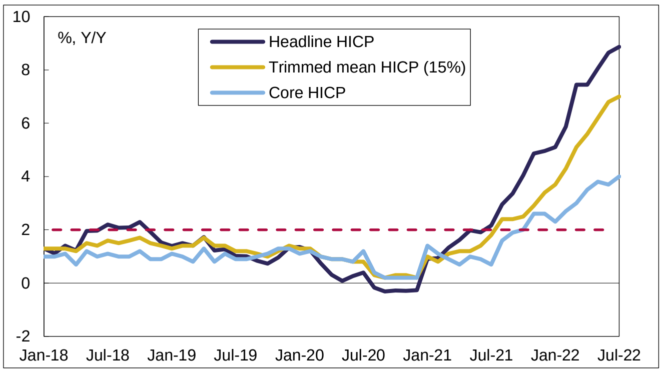
Further big rate hike signalled for September, QT could start before long

Emphasising also the difficulty of forecasting inflation in current conditions, Schnabel therefore judged that the ECB should now place relatively more weight on actual inflation outcomes than its own projections – i.e. adopt a backward-looking rather than forward-looking approach to monetary policy. In this context, she also assessed that deeply negative real short-term interest rates meant that the ECB's policy remains "quite far away" from a restrictive stance. Economic data due over the coming few weeks are unlikely to suggest that the ECB's concerns about inflation need not be so acute – indeed, developments with respect to the supply and wholesale price of natural gas might mean the opposite. So, assuming Schnabel's views continue to reflect those of the majority of Governing Council members, another rate hike on 8 September of at least the same magnitude of July looks likely. Moreover, Schnabel acknowledged that the case for slowing reinvestments of maturing securities held under the Asset Purchase Programme might be raised on the Governing Council next month, suggesting that ECB quantitative tightening could be underway by the end of the year.

Increasingly broad-based price pressures confirmed by final July data

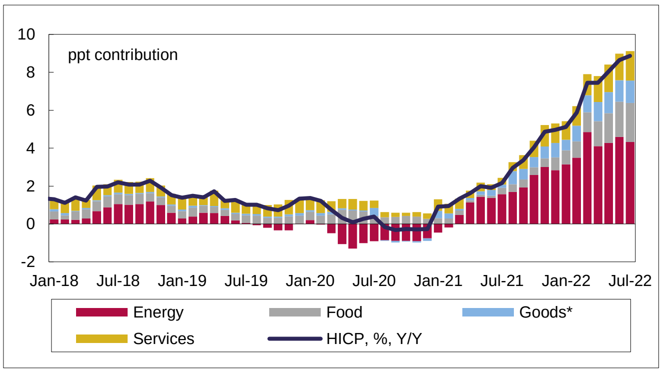
Schnabel's hawkishness accompanied today's publication of the final estimates of euro area inflation in July. Bang in line with the flash figure, the headline HICP rate rose 0.3ppt to a new series high of 8.9%Y/Y. With petrol prices lower, energy inflation eased by 2.4ppts (marginally more than previously thought) to 39.6%Y/Y, although this component still accounted

Euro area measures of HICP inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to HICP inflation



**Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

for a little more than 4ppts of total inflation. And the impact of the fall in energy inflation was fully offset by the further rise in food inflation of 0.9ppt to a new series high of 9.8%Y/Y, accounting for more than 2ppts of total inflation. But, as flagged by Schnabel, underlying price pressures continued to rise as increased costs were passed on to consumers. While clothing inflation shifted into negative territory, non-energy industrial goods inflation rose 0.2ppt to 4.5%Y/Y, similarly a new series high, as car inflation picked up further to 8.3%Y/Y. And despite a temporary negative impact from Germany's cut in summer public transport fares, euro area services inflation rose 0.3ppt to 3.7%Y/Y as a range of components related to eating out, air fares, road and sea transport, personal care and household services, among other items, accelerated. As such, core inflation matched the flash estimate of 4.0%Y/Y, up a larger-than-originally-expected 0.3ppt on the month to 4.0%Y/Y, similarly a record high. And the ECB's 15% trimmed mean estimate rose 0.2ppt to a new high of 7.0%Y/Y reinforcing the impression of increasingly broad-based pressures.

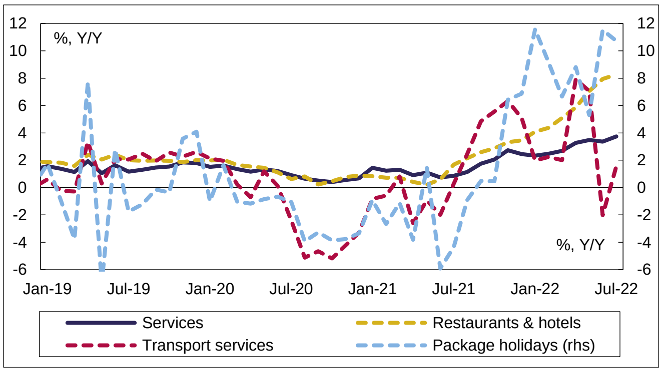
Construction output drops in Q2, outlook for the sector increasingly gloomy

In terms of economic activity, while a moderate easing of supply challenges allowed manufacturing production, particularly of autos, to post solid growth in Q2, construction firms remained hampered by shortages of materials and skills. Indeed, today's data showed that construction output dropped for a fourth successive month in June and by 1.3%M/M to the lowest level since December. So, over Q2 as a whole, construction output in the euro area fell 1.2%Q/Q, marking the first decline in three quarters. Building (-0.9%Q/Q) and civil engineering activity (-2.0%Q/Q) both fell last quarter. And struggles in the sector were widespread, with output down particularly in Germany (-3.2%Q/Q), France (-0.5%Q/Q) and Spain (-1.6%Q/Q). Survey indicators for July, such as the construction PMIs, suggested significant weakness across all subsectors and each of the large member states at the start of Q3. Drops in construction activity and new orders – the latter the sharpest since the first wave of Covid-19 – coincided with ongoing cost pressures, lengthy (albeit declining) delivery times, and still-low availability and quality of subcontractors. Projects part-financed by the EU recovery funds should provide some support over coming quarters. But with cost pressures persisting, monetary policy tightening, real household incomes to be squeezed further, and business sentiment likely to weaken amid uncertainties regarding energy supply and external demand, we expect the construction sector to subtract from GDP growth over the second half of the year and into 2023.

The day ahead in the euro area

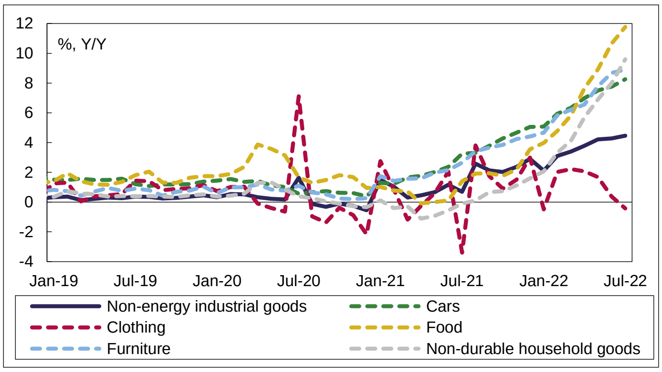
The economic data calendar ends on a relatively quiet note tomorrow, with German producer prices data for July the most notable new release. In June, German producer prices rose 0.6%M/M, the least since November 2020. Notwithstanding risks of additional pressures from natural gas prices ahead, the data offered some cause for cautious optimism that pipeline inflation might have been peaking for the time being. And the monthly increase in producer prices in July is expected to be

Euro area: Services inflation – selected components



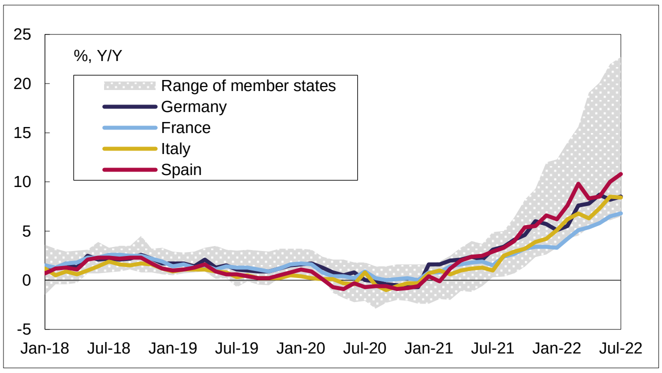
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Goods inflation – selected components



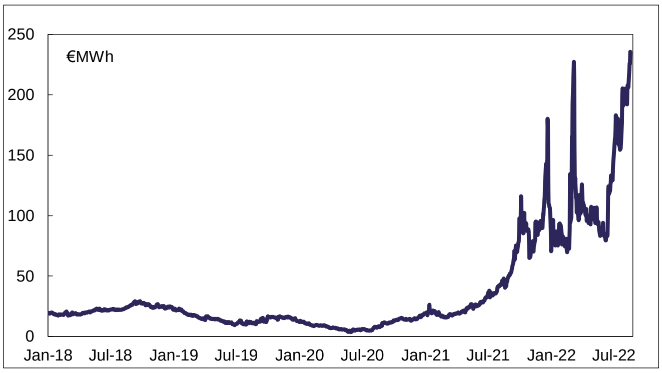
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation by member state



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Europe: Natural gas price – 6-month futures



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

less than 1% again (+0.7%M/M), resulting in the annual rate falling for the second successive month, by a further 0.9ppt, albeit to a still-lofty 31.8%Y/Y.

UK

The day ahead in the UK

Following a quiet day data-wise in the UK today, with no releases to report of, the focus tomorrow turns to July's retail sales numbers. These are expected to reveal a further drop in spending on goods at the start of the third quarter as consumers tightened their belts in the face of soaring inflation and weak confidence. Retail sales excluding auto fuels are expected to fall 0.3%M/M, leaving sales down 3.1%Y/Y, albeit 3% higher than February 2020's pre-pandemic level. Certainly, given rising concerns about the extent of further increases in household energy prices to come, the latest GfK consumer sentiment survey, also due tomorrow, seems unlikely to report a let up in pessimism about the near-term outlook, therefore signaling further weakness in spending ahead too. Finally, against the backdrop of the ongoing Conservative leadership contest and contrasting arguments on fiscal policy from the two candidates to succeed Boris Johnson as PM, public finance figures for July will also be watched. Excluding the banking sector, public sector net borrowing is expected to be £3.2bn in July, compared with £6.4bn the same month a year ago.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final HCIP inflation M/M% (Y/Y%)	Jul	**0.1 (8.9)**	0.1 (8.9)	0.8 (8.6)	-
	Final core HCPI inflation Y/Y%	Jul	**4.0**	4.0	3.7	-
	Construction output M/M% (Y/Y%)	Jun	**-1.3 (0.1)**	-	0.4 (2.9)	**-0.3 (2.3)**
Spain	Trade balance €bn	Jun	**-5.4**	-	-4.8	-

Auctions

Country	Auction
France	sold €2.20bn 0.50% 2025 bonds at an average yield of 0.98%
	sold: €3.80bn of 0.75% 2028 bonds at an average yield of 1.27%
	sold €650mn of 1.85% 2027 index-linked bonds at an average yield of -1.87%
	sold €101mn of 0.10% 2032 index-linked bonds at an average yield of -0.93%
	sold €249mn of 3.15% 2032 index-linked bonds at an average yield of -1.02%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	09.00	Current account balance €bn	Jun	-	-4.5
Germany	07.00	PPI M/M% (Y/Y%)	Jul	1.2 (32.0)	0.6 (32.7)
UK	00.01	GfK consumer confidence survey	Aug	-42	-41
	07.00	Retail sales including auto fuels M/M% (Y/Y%)	Jul	-0.2 (-3.33)	-0.1 (-5.8)
	07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Jul	-0.3 (-3.1)	0.4 (-5.9)
	07.00	Public sector net borrowing, excluding banks £bn	Jul	3.2	22.9

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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