Euro wrap-up

Overview

- Gilts made losses as the BoE left monetary policy unchanged but signalled the likelihood of easing in early August.
- Bunds made losses on a quiet day for economic news from the euro area.
- Friday brings inflation, trade and car registration data from the euro area and construction output figures from the UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.661	+0.013
OBL 0 04/21	-0.577	+0.017
DBR 0 08/26	-0.038	+0.036
UKT 1¼ 07/18	0.141	+0.023
UKT 1½ 01/21	0.373	+0.032
UKT 2 09/25	0.790	+0.044

*Change from close as at 4.30pm BST.
Source: Bloomberg

UK

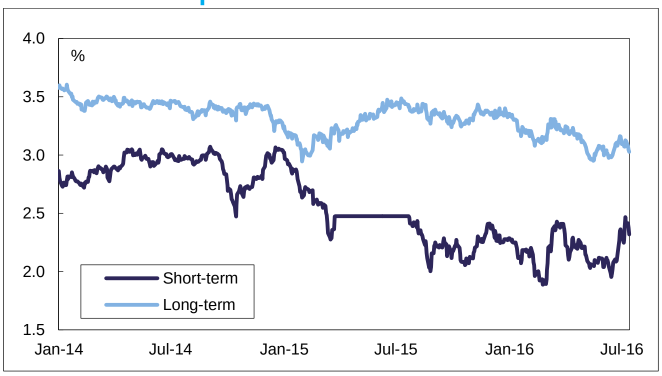
BoE shocks by doing nothing for now

Ahead of today's monetary policy announcement, expectations had mounted that the BoE would cut rates. Those expectations had been fuelled not least by Carney's comments on 30 June that the risks associated with the shock referendum outcome have begun to crystallise and that 'some monetary policy easing will likely be required over the summer', as well as recent evidence that economic sentiment and activity has already been hit. But, contrasting with the decision of the BoE's FPC on 1 July to ease capital requirements, the MPC today surprisingly left monetary policy unchanged with members voting 8-1 to leave Bank Rate at 0.5% for the eighty-ninth consecutive month, and only external representative Vlieghe voting for a 25bps cut. However, the post-meeting statement made clear that 'most members of the Committee expect monetary policy to be loosened in August' with the precise size and nature of the stimulus to be guided by the BoE's updated economic forecasts. And while a cut in Bank Rate – perhaps to 0.25% – seems most likely to ensue when the next monetary policy meeting concludes in three weeks' time, the MPC also signalled that 'various easing options and combinations thereof' had been discussed today and so a full package, presumably including credit/quantitative easing measures such as purchases of corporate bonds and/or Gilts, could yet be forthcoming.

Case for easing in August likely to be irresistible

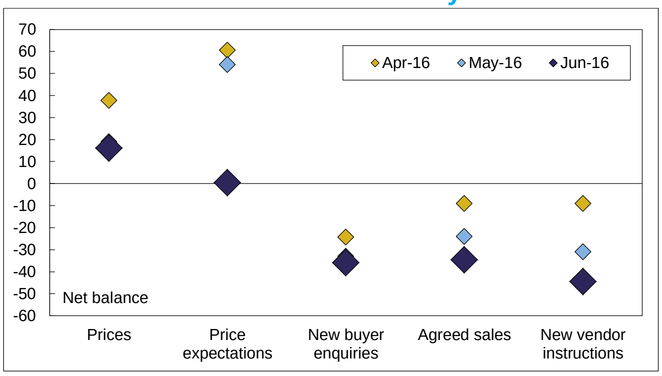
The MPC made clear that it is well aware that the economy has likely weakened. It noted early signs that the referendum has hit household and business confidence, leading firms to delay investment projects and postpone recruitment decisions. And it also recognised the significant drop in expected activity in the housing market, as was signalled by the latest RICS survey discussed below. But the MPC has to keep an eye on inflation too, and it acknowledged that sterling weakness will put additional upwards pressure on CPI in the short term and near-term financial market inflation expectations had moved higher, albeit only to historical averages. Policymakers also noted that market inflation expectations at longer-term horizons had fallen since the vote and so, by implication, the trade-off between output and inflation on a sustainable basis should not have worsened excessively. And the MPC implied that in the absence of notable deterioration in the inflation outlook, it should have no concerns next month about finally delivering the support that Carney has already all-but promised and the economy currently requires. Indeed, if it doesn't ease policy then, any future policy signals by the MPC will be taken with a pinch of salt.

UK: Inflation expectations*



**5Y5Y forward and 2Y ahead instantaneous RPI inflation implied from swaps*
Source: Bank of England and Bloomberg

UK: RICS Residential Market Survey



Source: RICS, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

RICS highlights property market weakening

As alluded to by the MPC in its statement, further evidence of the need for monetary stimulus came overnight with the results of the latest RICS Residential Market Survey, conducted following the referendum, which made clear that the outlook for the housing market has deteriorated significantly. In particular, house prices are expected to fall nationwide over the coming few months and, in particular, be lower in London and the East in twelve months' time. Uncertainty has seen new buyer enquiries fall sharply to the lowest level since mid-2008, while new vendor instructions remain firmly in negative territory and agreed sales have fallen sharply since the vote and are expected to decline further. And this all spells bad news for the wider economy. Activity in the housing market is closely correlated to wider spending on consumer durables, such as home furnishings and white and electronic goods, and certain services too. House prices have a further impact on economic confidence and balance sheets too. And the extent to which the London market is singled out as a source of weakness might act as cause for caution among those who expected sterling's depreciation to inject new demand into the sector from abroad.

Key ministerial appointments do not engender confidence

While the economic outlook deteriorates, new PM Theresa May's appointments to her key Cabinet positions hardly give cause for optimism that the post-referendum uncertainty hanging over the economy will be lifted swiftly. In an article written earlier this week, new Brexit Minister David Davis broadly concurred with May that the government should take 'a little time' to allow for the preparation of a workable negotiating strategy before invoking Treaty Article 50 to launch the formal divorce proceedings between the UK and EU. But while he suggested specifically that this 'process should be completed to allow triggering of Article 50 before or by the beginning of next year', early 2017 might represent the more plausible working assumption for now.

More significantly perhaps, Davis' article suggests that he has an unrealistic expectation of the ease by which future negotiations on a new relationship might eventually be concluded in a way that can preserve UK access to the Single Market close to current arrangements while gaining new controls on migration of EU citizens. His previous experience as Minister of State for Europe in the Major administration of the 1990s might be of little help in the modern enlarged EU of 28 Member States where the introduction of the euro has also changed dramatically the dynamics of national interests and alliances. And his preoccupation with trade in goods – and willingness to provide government support to manufacturers in the event that WTO rules and levies are subsequently imposed on UK exports – was matched with a failure to acknowledge the knotty issues (such as passporting) related to trade in services, which accounts for more than 40% of UK exports and for which issues related to freedom of movement of people are most closely entwined.

Moreover, Davis' optimism that new trade deals can be swiftly concluded with third countries such as the US, China and Japan smacks of naïveté, while May's appointments of fellow Brexiteers former Defence Minister Liam Fox as new Minister for International Trade and national (unfunny) clown Boris Johnson as Foreign Minister – whose input will be key in developing those future relationships – did nothing to engender confidence that the UK's diminished access to markets in neighbouring Europe will be more than compensated by increased access to more dynamic markets further afield. Indeed, ultimately, May's strategy of appointing leading members of the Leave campaign to such important portfolios seems most likely eventually to highlight the unrealistic promises made by them to the electorate ahead of the referendum.

The day ahead in the UK

The end of the week brings the latest construction figures, which are expected to show that output fell in May, likely by more than 1%M/M. And comparing to a year ago, output growth should be little changed, likely at around -3.5%Y/Y.

Euro area

The day ahead in the euro area and US

After a quiet day today with no notable data released, Friday will bring the final estimate of euro area inflation in June. With the flash estimates confirmed in three of the four largest member states, we expect headline CPI similarly to be confirmed at the preliminary estimate of 0.1%Y/Y, up from -0.1%Y/Y in May and a five-month high. And with the national measures of core CPI in the largest members having remained subdued there is a risk that euro area core CPI will be revised down from the flash estimate by 0.1ppt to 0.8%Y/Y. Meanwhile, the euro area trade report for May is also due and seems likely to show a modest drop in the still-large surplus to about €25bn. And euro area new car registration data are also due for release.

In the US, meanwhile, Friday brings numerous top-tier releases including June inflation, retail sales and industrial production data. Headline CPI is expected to edge slightly higher, rising 0.2% on the month to take the year-on-year rate up to 1.1%Y/Y. Meanwhile, the expected similar 0.2%M/M increase in prices excluding food and energy would leave the annual core CPI rate unchanged at 2.2%Y/Y. In addition, retail sales and manufacturing output are both expected to have posted modest increases at the end of Q2. Also noteworthy on Friday will be the preliminary University of Michigan consumer sentiment survey for July and May business inventories data.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
UK		RICS house price balance %	June	**16**	10	19	**-**
		BoE bank rate %	Jul	**0.50**	*0.25*	0.50	**-**
		BoE asset purchase target £bn	Jul	**375**	*375*	375	**-**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		07:00	EU27 new car registrations Y/Y%	Jun	-	16.0
		10:00	Trade balance €bn	May	25.0	28.0
		10:00	Final CPI (core) Y/Y%	Jun	0.1 (0.9)	-0.1 (0.8)
Italy		09:00	Trade balance total €bn	May	-	4.5
UK		09:30	Construction output M/M% (Y/Y%)	May	-1.2 (-3.5)	2.5 (-3.7)

Auctions and events

Country		BST	Auction / Event
UK		13:00	BoE's Carney is scheduled to speak in Toronto

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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