Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made losses at the short end but gains further along the curve as the ECB raised rates by 50bps but also agreed a new policy tool to allow it to buy bonds to counter unwarranted spread-widening.
- BTPs made significant losses as Mario Draghi resigned as Italian Prime Minister and elections were scheduled for September.
- Gilts followed USTs higher despite a rise in UK public debt interest payments to a record high.
- Friday will bring the flash PMIs and UK retail sales data.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.616	+0.039
OBL 1.3 10/27	1.011	+0.008
DBR 1.7 08/32	1.213	-0.037
UKT 1 04/24	2.001	-0.062
UKT 1¼ 07/27	1.848	-0.070
UKT 4¼ 06/32	2.047	-0.095

*Change from close as at 5.00pm BST.
Source: Bloomberg

Euro area

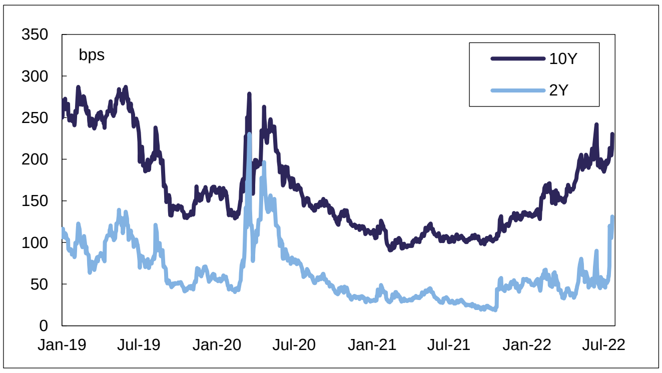
ECB brings an end to era of negative rates and forward guidance with surprise 50bps hike

While last month it had stated unambiguously that it intended to tighten monetary policy by 25bps today, the ECB ignored that forward guidance. Instead, it raised its main interest rates by 50bps. Most notably, therefore, its deposit rate rose to zero percent, bringing to an end the eight-year era of negative rates. And while it reaffirmed that further normalisation will be appropriate at upcoming policy meetings, it gave no indication at what pace its interest rates are likely to be hiked from now on. So, today's announcements also effectively brought an end to the era of ECB forward guidance. Instead, from now on, the Governing Council will simply take its decisions on a "meeting-by-meeting" basis, depending on the economic data at the time. In her press conference, however, Christine Lagarde stated that while the ECB was making a bigger first step towards normalisation, the likely end point for rates – a broadly neutral monetary stance – hadn't changed. Of course, where that neutral rate lies is highly uncertain. For the time being, therefore, we will continue to expect a hike of 50bps in September, and a terminal rate of 1.75%. But the range of possibilities for the pace of tightening over coming quarters and the ultimate destination is wide.

New policy tool agreed to allow bond purchases to counter unwarranted dynamics

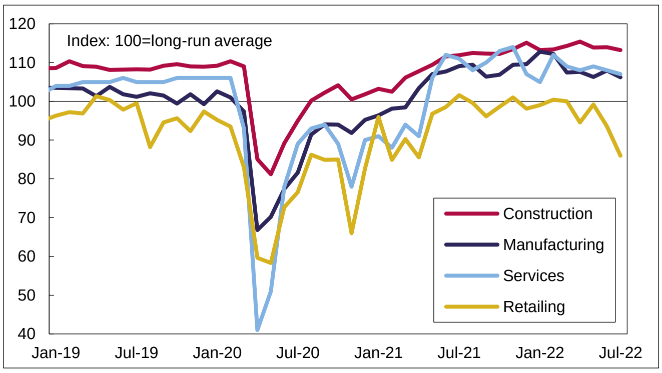
In its statement, the ECB said that it had raised rates by more than previously signalled as it judged that inflation risks had worsened since the June meeting. But it also did so because the Governing Council additionally agreed its new Transmission Protection Instrument (TPI) that will give it the ability to address any widening in spreads that risks impairing the effectiveness of its monetary policy. So, the higher rate increase appeared to be part of a compromise deal that persuaded the hawks to agree to the new targeted asset-purchase policy tool. In particular, the ECB stated that it could start buying bonds under the new TPI if and when it needs to "counter unwarranted, disorderly market dynamics". Any purchases would be focused on public sector securities – including bonds of regional governments and agencies, as well as central governments – with a remaining maturity of between one and ten years. But private sector bonds could also be considered, if appropriate. The impact of the purchases on the ECB balance sheet would be neutralised over an unspecified time horizon, with no details provided regarding how this might be achieved. And the overall scale of TPI purchases would depend on the severity of the risks, but was not restricted ex ante. Nevertheless, the ECB also made clear that use of the tool would be a last resort, with the flexible reinvestment of proceeds from maturing PEPP bonds (perhaps some €100bn over the coming year) would represent the "first line of defence".

Italy: BTP spread to Bunds



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

France: INSEE business sentiment indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

TPI eligibility criteria leave scope for Governing Council discretion and possible veto for the hawks

Most notably perhaps, the ECB set out its criteria for determining eligibility for use of the TPI. It identified several preconditions that were expected, including compliance with the EU fiscal framework and Commission's fiscal policy recommendations, adherence to commitments made with respect to national reform plans submitted to access the EU Recovery and Resilience Funds, and positive assessments of fiscal sustainability and the absence of macroeconomic imbalances. However, Lagarde stated that some criteria would not be published, in order to leave a degree of constructive ambiguity to address moral hazard risks. Moreover, and most importantly perhaps, she also insisted that the Governing Council would have significant discretion whether or not to activate the TPI for any country, suggesting scope for hawks to veto any purchases if they can be sufficient in number. So, the hurdle for activating the TPI might be relatively high. Certainly, with market dynamics needing to be "unwarranted" to justify purchases, the ECB might consider it inappropriate to step in to buy BTPs if further spread-widening is considered to be merely a wholly warranted response to the current Italian political dysfunction and uncertainty, which today saw Mario Draghi confirm his resignation as Prime Minister and President Mattarella dissolve parliament to make way for a general election on 25 September.

French survey flags retail sector weakness, but other business sectors still relatively sanguine

More prosaically, ahead of tomorrow's flash July PMIs, today's French INSEE business survey offered some insights into conditions at the start of Q3. Aligning with expectations, the headline sentiment indicator fell 1pt to 103 in July, still above the long-run average (100) but nevertheless the lowest since April 2021. While the deterioration in sentiment was widespread, it was most striking in retail, for which the business climate indicator fell a further 8pts in July to 86, well below the long-run average, reflecting a more downbeat assessment of recent sales. And while they were a touch less downbeat than before about the sales outlook, retailers planned to increase further their selling prices which could well dampen spending. Despite still favourable conditions in hospitality, the overall services business sentiment index slipped back slightly in July, by 1pt to 107, a six-month low reflecting softer recent activity. Firms in that sector were also less optimistic about the near-term outlook, citing ongoing recruitment challenges and intentions to increase selling prices further. Manufacturers also considered recent production to have been weaker than in previous months, with persisting staff shortages continuing to limit capacity, while orders had deteriorated slightly too. So, the manufacturing sentiment index fell 2pts on the month to 106, a level that was last lower in April 2021 but nevertheless still comfortably above the long-run average. Looking ahead to tomorrow's flash PMIs for July, with the retail sector not captured by the survey, we might well see only a modest weakening in the headline French composite index, albeit from the fourteen-month low (52.5) recorded in June.

The day ahead in the euro area

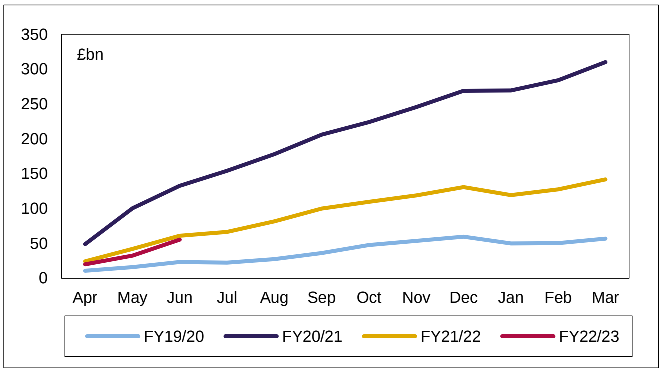
Data-wise, the focus in the euro area tomorrow will be the aforementioned flash July PMIs, which will be watched for a further weakening of economic growth at the start of the third quarter. Indeed, the euro area composite PMI is expected to fall to a seventeen-month low of 51.0 in July. The services activity PMI is expected to drop 1pt to 52.0, which would be the lowest since January. And having fallen to a two-year low of 49.3 in June, the manufacturing output PMI seems likely to remain below 50 suggesting contraction in the sector. The preliminary PMIs from the two largest euro area economies are likely to suggest an absence of economic growth in Germany and modest expansion in France. In addition to the flash PMIs, the results of the ECB's survey of forecasters might give a further clue as to why the Governing Council elected for a hike of 50bps today if it reports an upwards revision to medium-term inflation expectations.

UK

Government debt interest payments hit record in June due to high inflation

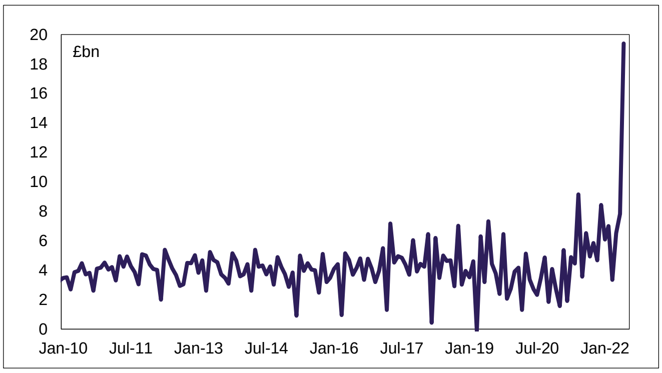
UK net public borrowing (excluding public sector banks) came in a touch below most expectations in June, at £22.9bn, £1.1bn below the median forecast on the Bloomberg survey albeit still £0.6bn above the OBR's forecast published in March. The figure was the second highest for any June, up £4.1bn from a year earlier and £15.6bn above the level in that month of

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.

2019 ahead of the pandemic. Compared with a year earlier, central government receipts were up £7.9bn, in part due to the government's hike in National Insurance Contributions at the start of April. But strikingly, central government current expenditure was up £9.0bn from a year earlier, with lower pandemic-related spending more than offset by an extra £10.3bn of debt interest payments, which reached £19.4bn in total, the highest on the series dating back to 1997. An eye-watering £16.7bn of that cost related directly to accrued interest on inflation-linked Gilts, which account for about 25% of the government's outstanding debt stock. Payments are linked to the RPI inflation measure, which rose in June to 11.8%Y/Y, almost 2½ppts above the CPI measure, and which is set to rise further in the autumn not least as household energy bills rise sharply again. So, the government's debt interest bill in the current fiscal year seems highly likely to significantly exceed the OBR's forecast of £87.2bn.

Risks to public borrowing outlook are skewed highly to the upside

More happily, the estimate of the deficit in May was revised down somewhat. However, cumulative net public borrowing in the first three months of the fiscal year reached £55.4bn, some £3.7bn above the OBR's forecast albeit still £7.5bn below the amount in the same period last fiscal year. Notably, the government's £15bn package of support for households announced in May, which will likely only in part be funded by a windfall tax on energy firms, has yet to show up meaningfully in the data. So, added to the ugly outlook for debt interest payments, full-year borrowing in FY22 seems bound to exceed the OBR's projection of £99.1bn. Nevertheless, if – as the bookies' odds suggest – she wins the Conservative party leadership and becomes Boris Johnson's replacement as Prime Minister, Liz Truss has committed both to reverse April's hike in National Insurance Contributions (estimated to raise some £16bn this year), remove current green levies from energy bills, and cancel next April's planned hike in the main rate of corporation tax, with no commensurate plans to offset the impact of borrowing through cuts in public expenditure. So, risks to the outlook for public borrowing in FY23 (which the OBR forecast at 'just' £50.2bn) appear very highly skewed to the upside.

The day ahead in the UK

Looking ahead, it will be a busy end to the week for top-tier UK economic reports, bringing June's retail sales data, as well as July's consumer consumer confidence and flash PMI surveys. Against a backdrop of negative real wage growth, surveys suggest that spending on discretionary items remained weak in June. And while food sales were given a boost by the extended bank holiday weekend at the start of the month, the public transport strikes towards the end of the month caused a marked drop in retail footfall. So, we expect total retail sales to have declined further in June. Excluding auto fuel, sales are expected to drop 0.4%M/M, after falling 0.7%M/M in May, to be down 1.0%Q/Q in Q2. Certainly, tomorrow's GfK consumer survey is likely to suggest that household confidence remains close to record lows in July with little appetite for major purchases. And the flash PMIs are expected to point to a deterioration in business conditions at the start of Q3. The composite output PMI is forecast to fall by more than 1pt in July, from 53.7 in June, with weakening in both services and manufacturing contributing to the slowdown.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	ECB refinancing rate %	Jul	**0.50**	*0.25*	0.00	-
	ECB deposit rate %	Jul	**0.00**	*-0.25*	-0.50	-
France	INSEE business confidence	Jul	**103**	103	104	-
	INSEE manufacturing confidence (production outlook)	Jul	**106 (-5)**	106 (-7)	108 (-5)	-
UK	Public sector net borrowing excluding banks £bn	Jun	**22.9**	24.0	14.0	**12.6**

Auctions

Country	Auction
France	sold €3.51bn of 0.75% 2028 bonds at an average yield of 1.47%
	sold €3.29bn of 0.00% 2025 bonds at an average yield of 1.00%
	sold €3.70bn of 0.75% 2028 bonds at an average yield of 1.44%
	sold €415mn of 0.10% 2028 index-linked bonds at an average yield of -0.96%
	sold €768mn of 0.10% 2031 index-linked bonds at an average yield of -0.52%
	sold €310mn of 0.10% 2053 index-linked bonds at an average yield of 0.07%
Spain	sold €1.13bn of 0.00% 2025 bonds at an average yield of 1.44%
	sold €1.54bn of 0.00% 2027 bonds at an average yield of 1.79%
	sold €2.40bn of 2.55% 2032 bonds at an average yield of 2.57%
UK	sold £3.5bn of 0.25% 2025 bonds at an average yield of 2.25%

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	51.0 (52.0)	52.1 (53.0)
		09.00	Preliminary composite PMI	Jul	51.0	52.0
Germany		08.30	Preliminary manufacturing (services) PMI	Jul	50.7 (51.4)	52.0 (52.4)
		08.30	Preliminary composite PMI	Jul	50.2	51.3
France		08.15	Preliminary manufacturing (services) PMI	Jul	51.0 (52.7)	51.4 (53.9)
		08.15	Preliminary composite PMI	Jul	51.1	52.5
UK		00.01	GfK consumer confidence	Jul	-42	-41
		07.00	Retail sales including auto fuel M/M% (Y/Y%)	Jun	-0.2 (-5.3)	-0.5 (-4.7)
		07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	Jun	-0.4 (-6.2)	-0.7 (-5.7)
		09.30	Preliminary manufacturing (services) PMI	Jul	52.0 (53.0)	52.8 (54.3)
		09.30	Preliminary composite PMI	Jul	52.4	53.7
Auctions and events						
Euro area		09.00	ECB survey of professional forecasters			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs