Euro wrap-up

Overview

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- Bunds made gains as the ECB unveiled new forward policy guidance implying that interest rates are unlikely to rise for years to come.
- Gilts also made gains as BoE Deputy Governor Broadbent suggested that the current rise in inflation did not merit a change to monetary policy.
- Friday will bring the flash PMIs along with new data for UK retail sales and consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/23	-0.728	-0.005
OBL 0 04/26	-0.704	-0.018
DBR 0 08/31	-0.423	-0.026
UKT 0¹/₈ 01/23	0.059	-0.034
UKT 0¹/₈ 01/26	0.264	-0.033
UKT 4¾ 12/30	0.566	-0.036

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

Euro area

ECB recasts forward guidance on rates, but says nothing new on asset purchases

At the conclusion of its latest Governing Council meeting, the ECB today strengthened its forward guidance on interest rates to align it with the findings of its strategic policy review announced earlier this month. In particular, it pledged to keep its main policy rates "at their present or lower levels until it sees inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term." It added that “This may also imply a transitory period in which inflation is moderately above target”. But, as after announcing the strategy review conclusions, ECB President Lagarde reiterated that this was not a policy of deliberate overshooting. Lagarde added that, while not unanimous, there had been an “overwhelming majority” in favour of the new guidance on rates. The ECB’s guidance on other policy tools, meanwhile, was not revised. So, it continues to expect PEPP purchases this quarter to be conducted at a significantly higher pace than during the first months of the year, but failed to make any commitment to the pace of buying thereafter. It also inevitably left the PEPP envelope unchanged at €1.85trn until at least the end of March 2022. And it said nothing about the nature of asset purchases to come once the pandemic phase has ended and PEPP net purchases have concluded.

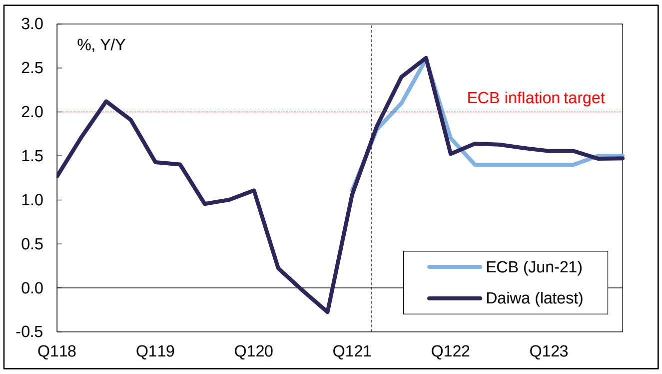
Lagarde denies rates will be “lower for longer”, and rejects case for further easing

Judging from the ECB’s current economic projections, which foresee inflation at just 1.5%Y/Y at the end of the horizon in Q423, the conditions required for raising rates under the new forward guidance would seem highly unlikely to be met for a long time to come. In our view, those criteria will almost certainly not be met before 2024 and perhaps not even until 2025 (when the ECB will hold another strategic policy review) or beyond. Nevertheless, in her press conference, Lagarde stated that the decision to change rates based on the new guidance would not be a mechanistic one, with the judgement of Governing Council members still to be required. And despite the projected persistent undershooting of the 2% target for years to come, she also deflected suggestions that the updated guidance would seem to merit additional stimulus at the current juncture. Indeed, she even rejected the assertion that the new guidance meant that rates would stay “lower for longer”. Instead, she argued that it merely intended to avoid premature monetary tightening.

Risks still judged to be broadly balanced despite spread of the delta variant

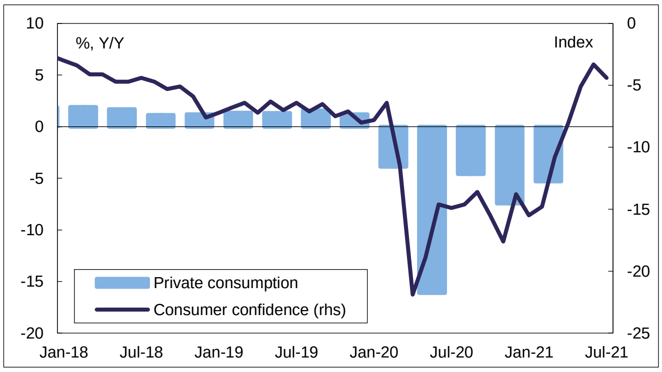
Despite the significant intensification of the pandemic since the projections were published in June, the ECB was still broadly upbeat today. Most notably, it judged that the economic recovery was “on track”, reflecting good progress with vaccination

Euro area: Inflation forecast



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

Euro area: Consumer confidence and consumption



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

programmes and the easing of lockdown restrictions in most member states. GDP was also still expected to return to its pre-pandemic level in Q1 next year. And, while the Governing Council acknowledged that the spread of the delta variant was a "growing source of uncertainty", it judged that the risks to the outlook remained "broadly balanced". Nevertheless, while it expected inflation to increase further over the coming months, the causes were still judged to be temporary and inflation was expected to decline again next year as their impacts fall out of the year-on-year calculation. The Governing Council also judged that there was "still some way to go before the fallout from the pandemic on inflation is eliminated" and inflation was still expected to remain sub-target into the medium term.

Euro area consumer confidence and French business sentiment soften slightly

Today's first key survey indicators for July suggested that recovery momentum remains elevated despite some likely softening due to the spread of the delta variant. In particular, having reached its highest level since January 2018 in June, the flash estimate of consumer confidence in July slipped back 1.1pts to -4.4, a level beaten only once on the past three years. In addition, ahead of tomorrow's flash PMIs for July, the INSEE French business confidence survey suggested that sentiment has softened only very slightly and remains strong by historical standards. In particular, the headline survey business climate index dropped just 1pt to 113, well above the long-run average of 100. In the manufacturing sector, the headline climate index rose a further 2pts to a three-year high of 110 boosted by assessments of order books and future production expectations. However, the share of firms in the sector reporting problems with supply chains rose to the highest since 2000 with producers of machinery and equipment joining car manufacturers as particularly affected. Indeed, 40% of all manufacturers reported that bottlenecks were becoming increasingly significant, with very few firms considering production capacity to be sufficient. But while still high, the expected trend in manufacturers' selling prices fell back in July for the first time in six months. Meanwhile, the headline confidence index for retail trade fell 1pt on lower expected sales but it too remained very high at 115. And despite a similar softening in expected future demand, the services index was unchanged at 112, well above the long-run average.

The day ahead in the euro area

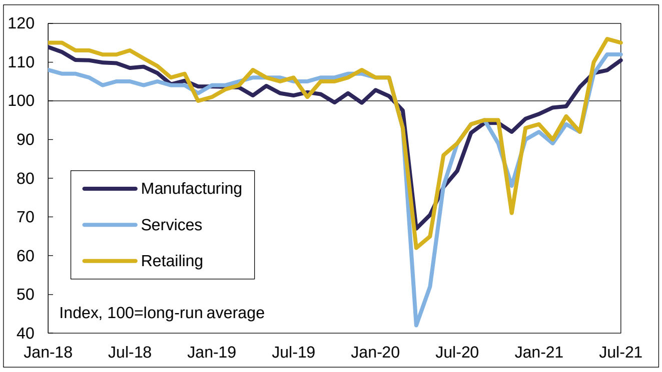
Tomorrow's focus in the euro area will be the publication of the flash PMIs for July, which are expected to suggest continued recovery at the start of Q3. In line with today's Commission and INSEE indices, however, we note the risks of a weakening, due to an increase in the number of new coronavirus cases in many member states (in particular Spain and the Netherlands) which has brought a tightening of restrictions in certain countries, as well as the severe flooding currently impacting Germany, Belgium and the Netherlands. According to the latest Bloomberg survey, the euro area services activity PMI is expected to rise 1pt to 59.3, which would be the highest since June 2006. However, the euro area manufacturing PMI is expected to fall back by almost 1pt from the prior month's series high, albeit remaining elevated at 62.5. The manufacturing PMIs also seem bound to continue to report backlogs of work close to record highs and ongoing strong input price pressures in the sector. Overall, the euro area composite output PMI is expected to rise ½pt to 60.0, which would also be the highest since June 2006.

UK

Broadbent suggests balance of views on MPC remains in favour of no policy change

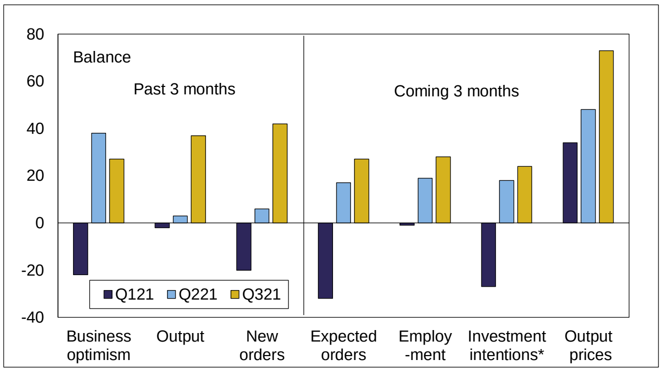
The most notable news out of the UK today came from the BoE, where Deputy Governor Broadbent set out his views on the recent rise in inflation. Crucially, while he thinks that inflation will rise further over coming months, he judged that transitory pressures associated with goods inflation, reflecting a surge in demand during the pandemic and more recently supply constraints, are largely to blame. So, while current mismatches in the labour market were also likely to be at play, and the outlook for the labour market remained particularly uncertain, he did not necessarily think that inflation would still be above target 18-24 months ahead, which is the relevant horizon for monetary policy. As such, and for now at least, Broadbent's views appear to align more closely with the dovish comments of fellow MPC member Haskel and nominee Mann (who will

France: INSEE business sentiment survey



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI industrial trends survey



**Over coming 12 months. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

join in September) than the hawkish views expressed last week by Deputy Governor Ramsden and MPC member Saunders. Certainly, based on today's speech, we would expect Broadbent to vote for no change to policy at the next MPC meeting on 5 August. And we would expect Governor Bailey, Deputy Governor Cunliffe and external member Tenreyro to share that view and make a majority in favour for no policy change at next month's meeting too.

Manufacturing output, orders and prices at elevated levels

Like the French INSEE indices, today's CBI industrial trends survey suggested that conditions in the UK's manufacturing remained buoyant in the three months to July, with output having been reported to have increased compared with a year ago in 16 out of 17 sub-sectors, driven by the transport equipment and food industries. Admittedly, recent growth has been flattered by the low base in the equivalent period last year and business optimism slipped back slightly from the 48-year high reached in April. But with orders reportedly rising at the fastest pace since 1973 and expected to remain strong over the near term, the share of firms expecting positive growth over the coming three months rose to the highest on record. This notwithstanding, production concerns related to supply constraints, labour shortages and plant capacity were at their highest since the mid-1970s. Against this backdrop, and no doubt benefiting from recent temporary tax incentives, firms' investment intentions improved to their strongest since the late 1980s. Less positively, tallying with other recent surveys, manufacturers reported that average input costs increased at the fastest pace since 1980, and as a consequence output price growth accelerated last quarter too. However, while manufacturers expected output prices to rise further over the coming three months, today's survey also suggested that input costs might now have peaked.

The day ahead in the UK

Like in the euro area, the preliminary UK PMIs for July are due out tomorrow along with the latest GfK consumer confidence survey. We expect these indices to be consistent with firm growth this month, although given the growing number of coronavirus cases we may see some levelling off in business optimism. The composite PMI is expected to remain close to June's record high of 62.2 thanks to robust conditions in both manufacturing and services. Also of interest tomorrow are retail sales data for June, which are likely to reveal that spending received a boost from the European football championships, not least related to items such as televisions, food and drink. We expect to see growth of around ½%M/M in retail sales excluding petrol, leaving sales up about 11% from the pre-pandemic level in February 2020. Consequently, retail sales would be around 1.4% higher in Q2 compared with Q1. However, we note downside risks associated with supply bottlenecks amid widespread reports of empty supermarket shelves.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB refinancing rate %	Jul	**0.00**	*0.00*	0.00	-
	Marginal lending facility rate %	Jul	**0.25**	*0.25*	0.25	-
	Deposit rate %	Jul	**-0.50**	*-0.50*	-0.50	-
	Commission's preliminary consumer confidence indicator	Jul	**-4.4**	-2.5	-3.3	-
France	INSEE manufacturing confidence (production outlook)	Jul	**110 (20)**	107 (28)	107 (27)	**108 (25)**
	INSEE business confidence	Jul	**113**	113	113	**114**
UK	CBI industrial trends survey, total orders (business optimism)	Jul	**17 (27)**	16 (34)	19 (38)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy		Industrial sales M/M% (Y/Y%)	May	**-1.0 (40.2)**	-	3.3 (105.1)	**-**
UK		Public sector net borrowing, excluding banking groups £bn	Jun	**22.8**	21.9	24.3	**20.6**

Auctions

Country		Auction
Germany		sold €1.23bn of 1.25% 2048 bonds at an average yield of 0.03%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Preliminary manufacturing (services) PMI	Jul	62.5 (59.3)	63.4 (58.3)
		09.00	Preliminary composite PMI	Jul	60.0	59.5
Germany		08.30	Preliminary manufacturing (services) PMI	Jul	64.1 (59.5)	65.1 (57.5)
		08.30	Preliminary composite PMI	Jul	60.7	60.1
France		08.15	Preliminary manufacturing (services) PMI	Jul	58.2 (58.8)	59.0 (57.8)
		08.15	Preliminary composite PMI	Jul	58.4	57.4
UK		00.01	GfK consumer confidence	Jul	-8	-9
		07.00	Retail sales, including auto fuel, M/M% (YY%)	Jun	-0.1 (9.5)	-1.4 (24.6)
		07.00	Retail sales, excluding auto fuel, M/M% (YY%)	Jun	0.1 (7.6)	-2.1 (21.7)
		09.30	Preliminary manufacturing (services) PMI	Jul	62.4 (62.0)	63.9 (62.4)
		09.30	Preliminary composite PMI	Jul	61.5	62.2

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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