Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds weakened as wholesale energy prices extended their uptrend amid escalating tensions in the Middle East.
- While UK inflation fell to a 15-month low, Gilts also followed the global trend lower.
- On Thursday, the ECB is widely expected to leave its key interest rates unchanged but make clear its readiness to tighten policy again in September.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.846	+0.047
OBL 2.9 10/31	2.946	+0.033
DBR 3 08/36	3.178	+0.015
UKT 4⅜ 03/28	4.427	+0.041
UKT 4⅛ 03/31	4.614	+0.037
UKT 4¾ 10/35	5.041	+0.016

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

UK

UK inflation falls to a 15-month low in June as energy and food pressures moderate

Following yesterday's soft labour market report, today's inflation data further reinforced the case for the MPC to leave Bank Rate unchanged at 3.75% next week. As we expected but slightly below the Bloomberg consensus, headline CPI inflation fell 0.2ppt in June to 2.6%Y/Y, a 15-month low. This pushed the quarterly rate down 0.3ppt to 2.8%Y/Y, also 0.3ppt below the BoE's Q2 baseline projection presented in April. Roughly half of the decline in June was accounted for by energy, with inflation of that component slowing 1.7ppts to a three-month low of 5.7%Y/Y. A second successive month of lower prices of petrol and other liquid fuels, thanks to improved crude oil market conditions, more than offset a modest upward contribution from electricity and gas. In addition, despite higher agricultural input costs, inflation of food and non-alcoholic beverages moderated to a near-two-year low of 1.7%Y/Y, more than 2ppts below the BoE's April forecast. In particular, past pressures on prices of meat, dairy, chocolate and certain other items continued to unwind. And as a result, the monthly increase in food prices was again below the long-run average for the fifth month out of the past six.

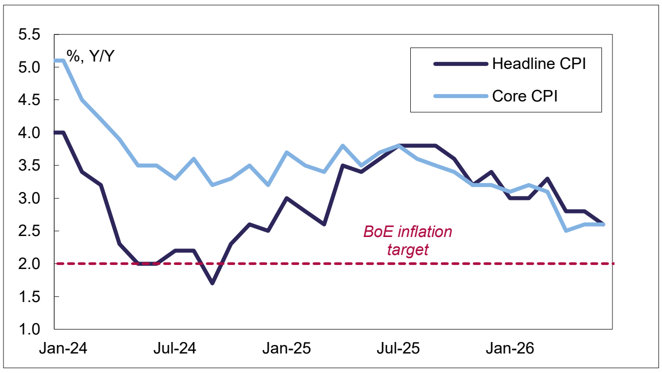
Core components continue to suggest only limited pass-through from the energy shock so far

More importantly, MPC policymakers might take encouragement from the underlying inflation picture, with little evidence to date of a broader pass through of higher energy prices to core components. Like the headline rate, non-energy industrial goods inflation also undershot the Bank's expectations, holding steady at 0.7%Y/Y, the joint-lowest level since October 2024. Admittedly, this partly reflected a larger period of seasonal clothing discounting compared to a year ago, which subtracted almost 0.05ppt from headline inflation. In contrast, however, pressures in the tech sector remained evident in items such as battery-powered electronics (19%Y/Y) and 'other recording media' including external storage devices (54%Y/Y). More encouragingly, services inflation edged down 0.1ppt to 3.6%Y/Y, in line with the BoE's forecast. Upward pressure from airfares and accommodation costs – perhaps reflecting increased demand for staycations amid the heatwave – was more than offset by lower charges for roadside recovery and certain cultural services. As a result, measures of underlying services inflation eased further in June, with the rate excluding indexed and volatile items, which is watched by the BoE, falling 0.2ppt to 3.7%Y/Y, its lowest level since September 2021. And while core inflation moved sideways at 2.6%Y/Y, this was just 0.1ppt above April's near-five-year low.

Headline inflation to step up in July on higher energy prices

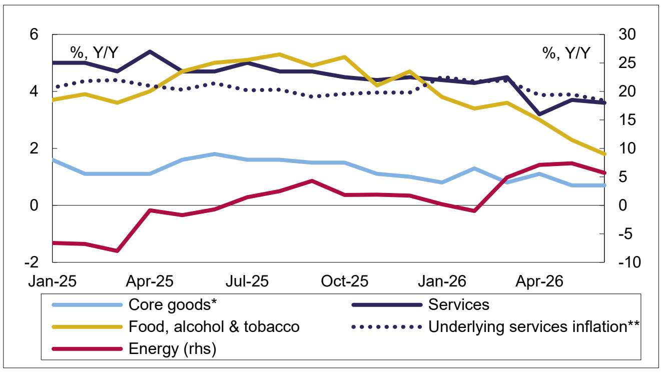
June is likely to mark the low point for inflation for the year. The near-13% increase in Ofgem's household energy tariff at the start of this month will push energy inflation back into double-digit territory for the first time in more than three years and add

UK: Headline & core CPI inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

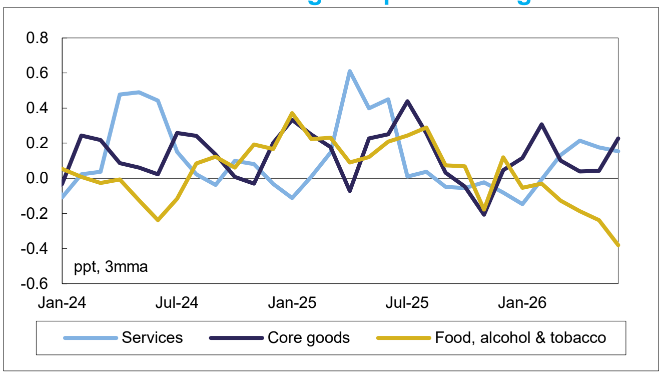
UK: Key CPI inflation components



**Non-energy industrial goods. **Excluding indexed & volatile items.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

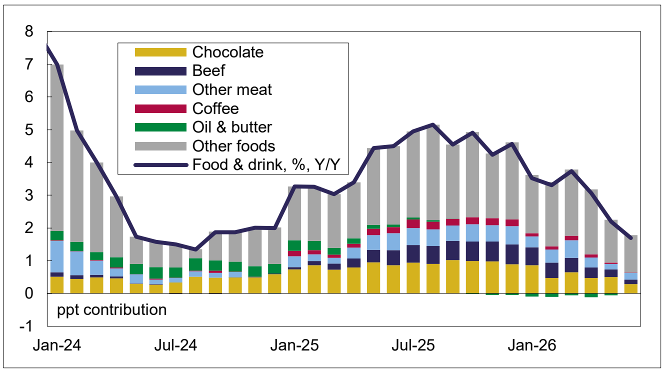
about 0.4ppt to headline inflation. The rebound in wholesale oil prices is also likely to feed through to higher petrol prices in August and September. And based on current wholesale prices, yesterday's announced reduction in VAT on electricity bills from 5% to zero will likely offset only part of the impact of a further increase in the Ofgem energy price cap in October. The spike in global fertilizer prices and prolonged European heatwave will likely exert upwards pressures later in the year and into 2027. Weak demand conditions should restrain firms' ability to pass on costs of core goods and services to customers. And certain other Government measures, including the temporary reduction in VAT on family attractions and cultural events over the summer and today's announced cap on bus fares from January, will also weigh slightly. But we still expect core inflation to rise gradually, peaking at just above 3%Y/Y in April next year. And as a result, headline inflation is projected to peak around 3.5%Y/Y from the autumn and into the New Year. Crucially, however, given persistent slack, surveys suggest that pay pressures will remain absent limiting second-round effects. And so, we continue to expect inflation to resume a gradual decline from March. And while risks to the near-term inflation outlook are skewed to the upside, our forecast remains closer to the Bank's scenario B, under which inflation is projected to return to the 2% target from the start of 2028.

UK: Deviations from long-run price change*



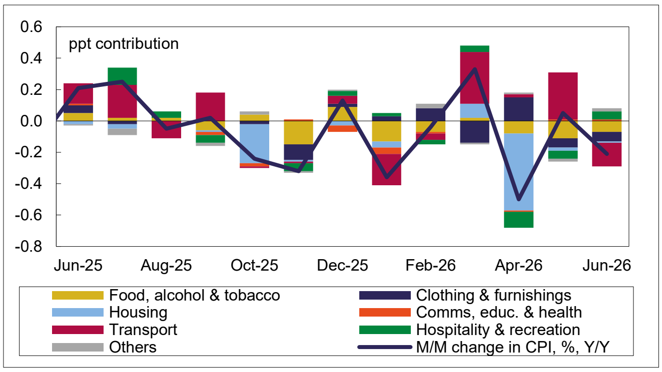
*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Food inflation



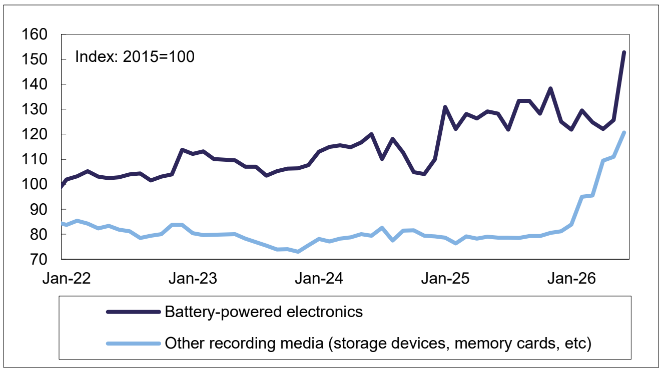
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to monthly change in CPI



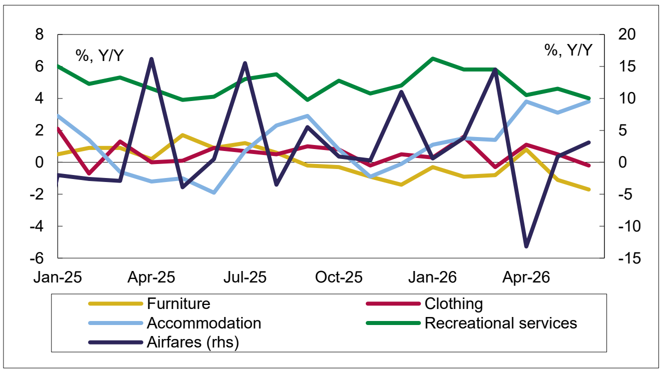
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Prices of electronics & other recording media



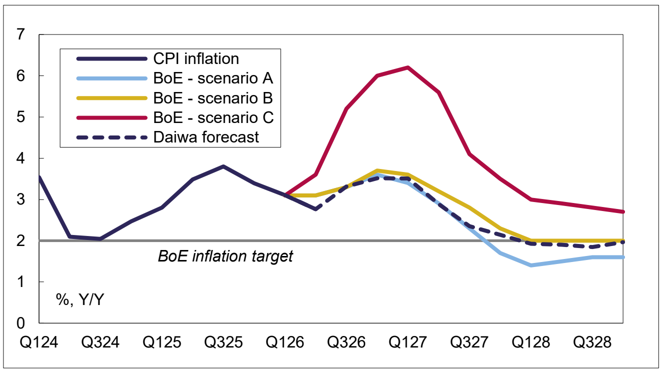
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected goods & services components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation projections



Source: BoE MPR Apr-26, Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

Tomorrow's CBI industrial trends survey results for July will give a clue to Friday's flash PMIs. However, last month the CBI survey provided a much more downbeat view of conditions in the manufacturing sector than the PMIs, reporting the weakest output volumes and order books since 2020 but also above-average selling-price expectations. Tomorrow's monthly survey release will be supplemented by the quarterly results for firms' investment and headcount expectations, which were similarly downbeat in the previous release in April.

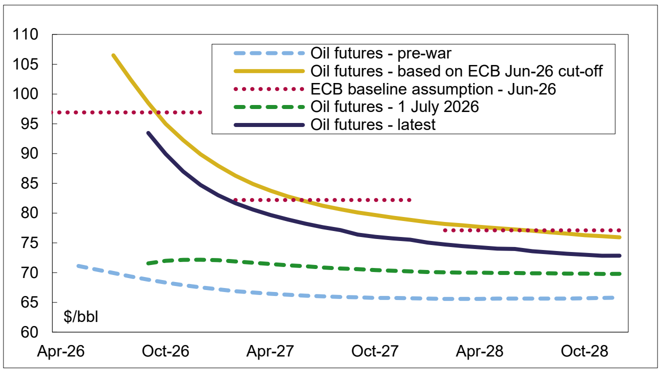
The day ahead in the euro area

Wholesale energy prices maintained their renewed uptrend today, with Brent crude briefly above $95bbl for the first time since early June and European gas prices around their highest levels since the start of the Iranian conflict. Notably, while oil futures were broadly consistent with the assumptions used in the ECB's June baseline projection, gas futures were significantly higher. That upwards shift to wholesale energy prices reinforces expectations that, after it hiked the deposit rate in June by 25bps to 2.25%, the ECB will soon tighten policy again. Indeed, its projections last month were predicated on the assumption of up to two further rate rises. But we still expect it to leave policy unchanged tomorrow with the next hike instead likely to come in September. June's inflation data undershot the ECB's projection with the headline and core rates down 0.4ppt and 0.2ppt to 2.8%Y/Y and 2.4%Y/Y respectively. And while there are already signs of indirect effects on prices and significant upside risks to the inflation outlook, there remains no evidence yet of second-round effects via wages.

So, we see no need for greater urgency from the ECB tomorrow. Indeed, at the end of last month, President Lagarde noted that, while some tightening was necessary, there was also no need to "react forcefully". And although Belgian Governor Wunsch has suggested that, if the ECB needs to move to a more restrictive policy stance, doing so sooner rather than later would be most appropriate, we think most Governing Council members will be willing to be patient and await further evidence on the conflict and its economic before raising rates again. So, the meeting statement will continue to avoid forward guidance, maintaining that rates are not on a pre-set path with decisions remaining data dependent and to be taken on a meeting-by-meeting basis. But the re-intensification of the conflict warrants a more hawkish tone from Lagarde in her post-meeting press conference than she used in Sintra. And she might note that if, as seems likely, the ECB's updated projections in September show that further restrictiveness is necessary, then the Governing Council will be ready to raise rates at that meeting and perhaps thereafter too. (Recent comments of Governing Council members can be found here).

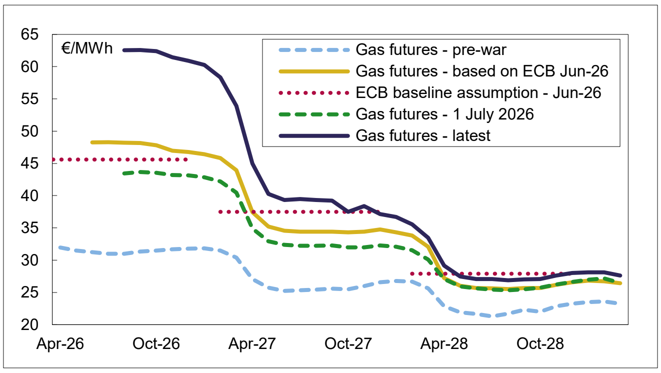
Data-wise, Thursday will bring the flash Commission estimate of euro area consumer confidence and INSEE French business survey results for July. We expect the Commission indicator to be little changed from June (-17.7), when it remained more than 5pts below its level before the start of the Iran conflict and less than 3pts above April's 3½-year low. Given the recent pickup in auto fuel prices, we see the risks to the downside. Meanwhile, not least due to its larger, more comprehensive sample, the INSEE survey should give a more reliable guide to conditions in the business sector than Friday's flash French PMIs. We expect signals of sluggish but positive economic growth in France at the start of Q3.

Euro area: Brent crude futures & ECB assumption



Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas futures & ECB assumption



Source: Bloomberg, ECB 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
UK		Headline (core) CPI Y/Y%	Jun	**2.6 (2.6)**	*2.6 (2.5)*	2.8 (2.6)	-
		PPI – output (input) prices Y/Y%	Jun	**3.5 (7.3)**	3.5 (8.2)	4.0 (8.7)	3.7 (9.3)
		House price index Y/Y%	May	**2.7**	-	3.8	3.9

Auctions

Country		Auction
Germany		sold €806mn of 2.6% 2041 bonds at an average yield of 3.46%
		sold €902mn of 3.4% 2047 bonds at an average yield of 3.60%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		05.00	New car registrations Y/Y%	Jun	-	3.3
		13.15	ECB Deposit (Refinancing) Rate %	Jul	*2.25 (2.50)*	2.25 (2.50)
		15.00	Preliminary Commission consumer confidence indicator	Jul	-17.0	-17.7
France		07.45	INSEE business (manufacturing) confidence indicator	Jul	95 (101)	94 (100)
		07.45	INSEE production outlook (own-company) indicator	Jul	-14 (4)	-15 (2)
UK		11.00	CBI industrial trends – total orders (selling prices) net balance %	Jul	-	-45 (22)
		11.00	CBI industrial trends survey – business optimism net balance %	Q3	-	-65

Auctions and events

Country		BST	Event
Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde to hold post-Governing Council meeting press conference
UK		10.00	Auction: to sell up to £500mn of 4% 2063 Gilts

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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