Euro wrap-up

Overview

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- Bunds made gains as the German ifo survey indicated a gloomy outlook with increasing likelihood of contraction in H222, while the ECB confirmed that some Governing Council members argued for a hike of just 25bps in July but that the hawks maintain a large majority.
- Gilts also made big gains despite a more upbeat UK retail sales survey.
- Friday will bring consumer sentiment indices from Germany, France and Italy, while the key focus in the coming week will be the euro area's flash inflation estimate for August (Wednesday).

Daily bond market movements

Bond	Yield	Change
BKO 0.4 09/24	0.849	-0.050
OBL 1.3 10/27	1.078	-0.066
DBR 1.7 08/32	1.318	-0.046
UKT 1 04/24	2.758	-0.138
UKT 1¼ 07/27	2.558	-0.125
UKT 4¼ 06/32	2.613	-0.080

*Change from close as at 4:35pm BST.
Source: Bloomberg

Euro area

German ifo survey beats expectations, but still paints a gloomy outlook

Today's German ifo business survey came in a touch firmer than expectations, particularly in light of the gloomy message presented by the flash PMIs earlier this week. This notwithstanding, the ifo indices still painted a fairly ominous picture of the outlook, noting widespread pessimism amid heightened uncertainties and the likelihood that Germany's economy will shrink this quarter. While the headline business climate index fell just 0.2pt in August to 88.5, this still marked the lowest reading since June 2020, with the index trending so far in Q3 almost 4pts below the Q2 average. Firms were somewhat less satisfied with their current business situations, although they were still considered to be more favourable than during the first year or so of the pandemic. But while the expectations index also edged only marginally lower on the month, it was still consistent with extreme pessimism. Indeed, the balance of firms citing weakening conditions (-31.6) was the third highest on the series, exceeded only by the trough at the start of the pandemic and height of the global financial crisis. Overall, the ifo institute forecasts GDP to contract by around ½%Q/Q in Q3.

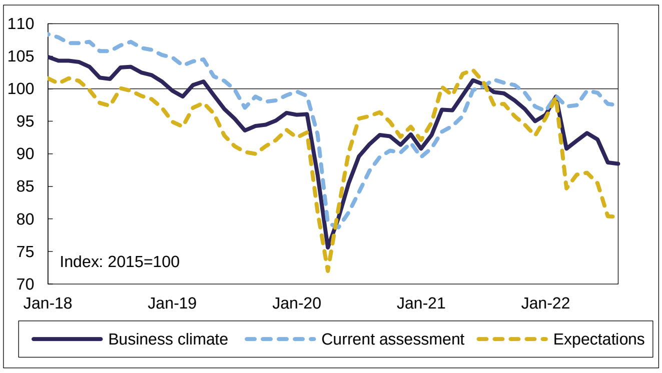
German firms across most sectors remain extremely downbeat

According to the detail of the ifo institute's survey, German retailers continued to be most acutely impacted by higher cost burdens and squeezed household budgets, with fewer and fewer firms reporting a positive business situation as higher consumer prices would likely weigh heavily on future demand. But while services firms were, on the whole, a touch more upbeat about the current climate, reflecting not least improved tourism over the summer, they were similarly downbeat about the outlook, with the hospitality sector expecting a considerable deterioration in business conditions. In contrast, manufacturers were somewhat less pessimistic about the outlook over the coming six months as order backlogs had reduced amid less acute supply constraints. This notwithstanding, the chemicals subsector reported a marked worsening in the current business climate, perhaps reflecting concerns about further supply disruption caused by near-record-low levels at key passing points on the Rhine earlier this month. Water levels have since risen back within the normal range for this time of year. But ongoing concerns about energy supply over the winter months and the increasing cost burdens these pose, combined with waning domestic and global demand, will continue to dampen business confidence for the foreseeable future.

German GDP up slightly in Q2 due to increased spending on services

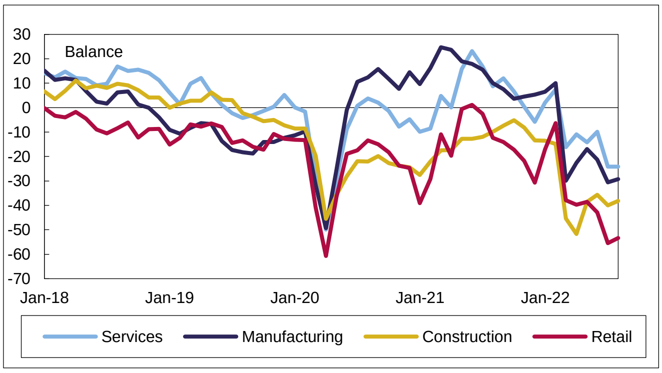
According to revised data, German GDP in Q2 rose 0.1%Q/Q, a touch better than the initial estimate of no change from Q1, to be up 1.7%Y/Y and only marginally below the pre-pandemic level in Q419. The small amount of growth came from consumption. Thanks not least to greater opportunities to travel and eat out after pandemic restrictions were eased at the

Germany: ifo business sentiment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: ifo business expectations



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

end of March, household spending rose 0.8%Q/Q. While high inflation led to weaker spending on durable goods and food, a drop in the savings ratio broadly back in line with the pre-Covid level supported the increased spending on services. Government consumption also made a positive contribution to economic growth, rising 2.3%Q/Q in part thanks to higher spending on healthcare. But due not least to a sharp pullback in construction (-3.4%Q/Q) after a strong showing during the mild winter, fixed investment dropped a larger-than-expected 1.3%Q/Q. Moreover, net trade subtracted a sizeable 0.6ppt from GDP growth as exports (up just 0.3%Q/Q) were outpaced by imports (1.6%Q/Q).

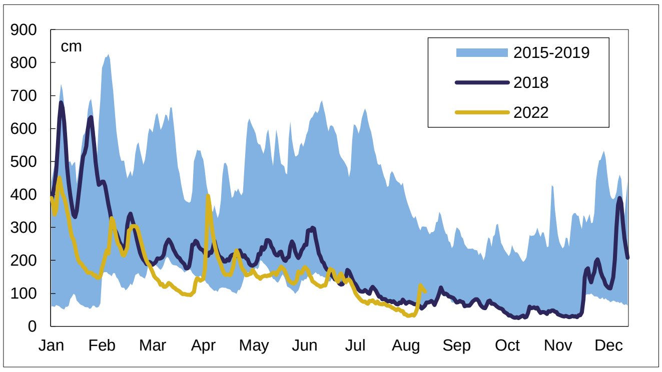
French business confidence holds steady in August, but remains well below levels in H122

Contrasting with the deterioration recorded in the flash PMIs, the INSEE survey suggested that French business conditions remained broadly stable in August, with the headline sentiment index unchanged at 103 (and actually up 0.6pt to 1 decimal place), to remain above the long-run average (100). Admittedly, that level is some 10pts below February's high and the lowest since the lockdowns in Spring 2021, thus suggesting a loss of economic momentum in the current quarter. According to the sectoral breakdown, the business climate among manufacturers deteriorated again in August, similarly to be its least favourable since April 2021, with firms more downbeat about past production and weaker order books. While the headline service sentiment index was unchanged at an above-long-run average reading, firms were again less upbeat about expected demand. And although there was an improvement in retail sentiment, the respective index was still just below the long-run average.

Some ECB policymakers wanted a smaller hike in July, but hawks maintain clear majority

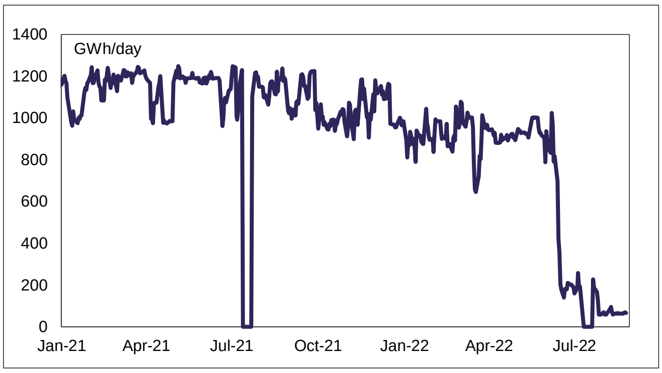
The account of the ECB's July monetary policy meeting, when the Governing Council abandoned its forward guidance and raised rates by a larger-than-signalled 50bps, offered no clues to the likely magnitude of rate hikes to come in September and beyond. It did, however, confirm that some members had argued in favour of an increase of just 25bps, in line with the prior forward guidance. Those members were mindful of recession risks, judged that the impact on inflation of ongoing shocks would likely be transitory and eventually fade, and were concerned that the ECB might fuel market uncertainties with the larger rate hike. All of this might suggest that 50bps, rather than 75bps, remains most likely to be the preferred magnitude at the September meeting too. Indeed, those who had argued for the smaller rate hike had only eventually joined the consensus for a hike of 50bps by insisting that the larger incremented should merely be regarded as frontloading the normalisation of monetary policy, rather than indicating an increase in the likely terminal rate for the cycle. Of course, the doves on the Governing Council remain clearly in the minority. And not least given the deterioration in the price outlook between June and July, and concerns about persistent overshooting of its inflation projections, the account reported that a "very large number" of members of the Governing Council backed the proposed hike of 50bps in rates as a "clear signal of its determination" to prevent inflation expectations becoming de-anchored.

Germany: Rhine river water level*



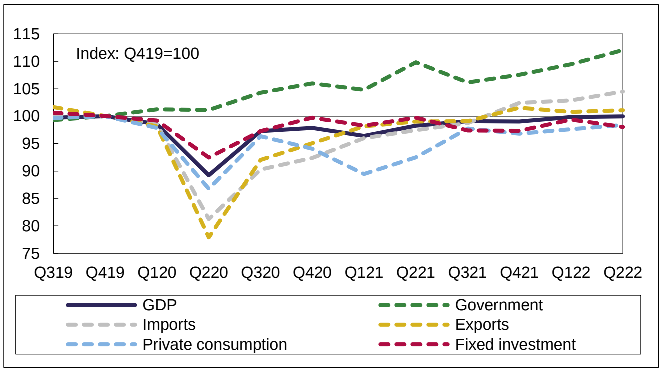
*Kaub crossing point. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Russia Nord Stream 1 pipeline gas inflows



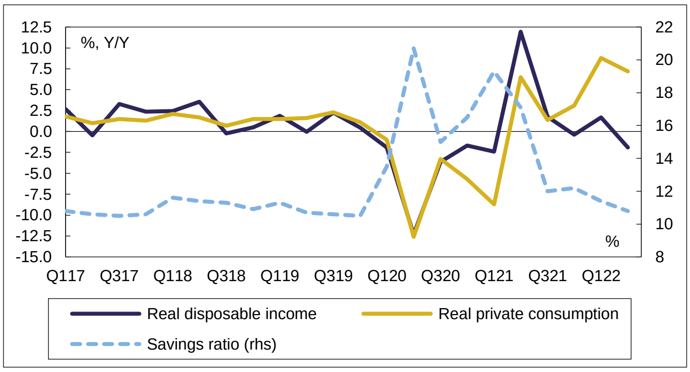
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: GDP and expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Consumption, income and savings ratio



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The week ahead in the euro area

The coming week will be a busy one for top-tier euro area data releases, with the calendar including the European Commission's business and consumer confidence surveys (Tuesday), flash consumer price inflation estimates (Tuesday and Wednesday), and the latest labour market data (Wednesday). Of most interest will be Wednesday's euro area inflation figures, which might well report that the headline HICP rate edged slightly lower in August, from July's record high of 8.9%Y/Y – our forecast is for a drop of 0.2ppt to 8.7%Y/Y – thanks not least to lower petrol prices. We expect the core HICP measure to move sideways, at 4.0%Y/Y, although risks surrounding these forecasts are subject to significant uncertainties. Equivalent member state numbers from Germany and Spain on Tuesday, as well as France, Italy and Portugal (Wednesday) will give a guide as to what to expect. Euro area PPI data for July (Friday) will offer further insight into pipeline price pressures, while the Commission's surveys will include an update on price expectations. Overall, the Commission's sentiment indices are likely to echo the deterioration in business conditions implied by this week's flash PMIs. But the headline economic index should gain support by the surprise slight pickup in consumer confidence – the flash index rose 2.1pts from July's series low of -27.0. While certain policy initiatives in the member states may have provided support to household sentiment, the labour market should also remain a source of encouragement, with the euro area unemployment rate expected to moved sideways at a record-low 6.6% in July. Of course, where possible households seem more likely to choose to save than spend – national retail sales figures from Germany, France and Spain for July will provide an insight into spending activity at the start of Q3. Meanwhile, final Q2 GDP figures for France and Italy are to be published on Wednesday and Thursday respectively. New car registrations numbers for August from France, Italy and Spain should also come on Thursday, followed by German trade figures for July on Friday. In terms of ECB-speak, Chief Economist Lane is scheduled to participate in a panel discussion on inflation and other challenges for monetary policy on Monday.

UK

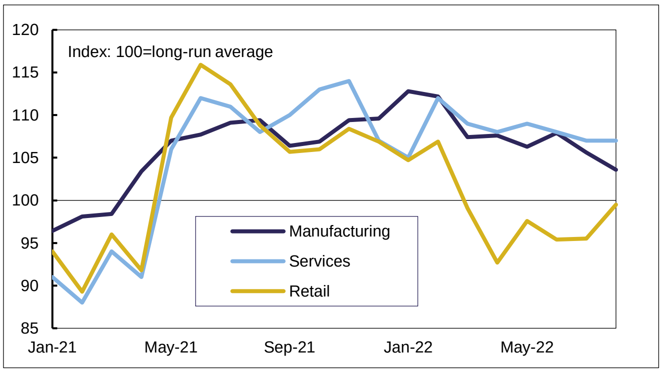
Sales appear resilient in August, but retailers increasingly downbeat about the outlook

According to the CBI's distributive trades survey, UK retail sales were remarkably resilient in August to raise the possibility of positive growth in household consumption in Q3 following the drop in Q2. Indeed, contrary to expectations of a sixth decline in the past seven months, retail sales volumes rose from a year earlier at the strongest rate since December (up 37% on the survey measure following a drop of 4% in July). Retailers also reportedly expect another month of firm growth in September (31%). So, having in July been judged to be "poor" for the time of year, sales volumes in August were considered to be broadly in line with seasonal norms, with expectations of a similar assessment next month. Moreover, employment in retail also reportedly grew at a moderate pace in the year to August. However, firms became even more pessimistic about the outlook for business over the coming three months, with the net balance of -22% (down from -13% in May) the weakest since the first wave of Covid-19 in May 2020. And retailers plan to cut investment in the coming twelve months (-31%). The downbeat assessment of the outlook inevitably reflects concerns about the impact of high inflation on consumer demand, with the survey's measure of average selling price inflation up in August to its highest since 1985 (87%, up 10ppts from three months earlier), with prices expected to rise at a similarly rapid pace in September.

Ofgem to announce size of new energy price shock for households tomorrow

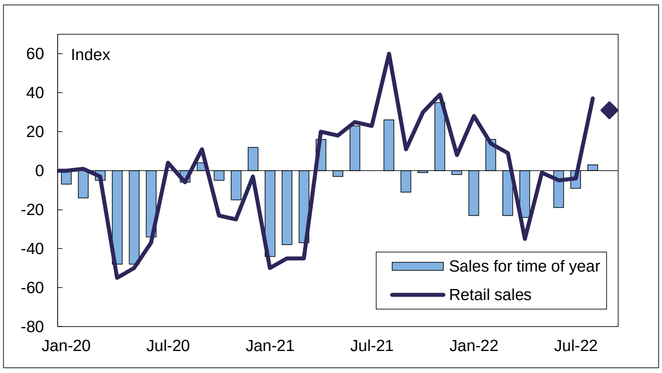
The key reason for retailers' pessimism about the outlook, of course, relates to energy bills, which – given the peculiarities of the UK's price-setting system – are set to rise sharply for the lion's share of households and businesses from October and will significantly weigh on demand from Q4 on. Tomorrow, Ofgem is expected to raise its household energy price cap from that month by about 80%, from £1971 per year to approximately £3600 for a household with "typical" consumption. Based on the most recent changes to its system for determining the price cap, household energy bills would leap again in January to above £4500 and higher still in April. As a result, the independent Resolution Foundation estimates that lower income households will on average have to cut non-essential spending by roughly one quarter to accommodate the increased energy bills. And some 4mn households (about one third of the poorest two deciles) on prepayment meters will on average have to cut non-essential spending by 50% or more. At the same time, small and medium-sized enterprises also face sharp increases in their energy bills over the near term, with many suppliers reportedly refusing to renew fixed-rate contracts from

France: INSEE business sentiment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CBI sales survey indicators*



**Diamond represents sales forecast for September. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

the start of October, when more than two thirds of firms' current contracts will have expired, leaving them exposed to far-higher default tariffs. The Federation of Small Businesses recently reported that many firms on two-year contracts face five-fold increases in energy bills, with those on annual contracts facing a doubling of bills or more, raising the prospect of widespread business failures heading into the winter.

Paths of GDP, inflation and Bank Rate to depend on next PM's policy response

Faced with such a damaging price shock, more fiscal policy support – and perhaps new direct intervention from government in the energy market – is anticipated. Quite what shape and size the new policies will take will remain unclear, however, until after the identity of the new Prime Minister – presumably Liz Truss – is confirmed on 5 September, and a new emergency government budget is presented, most likely in mid-September. Truss's current policy proposals – to scrap the so-called "green levies" from energy bills and reverse the recent increase in National Insurance Contributions – appear woefully inadequate. But much larger interventions now appear highly likely, and expectations of substantive new initiatives to help households and businesses with rising energy bills are probably one key driver of the marked uptrend in Gilt yields seen since the middle of August. The precise details of those measures will have a key bearing on the near-term outlook for UK GDP and inflation, as well as the path of Bank Rate.

The week ahead in the UK

In the UK, the Bank Holiday-shortened week ahead is set to be relatively quiet on the economic data front. Of most interest on Tuesday will be the BoE's latest bank lending numbers, which might confirm that demand for consumer credit remained firm at the start of the third quarter as household budgets continue to be squeezed by high inflation. The BRC's shop price index (Wednesday) seems bound to flag elevated price pressures on the High Street, not least due to higher global food prices, with the headline rate likely to have risen further above July's series high of 4.4%Y/Y. The final manufacturing PMIs for August are due Thursday, with the Lloyds business barometer for the same month also due that day. We could also get the latest Nationwide house price indices, which are expected to report a further modest monthly increase in August (0.1%M/M), albeit this would leave the annual growth rate easing 2.1ppts to 8.9%Y/Y, a sixteen-month low.

The next edition of the Euro wrap-up will be published on 30th August 2022

Daiwa economic forecasts

	2022				2023		2022	2023	2024
	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	%, Q/Q						%, Y/Y		
Euro area	0.5	0.6	0.0	-0.1	-0.3	-0.1	2.9	-0.2	0.8
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	9.0	9.4	8.4	6.9	8.2	6.1	2.1
Core HICP	2.7	3.7	4.2	4.7	4.9	4.7	3.8	4.3	2.3
UK									
Headline CPI	6.2	9.2	10.1	13.6	13.1	9.5	9.8	8.4	2.0
Core CPI	5.1	6.0	6.2	6.1	5.1	3.9	5.8	3.7	2.0
Monetary policy, %									
ECB									
Refi Rate	0.00	0.00	1.00	1.75	2.00	2.00	2.00	2.00	1.75
Deposit Rate	-0.50	-0.50	0.50	1.25	1.75	1.75	1.25	1.75	1.50
BoE									
Bank Rate	0.75	1.25	2.25	3.00	3.00	3.00	3.00	3.00	2.50

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
Germany		Final GDP Q/Q% (Y/Y%)	Q2	**0.1 (1.7)**	*0.0 (1.4)*	0.8 (3.9)	**- (3.6)**
		Ifo business climate	Aug	**88.5**	86.8	88.6	**88.7**
		Ifo current assessment (expectations) balance	Aug	**97.5 (80.3)**	96.0 (79.0)	97.7 (80.3)	**- (80.4)**
France		Business confidence	Aug	**103**	101	103	**-**
		Manufacturing confidence (production outlook)	Aug	**104 (-2)**	104 (-8)	106 (-5)	**-**
Spain		PPI M/M% (Y/Y%)	Jul	**0.0 (40.4)**	-	1.9 (43.2)	**- (43.1)**
UK		CBI distributive trades survey, reported retail sales	Aug	**37**	-	-4	**-**

Auctions

Country		Auction
Italy		sold €2.5bn of 1.750% 2024 bonds at an average yield of 1.86%
UK		sold £1.5bn of 0.625% 2025 bonds at an average yield of 2.648%

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	M3 money supply Y/Y%	Jul	5.5	5.7
Germany		07.00	GfK consumer confidence	Sep	-32.0	-30.6
France		07.45	INSEE consumer confidence	Aug	79	80
Italy		09.00	ISTAT business (manufacturing) confidence	Aug	- (104.2)	110.8 (106.7)
		09.00	ISTAT consumer confidence	Aug	92.5	94.8

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ <u>Daiwa forecast/actual</u>	Previous
			Monday 29 August 2022			
Germany		-	Retail sales* M/M% (Y/Y%)	Jul	-	-1.5 (-9.6)
			Tuesday 30 August 2022			
Euro area		10.00	European Commission's economic confidence	Aug	-	99.0
		10.00	European Commission's industrial (services) confidence	Aug	-	3.5 (10.7)
		10.00	European Commission's final consumer confidence	Aug	<u>-24.9</u>	-27.0
Germany		13.00	Preliminary CPI M/M% (Y/Y%)	Aug	0.2 (7.8)	0.9 (7.5)
		13.00	Preliminary EU-harmonised CPI M/M% (Y/Y%)	Aug	0.2 (8.6)	0.8 (8.5)
Spain		08.00	Preliminary CPI M/M% (Y/Y%)	Aug	-	-0.3 (10.8)
		08.00	Preliminary EU-harmonised CPI M/M% (Y/Y%)	Aug	-	-0.6 (10.7)
		08.00	Retail sales Y/Y%	Jul	-	1.0
UK		09.30	Net consumer credit £bn (Y/Y%)	Jul	-	1.8 (6.5)
		09.30	Net mortgage lending £bn (approvals '000s)	Jul	-	5.3 (63.7)
			Wednesday 31 August 2022			
Euro area		10.00	Preliminary CPI M/M% (Y/Y%)	Aug	<u>0.2 (8.7)</u>	0.1 (8.9)
		10.00	Core CPI Y/Y%	Aug	<u>4.0</u>	4.0
Germany		08.55	Unemployment change '000s (rate %)	Aug	27.5 (5.5)	47.0 (5.4)
France		07.45	Preliminary CPI M/M% (Y/Y%)	Aug	-	0.3 (6.1)
		07.45	Preliminary EU-harmonised CPI M/M% (Y/Y%)	Aug	-	0.3 (6.8)
		07.45	Final GDP Q/Q% (Y/Y%)	Q2	<u>0.5 (4.2)</u>	-0.2 (4.8)
		07.45	Consumer spending M/M% (Y/Y%)	Jul	-	0.2 (-4.4)
		07.45	PPI M/M% (Y/Y%)	Jul	-	1.3 (27.0)
Italy		10.00	Preliminary CPI M/M% (Y/Y%)	Aug	-	0.4 (7.9)
		10.00	Preliminary EU-harmonised CPI M/M% (Y/Y%)	Aug	-	-1.1 (8.4)
UK		00.01	Lloyds business barometer	Aug	-	25
		00.01	BRC shop price index Y/Y%	Aug	-	4.4
			Thursday 01 September 2022			
Euro area		09.00	Final manufacturing PMI	Aug	<u>49.7</u>	49.8
		10.00	Unemployment rate %	Jul	6.6	6.6
Germany		08.55	Final manufacturing PMI	Aug	<u>49.8</u>	49.3
France		08.50	Final manufacturing PMI	Aug	<u>49.0</u>	49.5
		-	New car registrations* Y/Y%	Aug	-	-7.1
Italy		08.45	Manufacturing PMI	Aug	-	48.5
		09.00	Unemployment rate %	Jul	-	8.1
		10.00	Final GDP Q/Q% (Y/Y%)	Q2	<u>1.0 (4.6)</u>	0.1 (6.2)
		17.00	New car registrations Y/Y%	Aug	-	-0.9
Spain		08.15	Manufacturing PMI	Aug	-	48.7
		-	New car registrations* Y/Y%	Aug	-	-12.5
UK		09.30	Final manufacturing PMI	Aug	<u>46.0</u>	52.1
			Friday 02 September 2022			
Euro area		10.00	PPI M/M% (Y/Y%)	Jul	-	1.1 (35.8)
Germany		07.00	Trade balance €bn	Jul	-	6.3
Spain		08.00	Unemployment change '000s	Aug	-	3.2

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

The coming week's key events & auctions			
Country		BST	Event / Auction
			Monday 29 August 2022
Euro area		14.00	ECB Chief Economist Lane scheduled to take part in panel discussion on inflation and challenges for policy
UK		-	Public holiday – Summer bank holiday
			Tuesday 30 August 2022
Italy		10.00	Auction: 5Y and 10Y bonds
			Wednesday 31 August 2022
			- Nothing scheduled -
			Thursday 01 September 2022
Euro area		11.30	ECB's Centeno scheduled to take part in a panel discussion about 'financial capitalism and sustainability'
France		09.50	Auction: Bonds of various maturities
Spain		09.30	Auction: Bonds of various maturities
UK		09.30	BoE publishes Decision Maker panel data for July
		10.00	Auction: 0.875% 2046 bonds
			Friday 02 September 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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