Euro wrap-up

Overview

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- Bunds rallied as the flash euro area PMIs missed expectations, signalling a notable slowdown in economic activity amid a reported drop in demand.
- Gilts also made big gains as the flash UK PMIs suggested a weakening in new orders, while public borrowing rose above expectations due to a marked impact of high inflation on debt interest payments.
- Friday will bring the latest German ifo business survey as well as new data for UK retail sales and consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.788	-0.233
OBL 0 04/27	1.155	-0.253
DBR 0 02/32	1.424	-0.204
UKT 1 04/24	1.906	-0.209
UKT 1¼ 07/27	1.945	-0.206
UKT 4¼ 06/32	2.310	-0.185

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

Euro area

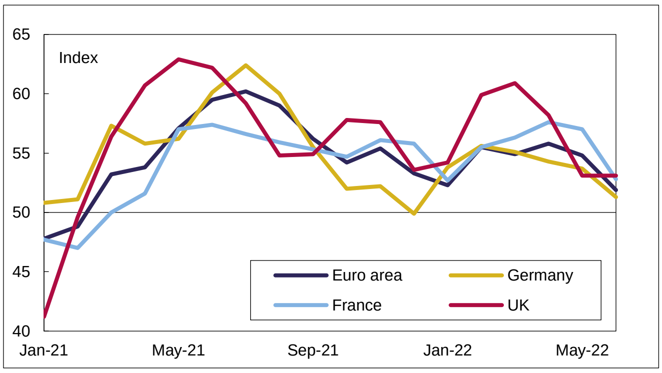
Flash PMIs miss expectations signalling slowing services activity and falling factory output

The flash PMIs for June significantly missed expectations, suggesting a notable loss of economic recovery momentum at the end of Q2. Indeed, the euro area composite output PMI dropped for a second successive month and by almost 3pts – the most since November 2020 – to a sixteen-month low of 51.9. Both main sectors reported a deterioration. Growth in services activity reportedly slowed abruptly, also by the most since late 2020, to the softest pace since January. With S&P Global reporting a notable cooling in consumer-facing services as high inflation eroded purchasing power, the respective euro area headline services PMI fell more than 3pts to 52.8, with the weakening in new business even more marked. Additionally, judging from the manufacturing output PMI, which dropped more than 2pts to 49.3, industrial production in the euro area shifted into reverse gear for the first time since June 2020, while new factory orders dropped the most since the first wave of Covid-19. With demand evidently cooling in both manufacturing and services, firms revised down their expectations for the coming twelve months to the lowest since October 2020. Accordingly, firms moderated their job-hiring to the softest in more than a year. At the country level, the picture was similar in Germany and France, with the PMIs suggestive of contracting manufacturing production and the softest growth in services activity since January's omicron wave of Covid-19. And S&P Global reported that manufacturing output growth near-stalled in the remainder of the euro area, where services activity also slowed the most since the start of the year.

Further hints of an easing of supply pressures as demand weakens

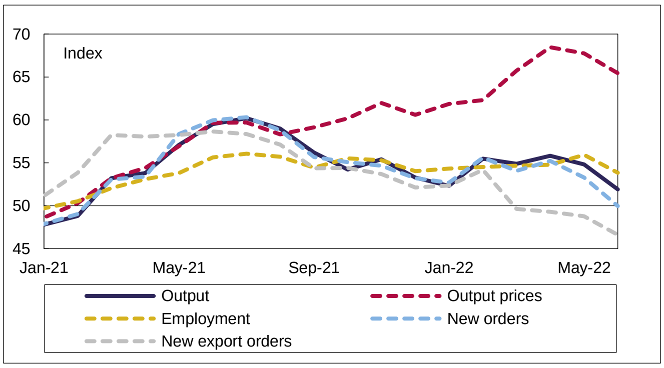
While the PMIs for price pressures remained within reach of historically high levels, manufacturers reported the softest pace of increase in input costs since March 2021. In contrast, services firms reported an acceleration in costs to the steepest since April, reportedly in part reflecting the pass-through of previous increases in prices of energy and higher wages. However, in both main sectors average output prices slowed, leaving the respective composite index suggesting the slowest pace since February. In addition, in tandem with the signs of weakening demand, the detail of the PMI survey suggested some further modest easing of supply disruption. For example, firms reported a big increase in post-production inventories, with German manufacturers in particular noting the biggest increase in stocks of their own products since the initial Covid-19 shock, and reportedly in part due to cancellations of orders. And while stock-building of materials and input components continued at a relatively firm pace, delivery times in manufacturing lengthened the least since the end of 2020.

Europe: Composite output PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

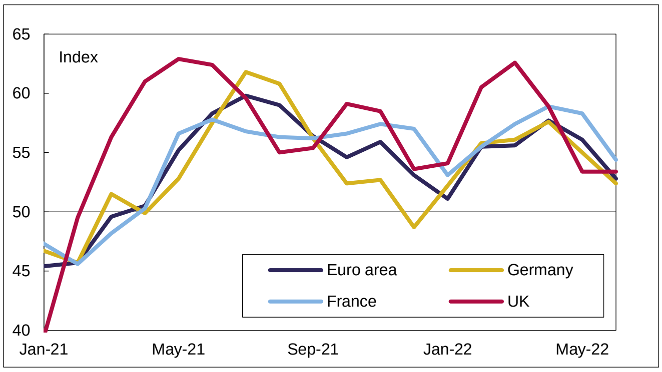
GDP growth likely to have slowed in Q2, PMIs flag risk of contraction in Q3

Looking through the monthly volatility, the average euro area composite output PMI in Q2 was unchanged from Q1 at a seemingly-respectable 54.2. At face value, that might suggest another quarter of GDP growth at the 0.6%Q/Q rate of Q1. However, we caution that growth in Q1 was exaggerated by the activities of multinational corporations based in Ireland, payback for which should be expected to come in Q2. And, excluding certain readings throughout the pandemic, the deterioration in the composite output PMI in June was steeper than at any time since the global financial crisis. So, overall, we maintain our forecast of euro area GDP growth of just 0.1%Q/Q this quarter. More of a concern perhaps, today's survey flags significant downside risks to economic activity in the second half of the year, as the cost-of-living crisis, rising interest rates, near-record low consumer confidence and growing concerns about the consequences of the war in Ukraine – including possible energy rationing – are all evidently weighing increasingly on demand. Indeed, the services PMIs suggest that post-Covid pent-up demand in services might have been to a large extent exhausted ahead of expectations. Moreover, the manufacturing survey points to a sudden sharp decline in demand for goods as willingness to make large-scale purchases – both in Europe or further afield – appears to be falling fast. The headwinds to growth are undeniably picking up. However, unless that translates into a notable weakening in the labour market and falling inflation expectations, the ECB will not adjust its current baseline plans for rate hikes of 25bps in July, more than that in September, and further tightening beyond.

The day ahead in the euro area

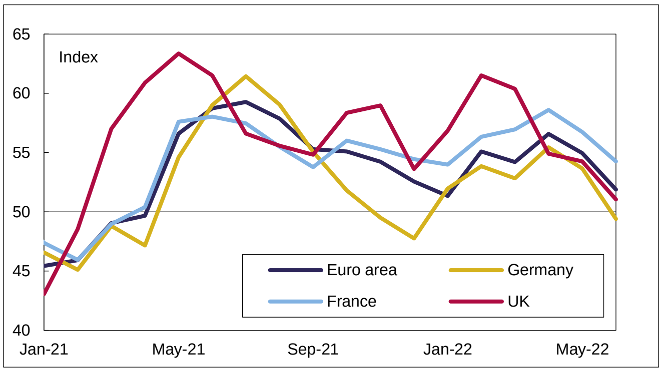
The flow of June euro area economic sentiment survey results continues tomorrow, with Germany's ifo business climate indices most notable. While the median forecast on the Bloomberg survey is for the ifo current assessment balance to move broadly sideways and the expectations balance forecast to edge higher, today's disappointing flash PMIs point to clear downside risks. Elsewhere, Italy's ISTAT business confidence indicators are expected to see little improvement in June, while ISTAT's consumer confidence index is expected to pick up somewhat for the second successive month in June, albeit remaining well below its highs last year. Meanwhile, revised Spanish GDP data for Q1 are also due (growth was previously estimated at 0.3%Q/Q and 6.4%Y/Y). We will also hear from the ECB's Vice President de Guindos tomorrow, who is due to participate in a panel discussion about inflation.

Europe: Services activity PMIs



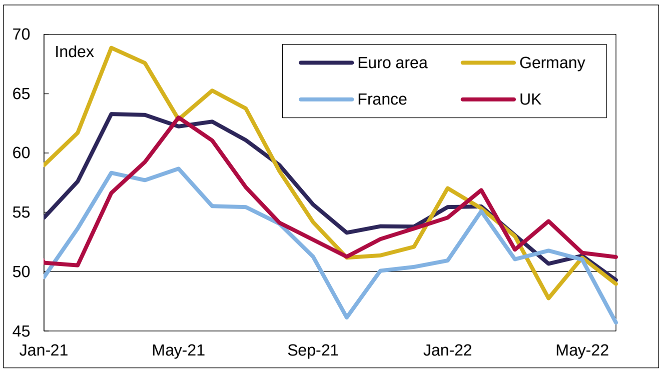
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Services new business PMIs



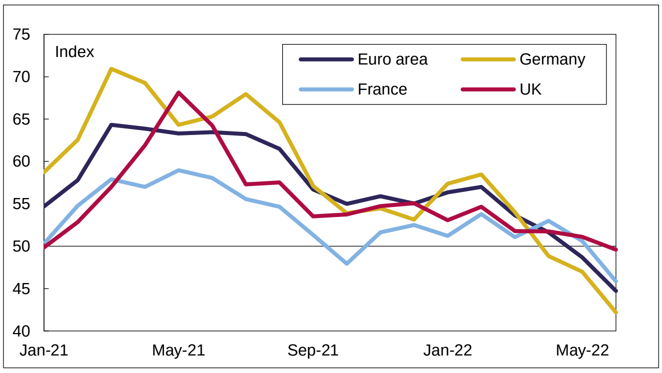
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Manufacturing output PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: Manufacturing new orders PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK

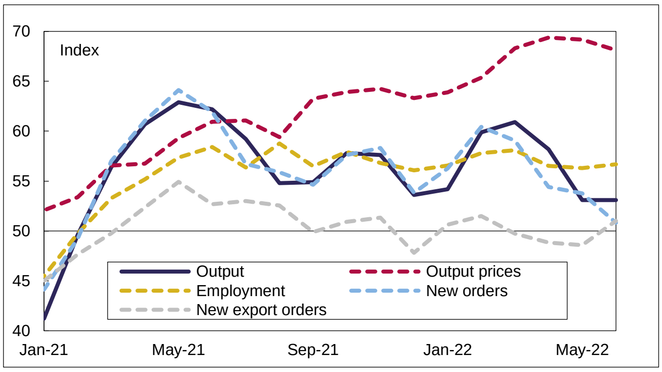
Headline UK services PMI steady, but survey detail still very weak

At face value, today's flash PMI surveys exceeded expectations, suggesting that activity stabilised at the end of the second quarter. Certainly, the headline services activity index unexpectedly moved sideways in June at 53.4. Nevertheless, this was still the softest reading since February 2021. And, following the steep declines in the previous two months, it left the index well below the quarterly average in Q1 (59.1). While survey respondents reported a boost from increased tourism, they suggested that overall demand had weakened for the fourth consecutive month as concerns about the cost of living and heightened economic uncertainty weighed. Indeed, the new business component fell a steep 3.2pts to 51.1, a sixteen-month low. And with household real disposable income set to remain squeezed for some time to come, firms in the sector were the most downbeat about expectations for the coming twelve months since the first wave of Covid-19 in May 2020. The combination of waning demand and persisting supply bottlenecks also continued to limit production capacity in the manufacturing sector. The output PMI slipped back a further 0.4pt to a fifteen-month low of 51.2, while the new orders PMI fell 1.5pts to 49.6, the lowest since January 2021, despite a softer pace of contraction in export orders (up 2.2pts to 48.5).

Composite PMI well down on Q1 average, and optimism about outlook at two-year low

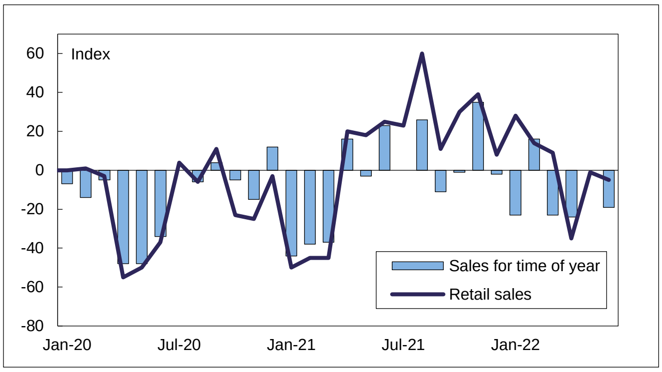
While the composite output PMI was unchanged in June at 53.1 (a reading supposedly consistent with ongoing expansion), today's survey was conducted ahead of this week's public transport strikes, which seems bound to have further restricted economic activity at the end of this month. Moreover, the composite PMI was well down on the level recorded at the end of Q1 (60.9) and further supports our forecast that GDP contracted in Q2. And given ongoing concerns about the impact of high inflation, optimism about future output fell for the fourth consecutive month and is now at the lowest in just over two years. Despite weakening demand, the PMIs implied ongoing robust employment growth at the end of Q2 as firms tried to fill persisting vacancies. But firms again flagged hiring difficulties amid labour shortages. And these continued to push wages higher, adding to already elevated input costs. With profit margins increasingly squeezed, manufacturing and services firms alike reported the need to pass these on to consumers. So, while the output price PMI edged lower for the second successive month, at 68.1 it was still significantly higher than at any time in the two decades before the pandemic. And high inflation seems bound to restrain demand for several quarters to come.

UK: Composite PMIs



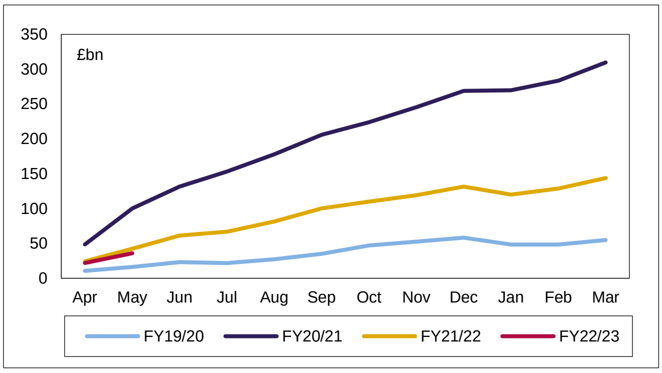
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: CBI distributive trades survey indicators



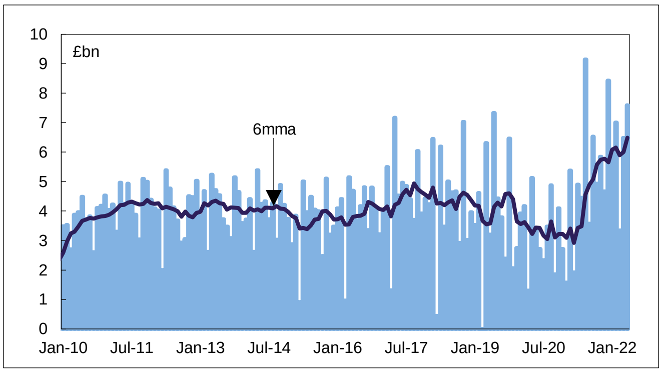
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



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

UK: Central government debt interest payments



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

CBI survey signals poor retail sales despite extended bank holiday weekend

While UK retail sales were surprisingly strong at the start of the second quarter, today's CBI distributive trades survey similarly flagged weakening momentum at the end of the second quarter as sales faced significant headwinds from squeezed household budgets. Despite the extended bank holiday weekend, the survey suggested that retail sales fell in the year to June, with the relevant survey balance dropping 4ppts to -5%, the third consecutive negative reading. Sales were considered to be particularly poor for the time of year, with retailers expecting them to remain below seasonal norms in July too and assessing inventories to be too high compared with demand. While this survey failed to capture the strength in the official data in April, with consumer confidence at a record low and households' disposable income falling sharply, we continue to expect spending on non-essential items to have fallen sharply over the remainder of the second quarter.

UK public borrowing exceeds expectations again

UK net public borrowing (excluding public sector banks) came in above expectations again in May, reaching £14.0bn, £2.0bn above the median forecast on the Bloomberg survey and £3.7bn above the OBR's forecast. The figure was the third highest for any May, down £4.0bn from a year earlier but £8.5bn above the level in that month of 2019 ahead of the pandemic. Compared with a year earlier, central government receipts were up £5.7bn, in part due to the government's hike in National Insurance Contributions but also increased VAT receipts thanks to higher private spending. Central government current expenditure was down £2.2bn from a year earlier, with the savings of £4.9bn in pandemic-related subsidies in part offset by an extra £3.1bn of debt interest payments due not least to the impact of high inflation on indexed-linked Gilts.

Inflation pushes debt interest payments to highest for any May, further increase inevitable

Indeed, central government debt interest payments of £7.6bn were the highest ever for May, and the third-highest in any single month on the series. Strikingly, £5.0bn of those payments related directly to accrued interest on inflation-linked Gilts. However, this estimate was based on the increase in the Retail Price Index (RPI) between February and March, since when the RPI has risen by a record 3.4%M/M in April and a further 0.7%M/M in May to push the annual rate well above expectations to a four-decade high of 11.7%Y/Y. With index-linked Gilts accounting for almost 25% of the market, the government's debt interest bill seems bound significantly to exceed the OBR's forecast of £87.2bn for the current fiscal year.

OBR borrowing forecast will need to be revised higher in the autumn

The wider-than-expected deficit in May meant that cumulative net public borrowing in the first two months of the year reached £35.9bn, already some £6.4bn above the OBR's forecast. That was £6.4bn below the amount in the same period last fiscal year, but almost £20bn higher than in the first two months of FY19. The slowdown in economic activity will now likely weigh on revenue growth. And the government's £15bn package of support for households announced last month, which will likely only in part be funded by a windfall tax on energy firms, has also yet to show up in the public borrowing data. So, added to the ugly outlook for debt interest payments, full-year borrowing in FY22 seems bound to significantly exceed earlier projections. Added to concerns about any additional inflationary impact from a loosening in the fiscal stance, the worsening underlying health of the public finances is likely to diminish scope for the government to provide extra support for the weakening UK economy in the autumn Budget.

The day ahead in the UK

The UK data highlights tomorrow will be the delayed release of May's retail sales data, as well as the GfK consumer confidence survey for June. We expect to see some adverse payback in retail sales – perhaps as much as 1%M/M – for the surprising jump (+1.4%M/M) in April, while consumer confidence is likely to remain unchanged at the series low of -40. In terms of BoE speak, Chief Economist Pill and hawkish external MPC member Haskel are due to speak publicly at separate events.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary manufacturing (services) PMI	Jun	**52.0 (52.4)**	53.8 (55.5)	54.6 (56.1)	-
		Preliminary composite PMI	Jun	**51.9**	54.1)	54.8	-
Germany		Preliminary manufacturing (services) PMI	Jun	**52.0 (52.4)**	54.0 (54.5)	54.8 (55.0)	-
		Preliminary composite PMI	Jun	**51.9**	53.0	53.7	-
France		INSEE business confidence	Jun	**104**	105	106	-
		INSEE manufacturing confidence (production outlook)	Jun	**108 (-5)**	105 (-11)	106 (-9)	-
		Preliminary manufacturing (services) PMI	Jun	**51.0 (54.4)**	53.9 (57.6)	54.6 (58.3)	-
		Preliminary composite PMI	Jun	**52.8**	56.0	57.0	-
UK		Public sector net borrowing, excluding banks £bn	May	**14.0**	12.1	18.6	**21.9**
		Preliminary manufacturing (services) PMI	Jun	**53.4 (53.4)**	53.6 (52.9)	54.6 (53.4)	-
		Preliminary composite PMI	Jun	**53.1**	52.4	53.1	-
		CBI distributive sales, reported retail sales balance %	Jun	**-5**	-	-1	-

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
Germany		09.00	Ifo business climate	Jun	92.8	93.0
		09.00	Ifo current assessment (expectations) balance	Jun	99.0 (87.4)	99.5 (86.9)
France		07.45	Final wages Q/Q%	Q1	*1.1*	0.5
Italy		09.00	ISTAT consumer confidence index	Jun	103.0	102.7
		09.00	ISTAT business (manufacturing) sentiment indicator	Jun	- (108.5)	110.9 (109.3)
Spain		08.00	Final GDP Q/Q% (Y/Y%)	Q1	*0.3 (6.4)*	2.2 (5.5)
UK		00.01	GfK consumer confidence	Jun	-40	-40
		07.00	Retail sales including auto fuel M/M% (Y/Y%)	May	-0.7 (-4.5)	1.4 (-4.9)
		07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	May	-0.9 (-5.0)	1.4 (-6.1)

Auctions and events

Country		BST	Event
Euro area		12.30	ECB's de Guindos scheduled to speak – 'Central banks and inflation'
Italy		10.00	Auction: €4bn of 1.75% 2024 bonds
UK		13.30	BoE's Pill scheduled to speak
		14.45	BoE's Haskel scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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