Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds made gains as data confirmed that the pace of decline in euro area industrial production accelerated in Q2 while employment growth moderated.
- Gilts made further losses as UK inflation data for July suggested that core price pressures persist as the services component picked up again.
- Euro area goods trade data for June are due on Thursday while the week will end with UK retail sales and final euro area inflation figures for July.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.061	-0.033
OBL 2.4 10/28	2.646	-0.035
DBR 2.6 08/33	2.638	-0.031
UKT 0⅝ 06/25	5.138	+0.049
UKT 1⅝ 10/28	4.627	+0.046
UKT 3¼ 01/33	4.625	+0.043

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

Euro area

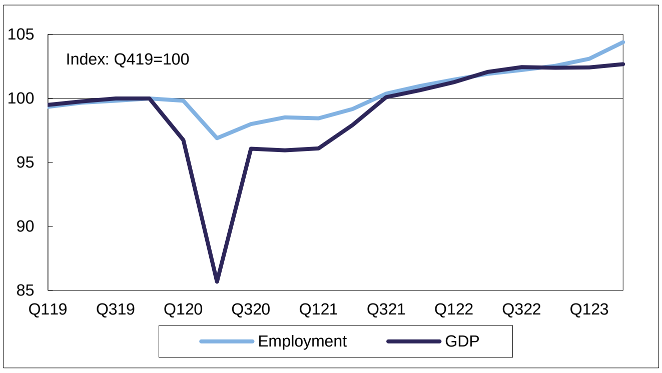
Return to GDP growth confirmed in Q2, when IP fell and employment growth moderated

Today's second estimate of euro area GDP confirmed that, after a contraction in Q422 and a flat Q1, growth resumed in Q2 at the rate of 0.3%Q/Q and 0.6%Y/Y, which left economic output 2.7% above the pre-pandemic level in Q419. There was significant variation among the member states. We already knew that, buoyed by the activities of multinationals, Ireland (3.3%Q/Q) accounted for roughly half of all GDP growth in the euro area last quarter. The expansion in France (0.5%Q/Q) and Spain (0.4%Q/Q) was also relatively strong. In contrast, GDP in Germany and Portugal was unchanged, while it fell in Italy and Austria (both contracting 0.3%Q/Q). Today's data also confirmed that GDP in the Netherlands dropped 0.3%Q/Q. No expenditure detail will be released until the third estimate on 7 September. However, growth currently looks to have come from consumption and net trade, with weakness in fixed investment, particularly in construction. And momentum faded throughout the quarter. Given recent surveys and high-frequency data, we currently forecast a slowdown in growth to 0.1%Q/Q in Q3 with the risks skewed to the downside.

Based on today's figures for June, industrial production (excluding construction) contracted for a third successive quarter and by 1.0%Q/Q in Q2 following the dip of 0.3%Q/Q in Q1. That occurred despite a rise of 0.5%M/M at the end of the quarter, which left it down 1.2%Y/Y albeit still 2.5% above the pre-pandemic level in February 2020. The IP detail provided by Eurostat raise some questions about data quality, however. Of the major subcomponents, only energy (0.5%M/M) is assessed to have grown in June but production of consumer, intermediate and capital goods was all down on the month. And over the quarter as a whole, only output of capital goods rose in Q2, reflecting a rebound in certain transport goods. In contrast, output of machinery equipment softened while production of energy-intensive items such as chemicals and basic metals remained subdued having contracted significantly since Russia's invasion of Ukraine. Of course, the accelerated decline in IP in Q2 reflects the deterioration in survey indicators, e.g. the manufacturing output PMI having dropped 3.4pts on the quarter to 46.4. And with that indicator having fallen further to just 42.7 in July, the PMIs and other surveys point to another quarter of contraction in IP to come in Q3.

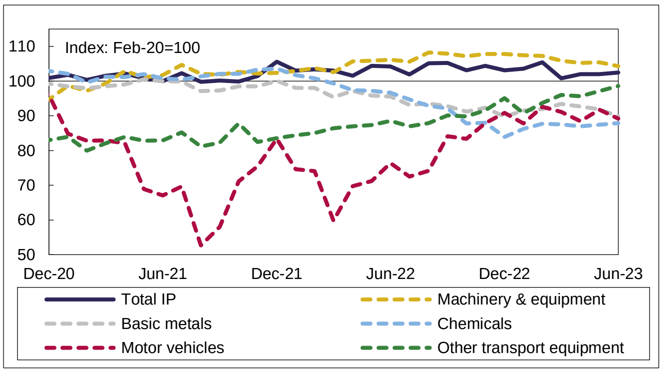
More happily, the resumption of growth in euro area GDP in Q2 was accompanied again by ongoing resilience in the labour market. Today's figures reported a ninth successive quarterly increase in employment, albeit with the pace moderating by 0.3ppt from downwardly revised growth in Q1 to 0.2%Q/Q (344k), the softest rate since Q121. That left it up 1.5%Y/Y and 3.3% (and 5.34mn) above the pre-pandemic level in Q419. Employment appears to have continued to have grown widely across the euro area in Q2, with increases even in those member states where GDP contracted. Surveys and high-frequency national data point to continued, but again somewhat softer, growth in employment in Q3.

Euro area: GDP & employment levels



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The coming two days in the euro area

Tomorrow is set to be relatively quiet on the economic data front, with only euro area goods trade figures for June of any note. On Friday, we will get final euro area inflation figures for July, which are expected to confirm the flash data. These suggested that consumer prices fell for the first month in six (-0.1%M/M), helping the headline HICP rate to ease a further 0.2ppt in July, to 5.3%Y/Y, the lowest rate since January 2022 and exactly half the peak recorded last October. The decline in inflation can be attributed to the food and energy components. The flash estimate of core inflation moved sideways at 5.5%Y/Y, still nevertheless 0.2ppt lower than the series high reached in March. Euro area construction output data for June are also set to be published at the end of the week. Given marked declines of more than 2½%M/M in both Germany and France, euro area construction output appears to have declined sharply in June, to be down 1.5%Q/Q or more, having grown in each of the prior two quarters. The contraction would be fully consistent with downbeat survey indicators reflecting the hit to demand in the sector related in part to concerted monetary tightening.

UK

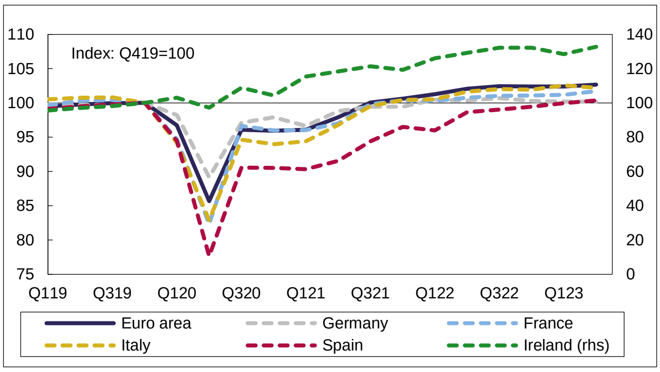
Inflation drops to 17-month low on energy and food but core rate remains sticky

Broadly as expected, UK consumer price inflation took a significant step down in July, with the headline CPI rate dropping 1.1ppts to 6.8%Y/Y, the lowest since February 2022. The main cause of the decline was the cut in Ofgem's regulated household energy price cap from the start of the month, which meant that gas prices fell a record 25.2%M/M and electricity prices fell 8.6%M/M. In addition, petrol prices were down slightly from June. So, overall energy inflation declined 11.0ppts to -7.8%Y/Y, the lowest since January 2021, to account for more than 0.8ppt of the decline in the headline CPI rate. Meanwhile, food prices rose just 0.1%M/M, the least since September 2021. So, the annual rate of food inflation dropped 2.4ppts to a ten-month low of 14.9%Y/Y, subtracting almost 0.3ppt from overall inflation. Among the core items of the inflation basket, however, the relative price shifts were more modest. Lower inflation of used cars, pet products, games, toys and hobbies helped inflation of non-energy industrial goods fall 0.5ppt to a four-month low of 5.9%Y/Y. But increased inflation in hotels and airfares – perhaps in part due to the timing of the sample this July – as well as a sharp pickup in rents, particularly related to social housing, reversed the prior month's 0.2ppt drop in services inflation back to the series high of 7.4%Y/Y. As a result, core CPI inflation remained unchanged at 6.9%Y/Y, down just 0.2ppt from the peak in May, and a level now above the headline CPI rate.

Services inflation exceeds BoE forecast with most price increases still above long-run norms

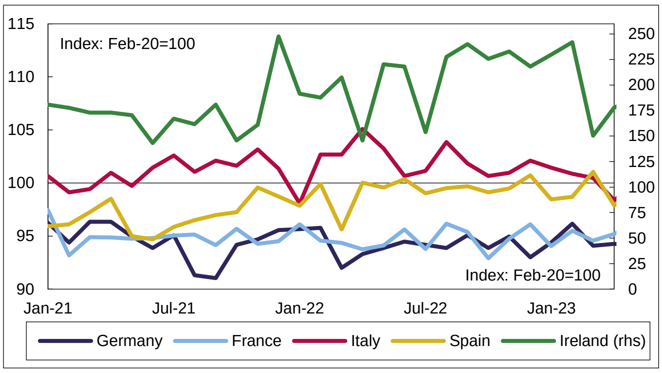
Headline CPI inflation in July was bang in line with the BoE's forecast of 6.8%Y/Y. However, the monthly increases in prices of services, core goods and food were all still firmly above their respective long-run averages for July. While the NIESR

Euro area: GDP by member state



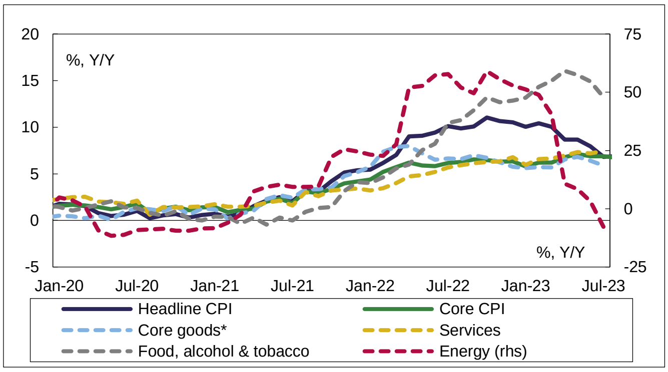
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production by member state



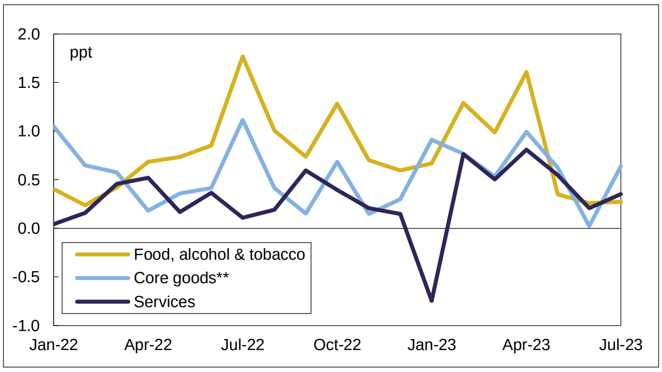
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation



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

UK: Deviations from l-r average price change*



**Deviation from long-run average monthly price change. **Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

trimmed mean CPI rate, which excludes the 10% of items with the highest and lowest inflation rates, fell 0.6ppt, it remained elevated at 8.6%Y/Y. And almost four-fifths of items in the inflation basket continued to report inflation above 3.0%Y/Y, while significantly less than one fifth reported inflation less than 2.0%Y/Y. Most importantly perhaps, services inflation, which the MPC has singled-out for attention when determining the path of monetary policy, was 0.1ppt above the BoE's forecast in July. So, based on today's data, the MPC will be no less concerned about inflation persistence than it was when it raised rates earlier this month.

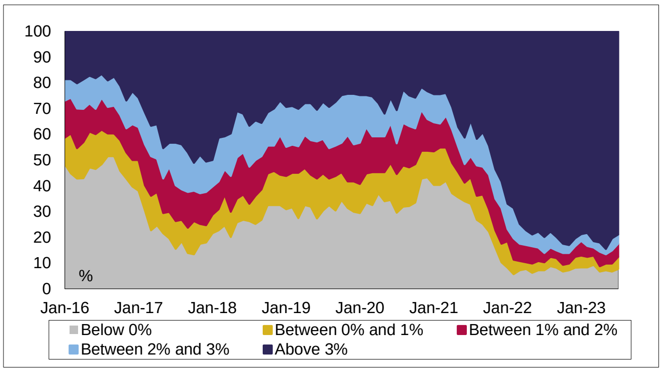
BoE inflation projection remains plausible but pay data will prompt extra tightening into the autumn

Looking ahead, wholesale and producer price data, as well as the significant appreciation of sterling over the past year or so and recent global economic developments, all still point to a further significant softening in consumer goods inflation over coming months. Indeed, producer food output price inflation fell 2.4ppts in July to 6.3%Y/Y while core producer output price inflation fell 0.9ppt to 2.3%Y/Y, the lowest in more than two years. With Ofgem's price cap likely to be cut by about 5% in October, energy will subtract more than 1.0ppt from headline inflation by Q4. Firms should also feel under less pressure to pass on increased energy costs to consumers. But the accelerated wage growth in Q2 reported yesterday tallies with other survey findings that broader input cost pressures remain relatively strong in services. And higher real wage growth should ensure that demand remains relatively resilient over the near term, maintaining scope for services firms to continue to pass on costs to consumers should they feel the need to do so. Overall, today's data suggest that the BoE's August inflation projection – which saw services inflation edge below 7.0%Y/Y by Q4 and decline more rapidly from Q224 on, allowing the headline CPI rate to drop below 5.0%Y/Y in Q4, to around 3½%Y/Y by Q224 and sub-3%Y/Y by end-2024 – remains plausible. Indeed, our own baseline projection foresees a similar path to Q124 and a slightly accelerated decline over the remainder of next year. But yesterday's labour market figures suggest that the risks of inflation persistence have likely increased further. And so, we maintain our forecast of two further rate hikes of 25bps apiece in September and November.

The coming two days in the UK

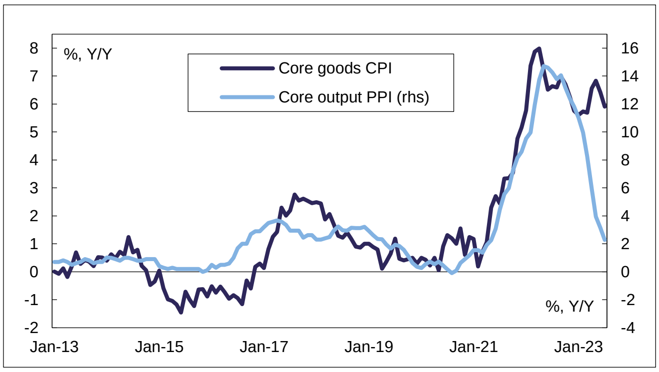
After a quiet day in the UK tomorrow, with no top-tier data scheduled for release, Friday brings the latest retail sales report. Following three successive monthly increases, retail sales volumes always seemed likely to fall in July. And with surveys having reported that demand was particularly weak, as wet weather hit footfall and deterred purchases of seasonal items, we expect a drop of between 0.5-1.0%M/M, the most since March. The deterioration in consumer confidence in July will not have encouraged spending either. And we expect no significant improvement in sentiment to be reported in the August GfK survey, also due on Friday.

UK: Share of CPI basket by inflation rates



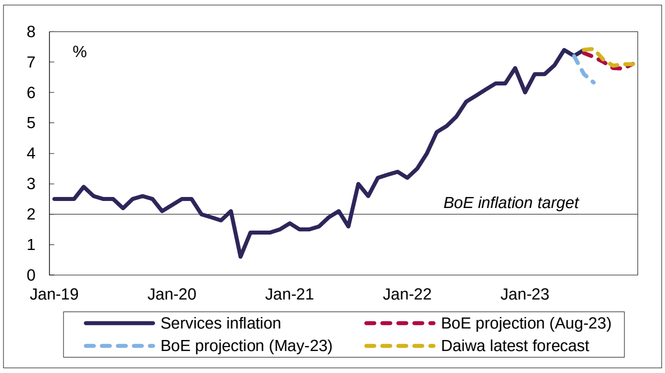
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Consumer & producer prices



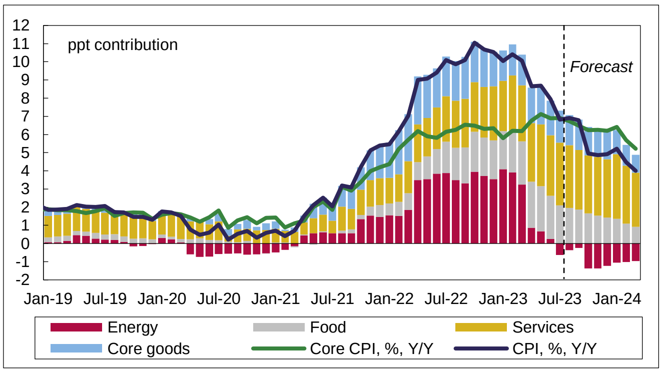
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Services inflation & forecasts



Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation & selected contributions



Source: Refinitiv Datastream 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		GDP – second estimate Q/Q% (Y/Y%)	Q2	**0.3 (0.6)**	*0.3 (0.6)*	0.0 (1.1)	-
		Preliminary employment Q/Q% (Y/Y%)	Q2	**0.2 (1.5)**	-	0.6 (1.6)	0.5 (-)
		Industrial production M/M% (Y/Y%)	Jun	**0.5 (-1.2)**	*0.4 (-2.9)*	0.2 (-2.2)	0.0 (-2.5)
UK		(Core) CPI Y/Y%	Jul	**6.8 (6.9)**	6.8 (6.8)	7.9 (6.9)	-
		PPI output (input) prices Y/Y%	Jul	**-0.8 (-3.3)**	-1.3 (-2.8)	0.1 (-2.7)	0.3 (-2.9)
		House price index Y/Y%	Jun	**1.7**	-	1.9	1.8

Auctions

Country		Auction
Germany		sold €787mn of 0.00% 2050 bonds at an average yield of 2.68%
		sold €1.3bn of 0.00% 2052 bonds at an average yield of 2.68%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		10.00	Trade balance €bn	Jun	4.0	-0.9
Spain		09.00	Trade balance €bn	Jun	-	-3.1

Auctions and events

Country		BST	Event
France		09.50	Auction: 2.50% 2026 bonds
		09.50	Auction: 2.75% 2029 bonds
		09.50	Auction: 1.50% 2031 bonds
		10.50	Auction: 1.85% 2027 index-linked bonds
		10.50	Auction: 0.10% 2038 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
Euro area		10.00	Final (core) CPI Y/Y%	Jul	*5.5 (5.5)*	6.1 (5.5)
		10.00	Construction output M/M% (Y/Y%)	Jun	-	0.2 (0.1)
UK		00.01	GfK consumer confidence	Aug	-29	-30
		07.00	Retail sales including auto fuel M/M% (Y/Y%)	Jul	-0.6 (-2.1)	0.7 (-1.0)
		07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Jul	-0.7 (-2.2)	0.8 (-0.9)

Auctions and events

Country		BST	Event
Euro area		11.00	ECB Chief Economist Lane scheduled to speak – 'The role of banks in fighting inflation'

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 18th August 2023

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs