Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds followed gains in the UST market as euro area industrial production figures undershot downbeat expectations.
- Gilts also followed USTs higher after initially losing ground in the wake of a significant upside surprise to UK consumer price inflation in June.
- Tomorrow will bring the UK's latest labour market report and final Italian inflation figures for June.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/23	-0.683	-0.003
OBL 0 04/26	-0.618	-0.014
DBR 0 08/31	-0.316	-0.019
UKT 0¹/₈ 01/23	0.066	-0.004
UKT 0¹/₈ 01/26	0.302	+0.008
UKT 4¾ 12/30	0.632	-

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

Euro area

Euro area production falls in May

With data already released having reported manufacturing weakness in each of the largest three member states in May, aggregate euro area industrial production was inevitably anticipated to be relatively soft that month. But today's figures undershot even those downbeat expectations, reporting the steepest monthly drop in three, down 1.0%M/M in May, to leave industrial output still 1.4% below the pre-pandemic peak. In addition to falls in Germany (-0.6%M/M), France (-0.3%M/M) and Italy (-1.5%M/M), production (excluding construction) was down by 4½%M/M or more in Portugal, Ireland and Greece. In contrast, Spanish output rose 4.3%M/M, while production in the Netherlands was up 0.8%M/M. Among the larger member states, only in Spain, the Netherlands and Ireland is the level of IP back above the pre-pandemic level.

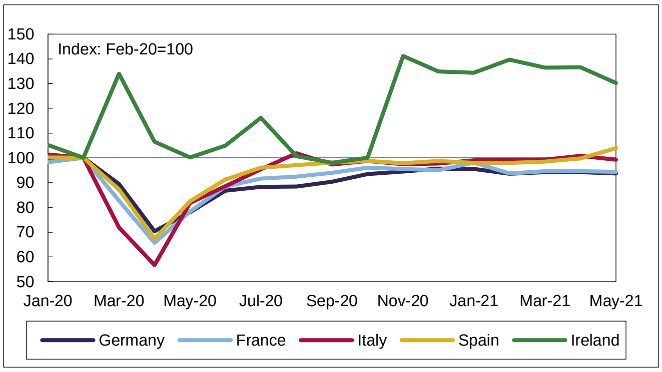
Weakness driven principally by autos output, but softness in other major components too

While the weakness was also widespread across the subsectors in May, the ongoing contraction in the autos sector due to supply bottlenecks was clearly evident, with production down 10.8%M/M. That represented the sixth consecutive monthly decline and left it down by more than a quarter since the end of last year. But other major components were soft too, suggestive of wider supply-side challenges beyond autos. For example, with production of machinery (-1.1%M/M) and electrical equipment (-0.7%M/M) down too, overall output of capital goods was down more than 1½%M/M, and trending so far in Q2 0.8% below the Q1 average. Among other items, production of pharmaceutical products also fell sharply for a second successive month (-5.7%M/M). But while production of intermediate (-0.2%M/M) and consumer goods (-1.9%M/M) fell in May, output of both was on average in April and May higher than the average in Q1 (by 1.1% and 2.7% respectively). Overall, industrial production is currently on track to move broadly sideways this quarter from its level in Q1. And while surveys point to ongoing growth heading into Q3 – the manufacturing output PMI posted the fourth consecutive above-60 reading in June as well as strong orders – supply constraints seem likely to restrain the recovery throughout the second half of the year.

The day ahead in the euro area

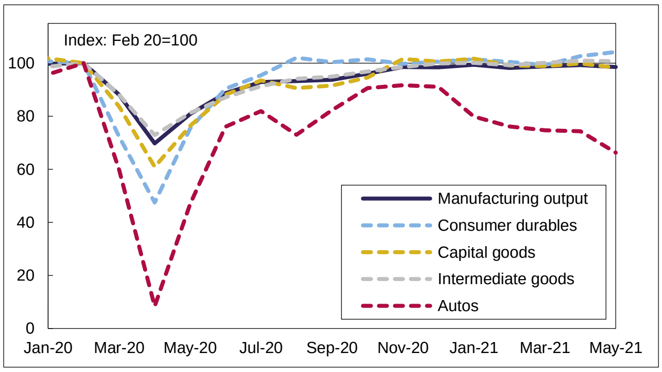
Looking ahead, tomorrow's euro area economic data calendar is relatively quiet, with only final Italian CPI figures for June scheduled for release. Like yesterday's German and French results, but in contrast to today's upward revision to Spanish inflation – by 0.1ppt to 2.5%Y/Y, a more-than four-year high on the HICP measure – the Italian data are expected to confirm the flash estimates. These revealed that the EU-harmonised measure of inflation rose 0.1ppt from May to 1.3%Y/Y.

Euro area: Industrial output by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output by subsector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

Consumer price inflation surprises on the upside again

UK inflation again surprised on the upside in June, with the headline CPI rate jumping 0.4ppt to 2.5%Y/Y, the highest since August 2018. While this in part reflected higher energy inflation (up 0.9ppt to 10.3%Y/Y), the increase was broad-based. Inflation of non-energy industrial goods rose 0.6ppt to 2.8%Y/Y, with services inflation up 0.2ppt to 2.1%Y/Y. As such, core inflation also jumped 0.3ppt to 2.3%Y/Y, also the highest since February 2018. In light of yesterday's US data, it was notable to see prices of second-hand cars (up 5.6%Y/Y after a rise of just 0.9%Y/Y in May) as one driver of higher inflation, seemingly reflecting increased demand following the reopening of the economy and reduced demand for public transport, perhaps as well as supply bottlenecks impacting production of new autos. Inflation of new cars, however, fell back 0.2ppt to 3.2%Y/Y. Meanwhile, inflation of clothing and footwear jumped 0.9ppt to 3.0%Y/Y, exaggerated again by the change to seasonal price patterns including a low base this time last year, and much improved demand associated with the relaxation of pandemic restrictions. Similarly, the hospitality component maintained its upwards trend, with inflation of hotels and restaurants up 0.7ppt to 2.5%Y/Y, having been just 0.9%Y/Y a year earlier.

Producer price inflation past its peak?

In contrast to the CPI data, the industrial producer price inflation figures for June surprised on the downside, suggesting that pipeline pressures might now have peaked. Indeed, input prices of materials and fuels fell 0.1%M/M, the first monthly drop since August. So, having risen to a decade high in May, the year-on-year increase in input producer prices moderated 1.3ppts to a three-month low of 9.1%Y/Y. Much of that drop was accounted for by inflation of crude oil, which fell more than 50ppts to 54.4%Y/Y reflecting base effects, while easing food and metals inflation also contributed. With the sterling effective exchange rate up 6.6%Y/Y, inflation of imported inputs slowed 1.1ppts to 3.7%Y/Y. Producer output prices rose 0.4%M/M, but that also meant that the equivalent annual rate of inflation also fell slightly by 0.1ppt to 4.3%Y/Y. Like for input prices, an easing of petroleum inflation was the principal driver and reflected base effects, while food products also made a contribution. Services producer price inflation – which is measured on a quarterly basis – rose 0.7ppt to a three-year high of 2.0%Y/Y, largely reflecting an acceleration in the pace of professional, scientific and technical activities.

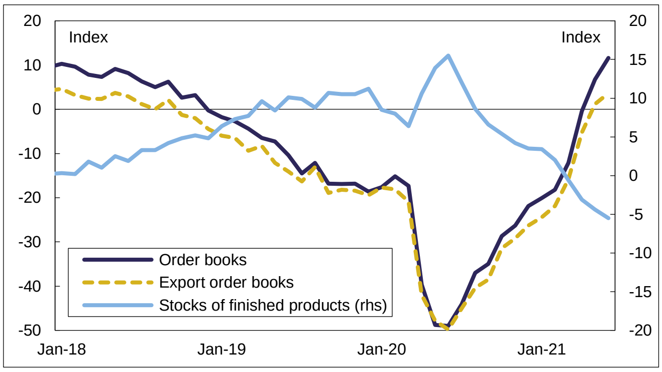
Most consumer prices appear transitory, so inflation should return to target in 2022

Looking ahead, the inflation outlook in the UK remains highly uncertain, with lack of clarity as to whether pressures will prove transitory or persistent. With higher inflation of clothing due in part to changes in the timing of seasonal discounting, the jump in June is unlikely to be long-lasting. Likewise, base effects from past shifts in energy prices should see an accelerated decline in the contribution of that item in the course of 2022. However, over the near term, services inflation might be expected to take a further step up as more restrictions are lifted, staycations place domestic tourism prices under additional pressure, labour shortages and associated wage pressures in hotels and restaurants are reflected in prices for consumers, and international travel resumes. Indeed, base effects associated with last year's hospitality subsidies and VAT cut are likely to see headline inflation take a notable step up in August. So, we expect the headline CPI rate to temporarily break above 3%Y/Y later in the year. But as pandemic-related base effects in energy and other items wear off, and sterling weighs on prices of imported goods, we continue to expect the headline CPI rate to fall back close to and eventually below 2.0%Y/Y in the second half of 2022.

BoE focused on relative balance between demand and supply

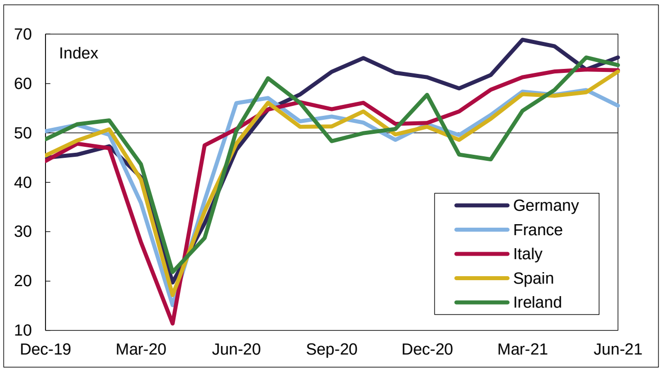
In an interview today, BoE Deputy Governor Jon Cunliffe suggested that some price pressures were likely to recede in due course while others would likely prove more pervasive. But he added that the BoE was focused primarily on the "underlying" issues related to the relative strengths of demand and supply. In this respect, there has undeniably been a strong rebound in demand as pandemic restrictions have been eased. And after a strong first couple of months of Q2 – according to the official

Euro area: Manufacturing orders and inventories



Source: Refinitiv, European Commission and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing PMIs by member state*



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

ONS data, retail sales jumped 9.2%M/M in April before easing back just 1.4%M/M in May – yesterday's BRC retail sales monitor pointed to another month of solid spending on the UK high street in June. According to the survey, clothing and footwear sales were reportedly particularly vigorous early in the month while the European football championships provided a boost for sales of TVs and beer as the month went on. The slowdown in the survey measure of total sales growth of 18ppts to 10.4%Y/Y predominantly reflected base effects from the sharp movements a year earlier.

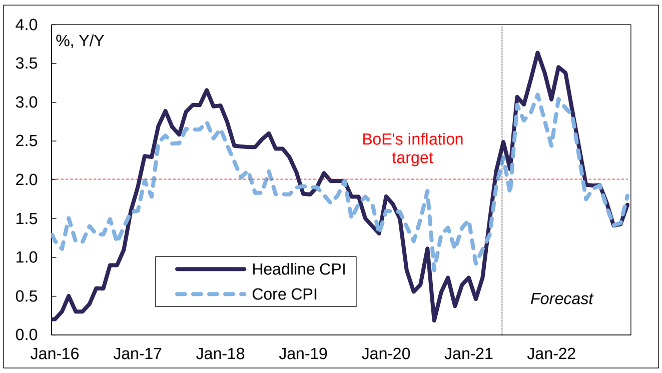
BoE still keen to avoid a premature withdrawal of support

Nevertheless, according to Cunliffe, the rebound in demand might prove short-lived. Indeed, yesterday the BoE's Financial Stability Report flagged the persistent downside risks to economic activity, not least those posed by the pandemic. And with government support for the economy being phased out gradually from the current month, the BoE judged that households and businesses are likely to need continuing support from the financial system even as the economy recovers. As such, to help banks to continue to provide the necessary support to the economy, the FPC stated that it expects to maintain its countercyclical capital buffer rate at 0% until at least December 2021. Given the usual 12-month implementation lag, that means that any subsequent increase would not be expected to take effect until the end of 2022 at the earliest. By the same token, we would not expect to see any tightening of monetary policy before the end of 2022 at the earliest too.

The day ahead in the UK

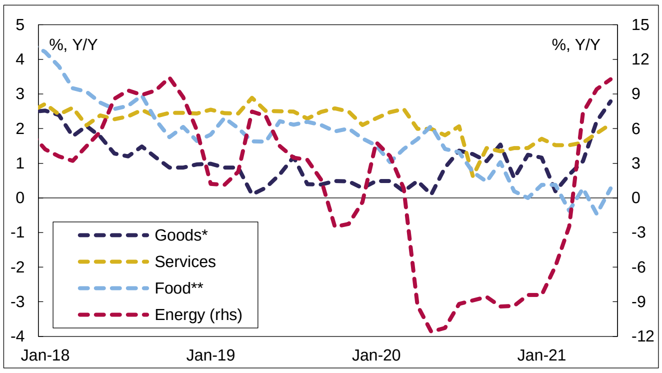
Tomorrow sees the release of the latest UK labour market report. With the government's Job Retention Scheme still in full operation up to the end of last month and the economy continuing to return to some form of post-lockdown normality, we expect to see a further tightening in labour market conditions, including a further notable increase in payrolls and vacancies in June. The unemployment rate is expected to have moved sideways in the three months to May – although it is worth noting that recent unemployment, employment and inactivity figures will be revised slightly due to methodological changes (the unemployment rate will be nudged up between 0.1-0.2ppt and employment rate revised down by 0.3ppt). Meanwhile, growth in average labour earnings seems highly likely to rise above 6½%Y/Y, supported in part by base and composition effects. Thursday will also see the BoE publish its latest quarterly credit conditions and bank liabilities surveys, while MPC member Saunders will participate in a webinar on the inflation outlook.

UK: Headline and core CPI



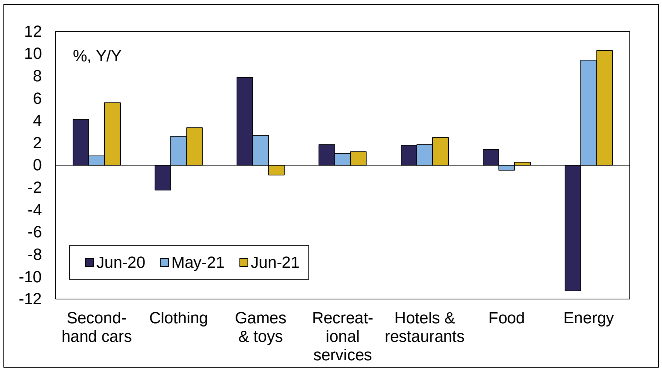
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Key CPI components



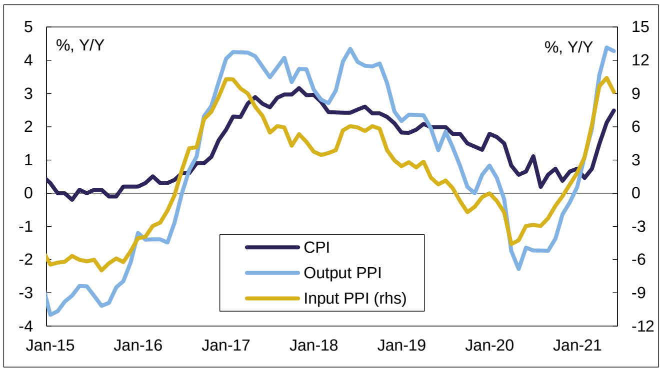
*Non-industrial energy goods. **Excluding fresh foods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI and PPI inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area	Industrial production M/M% (Y/Y%)	May	**-1.0 (20.5)**	-0.1 (22.4)	0.8 (39.3)	**0.6 (39.4)**
Spain	Final CPI (EU harmonised CPI) Y/Y%	Jun	**2.7 (2.5)**	2.6 (2.4)	2.7 (2.4)	-
UK	CPI (core CPI) Y/Y%	Jun	**2.5 (2.3)**	_2.1 (1.9)_	2.1 (2.0)	-
	PPI output prices (input prices) Y/Y%	Jun	**4.3 (9.1)**	4.8 (11.0)	4.6 (10.7)	**4.4 (10.4)**
	ONS house price index Y/Y%	May	**10.0**	9.4	8.9	-

Auctions

Country	Auction
Germany	sold €3.4bn of 0% 2031 bonds at an average yield of -0.3%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Germany	Final CPI (EU harmonised CPI) Y/Y%	Jun	2.3 (2.1)	2.3 (2.1)	2.5 (2.4)	-
France	Final CPI (EU harmonised CPI) Y/Y%	Jun	1.5 (1.9)	1.5 (1.9)	1.4 (1.8)	-
UK	BRC retail sales monitor, like-for-like sales Y/Y%	Jun	6.7	-	18.5	-

Auctions

Country	Auction
Germany	sold €4bn of 0% 2023 bonds at an average yield of -0.67%
Italy	sold €4.5bn of 0% 2024 bonds at an average yield of -0.19%
	sold €2.75bn of 0.5% 2028 bonds at an average yield of 0.38%
	sold €1.75bn of 0.95% 2037 bonds at an average yield of 1.19%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised

- Nothing to report -

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	Final CPI (EU harmonised CPI) Y/Y%	Jun	1.3 (1.3)	1.3 (1.2)
UK	07.00	Claimant count rate % (change 000s)	Jun	- (-)	6.2 (-92.6)
	07.00	ILO unemployment rate 3M%	May	4.7	4.7
	07.00	Employment change 3M/3M 000s	May	91	113
	07.00	Average earnings (excluding bonuses) 3M/Y%	May	7.1 (6.6)	5.6 (5.6)
Auctions and events					
France	09.50	Auction: 0% 2024 bonds			
	09.50	Auction: 0% 2026 bonds			
	09.50	Auction: 2.75% 2027 bonds			
	09.50	Auction: 0.75% 2028 bonds			
	10.50	Auction: 0.1% 2031 index-linked bonds			
	10.50	Auction: 0.1% 2036 index-linked bonds			
Spain	09.30	Auction: 0.25% 2024 bonds			
	09.30	Auction: 0% 2028 bonds			
	09.30	Auction: 0.5% 2031 bonds			
	09.30	Auction: 4.2% 2037 bonds			
UK	09.30	BoE publishes Bank Liabilities and Credit Conditions Survey			
	11.00	BoE MPC member Saunders to speak on "The inflation outlook"			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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