Euro wrap-up

Overview

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- Bunds made modest losses while the German ZEW investor survey pointed to a brighter economic outlook and an ECB survey suggested that corporate loan demand improved in Q2 as firms revised up their capex plans.
- Gilts ended the day little changed as UK private regular pay growth slowed to a 5½-year low.
- Wednesday will bring UK inflation figures for June.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.799	+0.017
OBL 2.9 10/31	2.912	-
DBR 3 08/36	3.162	+0.014
UKT 4⅜ 03/28	4.386	-0.007
UKT 4⅛ 03/31	4.578	+0.003
UKT 4¾ 10/35	5.025	-0.002

*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

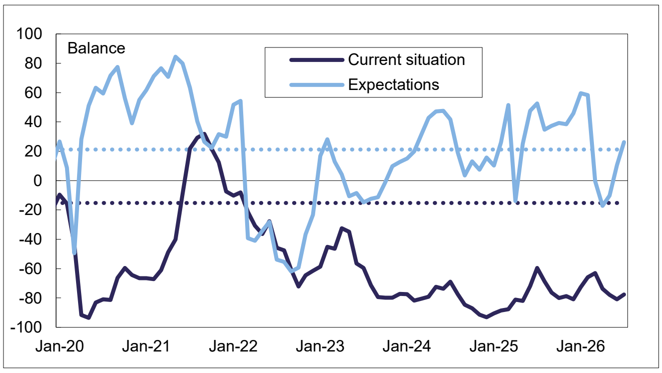
German ZEW survey points to a brighter H226 as inflation & rate-hike fears ease

The German economy appears to have weathered the energy shock better than expected. After GDP growth accelerated to 0.3%Q/Q in Q1, the strongest pace in a year, hard data point to another quarter of respectable growth in Q2, with industrial and construction output in April and May tracking some ½% and 2½% above their Q1 average levels respectively. Surveys largely suggested that the expansion continued in June. And today's ZEW survey indicated that investors have become somewhat more optimistic about the economic outlook at the start of Q3 too. Admittedly, the survey's current situation balance (-77.8) remained extremely low, and the improvement largely reflected fewer respondents judging conditions to be 'bad' rather than a meaningful rise in positive assessments. Indeed, for a third successive month, no respondents considered conditions to be 'good' in July. Nevertheless, sentiment regarding the outlook remained more positive. Despite the renewed rise in wholesale energy prices, the share of investors expecting inflation to increase moderated sharply in July. Accordingly, only around half of respondents expected interest rates to rise over the coming six months, down from three-quarters in June. And economic expectations strengthened significantly, with the respective balance (26.3) above the long-run average for the first time in five months, albeit remaining well down on the range in the nine months before the Iran conflict. As such, profit expectations largely strengthened, with services and IT-related subsectors expected to deliver the strongest gains. The autos sector was the notable exception as competition from China and changing consumer preferences remained a challenge.

Corporate loan demand improved as firms revise up capex plans

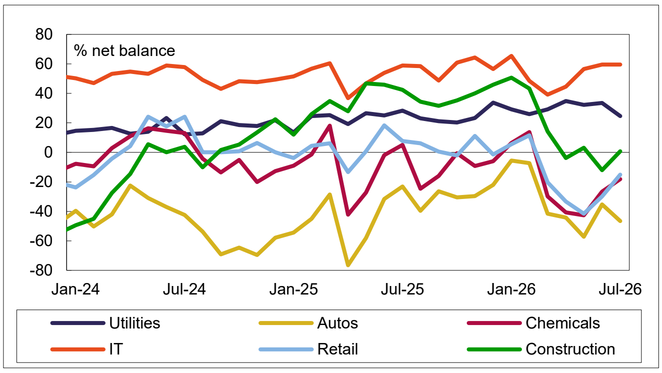
With the ECB having raised rates by 25bps in June, its Bank Lending Survey (BLS) and Survey on Access to Finance of Enterprises (SAFE) unsurprisingly signalled a further tightening in euro area financial conditions in Q2. However, the BLS suggested that credit standards on corporate loans (+7.3) tightened by less than in Q1 and significantly less than banks had anticipated. Moreover, an even smaller share of lenders expects to tighten corporate lending conditions further in Q3. By contrast, household lending conditions deteriorated more markedly. Having been relatively resilient in Q1, credit standards on housing loans tightened by the most in almost three years (+8.8), reflecting reduced risk tolerance amid heightened economic and housing market uncertainty. Banks also expect to see a further significant tightening in consumer credit standards this quarter. Unsurprisingly, demand for mortgages and consumer credit weakened in Q2 and is expected to remain subdued in the near term. Corporate credit demand was more mixed. While demand from SMEs continued to soften, demand from large firms reportedly rebounded unexpectedly due to increased financing needs for inventories, working capital and fixed investment. Indeed, the SAFE survey suggested that firms revised up their capex intentions, driven in part by growing investment in AI-related technologies.

Germany: ZEW economic conditions indices*



*Dotted lines represent long-run average.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW profit expectations indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

On a quiet day for euro area data releases, focus should turn to Thursday's monetary policy announcement.

UK

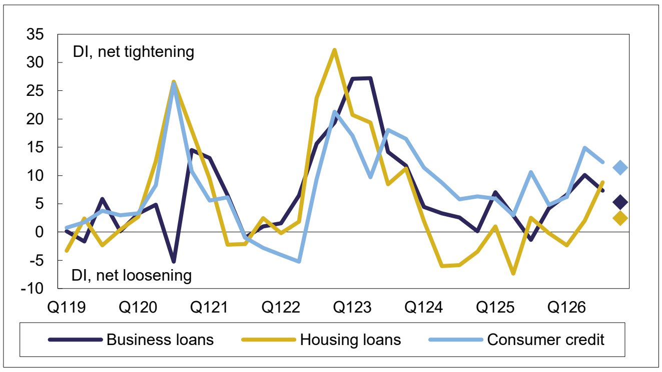
Burnham's Treasury appointments should reduce somewhat concerns about fiscal policy direction

With the transfer of power from Keir Starmer to Andy Burnham, UK fiscal policy remains in the spotlight, raising issues for the path of monetary policy and questions about the deliverability of future deficit reduction. After speculation that Burnham might take a marked detour from Starmer's plans for the public finances at the cost of Gilt market stability, his selections of senior ministers at HM Treasury should have allayed some of the hyperbole. While he will certainly seek to boost defence expenditure over the medium term, John Healey, Burnham's appointment as Chancellor, was an acolyte of Gordon Brown and will likely be no less orthodox than either his former mentor or his predecessor Rachel Reeves. And Emma Reynolds, the new Chief Secretary to the Treasury responsible for public expenditure control, is a Blairite and equally committed to low public borrowing. While Burnham's comments yesterday that his government should seek to exploit the flexibility within the current fiscal rules appeared to pressure Gilts, we do see scope for extra support to be provided for public investment, not least via the public financial institutions (such as the National Wealth Fund), without jeopardising the stabilisation of public sector net financial liabilities according to the current timetable. Admittedly, Burnham's new commitment to cut from 5% to zero the VAT rate on electricity bills from October – perhaps initially only until end Q127 – today provoked an untimely debate about financing. But the near-term budgetary impact appears for the time being to have been offset by his further decision to ditch Stamer's costly digital ID card project. For what it's worth, the VAT cut will mean that CPI inflation from October will be 0.1ppt lower than it otherwise would have been. But if the recent increase in wholesale gas and electricity prices persists, it might simply negate the impact of an increase in the Ofgem household energy price cap and result in stable (rather than lower) utility bills for consumers.

Scope for funding new policy priorities constrained by fiscal rules, tax pledges & spending realities

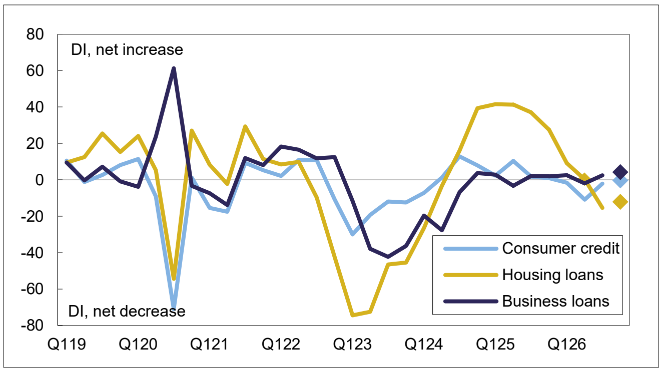
Currently at least, public sector net borrowing (PSNB) is trending below its level in the last fiscal year. PSNB in June came in at £16bn, marginally below the OBR's forecast and one third below the level a year earlier. So, cumulative borrowing in the first three months of the fiscal year reached £57.6bn, some £3.7bn (6%Y/Y) lower than the equivalent period in FY25/6 albeit

Euro area: BLS – credit standards*



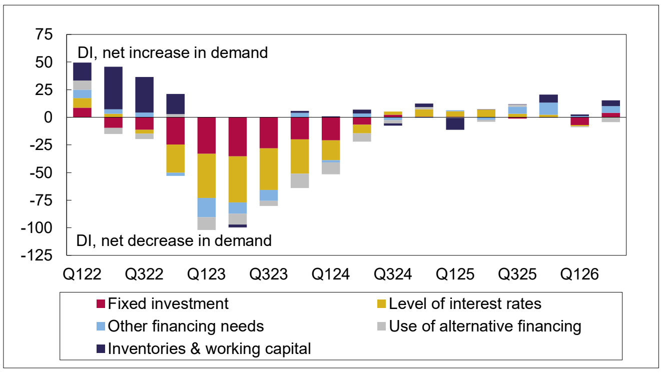
Diamonds reflect survey forecast for Q326. Source: ECB Business Lending Survey, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: BLS – loan demand*



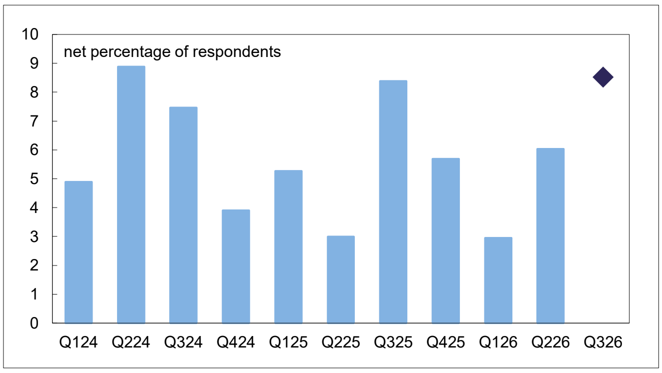
Diamonds reflect survey forecast for Q326. Source: ECB BLS, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: BLS – factors driving NFC loan demand



Source: ECB BLS, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: SAFE – firms' capex intentions*



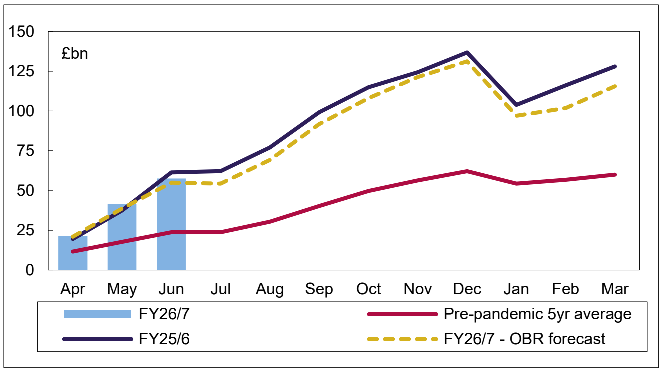
Diamond represents forecast for Q326. Source: ECB Survey on Access to Finance of Enterprises, Macrobond and Daiwa Capital Markets Europe Ltd.

still some £2.7bn above the OBR's projection despite favourable revisions to the estimates for prior months. The overshoot relative to the OBR's forecast relates to central government spending, specifically higher debt interest on inflation-linked gilts and welfare benefits, as well as borrowing by public corporations. But stronger-than-expected corporation tax and personal tax receipts provided some offset. Looking ahead, the OBR previously projected PSNB to decline by 0.6ppt to 3.6% of GDP this fiscal year, and below 2% of GDP by FY29/30. More important for policy is the trajectory of the current budget (i.e. borrowing net of investment), which the Government's binding fiscal rule states should be in balance or surplus by FY29/30. The current deficit was previously projected to drop 0.4ppt this fiscal year to 1.1% of GDP and decline further over coming years to reach a surplus of 0.7% of GDP by FY29/30, representing some £23bn of policy headroom for the Government. But the inflation shock from the Middle East will sustain debt interest costs above the OBR's projection over coming quarters, while spending on state benefits will also likely remain elevated, thus eroding roughly half of that headroom. Spending at most government departments is already planned for significant restraint over coming years. And receipts as a share of GDP are set to rise this year to the highest level in more than five decades. Of course, Burnham and Healey have pledged to adhere to Starmer's manifesto commitment not to raise income tax, VAT and national insurance rates. So, their scope to funnel extra resources towards new priorities such as defence, council housebuilding, the regions and low-income workers will require a creative approach to tax-raising and ruthlessness in public expenditure control, which itself not be without political and economic risk.

Private wage growth slows to softest pace since October 2020, undershooting the BoE's forecast

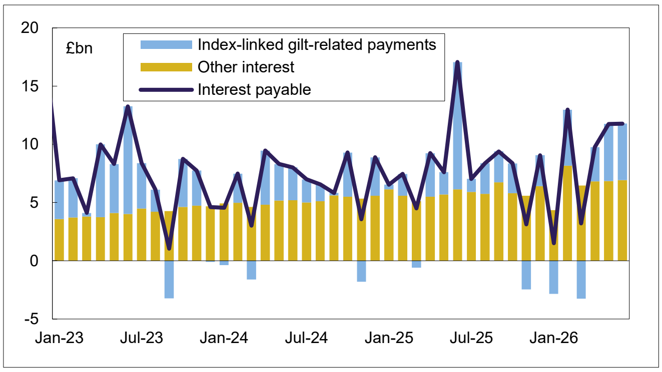
Ahead of the MPC's interest rate decision on 30 July, today's labour market data offered mixed signals. But they remained broadly consistent with persistent economic slack. And not least given the continued moderation in pay growth, they should have underscored expectations that the majority on the MPC will again 'actively hold' Bank Rate at 3.75% this month. Admittedly, although total pay growth edged slightly lower in May, at 4.3%3M/Y it was still 0.4ppt higher over the quarter and broadly in line with the average for the past six months. But that was in part exaggerated by the timing of public sector settlements and stronger private sector bonus payments. Underlying trends continue to point to diminishing wage pressures. Most notably, private regular pay growth slowed to 2.9%3M/Y, the weakest reading since October 2020 and slightly below the BoE's Q2 projection. And the single-month rate in May dropped to just 2.7%Y/Y, close to the rate that Bank staff judge to be consistent with achieving the inflation target over the medium term. Wage momentum suggests that private pay growth will remain sub-3%Y/Y over the near term. And with inflation set to rise above 3%Y/Y for a while, real regular pay growth – which stood at just 0.3%3M/Y in May – looks set to slip back into negative territory, posing an additional headwind to household spending.

UK: Public sector net borrowing



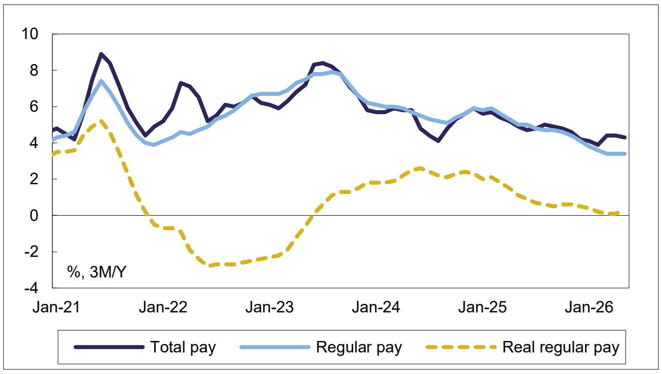
Source: OBR, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Central government debt interest payments



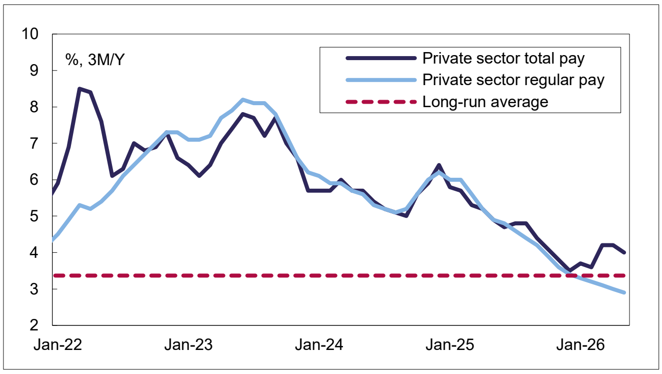
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Nominal & real pay growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Private sector total & regular pay growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

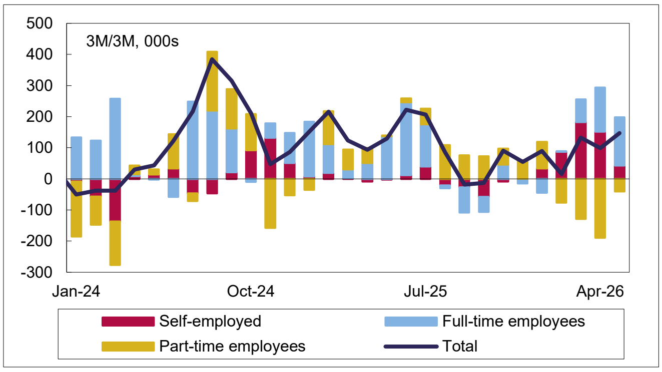
Mixed employment signals, but falling job vacancies add to evidence of labour market slack

At face value, the Labour Force Survey (LFS) suggested a marked improvement in labour market conditions in the three months to May, with employment rising 148k, the most since last July. This reflected the first increase in employee numbers (155k) in four months, leaving them some 240k higher than a year earlier. In part due to the return of workers previously inactive because of long-term and temporary sickness, the unemployment rate held steady at 4.9%, below the BoE's Q2 forecast (5.1%). That quarterly jobless rate was distorted by a spike in March. And the more volatile single-month rate fell to an 11-month low of 4.65% in May. However, confidence in the LFS findings remains low, with the quality this month reduced further by an operational error. More importantly, the survey's results contrast markedly with other labour market indicators. HMRC data suggested that the number of payrolled employees fell by 90k in the three months to May, and a further 4k in June to its lowest level in almost three years and more than 70k below its level a year earlier. And job vacancies fell again in the three months to June to the lowest level in five years. As a result, the vacancies-to-unemployment ratio remained at one of the lowest levels in over a decade (outside of Covid lockdowns) consistent with persistent labour market slack that – consistent with signals from business surveys – should result in ongoing wage restraint and limited risks of second-round inflation effects.

The day ahead in the UK

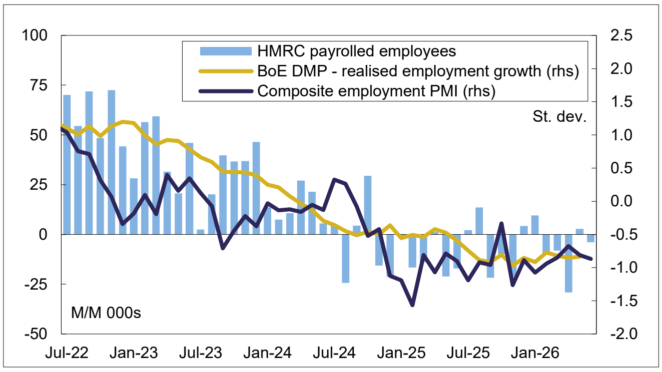
UK inflation data will provide the highlight of Wednesday's dataflow. Albeit only temporarily, CPI inflation is widely expected to receive some relief following last month's lull in global energy prices. Falling auto fuel prices should provide the largest downward impulse and will push energy inflation modestly lower. But milder cost pressures could also dull the impulse from indirect effects, which should reduce services inflation. And while the damaging effects of recent heatwaves and pass-through from higher fertiliser prices will be an upside risk in future months, we also expect to see further signs of softness in food inflation in June. Overall, those factors could take the headline CPI rate down as much as 0.2ppt to 2.6%Y/Y, a 15-month low, while core inflation may edge back down to 2.5%Y/Y. But the risks to our forecast are skewed slightly to the upside, as the slightly firmer Bloomberg survey consensus underlines (2.7%Y/Y). And while either of those readings would confirm a non-negligible undershooting of the BoE's projection back in April, policymakers are unlikely to draw too much comfort from a soft June reading whilst reescalation in the Middle East threatens to take inflation closer to 3.5%Y/Y by year-end. Elsewhere, the official UK house price index should revert closer to 2.5%Y/Y in May as distortions associated with last year's stamp duty changes coincide with weakening buyer demand.

UK: Employment growth



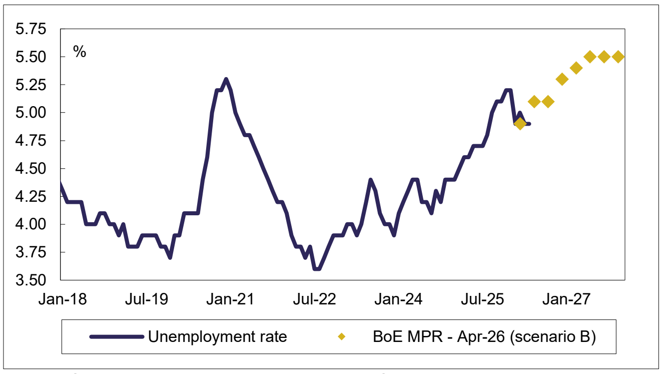
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Payrolled employees



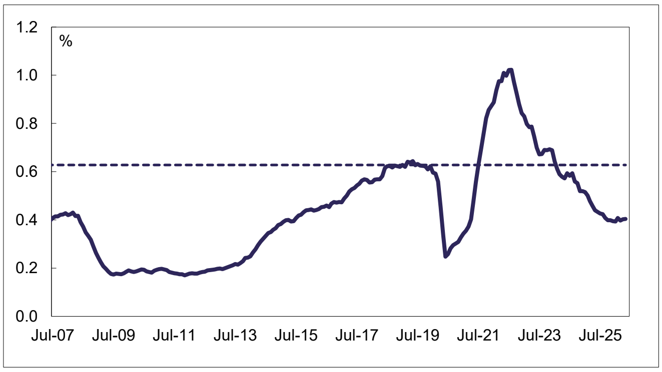
Source: S&P Global, BoE DMP, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Unemployment rate



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

UK: Vacancies to unemployment ratio*



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

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	ZEW current situation (expectations) balance	Jul	**-77.6 (26.3)**	-77.7 (15.3)	-81.0 (10.5)	-
UK	Average wages (excluding bonuses) 3M/Y%	May	**4.3 (3.4)**	4.5 (3.4)	4.4 (3.4)	-
	Private sector wages ex. bonuses 3M/Y%	May	**2.9**	*2.9*	2.9	3.0
	Unemployment rate 3M%	May	**4.9**	4.9	4.9	-
	Employment 3M/3M change 000s	May	**148**	80	100	99
	Payrolled employment M/M change 000s	Jun	**-4**	-8	2	3
	Claimant count rate % (change 000s)	Jun	**4.4 (6.7)**	-	4.5 (31.2)	4.4 (1.3)
	Public sector net borrowing £bn	Jun	**16.0**	17.8	23.3	20.0

Auctions

Country	Auction
Germany	sold €4.553bn of 2.9% 2031 bonds at an average yield of 2.89%
UK	sold £5bn of 4% 2029 bonds at an average yield of 4.463%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK	07.00	Headline (core) CPI Y/Y%	Jun	*2.6 (2.5)*	2.8 (2.6)
	07.00	PPI – output (input) prices Y/Y%	Jun	3.5 (8.2)	4.0 (8.7)
	09.30	House price index Y/Y%	May	-	3.8

Auctions and events

Country	BST	Event
Germany	10.30	Auction: to sell up to €1bn of 2.6% 2041 bonds
	10.30	Auction: to sell up to €1bn of 3.4% 2047 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.