

Euro wrap-up

Overview

- Bunds made modest gains and the latest German 30Y auction met with record demand as concerns persisted about the spread of Covid-19 in the region while final euro area inflation figures for July provided no surprises.
- Gilts made modest losses following an upside surprise to UK inflation in July.
- Thursday will bring the publication of the account of the ECB's July monetary policy meeting, as well as euro area construction output figures for June.

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Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.678	-0.008
OBL 0 10/25	-0.681	-0.011
DBR 0 08/30	-0.477	-0.012
UKT 0½ 07/22	-0.037	+0.011
UKT 0% 06/25	-0.032	+0.012
UKT 4% 12/30	0.231	+0.015

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

Euro area

Euro area inflation ticks slightly higher

Contrasting with the UK (see below), there were no surprises whatsoever from the final euro area CPI release. Indeed, today's figures aligned with the flash estimate showing that headline inflation edged only slightly higher to 0.4%Y/Y in July. While the increase in part reflected a softer pace of decline in energy prices (up 0.9ppt to -8.4%Y/Y), it principally reflected stronger non-energy industrial goods inflation, which leapt 1.4ppts to 1.6%Y/Y, the highest reading for more than eighteen years. But this was driven by a surge in clothing inflation in certain member states, to leave prices of such items in the region up 7%Y/Y, by far the strongest rate since the series began in the mid-1990s. As such, core inflation jumped 0.4ppt to 1.2%Y/Y. But if clothing had been excluded, core inflation would have moved sideways. And price pressures in the services sector continued to diminish in July, with such inflation falling to its weakest rate since April 2016 (down 0.3ppt to 0.9%Y/Y), partly reflecting a steeper decline in prices of package holidays and accommodation services.

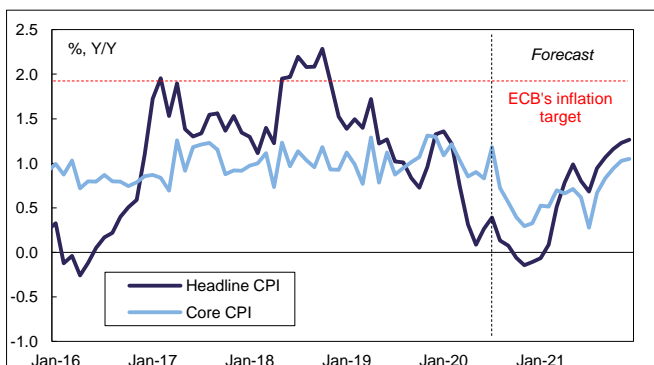
Underlying inflation pressures remain subdued

While some firms will in due course put prices up to cover the costs of social distancing, we expect many, particularly in hospitality and leisure, to continue to offer sizeable discounts to try to attract custom over coming months, especially as international travel restrictions remain in place in many places. The VAT cut in Germany through the second half of this year will also provide a modest downward pull. And the surge in clothing inflation last month seems bound to be at least partly reversed this month. Furthermore, while the German government is set to follow its French counterpart by extending its job-support scheme, the deteriorating labour market outlook seems likely to weigh on wage growth in due course, further weakening domestically-generated inflation particularly in the services sector. As such, we expect headline and core inflation to resume a downwards trend this month, with headline inflation likely to slip into negative territory and core inflation set to fall close to zero by the end of the year.

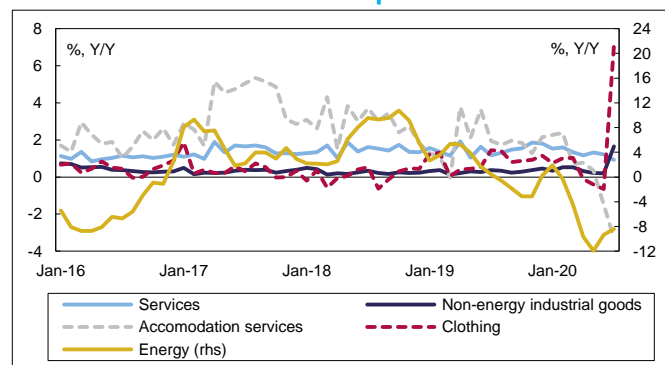
The day ahead in the euro area

Tomorrow will bring the publication of the detailed account of the ECB's [monetary policy meeting of 16 July](#). On that occasion, the Governing Council made no changes to policy, re-committing to keeping interest rates at the current levels or lower until the inflation outlook has moved back to target and reaffirming the PEPP purchase envelope at €1.35trn. In her subsequent press conference, President Lagarde stated that the ECB expects to purchase the full €1.35trn envelope unless there is a significant upside surprise to the economic outlook. But a subsequent report from Bloomberg suggested that there

Euro area: Headline and core inflation



Euro area: Selected CPI components



was not unanimity on the Governing Council on this point, and the account of the meeting might provide further colour on this aspect of the debate.

In terms of data, Thursday will see the belated release of euro area construction output figures for June. With Germany having posted a further modest increase and France recording double-digit monthly growth, we expect aggregate activity to have risen for the second successive month, albeit leaving the level of activity still well below the pre-pandemic level.

UK

A big upside surprise to inflation driven by one-offs

Inflation in the UK in July was much stronger than expected, with the headline CPI rate rising 0.4ppt to a four-month high of 1.0%Y/Y. In contrast, the BoE staff had expected an increase of just 0.1ppt to 0.7%Y/Y while the consensus was for no change. The rise in inflation in July partly reflected the rebound in global oil prices, with petrol prices at the pump up the most in almost a decade. So, energy inflation rose more than 3ppts, albeit remaining firmly in negative territory at -9.2%Y/Y. But despite a steep fall in the airfare category (down 2.5ppts to -1.9%Y/Y) as tourists largely stayed at home, services inflation jumped too, rising 0.3ppt to 2.1%Y/Y, as many firms – including hairdressers, physiotherapists and dentists – put prices up to cover the costs of personal protection equipment (PPE) and making their premises Covid-19 secure. And inflation of non-energy industrial goods rose 0.5ppt to a near two-year high of 1.4%Y/Y, as retailers of clothing and certain other items (e.g. furniture) delayed their usual summer sales following the earlier disruption caused by lockdown. So, contrary to the expected decline, core inflation rose 0.4ppt to a 12-month high of 1.8%Y/Y.

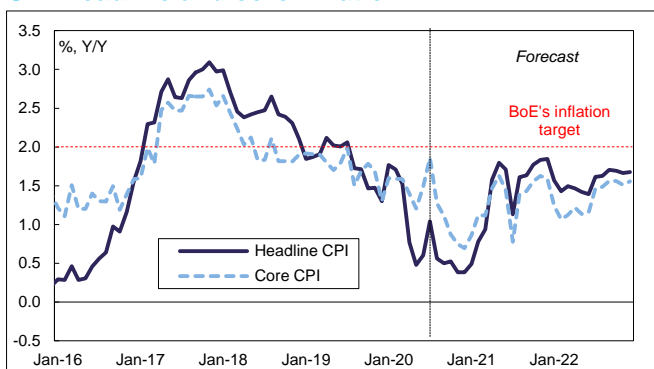
Expect inflation to drop sharply over the near term

Given the role of one-off (price rises to cover the costs of PPE) and temporary (delayed summer sales) effects, we expect July's rise to be reversed in August. Indeed, inflation looks set to drop sharply, as the temporary 15ppt cut in VAT on hospitality and entertainments combines with the impact of discounted restaurant meals related to the Government's Eat Out to Help Out scheme. And with the Government having reintroduced quarantine measures for travelers to the UK's most popular tourist destinations (Spain and France), air fares look set to remain under downwards pressure too. So, a drop in inflation back below 0.5%Y/Y still looks on the cards, from August through to the end of the year, before the hospitality VAT cut comes to an end and firms have to contend with the additional costs related to the end of the Brexit transition. With labour market conditions rapidly deteriorating, weak wage growth should help to ensure that underlying inflation remains relatively contained next year too.

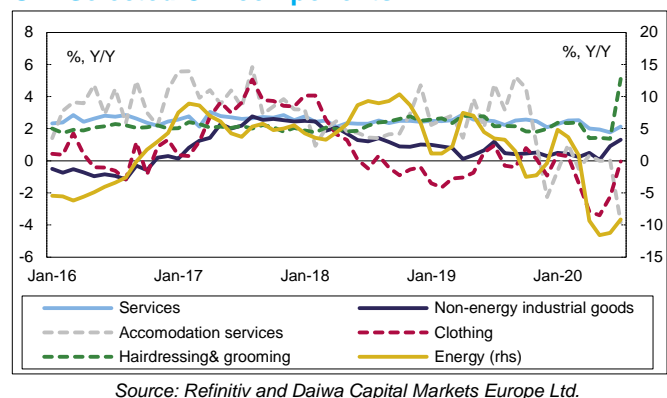
The day ahead in the UK

It should be a quiet day for UK economic news tomorrow, with no data due for release.

UK: Headline and core inflation







UK: Selected CPI components





European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ Daiwa forecast	Previous	Revised
EMU	 Current account balance €bn	Jun	20.7	-	8.0	11.3
	 Final CPI (core CPI) Y/Y%	Jul	0.4 (1.2)	0.4 (1.2)	0.3 (0.8)	-
UK	 CPI (core CPI) Y/Y%	Jul	1.0 (1.8)	0.6 (1.2)	0.6 (1.4)	-
	 PPI input prices (output prices) Y/Y%	Jul	-5.7 (-0.9)	-6.1 (-0.9)	-6.4 (-0.8)	-6.7 (-0.9)

Auctions

Country	Auction
Germany	 sold €1.25bn of 0% 2050 bonds at an average yield of -0.05%
UK	 sold £2.75bn of 0.875% 2029 bonds at an average yield of 0.153%




Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ Daiwa forecast	Previous	Revised
- Nothing to report -						



Auctions

Country	Auction
Germany	 sold €3.25bn of 0% 2027 bonds at an average yield of -0.6%
UK	 sold £3.25bn of 0.125% 2023 bonds at an average yield of -0.025%
	 sold £2bn of 0.625% 2050 bonds at an average yield of 0.784%









Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ Daiwa forecast	Previous
EMU	 10.00	Construction output M/M% (Y/Y%)	Jun	-	27.9 (-11.9)
Germany	 07.00	PPI Y/Y%	Jul	-1.8	-1.8

Auctions and events

Country	BST	Auction / Event
EMU	 12.30	ECB's account of its July monetary policy meeting
France	 09.50	Auction: 1.75% 2024 bonds
	 09.50	Auction: 0% 2025 bonds
	 09.50	Auction: 1% 2027 bonds
	 10.50	Auction: 0.1% 2028 index-linked bonds
	 10.50	Auction: 3.15% 2032 index-linked bonds
	 10.50	Auction: 0.1% 2036 index-linked bonds
UK	 10.00	Auction: £1.1bn of 0.125% 2028 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

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