

Euro wrap-up

Overview

- Ahead of this evening's key vote in the Italian parliament that will determine whether early elections can be avoided, Bunds largely made gains as euro area consumer confidence slumped to a record low while German producer price inflation eased very slightly for the first time in 25 months.
- Shorter-dated Gilts made losses as UK headline inflation rose to a new 40-year high although the core rate fell for a second successive month.
- On Thursday the ECB will raise rates for the first time since 2011, and might also agree its new anti-fragmentation policy tool.

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Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.582	-0.021
OBL 1.3 10/27	1.006	+0.003
DBR 1.7 08/32	1.254	-0.015
UKT 1 04/24	2.066	+0.026
UKT 1½ 07/27	1.911	+0.003
UKT 4¼ 06/32	2.134	-0.004

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

Euro area

Euro area consumer confidence slumps to new record low

Ahead of tomorrow's ECB policy announcement, today's flash Commission euro area consumer confidence index signalled a further notable deterioration in sentiment in July as households struggle with high inflation, and fret about possible disruption to energy supply, tighter monetary policy and a deteriorating economic outlook. In particular, the Commission's indicator slumped a larger-than-expected 3.2pts to -27.0, a new record low, some 2½pts below the initial pandemic trough and roughly 26pts below the long-run average. While we will have to wait for the final release (on 28 July) for the full detailed breakdown, surveys from the Netherlands and Belgium today offered some insights. Certainly, Dutch consumers were extremely gloomy, with the headline confidence indicator edging down 1pt to -51, well below the long-run average (-1) and similarly the lowest since the series began in April 1986. Respondents suggested that households have never been so pessimistic about the economic climate. And with bigger concerns about their future financial situation, today's survey also suggested that consumers judged circumstances never to have been less conducive for making major purchases. Meanwhile, confidence in Belgium bucked the more favourable recent trend, falling in July for the first month in four, as expectations regarding the economic outlook over the coming twelve months having deteriorated. Indeed, the headline index fell 2pts to -13, below the long-run average (-7), albeit still well above the post-pandemic trough (-26).

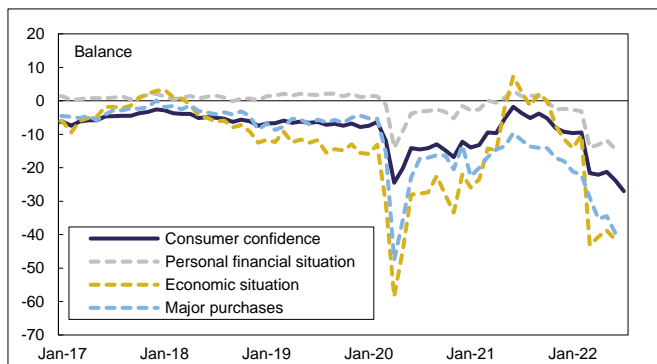
BoF retail survey reports big drop in sales in June to be unchanged in Q2

Consistent with the recent deterioration in confidence, the Bank of France's latest retail sales survey suggested a marked slowdown in spending at the end of the second quarter. In particular, the survey measure of sales fell 2.6%M/M, the biggest drop since August 2021, reflecting a sharp drop in clothing and footwear (-7.6%M/M and -9.0%M/M respectively), games and toys (-7.1%M/M) and new autos (-3.3%M/M), with the latter the lowest level since April 2020. Given the high level at the end of Q1, this left sales broadly flat over the second quarter as a whole, implying no support to GDP growth from spending on goods last quarter. Of course, some of this weakness will probably reflect increased opportunities to spend on services last quarter. Nevertheless, with the share of French consumers assessing it to be an appropriate time to make major purchases having taken a further step down in June, this weaker retail sales trend seems likely to continue this quarter too.

German PPI inflation still extremely elevated despite drop in latest month

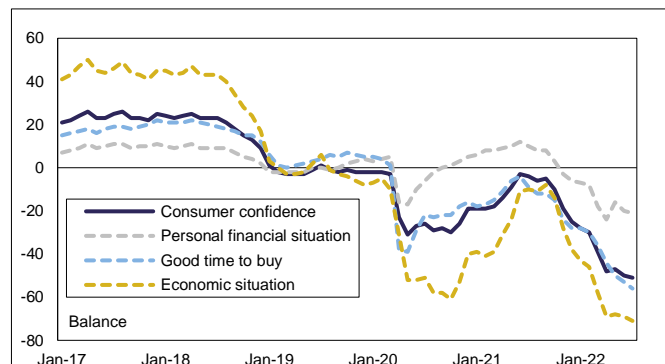
While yesterday's consumer price [inflation](#) figures confirmed that the euro area headline HICP rate rose to a new series high in June, today's German producer price inflation data came in softer than expectations, offering some cautious optimism that pipeline pressures might be peaking for now, notwithstanding risks of additional pressures from natural gas prices ahead. In

Euro area: Consumer confidence indices*



*Headline consumer confidence figure for July 2022 is flash estimate.
Source: Refinitiv, EC and Daiwa Capital Markets Europe Ltd.

Netherlands: Consumer confidence indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

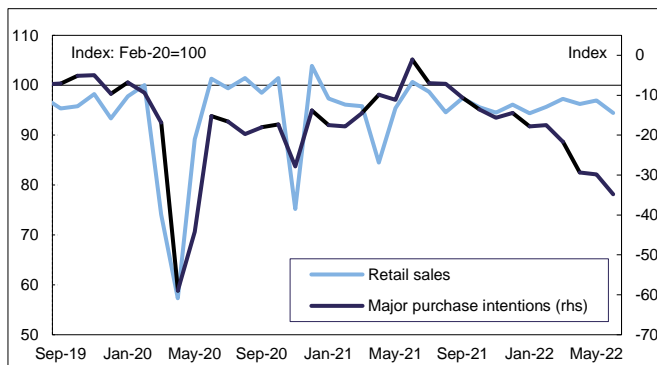
particular, the monthly increase in producer prices slowed to 0.6%M/M in June from 1.6%M/M in May and 2.8%M/M in April. And that saw the annual rate drop for the first time in 25 months, by 0.9ppt, albeit to a still-lofty 32.7%Y/Y. Energy remained the principal source of inflationary pressure, with producer prices up a further 1.6%M/M in June, although this was roughly one-quarter the average increase over the past year, with the annual rate easing 1ppt to 86.1%Y/Y. While electricity prices were up a further 4%M/M (93.3%Y/Y), prices of natural gas slipped back very slightly (-0.2%M/M), albeit leaving them still up more than 140%Y/Y.

While cost pressures and supply disruption continued to push prices of many items higher further along the value chain, today's release similarly suggested that the impact was smaller than in previous months. In particular, prices of intermediate goods fell for the first time in almost two years, by 0.6%M/M, in June, to leave the annual rate easing to a four-month low of 22.3%Y/Y. Nevertheless, capital goods price inflation (up 0.3ppt to 7.4%Y/Y) rose to the highest since September 1975. And producer inflation of consumer goods prices increased 0.1ppt to 14.1%Y/Y. Of course, given the lagged effects of pass-through to consumers of six months or more, pipeline pressures look set to provide a positive impulse to German consumer price inflation over the remainder of the year at least.

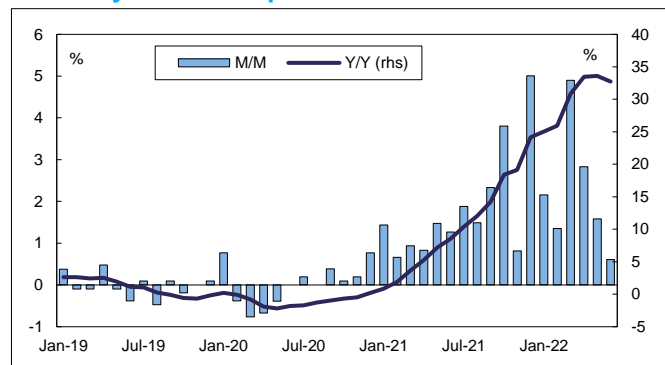
The day ahead in the euro area

The focus tomorrow will undoubtedly be on the ECB's policy announcement, which will bring the first hike in interest rates since the ill-fated tightening in 2011. With the macroeconomic projections presented to the 8-9 June meeting already out of date, as inflation in Q2 of 8.0%Y/Y was 0.5ppt above the ECB's forecast, there is arguably a case for substantive tightening at this meeting. And it was not a surprise that reports yesterday suggested that the Governing Council was set to discuss a hike of 50bps this week. However, with the Governing Council having stated last month that it "intends" to raise all of its rates by 25bps this month – a decision that the account of the meeting reported was backed by most members as proportionate – a decision to hike by more than that would arguably damage the credibility of its guidance in future. So, while we cannot rule out a bigger increase, we still expect the deposit rate will be merely hiked by 25bps to -0.25%, maintaining the incongruity of negative interest rates after headline inflation reached a new series high of 8.6%Y/Y in June. The Governing Council will nevertheless continue to signal that rates will rise by a larger albeit unspecified increment in September (unless the inflation outlook has markedly improved by then, which seems highly unlikely). And we would expect ECB President Lagarde to leave the door open to a hike of 75bps that month. In light of the highly uncertain economic outlook, not least risks of a lasting interruption to the supply of natural gas from Russia, the Governing Council might say little new regarding the expected rate profile in Q4 and beyond, instead likely maintaining its current guidance that it anticipates "a gradual but sustained path of further increases in interest rates".

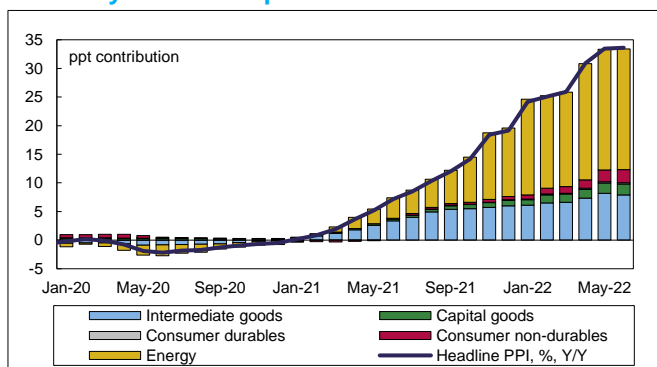
France: Retail sales and consumer confidence



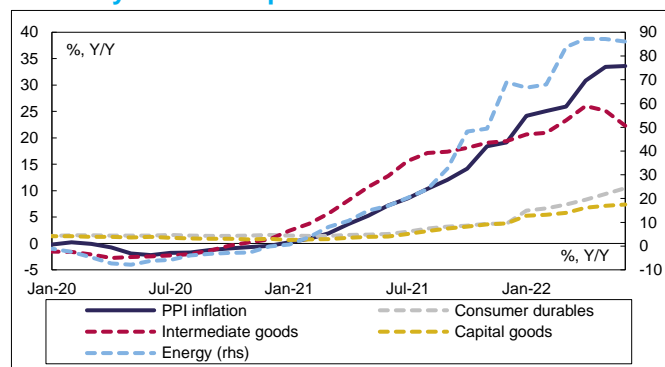
Germany: Producer price inflation



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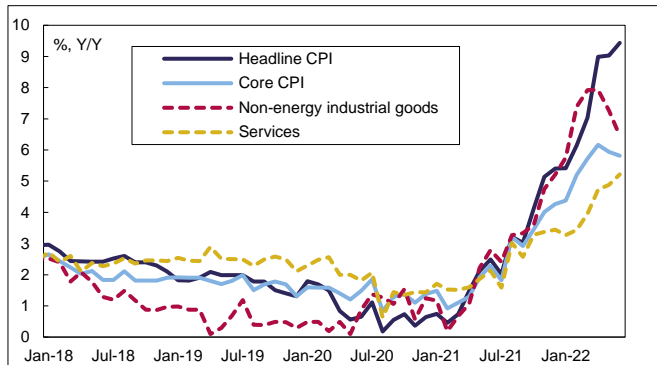
In addition to what the ECB decides on interest rates, the Governing Council might also reach agreement tomorrow on its planned anti-fragmentation policy tool, reportedly to be called the Transmission Protection Mechanism. In light of the past week's significant rise in Italian political uncertainty, if they do agree something in this respect, the Council's hawks will now feel justified in ensuring that the new instrument has visible safeguards against moral hazard. So, while the doves on the Governing Council will wish to create a policy instrument capable of correcting any big divergence in sovereign spreads from fundamentals that might impair its monetary transmission mechanism, the hawks will probably want to ensure that the criteria for triggering its activation are constructively ambiguous. In addition, while bond purchases conducted under the policy might theoretically be unlimited in size, the hawks will want policy conditionality attached to the use of the new mechanism to be relatively meaningful, and at a minimum linked to full consistency with EU policy guidance. Conditionality seems bound, however, to be looser than that attached to the Outright Monetary Transactions (OMT) instrument, which requires an ESM programme also to be in place. Finally, the Governing Council should also agree how the liquidity impact of any asset purchases conducted under the policy tool will be neutralized. In this respect, we expect the ECB to offer a higher interest rate on term deposits, determined at auction, rather than sell bonds of other countries from its portfolio.

UK

CPI inflation up to new high in June on higher prices of petrol, food and services

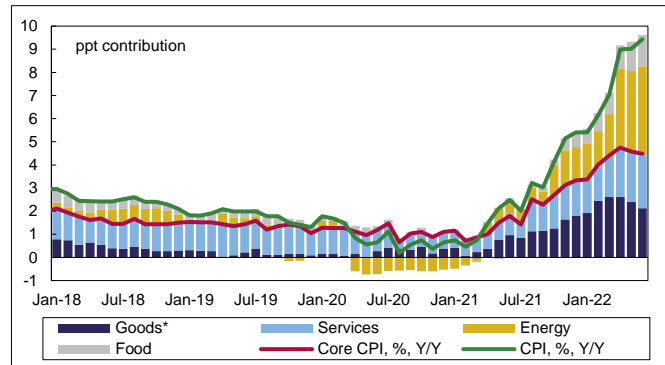
UK consumer price inflation rose further in June, with the headline CPI rate up 0.3ppt to 9.4%Y/Y, in line with our own forecast but 0.1ppt above the consensus on the Bloomberg survey. The rise in prices from a month earlier was again strong, at 0.8%M/M compared to an average of less than 0.1%M/M in June in the five years ahead of the pandemic. Perhaps unsurprisingly, the main cause of the rise was again energy inflation, which rose almost 5ppts from May to a new high of 57.3%Y/Y. Most notably, petrol prices rose more than 10%M/M – the most in any single month on the series – to be up almost 42%Y/Y. Beyond energy prices, food inflation also rose to a new 13-year high, up more than 1ppt to 9.8%Y/Y. There were also additional pressures in services (up 0.3ppt to 5.2%Y/Y), particularly with respect to air and road transport fares, and prices of package holidays, hospitality and recreation. However, inflation of non-energy industrial goods fell 0.8ppt to 6.5%Y/Y as prices of second-hand cars (for a fifth successive month) and audio-visual equipment fell back. So, core inflation moderated for the second successive month, down 0.1ppt to 5.8%Y/Y. On the month, however, the rise of core prices of 0.4%M/M was still well above normal for the month, with the average increase in June in the five years ahead of the pandemic effectively zero. And an alternative measure of underlying inflation – the NIESR 10% trimmed mean – rose 0.4ppt to 6.2%Y/Y, the highest since 1992.

UK: Consumer price inflation - selected components



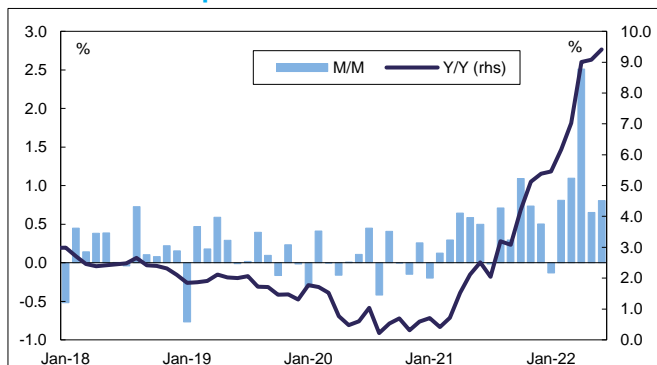
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation - contributions



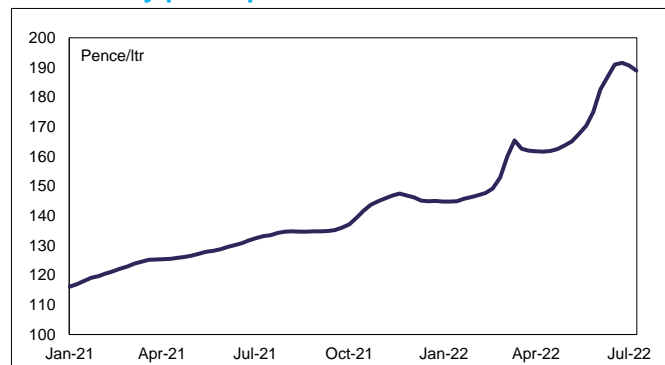
*Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Consumer price inflation



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Weekly petrol prices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Double-digit inflation ahead with PPI up again and energy bills set to leap in October

While core inflation has fallen for two successive months, there remain significant pipeline pressures that we expect to push it higher once again over the near term. Indeed, in the goods sector, output producer prices rose in June by a further 1.4%M/M, in line with the average of the past nine months, to push the annual rate up to a new 35-year high of 16.5%Y/Y. And services PPI inflation rose to 5.4%Y/Y, the highest on the series dating back to 1999. With further pass-through of such costs to consumers likely, we expect core CPI inflation to rise back firmly above 6%Y/Y over coming months. And with household energy bills likely to be hiked again in October by more than 50% and perhaps more than 60%, headline inflation is currently set to peak close to 11% or above, and remain above 10%Y/Y at least until January, before falling back over subsequent months on base effects.

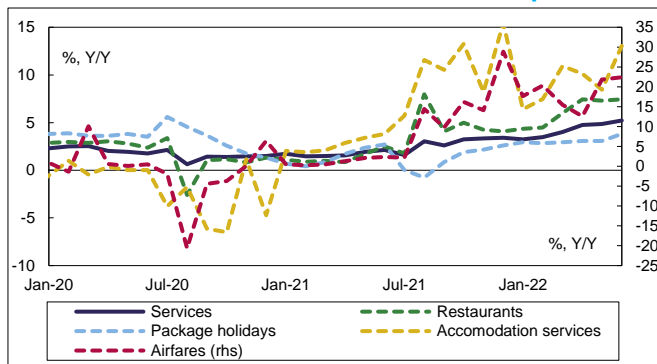
BoE likely to be concerned by ongoing uptrend in services given labour market tightness

Of course, the BoE will set monetary policy based on the risks that inflation will remain above target over the medium term. In this respect, the BoE might be particularly concerned about the ongoing uptrend in the services PPI and CPI rates, which are typically more sensitive to wage growth and might flag increased risks of inflation persistence due to conditions in the labour market. A sub-sectoral analysis suggests that recent increases in these rates are likely to have been driven principally by increased energy costs and not by pay pressures. At the same time, however, shifts in firms' price-setting behavior, related in part to diminished competition due to Brexit, might have contributed to a more rapid pass-through of such costs to consumer prices than in the past. And after yesterday's jobs data highlighted again that the labour market remains very tight, it was no surprise that Governor Bailey in the evening confirmed that a 50bps hike in Bank Rate will be discussed by the MPC in August, that further hikes are likely after that, and a programme of active BoE Gilt sales is likely to be underway from the autumn too.

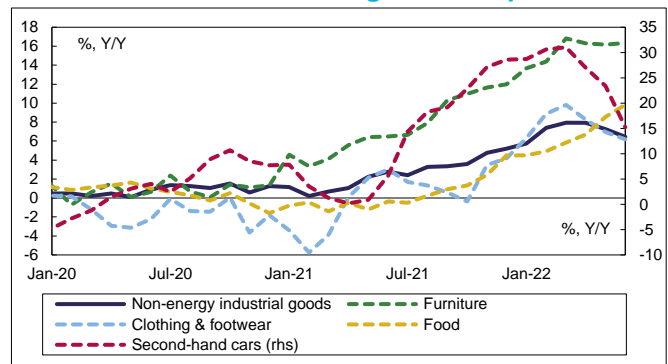
Truss bookies' favourite to be next Prime Minister as she makes run-off against Sunak

In this afternoon's final round of voting among Conservative MPs, lawmakers chose former Chancellor Rishi Sunak and Foreign Secretary Liz Truss as the two candidates from which party members will, over the course of the summer, elect the successor to Boris Johnson as their leader and national Prime Minister. The result of the vote among party members will be announced on 5 September. In the vote among MPs, Sunak came out on top, with 137 votes against 113 for Truss, and 105 for the defeated Penny Mordaunt. In light of recent opinion polls among Conservative MPs, Truss is now clear favourite among bookmakers to be Prime Minister, with an implied probability of 65%. However, opinion polls also suggest that whoever wins will be unpopular with the wider general public, and the Conservative party will subsequently be defeated decisively at the next general election due before January 2025.

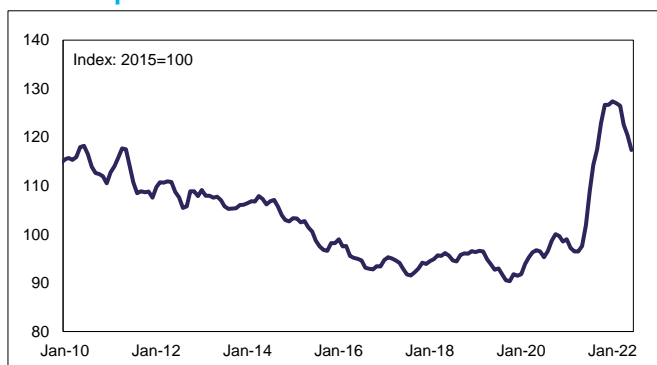
UK: CPI inflation – selected services components



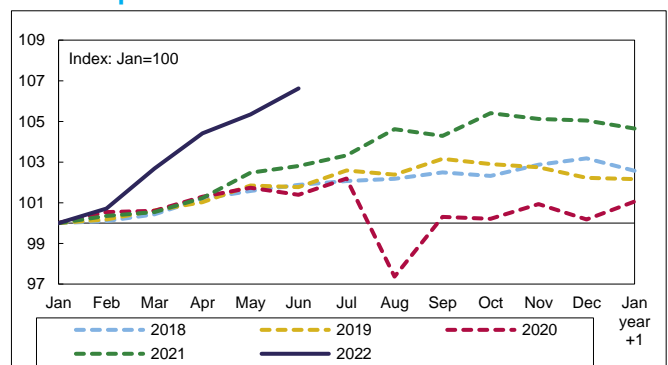
UK: CPI inflation – selected goods components



UK: CPI price index – second-hand cars



UK: CPI price index – hotels and restaurants



Sunak would represent economic policy continuity if not continuity in the style of government

There are inevitably many similarities in the policies advocated by Truss and Sunak. And if they become PM, neither will call a snap general election (perhaps understandably given the state of the opinion polls) and neither will have the discredited Johnson in their cabinet. However, there are notable differences on economic policy, for which Sunak was the architect for Johnson. So, if he was to become PM, we should expect broad continuity from Sunak in that respect. That likely implies some extra support for households to cope with high inflation, not least October's further big hike in household energy bills. And some further reductions in corporate taxation, e.g. by extending the investment super-deduction, would come ahead of the planned cut in income tax rates in April 2024. But notwithstanding the need to spend more on debt interest payments in light of the impact of high inflation on index-linked Gilts, government borrowing might seem unlikely to diverge very significantly from the path previously set out.

Truss seeks (unfunded) tax cuts and confrontation with the BoE and Brussels

In contrast, despite being Johnson's preferred candidate and representing continuity with Johnson's confrontational and destabilizing populist style of government, Truss has actively sought to distance herself from recent fiscal policy, which – including this year's increase in National Insurance Contributions (NICs) – has pushed taxes as a share of GDP to the highest in seven decades. Instead, imagining herself as an heir to Margaret Thatcher (albeit having a rather selective view of what Thatcher actually did policy-wise in her various terms as Prime Minister), Truss claims to have opposed the increase in NICs in Cabinet, and pledges to reverse it. She also wants to reverse the planned increase in the main rate of corporation tax from 19% to 25% scheduled for next year. Yet, with no serious plans for meaningful reforms to control public expenditure, her tax cuts would likely be funded largely by new borrowing and a refinancing of existing government debt on longer maturities. And they would likely be inflationary, requiring higher interest rates from the BoE than would otherwise be the case. Indeed, Truss has also attacked the BoE, calling (in a rather confused manner) for its mandate to be reformed, seemingly with an even stronger focus on inflation (which might seem difficult to articulate in a practical way) and an explicit role for monetary targets (which has long been discredited). As architect of the antagonistic Northern Ireland Protocol Bill, Truss might also be more likely to risk a trade war with the EU rather than seeking to reduce barriers to trade with the UK's biggest trading partner. So, Truss raises the biggest doubts over the credibility of economic policy going forward. But, by and large, neither of the two candidates have substantive policy proposals that address the UK's main economic weaknesses in the wake of Brexit. Both have question-marks regarding judgement and integrity.

The day ahead in the UK

Tomorrow's economic data calendar brings UK public finances data for June. Excluding the banking sector, net public borrowing is expected to come in at £24bn in June, down marginally from £25bn in the same month of last year, but still significantly higher than the pre-pandemic level of £8.8bn in June 2019. Most notably, while public spending on Covid-related activities will have fallen further, public spending on government debt interest will have increased substantively again due to the impact on high inflation on payments related to indexed-linked Gilts.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	Current account €bn	May	-4.5	-	-5.8	-3.9
	European Commission's preliminary consumer confidence	Jul	-27.0	-24.7	-23.6	-23.8
Germany	PPI M/M% (Y/Y%)	Jun	0.6 (32.7)	<u>1.0 (33.3)</u>	1.6 (33.6)	-
UK	CPI M/M% (Y/Y%)	Jun	0.8 (9.4)	<u>0.8 (9.4)</u>	0.7 (9.1)	-
	Core CPI Y/Y%	Jun	5.8	<u>5.9</u>	5.9	-
	PPI output prices M/M% (Y/Y%)	Jun	1.4 (16.5)	1.0 (16.0)	1.6 (15.7)	1.6 (15.8)
	PPI input prices M/M% (Y/Y%)	Jun	1.8 (24.0)	1.2 (23.0)	2.1 (22.1)	2.4 (22.4)
	House price index Y/Y%	May	12.8	12.0	12.4	11.9

Auctions

Country	Auction
Germany	sold €1.28bn of 0% 2030 bonds at an average yield of 1.05%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	13.15	ECB refinancing rate %	Jul	<u>0.25</u>	0.00
	13.15	ECB deposit rate %	Jul	<u>-0.25</u>	-0.50
France	07.45	INSEE business confidence	Jul	103	104
	07.45	INSEE manufacturing confidence (production outlook)	Jul	106 (-7)	108 (-5)
UK	07.00	Public sector net borrowing excluding banks £bn	Jun	24.0	14.0

Auctions and events

Euro area	13.45	ECB President Lagarde's post-meeting press conference
	15.15	ECB President Lagarde presents latest monetary policy decision on ECB podcast
France	09.50	Auction: 0.00% 2025 bonds
	09.50	Auction: 0.75% 2028 bonds
	10.50	Auction: 0.10% 2028 index-linked bonds
	10.50	Auction: 0.10% 2031 index-linked bonds
	10.50	Auction: 0.10% 2053 index-linked bonds
Spain	09.30	Auction: 0.00% 2025 bonds
	09.30	Auction: 0.00% 2027 bonds
	09.30	Auction: 2.55% 2032 bonds
UK	10.00	Auction: £3.5bn of 0.25% 2025 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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