Euro wrap-up

Overview

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- Bunds made modest gains as the ECB set a symmetric 2% medium-term inflation target and failed to mimic the Fed's overshooting strategy.
- Gilts made losses at the short end as surveys pointed to significant momentum in the UK labour market but a likely moderation ahead in the housing market.
- Friday will bring UK GDP data for May and the publication of the account of the ECB's June policy meeting.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/23	-0.692	-0.005
OBL 0 04/26	-0.614	-0.014
DBR 0 08/31	-0.315	-0.014
UKT 0¹/₈ 01/23	0.068	+0.017
UKT 0¹/₈ 01/26	0.254	+0.004
UKT 4¾ 12/30	0.606	+0.005

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

Euro area

ECB sets symmetric 2% inflation target, with mere tolerance of "transitory" above-target inflation

The long-awaited conclusions of the ECB's strategy review, announced at relatively short notice today, provided no major surprises. As widely anticipated, the Governing Council adopted a new symmetric 2% medium-term inflation target. That is slightly higher and less ambiguous than the ECB's previous stated aim to achieve inflation "below but close to" 2%, which was identified as a cause of persistent sub-2% inflation expectations and hence significantly sub-2% inflation outcomes since 2012. Importantly, the ECB refrained from a Fed-style average inflation targeting framework. Nor did it set a BoE-style tolerance range around the new target. Moreover, while the Fed has made an unambiguous commitment to achieve inflation "moderately above 2% for some time" to better anchor long-term inflation expectations, the ECB merely noted that inflation may rise "moderately above target" over a "transitory period" when "the economy is operating close to the lower bound on nominal interest rates [and] requires especially forceful or persistent monetary policy action." So, any period of above-target inflation would be an unintentional consequence, rather intentional outcome, from the ECB's policy.

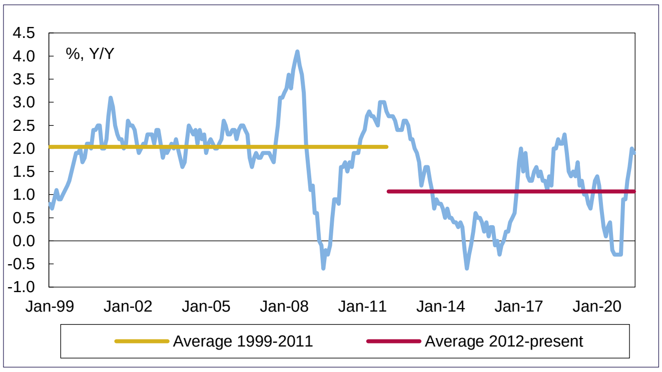
New inflation target and policy strategy unlikely to have material impact on policy outlook

The ECB's failure to commit to exceed its target for a while to better anchor inflation expectations reflects the (lamentable) need for unanimity on the Governing Council, which meant that hawks and doves alike had to sign up fully to the new strategy. Admittedly, in theory, the choice of words in the strategy review statement might at times open the door to more "forceful or persistent monetary action". However, the ECB's statement also made clear that negative and positive deviations from the inflation were equally undesirable. And, in response to a question in her press conference, Lagarde was also unambiguous that she thought the new policy target would have no material impact on the likely timetable for tightening policy going forward. So, while the ECB's current macroeconomic projections foresee inflation falling short of the 2% target over the coming three years, the outcome of the strategy is unlikely to see any changes made to policy at the next Governing Council meeting on 22 July. Indeed, more than anything, today's announcement seems to have been more about changing the presentation of monetary policy rather its future substance.

No big news on policy tools, but ECB to take into account owner-occupied housing costs

Certainly, with respect to the ECB's policy tools, there appeared to be little substance announced today, with its main interest rates reaffirmed as the primary instrument. Of course, in recognition of the effective lower bound on policy rates, the Governing Council also committed to continue to employ forward guidance, longer-term refinancing operations and asset purchases. But there was no indication as to whether the flexibility provided by the PEPP programme, which allows the ECB

Euro area: HICP inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: 5Y5Y inflation swap forward rate

Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

to deviate from the capital key to address bond-market fragmentation risks would be retained in any successor round of purchases once the pandemic phase has passed. Separately, with respect to assessing progress against the inflation target, the ECB reaffirmed that the euro area Harmonised Index of Consumer Prices (HICP) will remain the appropriate inflation measure. However, to better represent the inflation rate that is relevant for households, the Governing Council stated that it would like to take account of the costs related to owner-occupied housing, which are not currently incorporated into the HICP. As the full and accurate inclusion of owner-occupied housing in the HICP will be a multi-year project, the ECB's monetary policy assessments will, for the time being, take into account other inflation measures that include initial estimates of the cost of owner-occupied housing as supplementary information. Given recent housing market developments, owner-occupied housing costs are likely to exceed somewhat overall HICP inflation over the near term. But the impact is unlikely to be large (typically no more than 0.2ppt). On average over the medium- to longer-term, past experience suggests that the differences between the two rates will be minimally positive – a point noted by Christine Lagarde today. And, at some point in the future, the inclusion of owner-occupied housing costs could subtract from HICP inflation.

Climate change action plan to be implemented over coming three years

Finally, as expected, the ECB agreed an action plan to incorporate climate change considerations into its policy framework. Among other things, it will introduce climate-related disclosure requirements for private sector assets as a new eligibility criterion and a potential basis for a differentiated treatment for collateral and asset purchases. A detailed plan will be announced next year. The ECB will also consider climate change risks when reviewing the valuation and risk control frameworks for assets used as collateral in Eurosystem credit operations. And it will adjust its framework guiding the allocation of corporate bond purchases to incorporate climate change criteria. Given the amount of preparatory work required, however, it will only disclose the climate-related information related to its own corporate bond holdings from the first quarter of 2023. And disclosures in line with EU policies will be an eligibility requirement in the collateral framework and asset purchases only from 2024, based on disclosures covering 2023.

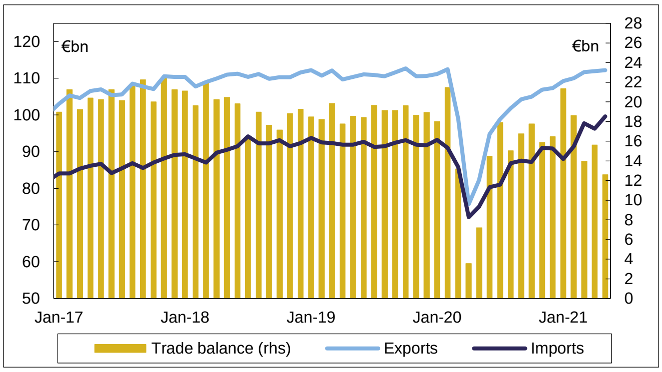
German exports continue to lag imports on price shifts and supply bottlenecks

On a relatively quiet day for economic data from the euro area, Germany's trade figures for May broadly tallied with the French equivalents published yesterday, showing that the recovery in exports continues to lag that of imports. In particular, the value of goods imports leapt a further 3.4%M/M to be 9.4% above the pre-pandemic level in February 2020. In contrast, export values rose just 0.3%M/M to be 0.3% below the pre-pandemic level. As a result, Germany's goods trade surplus narrowed a further €2bn to a ten-month low of €14.0bn. Of course, the unfavourable shift in the terms of trade continues to weigh on the trade surplus, with prices of imported items rising far faster than export prices. However, in volume terms, German exports fell for a second successive month in May, dropping 0.4%M/M to be 2.9% below the pre-pandemic level. In contrast, German import volumes rose 1.7%M/M to be 3.1% above the pre-pandemic level. As for overall manufacturing production, foreign orders suggest that German exports will move back above the pre-pandemic level in the second half of the year, assuming that supply bottlenecks gradually ease.

The day ahead in the euro area

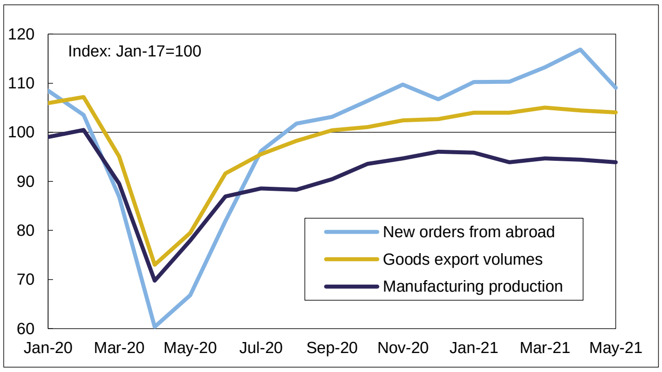
A quiet end to the week for data releases brings Italian industrial production figures for May, which are expected to post modest growth of 0.3%M/M, which would push the level up to 1.4% above the February 2020 level. Beyond the data, the account of the account of the ECB's June monetary policy meeting, which was originally scheduled for today but was postponed due to the strategy review announcement, will finally be published tomorrow. At the June meeting, the ECB published updated macroeconomic projections, which strongly suggested that current price pressures would be transitory, and thus committed to maintain net PEPP purchases over the coming three months at a significantly higher pace than at the start of the year. That policy decision was not unanimous, however, and the account will therefore reflect the range of views among Governing Council members.

Germany: Goods trade*



*Seasonally-adjusted values. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Exports, foreign orders and production*



*Seasonally-adjusted volumes. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

House price growth expectations moderate as government support for market phased out

A relatively quiet day for economic data from the UK brought a pair of second-tier surveys that were not without interest. Tallying with the Nationwide price indices, which suggested that the average house price rose last month by 13.4%Y/Y, the fastest rate since 2004, the RICS residential market survey underscored that house price pressure remained strong in June. Indeed, the survey net balance for price growth rose 0.4 to 82.9, the highest rate on the series going back more than twenty years. That partly reflected a shortage of properties on the market, with the new vendor instructions index falling a further 10pts to a weak -34.4, the most negative in five months. However, with the threshold at which stamp duty begins to be paid in England and Northern Ireland halved to £250k on 1 July, and set to be halved again back to its pre-pandemic level in September, new buyer enquiries fell too, with the respective balance down to the lowest in four months. And while prices are still continued to rise over the coming twelve months, expectations in that respect were somewhat less buoyant than in the prior three months, with overall sales growth expectations the most negative for seven months.

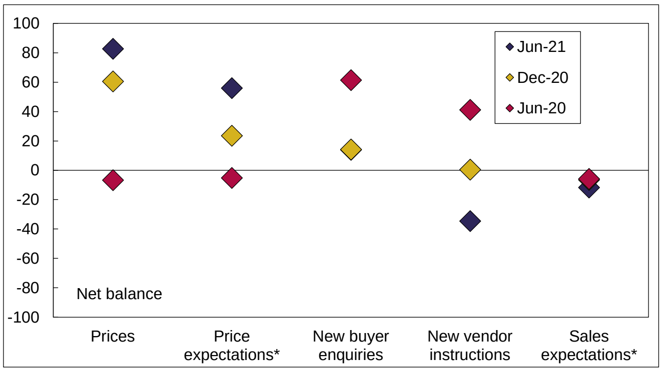
Further evidence of strong labour market momentum

Meanwhile, while the Job Retention Scheme is now starting to be phased out, with employers having to make a contribution to furloughed-staff pay from the start of July, further evidence of strong momentum in the labour market came from the latest KPMG and REC Report on Jobs survey of recruitment and employment consultancies. Among other things, the survey reported a surge in recruitment activity last month as firms in many services sectors benefited from an easing of lockdown measures eased. Permanent appointments growth rose to the highest on the series, which dates back to 1997. Temp billings growth rose to the highest in almost 23 years. And growth in vacancies rose to a new series record too. With many workers still on furlough, and hundreds of thousands of EU workers seemingly having returned to their home countries since the pandemic hit, the availability of workers fell at a record pace, with shortages of both temporary and permanent staff reported. As a result, salaries reportedly rose at the fastest rate since 2014.

The day ahead in the UK

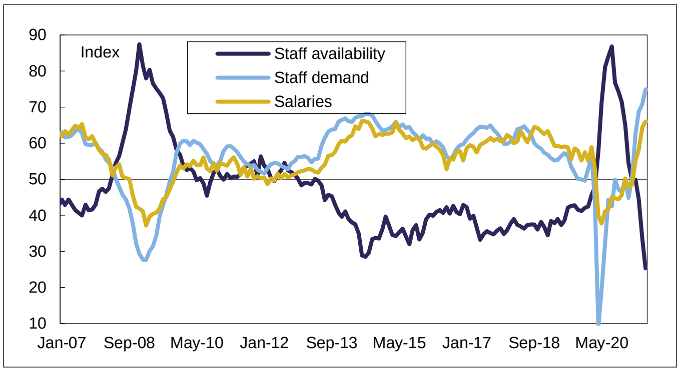
Friday will bring the most notable UK economic data of the week in the shape of May's GDP, production and trade figures. After non-essential stores were able to reopen in April, further easing of restrictions – particularly those affecting hospitality and entertainments – occurred in May. So, although retail sales fell back 1.4%M/M, services output is again set to lead overall economic growth in May, having risen a strong 3.4%M/M in May. Manufacturing production (-0.3%M/M) and mining and quarrying (-15.0%M/M due to planned maintenance at oil fields) should rebound too. And so, having grown in excess of 2.0%M/M in March and April, we expect GDP growth of 1.3%M/M in May to leave the level of output about 2.5% below the February 2020 level.

UK: RICS residential market survey indices*



**12-month ahead expectations.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: KPMG/REC report on jobs survey indices



Source: Markit, Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Trade balance €bn	May	**12.3**	15.1	15.2	**-**
UK	RICS house price balance %	Jun	**83**	79	83	**82**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy	09.00	Industrial production M/M% (Y/Y%)	May	0.3 (1.8)	1.8 (79.5)
UK	07.00	Monthly GDP M/M% (3M/3M)	May	*1.3 (3.7)*	2.3 (1.5)
	07.00	Industrial production M/M% (Y/Y%)	May	1.4 (21.6)	-1.3 (27.5)
	07.00	Manufacturing production M/M% (Y/Y%)	May	1.0 (29.5)	-0.3 (39.7)
	07.00	Index of services M/M% (3M/3M%)	May	1.6 (4.1)	3.4 (1.4)
	07.00	Construction output M/M% (Y/Y%)	May	1.0 (58.2)	-2.0 (77.9)
	07.00	Goods trade balance £bn	May	-11.1	-11.0

Auctions and events

Country	BST	Event
Euro area	11.00	ECB President Lagarde on panel discussion on digitalisation and intangibles ahead of the G20 meeting
	12.30	Publication of the account of the ECB monetary policy meeting of 9-10 June
UK	11.00	BoE Governor Bailey on panel discussion on digitalisation and intangibles ahead of the G20 meeting

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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