Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds made losses as reports suggested the ECB will discuss a 50bp rate hike this week and Russia is set to resume flows of gas via the Nord Stream pipeline, while euro area inflation was confirmed at a series high.
- Gilts made losses as UK job growth picked up but real wages fell at a record pace, while BoE Governor Bailey stated the MPC would discuss a 50bp hike in August and gave guidance on forthcoming BoE Gilt sales and redemptions.
- Wednesday brings euro area consumer confidence and UK inflation data, as well as key political votes in Italy and the UK.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.602	+0.129
OBL 1.3 10/27	1.001	+0.101
DBR 1.7 08/32	1.264	+0.057
UKT 1 04/24	2.040	+0.055
UKT 1¼ 07/27	1.908	+0.041
UKT 4¼ 06/32	2.182	+0.023

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

Euro area

Headline CPI confirmed at record high in June as ECB will reportedly discuss a 50bps rate hike

Ahead of the ECB's monetary policy announcement on Thursday, a Reuters report today suggested that the Governing Council will this week discuss whether to raise its key interest rates by 25bps or 50bps. A hike of the larger increment would be a big surprise, as only last month the Council stated unambiguously that it "intends" to hike by 25bps at the forthcoming meeting, while also stating that a larger hike would likely be appropriate in September. On balance, we still think the majority will wish to act in line with last month's forward guidance. Certainly, unlike the Fed, media leaks of this nature ahead of ECB monetary policy meetings do not typically reveal a sudden change of view among the majority of Governing Council members. Instead, they usually simply reflect the interests of one particular view, which is often held by the minority.

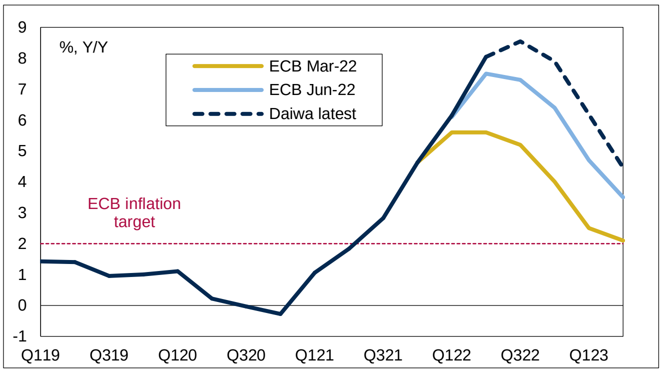
We continue to expect 25bps this week, but 75bps will likely be discussed in September

Moreover, the profile of hikes agreed last month appeared to be part of a compromise deal between the hawks and the doves, which seems unlikely to be undone this week. Indeed, the account from that meeting indicated that "most members" had judged the smaller magnitude to be a "proportionate first step" before the more aggressive tightening in September and possibly beyond. And a larger rate hike on Thursday would damage the credibility of the ECB's forward guidance in future. It could also be argued that there has been little in the way of compelling economic news over the past month to persuade the Governing Council to change its mind. For example, while wholesale natural gas prices are significantly higher, reports today suggested that Russia intends shortly to resume the flow via the Nord Stream 1 pipeline. And prices of crude oil and other commodities are significantly lower, while financial market measures of inflation expectations have fallen back too. Moreover, while today's final euro area inflation figures for June confirmed that the ECB's forecast for Q2 of 7.5%Y/Y was ½ppt too low, and might therefore call for more aggressive tightening, that had already looked likely at the time of the last meeting when the Governing Council set its guidance. So, overall, while we cannot reject outright the possibility of a 50bps hike on Thursday, we think the report is more likely to reflect the attempt by the hawks to push open the door to a hike of 75bps in September as a quid pro quo for agreeing just 25bps this week.

Core inflation eases on temporary policy measures, but underlying price pressures still broadening

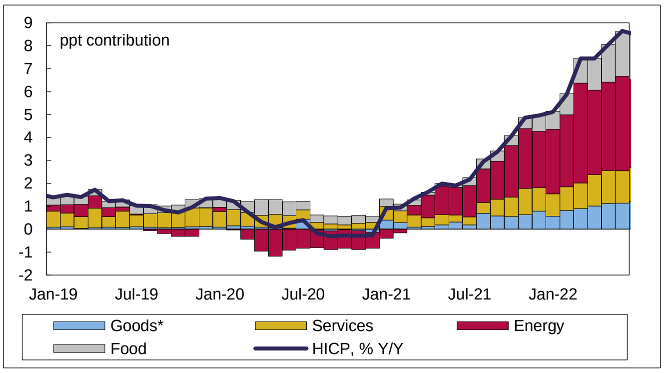
Today's figures confirmed that the euro area's headline HICP inflation rate rose 0.5ppt in June to 8.6%Y/Y, a new series high. But equally, core inflation also aligned with the flash estimate, easing 0.1ppt to 3.7%Y/Y. Within the CPI detail, energy continued to account for the lion's share of inflation in June, with prices rising a further 3.3%M/M to be up 42%Y/Y and

Euro area: HICP inflation forecast



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

Euro area: Contributions to HICP inflation



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

contributing roughly half of total inflation. But food inflation also rose 1.4ppts to a record high of 8.9%Y/Y, and contributed a further 1.9ppts to headline inflation. Among the core components, despite an easing in clothing inflation due to the change in timing of seasonal discounting, non-energy industrial goods prices still edged higher, with the annual rate up 0.1ppt to 4.3%Y/Y, similarly a series high. But that impact was more than offset by Germany's temporary policy measures – including a fuel discount and €9 monthly rail pass – which meant that euro area passenger transport fares fell sharply by 41%Y/Y. So, despite upwards pressures from tourism-related components – e.g. package holidays (up 6.2ppts to 11.5%Y/Y), accommodation (up 3.4ppt to 17.2%Y/Y) and catering (up 0.3ppt to 5.7%Y/Y) – services inflation eased very slightly, by 0.1ppt to 3.4%Y/Y. While the decision by the Spanish government to approve new transport subsidies and cut VAT on electricity bills will help to partly offset the upwards impact of the conclusion of the German measures in September, we still expect euro area core inflation to shift higher later this year. Indeed, the ECB's trimmed mean inflation measure – excluding 15% of items with the highest and lowest inflation rates – jumped 0.6ppt in June to 6.8%Y/Y, just below the equivalent measure in the US (6.9%Y//Y) and suggesting that underlying price pressures continue to broaden in the euro area.

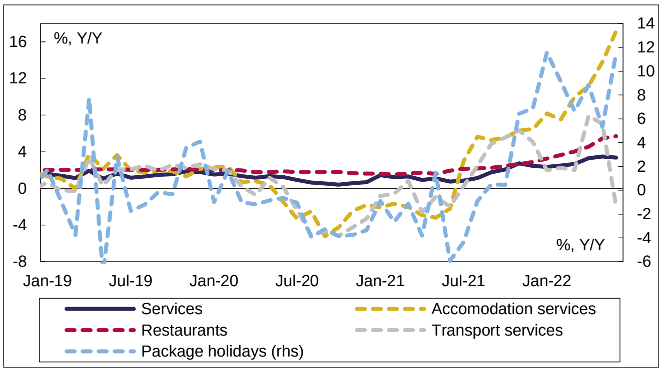
Lending conditions tighten ahead of ECB hike, while demand for loans for capex decline

With the Governing Council having signalled that interest rates will rise in the second half of the year (and possibly beyond), perhaps unsurprisingly, today's ECB bank lending survey signalled a substantial further tightening in credit standards over the past quarter. In particular, a net 16% of banks tightened their lending conditions to enterprises, up 10ppts from Q1 and the third highest share since the euro crisis in Q112, as lenders' risk tolerance diminished amid the deteriorating economic outlook. And while lenders indicated that demand for business loans continued to increase in Q2, this principally reflected higher funding needs reflecting increased costs. Indeed, demand for loans associated with fixed investment reportedly fell for the first time since Q121, suggesting that firms were postponing near-term capex projects amid increased economic uncertainties. And overall, lenders were forecasting a drop in demand for all business loans this quarter. At the country level, developments were mixed. Credit conditions tightened considerably in France and Italy last quarter but remained more stable in Germany. And, on balance, there was a net increase in loan demand from German and French enterprises, but no change in demand from Italian firms.

Demand for mortgages declines as interest rates rise

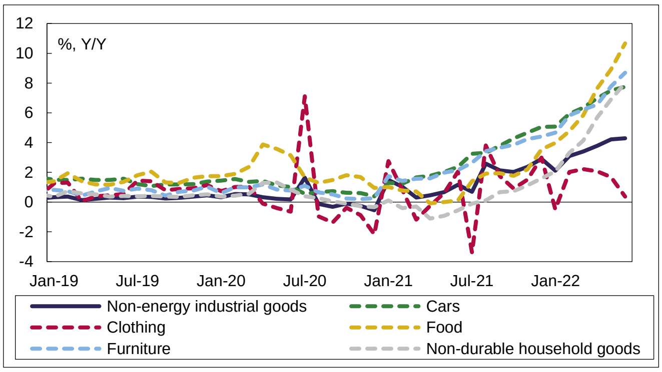
Likewise, lenders reported a strong and above-average net tightening of credit standards for housing loans last quarter due to higher risk perceptions and lower risk tolerance, with similar trends across the larger member states. On aggregate, a net 24% of lenders tightened standards on such loans last quarter, from just 2% in Q1. And given the recent increase in

Euro area: Services inflation



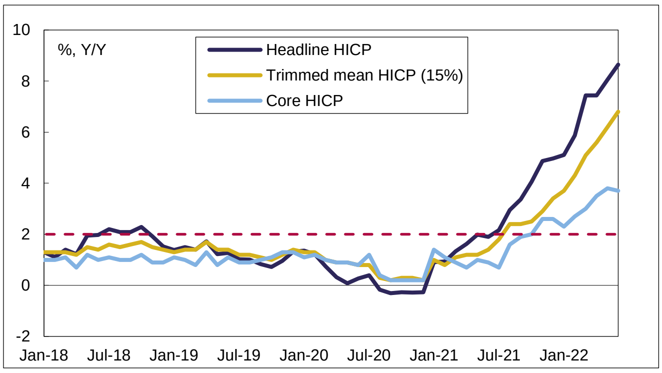
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Goods inflation



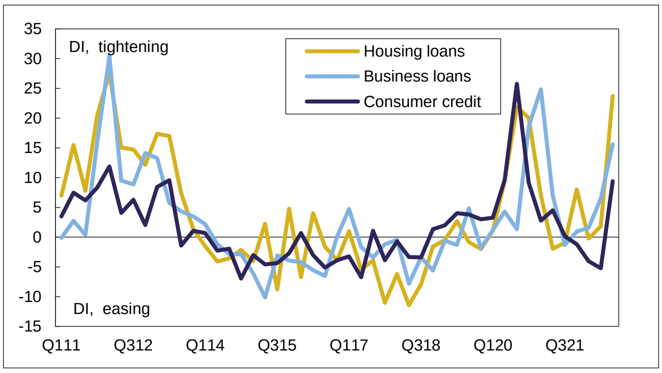
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of HICP inflation



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

Euro area: Change in credit standards



Source: Bloombereg, ECB bank lending survey and Daiwa Capital Markets Europe Ltd.

mortgage interest rates and near-record low consumer confidence, banks suggested that demand for secured lending had fallen in Q2 and was expected to fall significantly further in Q3 too. The weakness in confidence also had a dampening effect on demand for consumer credit. Banks expected demand to remain subdued this quarter too, supporting our view that household consumption will remain weak amid declining purchasing power.

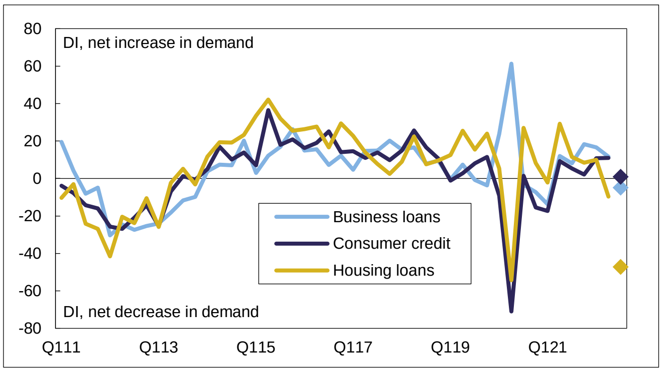
Construction output grows in May but on track for drop in Q2

Like industrial production, euro area construction output rose moderately in May but remained on track for a drop over the second quarter as a whole. In particular, production in construction grew 0.4%M/M in May, insufficient to reverse the fall of 1.0%M/M in April to be trending about 0.5% below the Q1 average in the first two months of Q2. While infrastructure activity rose in May, it was also on course for a drop over the second quarter, with the opposite being true of building work, which has up to now benefited from strong residential property demand and price growth. Among the large member states, construction output in Germany and Spain were on track for declines in Q2, but Italy was firmly on track for a sixth successive quarter of growth in the sector. Unfortunately, with the exception of Italy, survey indicators for June, such as the construction PMIs, suggested significant weakness across the subsectors and large member states at the end of Q2, as a drop in activity and new orders reportedly coincided with ongoing cost pressures, sizeable (albeit declining) delivery times, and diminished availability and quality of subcontractors. Projects part-financed by the EU recovery funds should provide some support over coming quarters. But with cost pressures likely to persist, monetary policy set to be tightened markedly, real household incomes to be squeezed further, and business sentiment likely to weaken amid uncertainties regarding energy supply and external demand, we expect the construction sector to offer little to no support to GDP growth over the second half of the year and into 2023.

The day ahead in the euro area

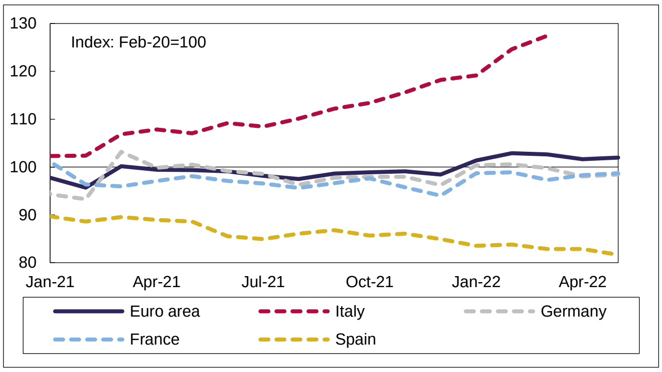
Ahead of Thursday's ECB policy announcement, tomorrow will bring the first of this week's sentiment data with the European Commission's flash euro area consumer confidence indicator. Against the backdrop of higher living costs, prospect of higher interest rates and concerns about energy supply, sentiment is likely to have fallen closer to the record low logged at the onset of the pandemic in April 2020. Equivalent surveys from the Netherlands and Belgium will provide a more detailed breakdown. The BoF retail survey for July is also due for release. In addition, Wednesday will bring the latest German PPI figures, which are expected to show that producer price pressures remain extremely elevated, with ongoing cost burdens being passed along the supply chain to prices of intermediate, capital and consumer goods.

Euro area: Change in demand for loans*



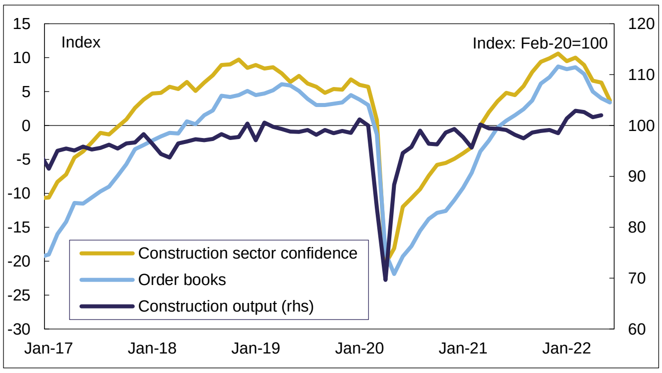
Diamonds represent survey forecasts for Q3. Source: Refinitiv, ECB bank lending survey and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output*



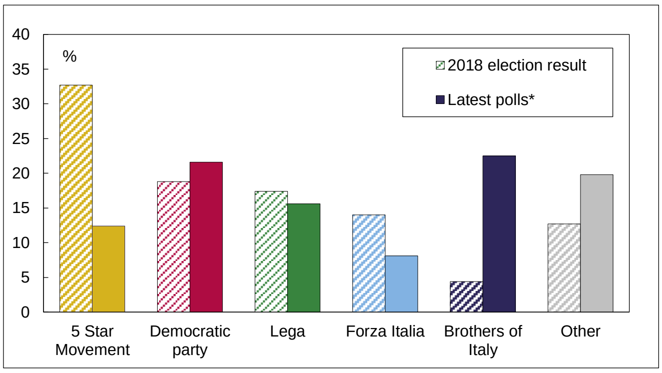
Latest Italian figures for March 2022. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction sector indicators



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

Italy: Political party support*



Average ratings in the past month. Source: Daiwa Capital Markets Europe Ltd.

Focus tomorrow will also be firmly on Italian politics, with key confidence votes to be held in the Senate and Chamber of Deputies to determine whether the Draghi government can survive or a snap general election will need to be held in the autumn. At the time of writing, no deal had been reached to persuade Draghi to remain as Prime Minister. But given the unpredictable nature of all the main Italian political protagonists we do not rule out the possibility that one might be secured at the last minute to give the Draghi government a second lease of life. Certainly, voters of the parties to have originally backed Draghi – including the Five Star Movement (M5S), which withheld support for him last week – appear to want him to stay in office. And reports today suggested that many M5S lawmakers might be willing to split from the party's leader Conte to try to persuade Draghi to remain in office.

UK

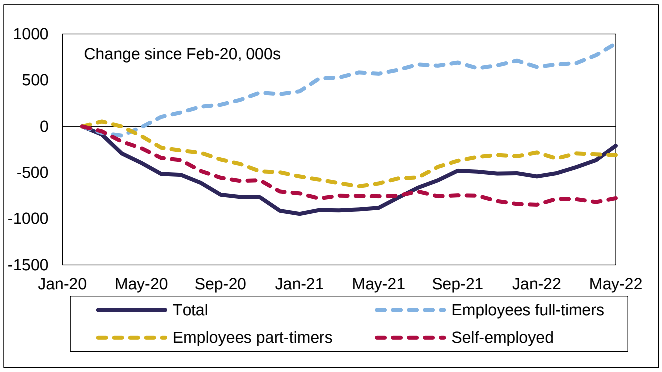
UK job growth picks up again with unemployment steady

The latest UK labour market data were a mixed bag, suggesting some favourable developments from both cyclical and structural perspectives, albeit providing a reminder of the intensifying hit to living standards. To start, in the three months to May, the unemployment rate was unchanged at 3.8%, which thankfully meant that the big (0.6ppt!) increase in the (typically volatile) single-month measure reported in April was fully reversed the following month. Moreover, the steady unemployment rate over the three months masked a chunky pickup in employment, with job growth over that period accelerating to 296k, eye-catchingly the strongest in eight years, benefiting from increases in both full-time and part-time work. The total number of people in work, however, remained 210k below the pre-pandemic level, in part due to the continued significant shortfall of self-employed workers.

Welcome fall in labour inactivity but further to go to ease tightness in the job market

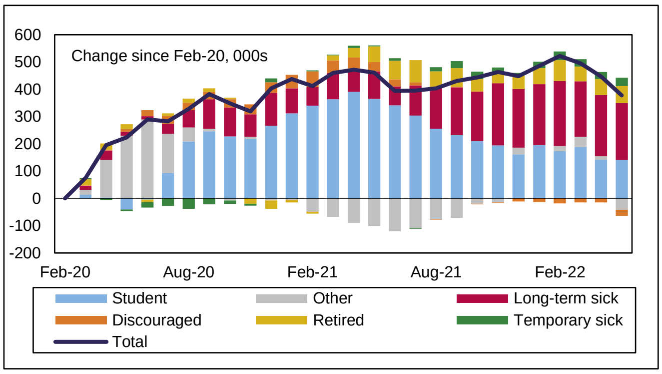
The strong growth in employment did not lower the unemployment rate, as the three-month inactivity rate fell back 0.2ppt on the month and 0.4ppt from three months earlier as many workers (particularly those over the age of 50 years) returned to the labour force – a particularly welcome structural development in light of labour and skills shortages. Notably, however, the inactivity rate remained some 0.9ppt above its pre-pandemic level, with the number of economically inactive people of working age up 378k from the same benchmark, suggesting still some way to go to return to a "normal" labour supply. And while the redundancy rate dropped to a record low in the three months to May as firms appeared to hoard labour despite the uncertain economic outlook, the more timely data pointed to a softening of job hiring momentum in June, with the estimate of payrolled employees (a figure that is typically revised down significantly) up just 30.7k, down slightly from May to be the

UK: Change in employment



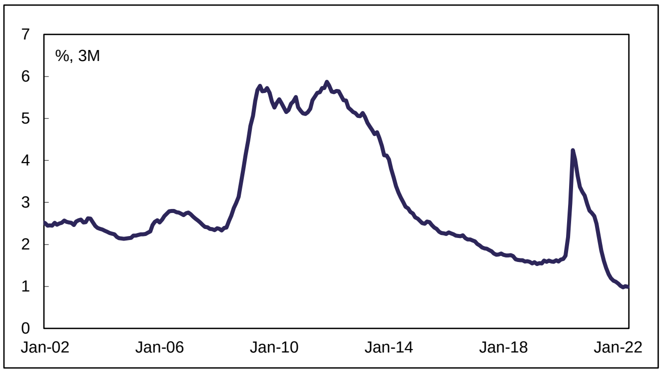
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Reasons for inactivity



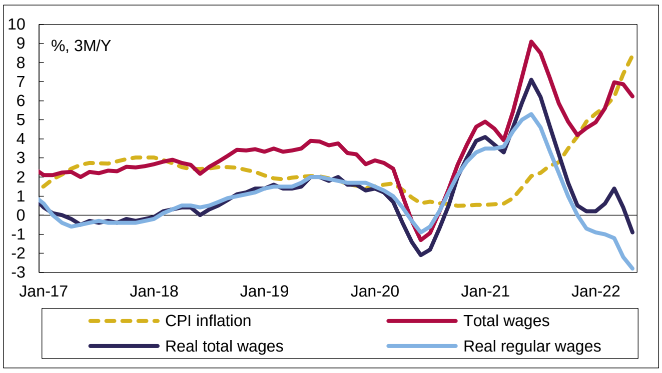
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Unemployment to vacancy ratio



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Wages and CPI inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

second-smallest increase over the past fifteen months. And while the number of job vacancies reached a new high of 1.294mn, slightly above the number of unemployed workers to suggest that the BoE will still be concerned about the continued tightness of the labour market, the pace of increase continued to slow.

Despite record drop in real wages, BoE will consider 50bps hike in August and soon start QT

Finally, while growth in employees' average total pay in May slowed 0.6ppt to 6.2%3M/Y, the moderation reflected an easing in the pace of bonus growth. Indeed, growth in regular pay (excluding bonuses) inched up 0.1ppt to 4.3%3M/Y. With that rate only slightly exaggerated by base effects associated with furlough, the BoE will still consider pay growth to be above levels consistent with the achievement of its inflation target over the medium term and will also note that payroll data suggested a further pickup in nominal wage growth in June. But given sky-high inflation, these rates are consistent with a big cut in purchasing power. Indeed, real total pay was down 0.9%3M/Y in May while real regular pay fell at a record pace of 2.8%3M/Y, rates that seem bound to worsen over the near term and suggest that private consumption growth will be weak – and probably negative – over the remainder of the year. Nevertheless, the advance release of BoE Governor Bailey's Mansion House speech, to be delivered this evening, confirmed that a 50bps rate hike will be considered by the MPC in August. Admittedly, he also insisted that it was not a done deal, although we would be very surprised if the BoE did not approve it. Moreover, he made clear that quantitative tightening via active Gilt sales would likely start in September. Combined with redemptions, the BoE will likely aim to reduce its stock of Gilts (currently £847bn) by between £50-100bn in the first year.

The day ahead in the UK

Tomorrow will bring the June CPI inflation report. Given the surge in petrol prices over the past month, we expect energy inflation to take a further step up in June, with food inflation also likely to rise to its highest since 2009. As such, we expect headline CPI inflation to have increased 0.3ppt to 9.4%Y/Y, the highest on the series dating back to 1997. But we expect core inflation to move sideways, albeit at a still-lofty 5.9%Y/Y, as a pickup in services inflation might have been offset by a temporary easing in non-energy industrial goods inflation. The UK's latest producer price inflation numbers are expected to have ticked higher in June too. But the ONS's house price figures are expected to show that annual growth eased slightly in May, albeit remaining firmly in double-digit territory.

Politics-wise, Conservative MPs will finally choose the two candidates from which party members will, over the summer, elect the successor to Boris Johnson as their leader and national Prime Minister. The result of the vote among party members will then be announced on 5 September. At this stage, former Chancellor Rishi Sunak seems highly likely to make it to the second round alongside Foreign Secretary Liz Truss (the preferred candidate of Boris Johnson and the party's right-wing populists) with more centrist Trade Minister Penny Mordaunt now looking less likely to be the other candidate. So far, Sunak is the only candidate not to be offering front-loaded tax cuts, instead suggesting a preference for fiscal responsibility and highlighting the trade-offs related to the overall macroeconomic policy mix. Indeed, because they have no serious plans for meaningful reforms to control public expenditure, the front-loaded tax cuts being proposed by the other two remaining candidates would have to be funded largely by new borrowing and would at the margin be inflationary, requiring higher interest rates from the BoE than would otherwise be the case. Truss has also attacked the BoE, calling for its mandate to be reformed, while she has also called for a refinancing of Covid-related government debt at longer maturities. So, she arguably would raise the biggest doubts over the credibility of policy going forward. But, by and large, none of the three candidates have substantive economic policy proposals that bear serious scrutiny, and all have question-marks regarding judgement and integrity.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Construction output M/M% (Y/Y%)	May	**0.4 (2.9)**	-	-1.1 (3.0)	-
		Final CPI M/M% (Y/Y%)	Jun	**0.8 (8.6)**	*0.8 (8.6)*	0.8 (8.1)	-
		Final core CPI Y/Y%	Jun	**3.7**	*3.7*	3.8	-
UK		Payrolled employees, monthly change '000s	Jun	**31**	-	90	**31**
		Unemployment claimant count rate % (change '000s)	Jun	**3.9 (-20.0)**	-	4.0 (-19.7)	**- (-34.7)**
		Average weekly earnings including (excluding) bonuses 3M/Y%	May	**6.2 (4.3)**	6.7 (4.3)	6.8 (4.2)	-
		ILO unemployment rate 3M%	May	**3.8**	3.8	3.8	-
		Employment change 3M/3M '000s	May	**296**	110	177	-

Auctions

Country		Auction
Germany		sold €2.68bn of 1.3% 2027 bonds at an average yield of 0.96%
UK		sold £2.00bn of 1.125% 2039 bonds at an average yield of 2.641%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy		Total trade balance €bn	May	**0.0**	-	-3.7	-
UK		Rightmove house price index M/M% (Y/Y%)	Jul	**0.4 (9.3)**	-	0.3 (9.7)	-

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
Euro area		09.00	Current account €bn	May	-	-5.8
		15.00	European Commission's preliminary consumer confidence index	Jul	-24.7	-23.6
Germany		07.00	PPI M/M% (Y/Y%)	Jun	1.0 (33.3)	1.6 (33.6)
UK		07.00	CPI M/M% (Y/Y%)	Jun	*0.8 (9.4)*	0.7 (9.1)
		07.00	Core CPI Y/Y%	Jun	*5.9*	5.9
		07.00	PPI output prices M/M% (Y/Y%)	Jun	1.0 (16.0)	1.6 (15.7)
		07.00	PPI input prices M/M% (Y/Y%)	Jun	1.3 (23.0)	2.1 (22.1)
		09.30	House price index Y/Y%	May	-	12.4

Auctions and events

Country		BST	Event
Germany		10.30	Auction: €1.5bn of 0% 2030 bonds
France		-	BoF retail survey, June

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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