Euro wrap-up

Overview

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- Bunds followed the global trend higher as euro area unemployment rose in June.
- Gilts rallied across the curve as the BoE's MPC voted 5-4 to cut Bank Rate and continued to forecast that inflation is likely to decline sustainably below target before the end of its projection horizon.
- Friday will bring updates on industrial production in France and Italy.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/26	2.441	-0.079
OBL 2½ 10/29	2.157	-0.075
DBR 2.6 08/34	2.240	-0.060
UKT 0⅛ 01/26	3.684	-0.102
UKT 0½ 01/29	3.663	-0.097
UKT 4⅝ 01/34	3.880	-0.089

*Change from close as at 5.00pm BST.
Source: Bloomberg

Euro area

Unemployment rate edges up in June with signs of more significant labour market weakening in Q3

While the resilience of the labour market has up to now been cited by the ECB hawks as a potential source of inflation persistence, recent data suggest that conditions are softening. Today's figures showed that the euro area unemployment rate ticked up 0.1ppt in June from the series low of the prior two months to 6.5%, back in line with the average of the previous twelve months. And the number of people unemployed rose for a second successive month, up 41k. The increase in the euro area unemployment rate was caused by a modest pickup in Italy (up 0.1ppt to 7.0%) as well as increases of 0.2ppt apiece in Portugal (6.7%), Ireland (4.2%) and Austria (5.3%). In contrast, reflecting firmer economic growth momentum, jobless rates continued to decline in Spain (11.5%) and Greece (9.6%). Within the core, unemployment rates on the harmonised measure in Germany (3.4%) and France (7.4%) were unchanged in June, albeit still 0.5ppt and 0.3ppt respectively above their recent lows. And survey indices, such as the Commission's Employment Expectations Indicators, point to a significant weakening of momentum in the labour market at the start of Q3. That deterioration appears most acute within the core, particularly in Germany and France, albeit also still principally concentrated in manufacturing and retail. But while labour cost and negotiated wage growth likely remained elevated in Q2 (with the respective data due 21 and 22 August), the looser conditions in the labour market should help to ensure that it moderates over coming quarters, broadly as suggested by wage trackers and the ECB's own projections.

The day ahead in the euro area

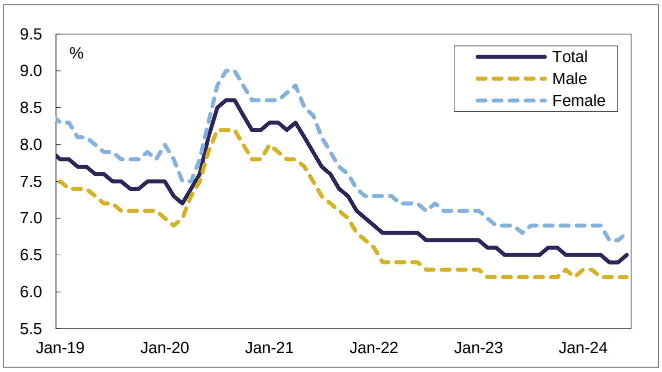
A relatively quiet end to the week for euro area economic data will bring French and Italian industrial production figures for June. After French output declined sharply in May – with the 2.1%M/M drop taking the level to a 19-month low – we expect some bounce back in June. The flash French GDP release published earlier this week implied IP growth of almost 3%M/M in June, which seems overly optimistic to us. Meanwhile, having risen in the previous three months, construction activity seems highly likely to decline in June, although the implied drop of 5%M/M also seems overdone. In contrast, in Italy, industrial production is forecast to move merely sideways in June, which would leave output down around 1%3M/3M in Q2.

UK

Bank of England cuts Bank Rate by 25bps in 5-4 vote

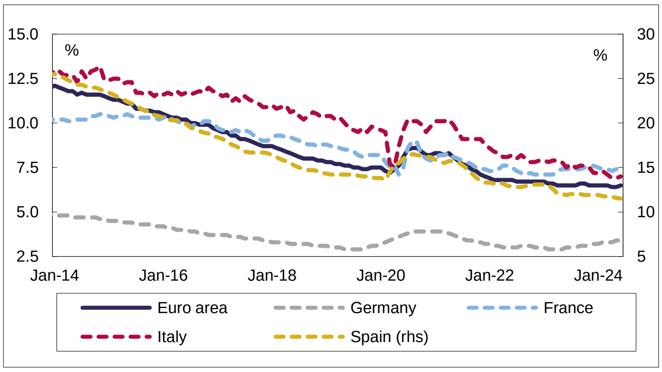
As we expected, the BoE cut Bank Rate by 25bps to 5.00% when its MPC meeting concluded today. Also, as expected, the decision appeared exceptionally close-run, with a rare five-to-four vote in favour of easing policy. Three of the four members voting against the rate cut were external, however, with Chief Economist Huw Pill the only BoE staff member to dissent, and

Euro area: Unemployment rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

perhaps as a token gesture to highlight that the case for easing today was not wholly clear-cut. Indeed, for some (and probably most) of the members who voted for a cut, the decision was "finely balanced", recognising that inflation persistence cannot yet be judged to have conclusively dissipated and that there remain some upside risks to the outlook. Indeed, the MPC statement maintained that policy would "remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term had dissipated further". And the BoE echoed the ECB in insisting that the appropriate degree of monetary policy restrictiveness would be reviewed at each meeting, underscoring that the MPC has no pre-ordained path in mind for Bank Rate. Indeed, in his post-meeting comment, Governor Bailey insisted that the Bank was mindful not to cut "too quickly or by too much". However, if the economy pans out in line with the MPC's updated forecasts, today's first step to ease policy should represent the first of several cuts over the next couple of years.

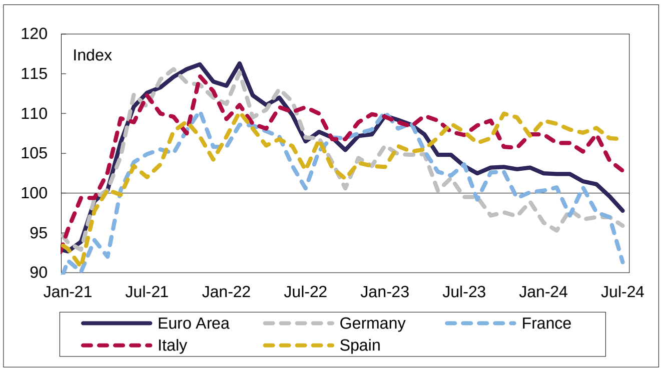
Inflation persistence less a concern as global shocks fade & projections become more reliable

Certainly, while inflation persistence undoubtedly remains a concern, the majority on the MPC judged that pressures have eased sufficiently as to merit a first rate cut. And as the impact of the global shocks from the pandemic and Russia's invasion of Ukraine have faded, and after headline CPI returned back (albeit temporarily) to target in May and June, the MPC has increased its confidence in the inflation outlook. Among the key variables in its recent policy reaction function, private sector regular pay growth recently moderated in line with its May projection. And while services inflation exceeded its expectation, the MPC rightly downplayed concerns, attributing the overshoot to components that are regulated or index-linked (such as mobile phone bills) and typically volatile items such hotels. So, it highlighted that underlying services inflation was likely much better-behaved. With greater confidence in its forecasting ability, therefore, the MPC has become less hung-up about individual monthly data observations and is now able to focus more on the medium-term inflation outlook. And supported by further evidence, such as from today's BoE DMP survey, that wage and price expectations are increasingly well anchored, its projections suggest that rates could be cut in line with, or even eventually more aggressively, than the path currently priced into the markets.

Inflation projected to decline below target in 2026 according to scenario MPC judges most likely

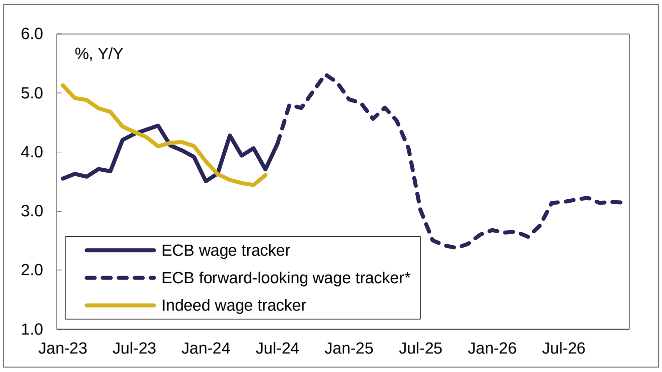
Over the near term, the MPC expects inflation to pick up to about 2¾%Y/Y in Q4 and Q1. However, that will primarily reflect energy base effects as well an expected rise of about 10% in the regulated household energy price cap in October. And excluding energy, inflation is expected gradually to decline. Indeed, assuming a market-implied path for Bank Rate, the monetary policy stance would be considered restrictive into 2026, weighing on underlying inflation. And the BoE judges that

Euro area: EC Employment expectations indices



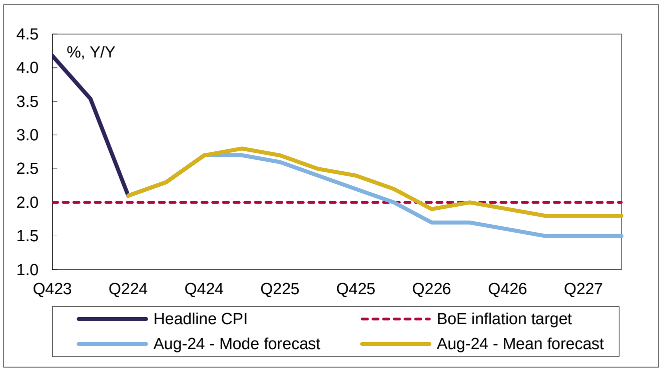
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Wage trackers



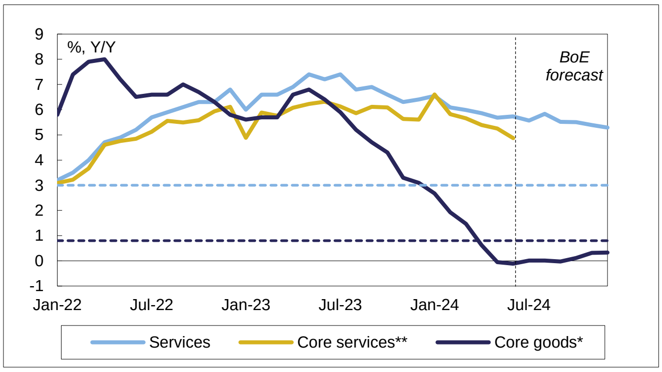
**Forward-looking wage tracker assumes growth unchanged at the latest agreements in Q224. Source: ECB Occasional Paper on "A forward-looking tracker of negotiated wages in the euro area*

UK: BoE inflation projections*



**Based on market- implied probabilities for Bank Rate of 4.9% at end-24, 4.1% at end-25 and 3.7% at end-36. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Goods & services inflation: BoE projections



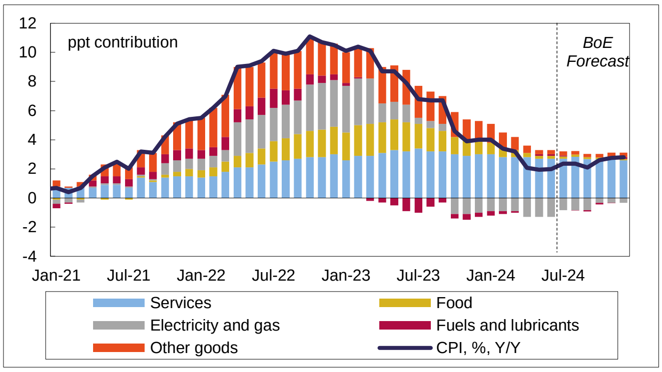
**Non-energy industrial goods. **Core services CPI excludes airfares, accommodation & rents. Dashed lines represent average between 2010 & 2019. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.*

the new government's fiscal commitments, including higher public sector pay settlements, will have a minimal impact on the inflation outlook. So, on its modal projection, which reflects the scenario that the MPC considers most likely to occur, services inflation is expected to continue to decline gradually. Slightly below the path of its May projection, headline inflation would fall back below 2½%Y/Y in the second half of next year, below target in 2026 and just 1½%Y/Y in 2027. Moreover, while the MPC has introduced a new upside skew to its projection to reflect a scenario whereby second-round effects on inflation are more potent due to structural changes in the economy, inflation is still expected to decline below target by the end of the horizon on its mean projection. As we consider the mode projection to be credible, we therefore maintain our expectation that Bank Rate will be cut by 25bps each quarter from now through to end-2026.

MPC relatively downbeat about GDP outlook, particularly if rate cuts are not forthcoming

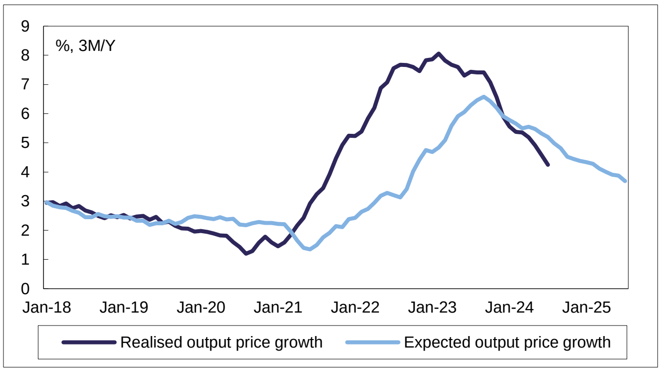
In terms of GDP, the MPC judged that the pickup in growth to 0.7%Q/Q in Q1 had extended into Q2. But that stronger growth was not considered to be an obstacle to a rate cut, being judged as temporary payback for the weakness in 2023. Certainly, the Bank interprets recent survey evidence to suggest that underlying growth is more subdued, and so GDP growth is likely to moderate to an average rate around 0.3%Q/Q in H224. Given the restrictiveness of monetary policy, it also projects that growth would likely moderate a little further in the first three quarters of 2025 to an average pace of around 0.2%Q/Q if rates

UK: Contributions to headline CPI inflation



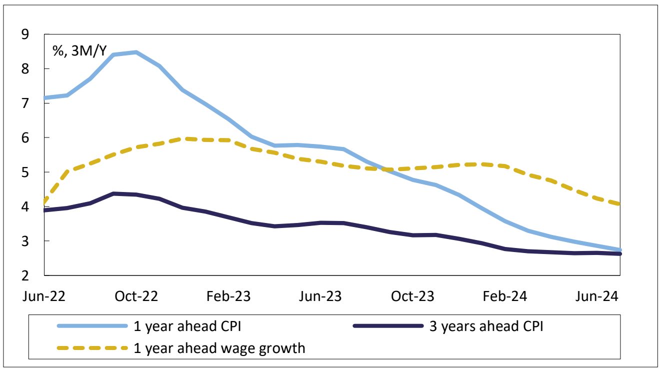
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: DMP survey: Firms' output price expectations



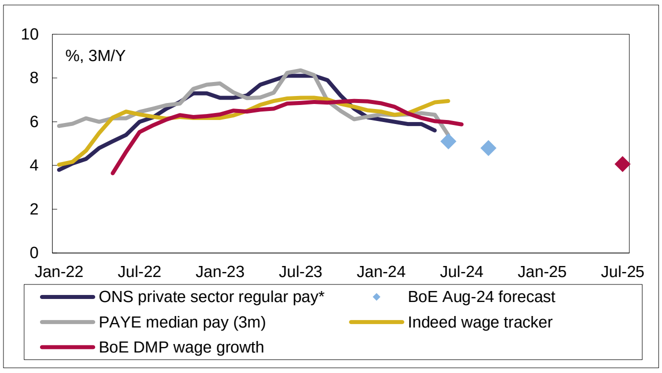
Source: BoE DMP survey, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: DMP survey: Firms' CPI & wage expectations



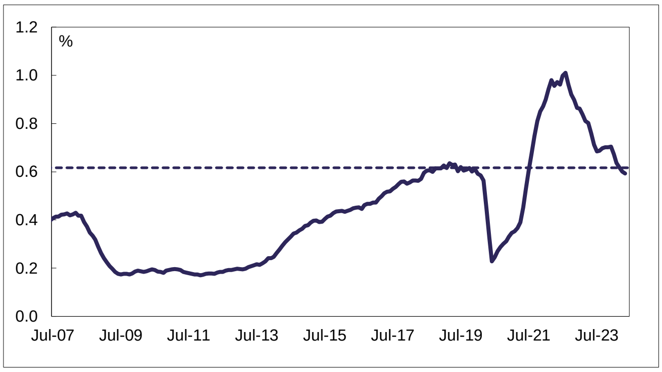
Source: BoE DMP survey, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Measures of wage growth



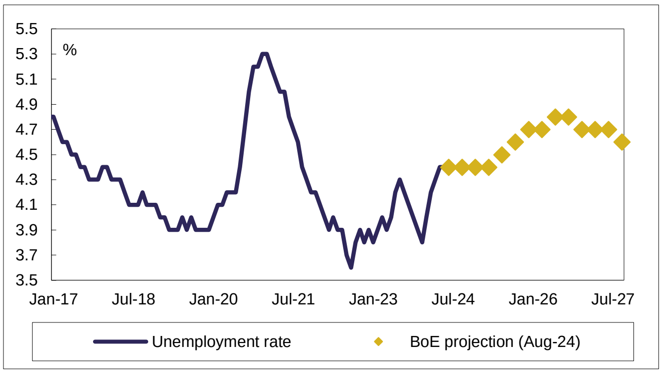
**Data between Jan-22 & Nov-22 are BoE staff estimates of underlying private regular pay growth. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Vacancies to unemployment ratio



**Dashed line represents 2019 average. Source: Macrobond, BoE and Daiwa Capital Markets Europe Ltd.*

UK: BoE unemployment rate projection



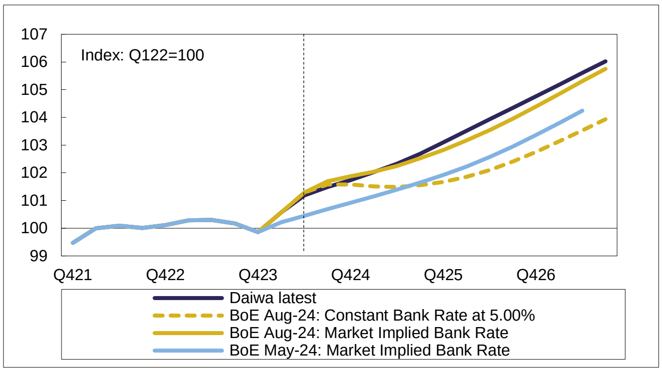
**Dashed line represents 2019 average. Source: Macrobond, BoE and Daiwa Capital Markets Europe Ltd.*

were cut in line with market pricing, and also projects that growth would grind to a halt if rates were not cut at all. Moreover, despite the stronger growth performance in the first half of this year, the MPC judged that the economy is now broadly in balance. The recent pickup in unemployment and improved survey indicators of capacity utilisation lend credence to that view. With full-year GDP growth expected by the MPC to moderate from 1¼%Y/Y this year to 1%Y/Y in 2025, unemployment is expected to rise gradually further and a margin of economic slack is projected to emerge by end-2024 and widen throughout next year and into 2026. That slack should weigh on underlying inflation and allow the series of rate cuts over coming quarters that we anticipate. While the MPC's hawks worry that the equilibrium rate of unemployment has risen and rates will need to be higher for longer to squeeze out inflation persistence, it also possible that the BoE remains too downbeat about the economy's potential growth rate. If so, unemployment could rise further and underlying inflation could yet fall faster than the MPC anticipates, eventually forcing the MPC to accelerate its monetary easing.

The day ahead in the UK

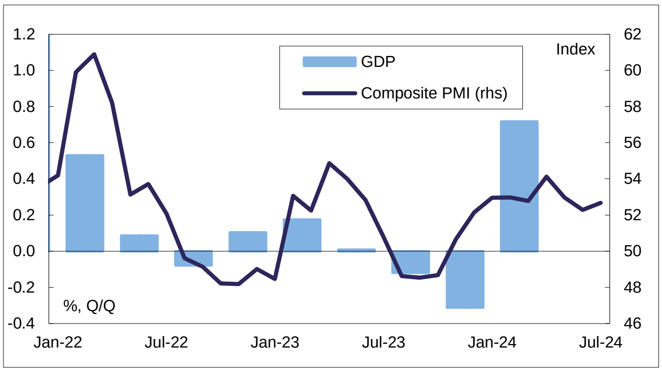
There are no UK top-tier data due for release on Friday.

UK: BoE GDP projections



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite output PMI



Source: Macrobond, S&P Global 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 manufacturing PMI	Jul	**45.8**	45.6	45.8	-
	Unemployment rate %	Jun	**6.5**	6.4	6.4	-
Germany	Final manufacturing PMI	Jul	**43.2**	42.6	43.5	-
France	Final manufacturing PMI	Jul	**44.0**	44.1	45.4	-
Italy	Manufacturing PMI	Jul	**47.4**	46.0	45.7	-
Spain	Manufacturing PMI	Jul	**51.0**	52.5	52.3	-
UK	BoE Bank Rate %	Aug	**5.00**	*5.00*	5.25	-
	Final manufacturing PMI	Jul	**52.1**	51.8	50.9	-
	DMP 3M output price (1Y CPI) expectations Y/Y%	Jul	**3.7 (2.5)**	-	3.9 (2.8)	-
	Nationwide house price index M/M% (Y/Y%)	Jul	**0.3 (2.1)**	0.1 (1.8)	0.2 (1.5)	-

Auctions

Country	Auction
France	sold €4.96bn of 3% 2034 bonds at an average yield of 3.01%
	sold €1.86bn of 1.25% 2038 bonds at an average yield of 3.21%
	sold €1.68bn of 2.5% 2043 bonds at an average yield of 3.36%
	sold €2.01bn of 4% 2055 bonds at an average yield of 3.49%
Spain	sold €1.83bn of 2.5% 2027 bonds at an average yield of 2.701%
	sold €766mn of 0.65% 2027 inflation-linked bonds at an average yield of 0.892%
	sold €2.86bn of 3.45% 2034 bonds at an average yield of 3.107%
	sold €1.18bn of 5.15% 2044 bonds at an average yield of 3.566%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
France	07.45	Industrial production M/M% (Y/Y%)	Jun	1.0 (-1.1)	-2.1 (-3.1)
	07.45	Budget balance YTD €bn	Jun	-	-114
Italy	09.00	Industrial production M/M% (Y/Y%)	Jun	-	0.5 (-3.3)
	10.00	Retail sales Y/Y%	Jun	-	0.4
Spain	08.00	Unemployment (employment) change 000s	Jul	-	-46.8 (31.3)

Auctions and events

Country	BST	Event
UK	12.15	BoE Chief Economist Pill to brief Bank's Agents on updated macroeconomic projections

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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