Euro wrap-up

Overview

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- Bunds made losses, particularly at the short end, as data confirmed that euro area IP made a positive contribution to GDP growth in Q2 as supply constraints eased somewhat.
- Gilts made losses across the curve even as data confirmed a drop in UK GDP in Q2.
- The coming week will bring new data on euro area and UK jobs, as well as July figures for UK inflation and retail sales.

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	0.589	+0.052
OBL 1.3 10/27	0.743	+0.043
DBR 1.7 08/32	0.984	+0.018
UKT 1 04/24	2.001	+0.039
UKT 1¼ 07/27	1.911	+0.044
UKT 4¼ 06/32	2.104	+0.049

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

Euro area

Industrial output rises for third successive month in June

Contrasting the signals from increasingly gloomy survey indicators, euro area industrial production rose for a third successive month in June. Growth of 0.7%M/M followed a significantly upwardly-revised increase of 2.1%M/M in May to mean that IP grew a respectable 1.1%Q/Q in Q2, the strongest rate in five quarters. Manufacturing output rose 1.0%M/M in June and 0.6%Q/Q in Q2. Growth in June was again led by capital goods output, up 2.6%M/M to be up 1.4%Q/Q, as production of autos also rose for a third successive month, evidently benefiting from an ongoing easing of supply-chain strains. Output of machinery and equipment similarly rose close to 1½%Q/Q. And despite a fall in June, output of consumer goods rose 1.4%Q/Q in Q2. But with production of items such as chemicals, metals and rubber all lower, intermediate goods output fell over the quarter.

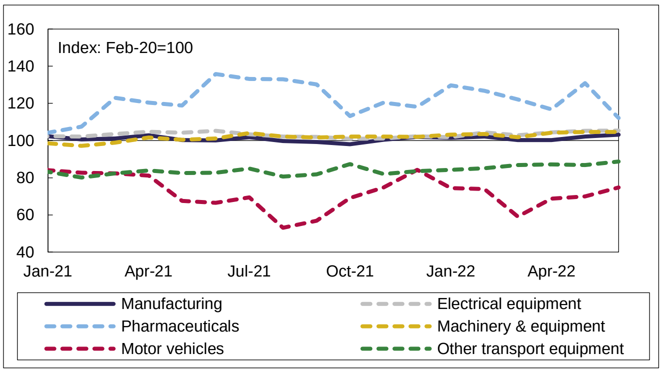
IP growth in Q2 likely reflects easing of supply chains but falling demand likely to weigh from Q3

While the growth in IP in Q2 comes as a positive surprise, it likely in part reflects the greater ability of manufacturers to fulfil past orders – which had been very strong earlier in the post-pandemic recovery – rather than a response to new demand. Indeed, in line with the sharp deterioration in consumer confidence amid declining real incomes, new orders continue to slow, while inventories of finished items continue to rise. We also caution that manufacturing sector growth in Q2 was again exaggerated by extremely strong growth in Ireland (almost 15%Q/Q in Q2 following growth of more than 10%Q/Q in Q1) where data quality is questionable, while production was down again in Germany and absent in France. Moreover, while concerns about the supply of certain components such as semiconductors might have declined, others – such as those related to natural gas or the transportation of important intermediate items up the River Rhine – continue to rise. We therefore expect the manufacturing sector to subtract from euro area GDP growth over the second half of the year, raising the likelihood of a contraction in overall economic output too.

The week ahead in the euro area

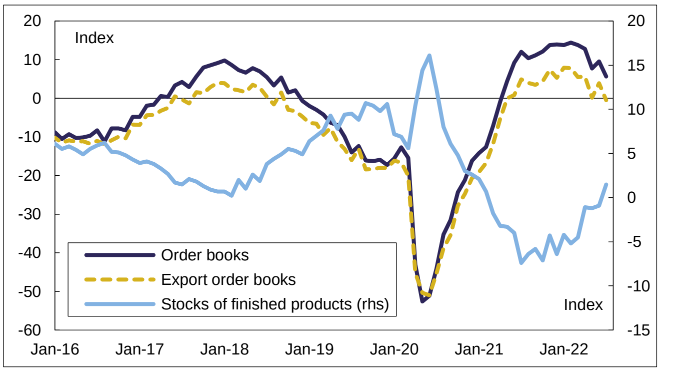
The euro area's economic data calendar in the coming week will bring an updated reading for Q2 GDP (Wednesday), which is expected to confirm the flash estimate of growth of 0.7%Q/Q, to leave output 1½% above the pre-pandemic level. This release will be accompanied by euro area employment figures for the second quarter, which are also likely to report job growth for a fifth successive quarter to a new series high, albeit at the slowest rate over that period. While we will have to wait until 7 September for the official expenditure breakdown of GDP, euro area goods trade figures for June (Tuesday) will provide some further guidance on the contribution from net trade in Q2. Tuesday will also bring Germany's ZEW investor

Euro area: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing orders and inventories



Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

sentiment survey for August, which is likely to suggest that confidence remains subdued as concerns about near-term recession, disruption to energy supply and higher interest rates persisted. Equity and bond market movements over the past month, however, might point to an improvement in expectations on hopes that global inflation pressures are close to the peak. Final euro area inflation data for July (Thursday) are expected to confirm that the headline HICP rate increased 0.3ppt to 8.9%Y/Y, with core inflation also up 0.3ppt to 4.0%Y/Y, both series highs. While we know that the increase was caused by higher inflation of services, non-energy industrial goods and food, this release will also provide the more granular detail. German PPI numbers for July will follow on Friday.

UK

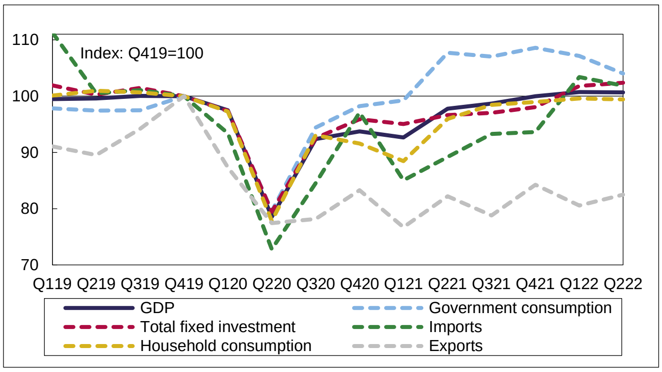
UK GDP contracts in Q2 due to lower spending by consumers and government

UK GDP declined for the first time in five quarters in Q2, and for the first time since the pandemic lockdowns, albeit dropping only 0.1%Q/Q, in line with our forecast and 0.1ppt better than the BoE's baseline projection published last week. So, quarterly GDP was 0.6% above the pre-pandemic level in Q419 and up 2.9%Y/Y. On a monthly basis, GDP fell 0.6%M/M in June, more than reversing growth of 0.4%M/M in May, to the lowest level since December, with the profile of activity affected by the unusual timing of Bank Holidays in both months. Looking through that volatility, the contraction in Q2 as a whole was due in part to a drop in household consumption of 0.2%Q/Q, which left it more than ½ppt below the pre-Covid-19 level. Consumers cut spending on a range of items including clothing, hospitality and food as high inflation eroded purchasing power. Indeed, given higher prices, nominal household expenditure still rose 2.6%Q/Q while nominal GDP rose 1.1%Q/Q. In addition, as pandemic-related spending was withdrawn, government consumption also subtracted from real GDP, dropping for a second successive quarter and by a sizeable 2.9%Q/Q.

Capex and net trade support growth but underlying trends still very weak

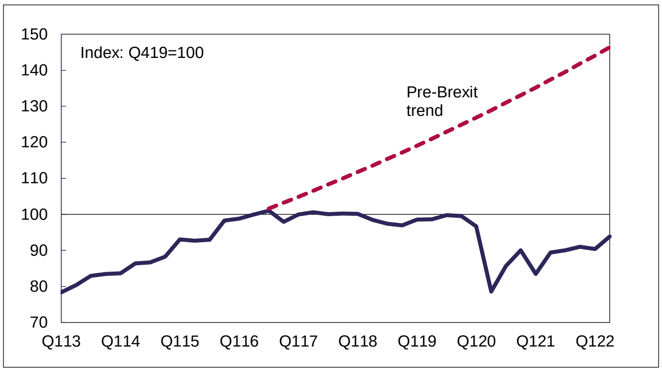
In contrast, net trade made a rare big contribution to GDP growth, of 1.1ppt. Export volumes reversed only a little more than half of the sharp drop of almost 4½%Q/Q in Q1, while import volumes fell back modestly after a surge of almost 10½%Q/Q in Q1. Given the adverse shock to relative prices, however, the overall trade deficit hit a record in nominal terms in Q2 of £27.9bn. While it declined 0.7ppt as a share of economic output from the series-high in Q1, it also remained historically large at 4.7% of GDP. And that improvement was only due to shipments in precious metals, which are highly erratic, excluding which the underlying deficit widened to a new high of 4.5% of GDP. Meanwhile, fixed investment rose 0.6%Q/Q in real terms, thanks to firmer growth in business investment (3.8%Q/Q). Nevertheless, business capex was still 5.7% below the pre-

UK: GDP and selected expenditure components



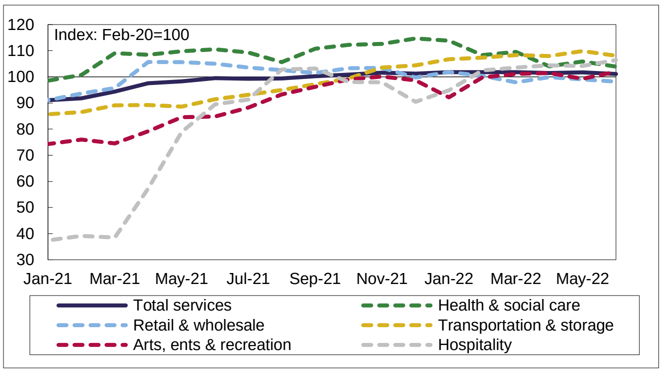
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Business investment



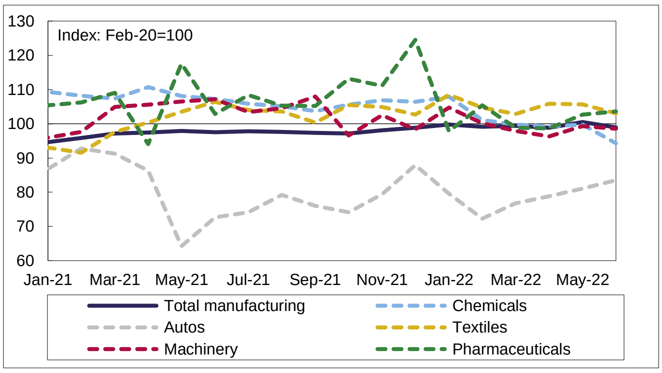
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Services output



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

UK: Manufacturing output



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

pandemic level and 6.2% below the level in Q216 when the Brexit referendum was conducted. Finally, inventories rose for a second successive quarter, but by less than in Q1 and so subtracted 0.6ppt from GDP growth.

Services output down in Q2 on lower retail and Covid-related activity, manufacturing flat

By sector, services output fell 0.4%Q/Q in Q2 to be 1.1% above the pre-pandemic level. That drop reflected lower Covid-19-related healthcare activity as well as a drop in wholesale and retail trade, which was in part offset by increased spending on takeaway food, arts, entertainments and recreation – likely to some extent related to June's extra Bank Holiday. Overall production rose 0.5%Q/Q, principally thanks to increased output from utilities. In contrast, manufacturing output was flat, as steady growth in autos (up 6.5%Q/Q but still more than 16% below the pre-pandemic level at the end of Q2) was offset by weakness in chemicals (-5.0%Q/Q) among others. Extraction was also little changed over the quarter. But despite a weaker end to the quarter, construction output rose 2.3%Q/Q.

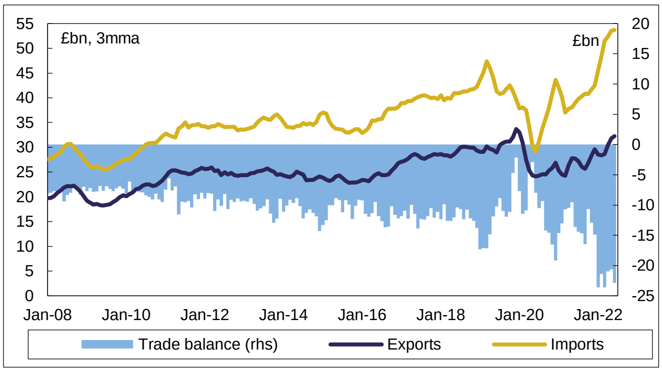
Expect further contraction in GDP in H222 and 2023

Looking ahead, the outlook for UK economic growth is extremely gloomy. Unsurprisingly, survey indicators such as the PMIs and consumer confidence suggest that weakness at the end of Q2 extended into the current quarter. And inflation continues to erode real incomes. While the headline CPI rate is likely to reach double-digits in the course of Q3, the extent of the further increase from October onwards remains impossible to predict with accuracy. Extreme weather in the UK and much of Europe will further boost food inflation. And, most importantly, Ofgem is set to announce the increase in its regulated household energy price cap to last from that month through to year-end on 26 August, with a tripling in the level from a year earlier likely. Given recent shifts in wholesale forward prices, further sharp increases in January and April 2023 are highly likely, so CPI inflation is on track to exceed 13%Y/Y in Q4 and Q1. Yet, as Boris Johnson is now an impotent Prime Minister awaiting the confirmation of his successor by his party members on 5 September, the current government vacuum means that households have no idea whether any extra government support to help cope with the hit to budgets will be delivered. So, we expect private consumption to remain soft in Q3 and to decline significantly over coming quarters. As a result, we now forecast a further slight drop in GDP in the current quarter, ahead of a more pronounced fall from Q4 and throughout much, if not all, of 2023.

The week ahead in the UK

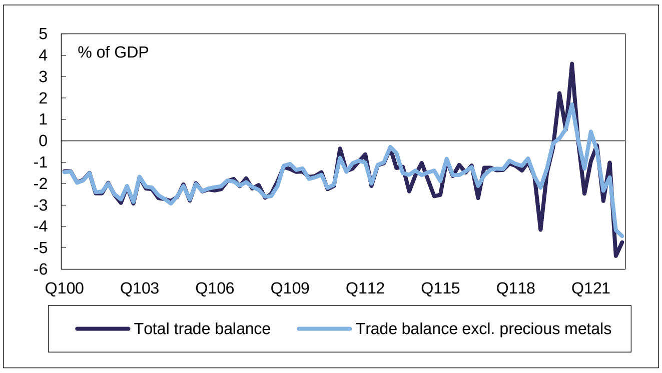
Several top-tier UK data releases are due in the coming week, including the latest labour market report on Tuesday, July inflation figures on Wednesday and retail sales data for the same month on Friday. We expect to see ongoing tightness in the labour market with participation remaining well below pre-pandemic levels. As such, the unemployment rate is expected to have remained unchanged at 3.8%. Meanwhile, average regular wage growth is expected to have remained above 4%3M/Y in June, with growth in total wages including bonuses above 6%3M/Y, too high for the BoE's comfort but still firmly in negative territory in real terms. Indeed, the headline CPI rate could rise 0.6ppt to an eye-catching 10.0%Y/Y, driven not least by an increase in the food component, as well as an uptick in non-energy industrial goods and services inflation. Indeed, we expect the core inflation rate to rise above 6.0%Y/Y. At the end of the week, the focus will turn to July's retail sales report, which is expected to reveal a further drop in spending on goods at the start of the third quarter as consumers tightened their belts in the face of soaring inflation and weak confidence. Certainly, given rising concerns about the extent of further increases in household energy prices to come, the latest GfK consumer sentiment survey (also due Friday) seems unlikely to report a let up in pessimism about the near-term outlook and therefore will signal further weakness in spending ahead too. Finally, against the backdrop of the ongoing Conservative leadership contest and contrasting arguments on fiscal policy from the two candidates to succeed Boris Johnson as PM, public finance figures for July will also be watched.

UK: Trade balance*



**Export and import values.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Trade balance as a % of GDP



Source: ONS and Daiwa Capital Markets Europe Ltd.

Daiwa economic forecasts

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2022	2023	2024
GDP	%, Q/Q						%, Y/Y		
Euro area	0.5	0.7	0.0	-0.1	-0.3	0.0	3.0	-0.1	0.9
UK	0.8	-0.1	-0.1	-0.4	-0.1	-0.2	3.3	-0.6	0.4
Inflation, %, Y/Y									
Euro area									
Headline HICP	6.1	8.0	8.9	8.8	7.3	5.8	8.0	5.4	2.5
Core HICP	2.7	3.7	4.1	4.4	4.3	4.1	3.7	3.7	2.2
UK									
Headline CPI	6.2	9.2	10.0	13.5	13.0	9.4	9.7	8.4	2.0
Core CPI	5.1	6.0	6.3	6.2	5.2	4.1	5.9	3.8	2.0
Monetary policy, %									
ECB									
Refi Rate	0.00	0.00	1.00	1.50	1.75	1.75	1.50	1.75	1.50
Deposit Rate	-0.50	-0.50	0.50	1.00	1.50	1.50	1.00	1.50	1.25
BoE									
Bank Rate	0.75	1.25	2.25	2.50	2.50	2.50	2.50	2.50	2.00

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Industrial production M/M% (Y/Y%)	Jun	**0.7 (2.4)**	*0.3 (1.1)*	0.8 (1.6)	**2.1 (1.6)**
France	ILO unemployment rate %	Q2	**7.2**	7.1	7.1	-
	Final CPI M/M% (Y/Y%)	Jul	**0.3 (6.1)**	*0.3 (6.1)*	0.7 (5.8)	-
	Final EU-harmonised CPI M/M% (Y/Y%)	Jul	**0.3 (6.8)**	*0.3 (6.8)*	0.9 (6.5)	-
Italy	Total trade balance €mn	Jun	**-21.7**	-	-12	**-62**
Spain	Final CPI M/M% (Y/Y%)	Jul	**-0.3 (10.8)**	*-0.2 (10.8)*	1.9 (10.2)	-
	Final EU-harmonised CPI M/M% (Y/Y%)	Jul	**-0.6 (10.7)**	*-0.5 (10.8)*	1.9 (10.0)	-
UK	Preliminary GDP Q/Q% (Y/Y%)	Q2	**-0.1 (2.9)**	*-0.1 (2.9)*	0.8 (8.7)	-
	GDP M/M%	Jun	**-0.6**	*-1.1*	0.5	**0.4**
	Industrial production M/M% (Y/Y%)	Jun	**-0.9 (2.4)**	-1.4 (1.6)	0.9 (1.4)	**1.3 (1.8)**
	Manufacturing production M/M% (Y/Y%)	Jun	**-1.6 (1.3)**	-1.9 (0.8)	1.4 (2.3)	**1.7 (2.6)**
	Index of services M/M% 3M/3M%	Jun	**-0.5 (-0.4)**	-1.0 (-0.4)	0.4 (0.1)	**0.2 (0.0)**
	Goods trade balance £bn	Jun	**-22.8**	-22.3	-21.4	**-20.7**

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 16 August 2022

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
			Monday 15 August 2022			
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Aug	-	0.4 (9.3)
			Tuesday 16 August 2022			
Euro area		10.00	Trade balance €bn	Jun	-	-26.0
Germany		10.00	ZEW current situation (expectations) balance	Aug	-49.8 (-53.8)	-45.8 (-53.8)
UK		07.00	Payrolled employees, change '000s	Jul	25	31
		07.00	Unemployment claimant count rate % (change '000s)	Jul	-	3.9 (-20.0)
		07.00	Average earnings including (excluding) bonuses 3M/Y%	Jun	4.6 (4.5)	6.2 (4.3)
		07.00	ILO unemployment rate 3M%	Jun	3.8	3.8
		07.00	Employment, change 3M/3M '000s	Jun	250	296
			Wednesday 17 August 2022			
Euro area		10.00	GDP – second estimate Q/Q% (Y/Y%)	Q2	*0.7 (4.0)*	0.5 (5.4)
		10.00	Employment – first estimate Q/Q% (Y/Y%)	Q2	-	0.6 (2.9)
UK		07.00	CPI M/M% (Y/Y%)	Jul	*0.5 (10.0)*	0.8 (9.4)
		07.00	Core CPI Y/Y%	Jul	*6.3*	5.8
		07.00	PPI output prices M/M% (Y/Y%)	Jul	0.8 (16.2)	1.4 (16.5)
		07.00	PPI input prices M/M% (Y/Y%)	Jul	0.7 (4.0)	1.8 (24.0)
		09.30	House prices Y/Y%	Jun	-	12.8
			Thursday 18 August 2022			
Euro area		10.00	Final CPI M/M% (Y/Y%)	Jul	*0.1 (8.9)*	0.8 (8.6)
		10.00	Final core CPI Y/Y%	Jul	*4.0*	3.7
		10.00	Construction output M/M% (Y/Y%)	Jun	-	0.4 (2.9)
Spain		09.00	Trade balance €bn	Jun	-	-4.8
			Friday 19 August 2022			
Germany		07.00	PPI M/M% (Y/Y%)	Jul	1.2 (32.0)	0.6 (32.7)
UK		00.01	GfK consumer confidence survey	Aug	-42	-41
		07.00	Retail sales including auto fuels M/M% (Y/Y%)	Jul	-0.2 (-3.2)	-0.1 (-5.8)
		07.00	Retail sales excluding auto fuels M/M% (Y/Y%)	Jul	-0.1 (-3.1)	0.4 (-5.9)
		07.00	Public sector net borrowing, excluding banks £bn	Jul	2.8	22.9

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions			
Country		BST	Event / Auction
			Monday 15 August 2022
			- Nothing scheduled -
			Tuesday 16 August 2022
Germany		10.30	Auction: €4bn of 1.3% 2027 bonds
UK		10.00	Auction: £2.75bn of 0.5% 2029 bonds
			Wednesday 17 August 2022
			- Nothing scheduled -
			Thursday 18 August 2022
Euro area		18.15	ECB's Schnabel scheduled to speak
France		09.50	Auction: 0.50% 2025 bonds
		09.50	Auction: 0.75% 2028 bonds
		09.50	Auction: 1.85% 2027 index-linked bonds
		09.50	Auction: 0.10% 2032 index-linked bonds
		09.50	Auction: 3.15% 2032 index-linked bonds
			Friday 19 August 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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