Euro wrap-up

Overview

Emily Nicol
+44 20 7597 8331

- While the BoE raised Bank Rate by 50bps and increased substantially its near-term inflation forecasts, Gilts made gains as the MPC forecast a recession ahead.
- Bunds also made gains as German factory orders maintained a downwards trend and the construction PMIs signalled a steeper pace of decline.
- Tomorrow brings June industrial production data from the euro area's larger member states, as well as a UK jobs market survey.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.307	-0.053
OBL 1.3 10/27	0.532	-0.074
DBR 1.7 08/32	0.802	-0.066
UKT 1 04/24	1.847	-0.007
UKT 1¼ 07/27	1.715	-0.012
UKT 4¼ 06/32	1.882	-0.031

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

UK

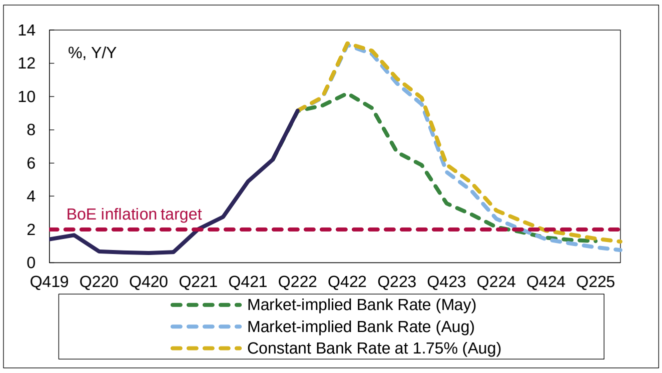
BoE steps up the pace of tightening, hiking Bank Rate by 50bps to 1.75%

As expected, the BoE raised Bank Rate for the sixth successive meeting and having hinted in June that it would 'act forcefully' amid signs of more persisting inflationary pressures, it delivered a bigger hike of 50bps to 1.75%. Eight members voted in favour, with just external member Silvana Tenreyro (typically more dovish) preferring a smaller hike of 25bps. Today's decision clearly reflects a significant worsening of the near-term inflation outlook, not least due to the substantial jump in wholesale gas prices and the associated subsequent impact on UK household energy bills. And while the BoE sees a considerable deterioration to the UK's growth outlook, forecasting that the economy will enter recession from Q4, the MPC maintained its previous guidance that it would be particularly alert to indications of more persistent inflationary pressures, and will if necessary *act forcefully* in response. Although, not least given the highly uncertain outlook, Governor Bailey emphasised that policy was not on a pre-set path. And in his press conference he noted that all options would be on the table at the September meeting. Assuming economic and financial market conditions are deemed appropriate, the BoE will also begin active selling shortly after the September MPC meeting (subject to a final vote next month). Together with ongoing redemptions, the BoE will reduce its stock of gilts by around £80bn over the subsequent twelve-month period – given the profile of maturing gilts, this would imply selling of around £10bn a quarter – with the pace of future sales to be considered annually. The Bank will also commence the sale of corporate bonds in the week of 19 September.

Inflation revised notably higher on energy, but domestically generated pressures also growing

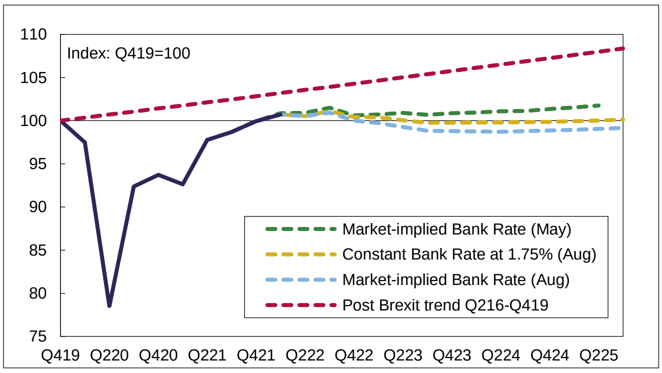
The decision to raise rates by a larger magnitude today was explained by the sizeable upwards revision to the near-term profile of inflation. The Bank now forecasts inflation to rise to around 10%Y/Y in Q3 and 13%Y/Y in Q4, with the latter some 3ppts higher than the May projection and energy accounting for roughly half. Indeed, Bank staff now assume that the regulated household energy price cap will rise a whopping 75% in October (official announcement due at the end of this month), compared with the 40% rise previously anticipated. This is based on wholesale energy market developments since the previous Monetary Policy Report in May – gas future prices for end-2022 having nearly doubled – and to a lesser extent Ofgem's announced changes to its methodology in calculating its price caps that will put more weight on the recent sharp price increases. While the vast majority of the rise in inflation in H222 relates to energy, the BoE thinks that nominal wage growth will be higher than previously anticipated through the first half of the forecast period as some firms consider further increases in pay settlements to compensate for high inflation. So, domestically-generated price pressures are also expected to grow. The Bank noted that firms expect their selling prices to rise markedly to protect their margins, with reports that past price increases, so far at least, have had a limited impact on demand. So, while base effects should allow inflation to fall back from Q1 on, the Bank's forecast for inflation at end-2023 of 5.5%Y/Y, was some 2ppts higher than in May.

UK: BoE inflation forecast*



*Market-implied Bank Rate to rise to 3.0% by Q323 and fall to 2.2% by Q325.
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE GDP forecast*



*Market-implied Bank Rate to rise to 3.0% by Q323 and fall to 2.2% by Q325.
Source: BoE and Daiwa Capital Markets Europe Ltd.

Growth outlook revised notably lower, with the economy to enter a recession from Q4

With exceptionally high inflation to persist for longer, the BoE now expects real household disposable income to decline a sharp 2¼%Y/Y next year – compared with growth of 1%Y/Y previously thought – following a fall of 1½%Y/Y this year, and then only modest growth in 2024 (¾%Y/Y). As a result, while households are expected to run down the stock of savings accumulated during the pandemic – the savings rate is likely to drop around 5ppts from peak to trough – consumer spending is expected to slow sharply, with the Bank now forecasting a decline of ¾%Y/Y next year, compared with growth of 1%Y/Y previously expected. Business investment was also revised notably lower, with hefty declines now forecast in 2023 and 2024, with significant falls in housing investment expected too. So, the Bank was markedly more downbeat about GDP growth, forecasting a (prolonged) recession for the first time (when not already in one). Indeed, the forecast contraction between Q422 and Q423 would mark the longest since the global financial crisis and amount to a cumulative decline of more than 2%. And with only minimal growth anticipated in H224, full-year GDP in 2024 was also expected to decline ¼%Y/Y. As such, in due course, the unemployment rate is forecast to rise steadily to just below 6½% by the end of the projection period. And a negative output gap is expected to emerge and rise to more than 3%, pushing down on underlying inflation.

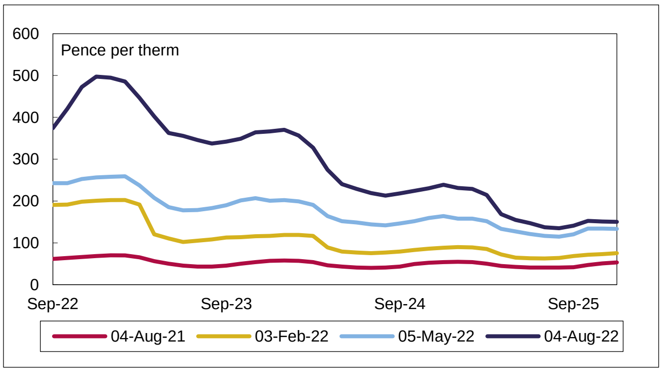
Outlook remains highly uncertain, but further policy tightening likely required

As a result, the BoE's baseline forecast projects CPI inflation in Q325 at just 0.8%Y/Y, and its forecast based on a market-implied path for energy prices at 0.3%Y/Y that quarter. As such, we continue to believe that market pricing of future hikes in Bank Rate is overdone. Of course, there is huge uncertainty surrounding the inflation outlook, not least reflecting ongoing geopolitical tensions. And the domestic political backdrop and likelihood of extra fiscal support when a new Prime Minister is appointed in September could pose an additional inflationary impulse. So, we continue to expect further policy tightening ahead. Given that the MPC left unchanged its forward guidance that it may have to 'act forcefully', markets are currently pricing in an 80% probability of another 50bps hike next month. Of course, this may well prove challenging as the economy heads towards recession. On balance, we currently maintain our forecast that Bank Rate will end the year at 2.50%.

UK construction PMI signals contraction, new car sales the weakest in any July since 1999

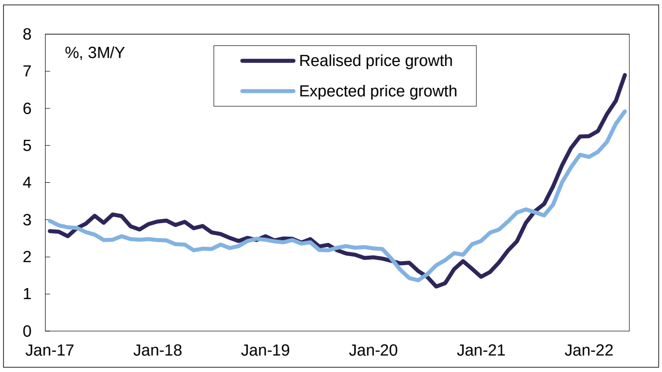
While of secondary importance, today's construction PMI survey fell well short of expectations, as headwinds to client demand intensified from rising inflation, record low consumer confidence and higher interest rates. In particular, the headline activity index declined for the fourth consecutive month and by 3.7pts to 48.9, the first contractionary reading since January, the weakest since May 2020 and almost 7pts lower than the Q2 average. This largely reflected a collapse in civil engineering

UK: Natural gas price futures*



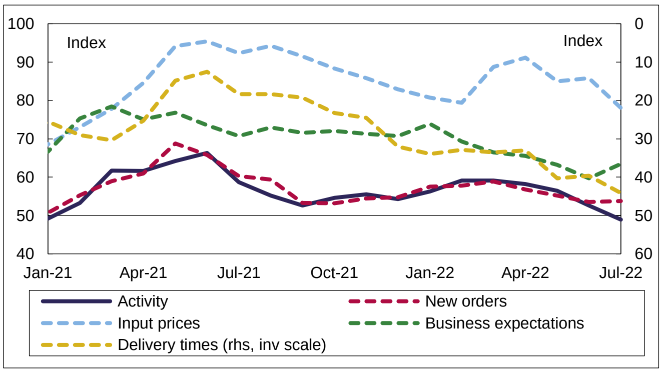
*BoE MPR publication dates. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: BoE Agents' reported price growth



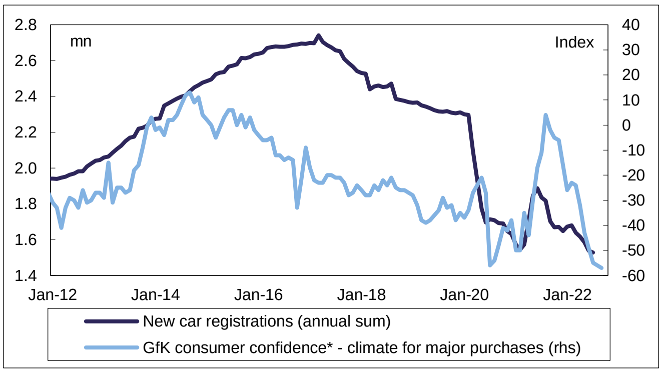
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Construction PMIs



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

UK: Consumer confidence & new car registrations



*Three-month lead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

(down 14.3pts to 40.1), with commercial activity fading but still reportedly expanding (52.3). Although the new business component edged slightly higher and remained in expansionary territory (53.8), it was well down on the average seen through the first half of the year. Meanwhile, the latest new car registrations figures were also disappointing, with just 112k units sold in July, the weakest outturn for the month of July since 1999 and still 9% lower than a year ago. While this in part reflects ongoing supply disruption in the autos sector, the steady decline in consumer confidence seems bound to have played its role too.

The day ahead in the UK

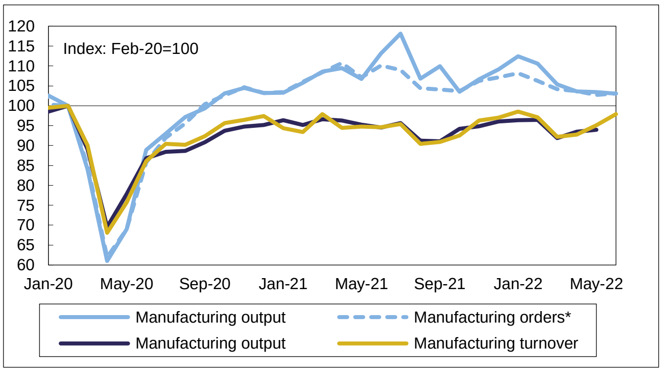
After an eventful day today, tomorrow brings the REC/KPMG Report on Jobs for July. In particular, it will be watched for any further slowdown in demand, albeit with a lack of supply it will continue to point to a tight labour market. Meanwhile, BoE Chief Economist Pill is due to speak tomorrow on the Bank's latest monetary policy decision and economic forecasts.

Euro area

German new factory orders maintain downwards trend, but turnover more encouraging

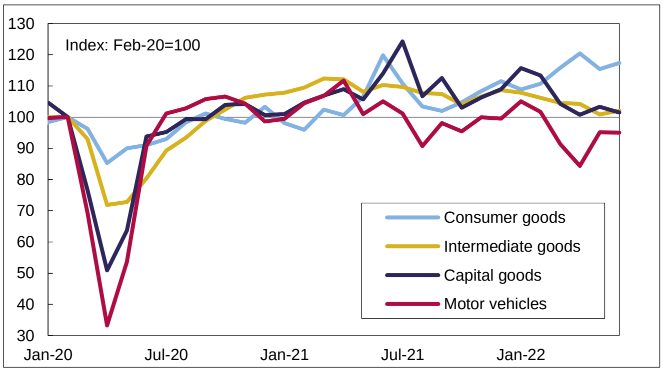
While today's German factory orders release came in a touch firmer than expected in June, the downtrend seen since the start of the year was maintained, with orders down for the fifth successive month, by 0.4%M/M, to leave them more than 5½% lower over the second quarter as a whole and down 9% compared with a year earlier. Admittedly, Destatis suggested that major one-off orders were to blame for the drop in June – indeed, core orders rose 0.4%M/M, but were nevertheless still down by almost 3%Q/Q in Q2, further highlighting a marked weakening in underlying demand for German goods last quarter. The weakness in new goods orders demand in June principally reflected a fall in orders from non-euro area countries (-4.3%M/M), with increasing orders from elsewhere in the euro area (+3.4%M/M) and domestically (+1.1%M/M) largely offsetting declines earlier in the quarter. By type of good, increases in intermediate (1.2%M/M) and consumer goods (1.7%M/M) only partly reversed the weakness in May and were offset by a decrease in new orders for capital goods (-1.8%M/M). More encouragingly, looking ahead to tomorrow's production data, manufacturing turnover rose for a third month in June, up 3.0%M/M following growth of 2.5%M/M in May, with sizeable increases in turnover of capital goods (+5.2%M/M) and energy (11.0%M/M). So, while this left turnover still some 2% lower than the pre-pandemic level in February 2020 and down 0.7%Q/Q in Q2, today's release also suggests non-negligible upside risks to the consensus forecast (currently -0.4%M/M) for industrial production growth in June.

Germany: Manufacturing output, turnover & orders



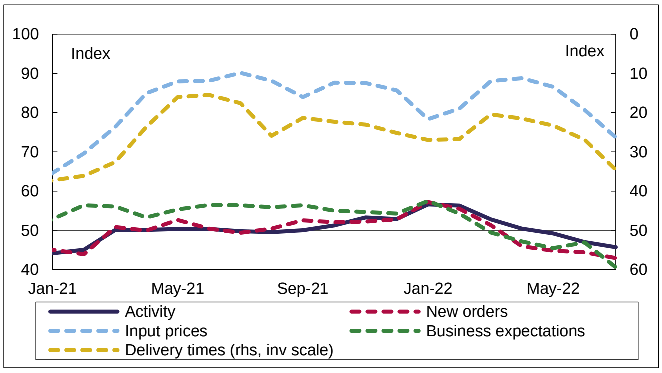
Excluding major orders. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders



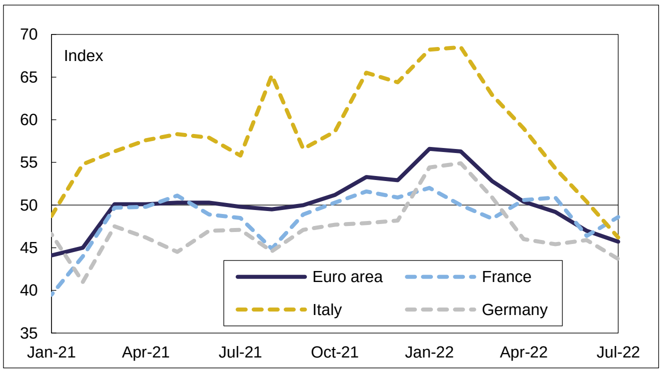
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



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

Euro area: Construction PMIs



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

Daiwa Capital Markets

Euro area construction PMIs point to a faster pace of contraction at start of Q3

The euro area construction PMIs implied a further contraction in activity in the sector in July, with the headline activity index down for the sixth consecutive month and by 1.3pts to 45.7, the lowest level since February 2021. And the survey detail suggested further weakening ahead, with the new orders index declining to just 43.0, the lowest for more than two years, implying a substantial decline as demand for new projects was impacted by higher costs and an increasingly challenging economic outlook. Indeed, although the survey suggested that supply-chain disruption and input price pressures had eased, they remained elevated by historical standards and seem likely to maintain a limiting impact on activity for some time to come. And so firms expressed greater pessimism about future activity, with the relevant survey index slumping 6.4pts to 40.6, the lowest since April 2020. Consistent with the euro area aggregate index, there was a deterioration in the German activity PMI, down 2.2pts on the month to 43.7, the lowest of the member states, with business expectations down to one of the lowest readings on record (27.4). The collapse in the Italian construction PMI seen since Q1 was maintained in July, down a further 4.2pts to 46.2, the lowest since April 2020 and consistent with a marked drop in output. And while the French PMI rose in July, at 48.6 it too signalled ongoing contraction in the sector.

The day ahead in the euro area

The data focus in the euro area tomorrow will be on the manufacturing sector, with June industrial production releases from the large four member states. The aforementioned German industrial production data are likely to come in ahead of the Bloomberg consensus survey, for a decline of 0.3%M/M in June., albeit still likely showing that supply constraints continue to hamper the manufacturing recovery. In France, output is predicted to report a fall of 0.3%M/M (-2.6%Q/Q), while Italy and Spain are expected to both expected to see a modest decline of 0.1%M/M (+7.1%Q/Q and +5.9%Q/Q respectively).

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Construction PMI	Jul	**45.7**	-	47.0	-
Germany	Factory orders M/M% (Y/Y%)	Jun	**-0.4 (-9.0)**	-0.9 (-9.2)	0.1 (-3.1)	**-0.2 (-3.2)**
	Construction PMI	Jul	**43.7**	-	45.9	-
France	Construction PMI	Jul	**48.6**	-	46.4	-
Italy	Construction PMI	Jul	**46.2**	-	50.4	-
UK	Construction PMI	Jul	**48.9**	52.4	52.6	-
	New car registrations Y/Y%	Jul	**-9.0**	-	-24.3	-
	BoE Bank Rate %	Aug	**1.75**	*1.75*	1.25	-

Auctions

Country	Auction
France	sold €4.13bn of 2.00% 2032 bonds at an average yield of 1.43%
	sold €1.87bn of 1.25% 2034 bonds at an average yield of 1.57%
Spain	sold €1.03bn of 1.30% 2026 bonds at an average yield of 1.06%
	sold €1.76bn of 0.80% 2029 bonds at an average yield of 1.55%
	sold €1.79bn of 2.55% 2032 bonds at an average yield of 1.99%
	sold €582mn of 0.70% 2033 inflation-linked bonds at an average yield of -0.11%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Germany		07.00	Industrial production M/M% (Y/Y%)	Jun	-0.4 (-1.2)	0.2 (-1.5)
France		07.45	Trade balance €bn	Jun	-	-13.0
		07.45	Industrial production M/M% (Y/Y%)	Jun	-0.5 (-0.5)	0.0 (-0.4)
		07.45	Manufacturing production M/M% (Y/Y%)	Jun	-	0.8 (2.2)
Italy		09.00	Industrial production M/M% (Y/Y%)	Jun	-0.1 (2.7)	-1.1 (3.4)
Spain		08.00	Industrial production M/M% (Y/Y%)	Jun	-0.1 (4.6)	-0.2 (3.8)
Auctions and events						
UK		00.01	REC/KPMG report of jobs			
		12.15	BoE Chief Economist Pill scheduled to speak about the Bank's latest interest rate decision and forecasts			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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