Euro wrap-up

Overview

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- Bunds made losses as President Lagarde insisted that ECB policy will remain restrictive for some time to come.
- Gilts also made sizeable losses despite a survey signalling a moderation in UK shop price inflation.
- Wednesday will bring euro area bank lending and flash Italian inflation estimates, while Lagarde will be joined by her central bank governor peers Powell, Ueda and Bailey on a policy panel discussion in Sintra.

Daily bond market movements

Bond	Yield	Change
BKO 2.8 06/25	3.148	+0.080
OBL 2.4 10/28	2.519	+0.077
DBR 2.3 02/33	2.361	+0.056
UKT 0⅝ 06/25	5.283	+0.130
UKT 1⅝ 10/28	4.684	+0.131
UKT 3¼ 01/33	4.390	+0.090

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

Euro area

Lagarde insists that ECB policy will remain restrictive for some time to come

While many top-tier surveys have signalled a notable softening in economic activity at the end of Q2, President Lagarde today appeared unperturbed, maintaining a hawkish tone and insisting that ECB monetary policy currently only has one goal: to break the persistence of high inflation and return inflation to target in a timely manner. Inevitably, her introductory speech to the Sintra central banking forum repeated assurances that policy would remain data-dependent. But arguing that the pass-through of the initial huge price shocks was ongoing despite the recent decline in headline inflation, “as different economic agents try to pass the costs on to each other”, Lagarde insisted that the ECB now needed “a more persistent policy – one that not only produces sufficient tightening today, but also maintains restrictive conditions until we can be confident that this second phase of the inflation process has been resolved”. So, she emphasised that both the peak “level” of rates and the “length” of time during which rates will stay high will be “critical”. She thus recited the Governing Council’s forward guidance that it will raise rates further to “sufficiently restrictive” levels and keep them there “for as long as necessary”. Moreover, she intimated that, even when the ECB eventually pauses, the Governing Council will not “be able to state with full confidence that … peak rates have been reached”. So, the Bank might seem likely to maintain a tightening bias for some time to come, to try to “ensure that hiking rates does not elicit expectations of a too-rapid policy reversal”. And the Governing Council might want to continue to push against current swap market pricing that suggests the ECB might be cutting rates as soon as Q2 next year. And, over the near term, a further hike in September as well as in July might now seem more likely than not.

ECB fears that wage growth might now become more inflationary than previously expected

In her discussion of the current price-formation process, Lagarde acknowledged that the first phase of high inflation had been driven by firms, which had reacted to steeply rising input costs by defending their margins and successfully passing on the cost increases to consumers to an unusual extent. Indeed, she noted that the share of domestic inflation last year accounted for by unit profits had been twice as large as the norm in the prior two decades. But while the energy price shock is now reversing, she asserted that the second phase of the inflation process – centred on workers, who are now seeking to recover their losses from the initial shocks – is becoming stronger. She stated that the Governing Council expects this phase to play out over several years, as workers seek to fully recover their pre-pandemic level of real wages – a threshold the ECB projections suggest will only be reached by the end of 2025. And given recent weak productivity growth, related in part to continued labour hoarding and job gains in low-productivity sectors, the ECB now forecasts unit labour cost growth to be stronger and more inflationary than it previously expected.

ECB rates currently seeking to dampen demand into 2025 and beyond if required

Lagarde rightly acknowledged that inflation expectations remain relatively well anchored and there is no evidence of a wage-price spiral. But for inflation to be able to return to target “in a timely manner” as workers recoup lost purchasing power, she insisted that firms will now need to absorb rising labour costs within their margins. And a precondition for that, she argued, will be weak demand. Hence the ECB’s judgement that restrictive policy will be required “until this second phase of the inflation process has been resolved”, a threshold which its projections currently suggest will not be reached until 2025 or beyond. We note, however, that the risks to the outlook are two-sided and substantial, not least given significant uncertainties about the current nature of the monetary transmission mechanism; the difficulties forecasting developments in wages, productivity, unit labour costs and profit margins; and – as illustrated by the weekend’s extraordinary events in Russia – the potential for further external shocks. The outlook for ECB rates, therefore, remains extremely uncertain.

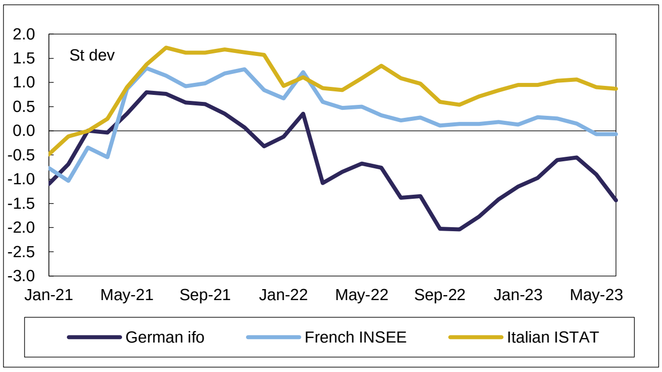
Italian business sentiment holding up relatively well despite weakening in manufacturing

While euro area GDP contracted around the turn of the year, and surveys on the whole point to a loss of momentum at end-Q2, Italian data and surveys have largely remained encouraging. In marked contrast to the drop of 0.1%Q/Q in the euro area as a whole, Italian GDP rose a solid 0.6%Q/Q in Q123 to leave the level of output some 2½% above the pre-pandemic benchmark in Q419 – the strongest performance of the larger member states. And while today's economic surveys published by ISTAT suggested some divergence between business and consumer sentiment, on the whole, they were consistent with ongoing, albeit somewhat less vigorous, expansion. Certainly, the decline in the survey's composite business index, down 0.3pt to a six-month low of 108.3, was much less marked than the weakness suggested by Germany's ifo indices and the euro area flash PMIs. Furthermore, the index remained well above the long-run average (99). Admittedly, the performance between sectors was mixed. After industrial output fell sharply in April (-1.9%M/M), and with production expectations and order books reportedly worsening in June, Italian manufacturers were again more downbeat, with the headline sentiment index slipping to a below-average 100.3, the weakest reading since the start of 2021. Retailer sentiment also maintained a steady downwards trend in June to a five-month low. And the respective services index edged down to a three-month low too, as a deterioration in tourism offset improvements in transport, information and communications. Nevertheless, contrasting with manufacturing and retail, the headline services index was still on average in Q2 above the level in Q1. And notwithstanding significant monthly volatility, the construction index signalled solid expansion (up 3.7pts in Q2). Also particularly encouraging, firms in every sector reported a drop in selling-price expectations in June.

Italian consumers most upbeat since the Russian invasion of Ukraine

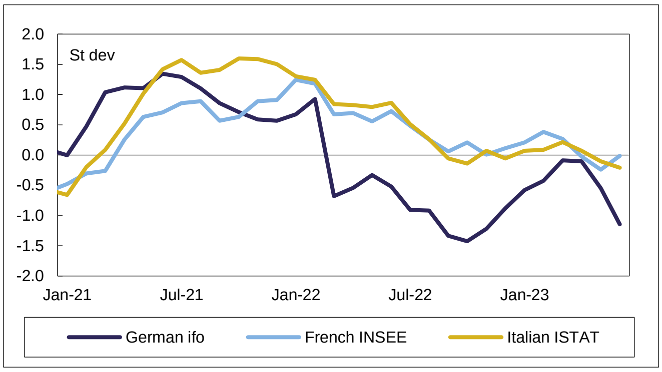
Today's survey results also suggested a solid improvement in Italian consumer confidence at the end of Q2, suggesting that household consumption likely maintained positive support to GDP growth. The headline sentiment index rose 3.5pts on the month – the most in six months – to 108.6, still just shy of the pre-pandemic level but comfortably above the long-run average (104) and the highest reading since the Russian invasion of Ukraine. The improvement was widespread, with expectations for the indices related to the economic outlook and personal financial situation over the coming twelve months rising to the highest since February 2022, likely reflecting an improved inflation outlook. Households also reported a notable decline in unemployment fears, to their lowest in almost eight years. And so, consumers also appeared less reluctant to spend in June, with the respective index rising to the highest in ten months, albeit remaining below the long-run average. While the pace of consumption will likely be restrained by tighter financial conditions, and GDP growth will moderate from Q1, like the Bank of Italy, we expect Italy's economy to maintain a moderate expansion trend over coming quarters.

Euro area: Business confidence indices



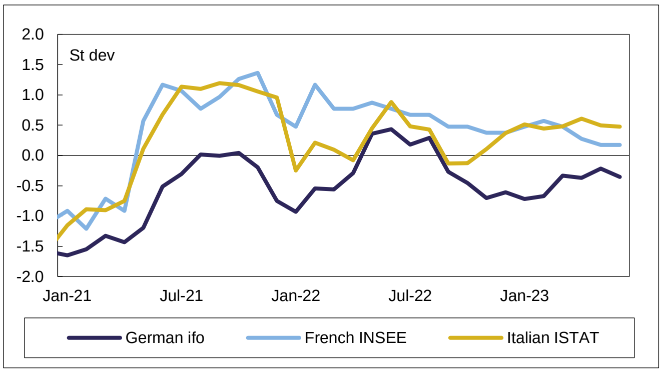
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing confidence indices



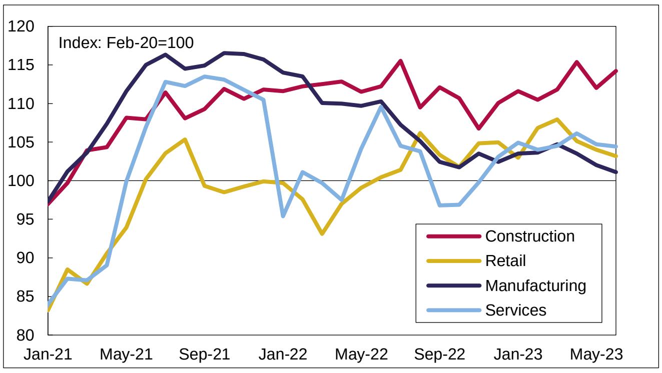
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Services confidence indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Italy: Business confidence indices



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

The day ahead in the euro area

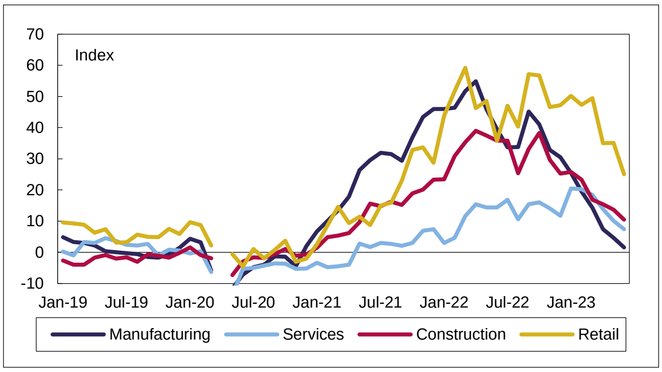
It will be a busy day for economic news in the euro area on Wednesday, with new data due to include the ECB's latest money supply figures for May, which will be watched for further evidence of the impact of the past year's aggressive monetary policy tightening on lending and deposit holdings. Meanwhile, ahead of the euro area's flash inflation estimates on Friday, tomorrow will bring the first of the national preliminary inflation figures from Italy, which are expected to show that the headline HICP rate fell sharply in June, by more than 1ppt from 8.0%Y/Y in May. The latest consumer confidence survey results from Germany and France are also due. Aside from the data, focus will remain on the ECB's forum in Sintra, with President Lagarde to be joined on a monetary policy panel discussion by her central bank governor peers Powell, Ueda and Bailey.

UK

Survey suggests welcome moderation of shop price inflation in June

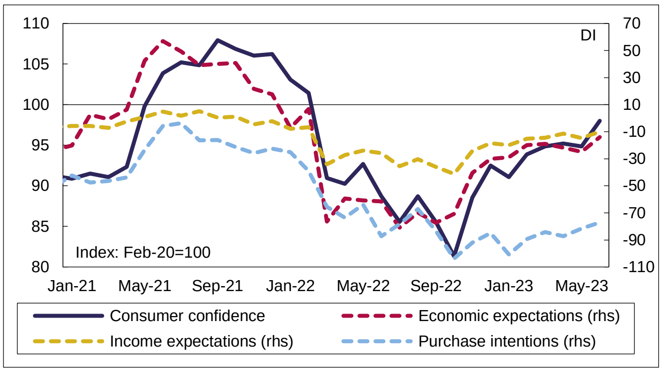
According to the BRC Nielsen shop price survey, inflation on the UK high street moderated in June but inevitably remained high by historical standards. The survey's headline inflation rate slowed 0.6ppt from May's series high to a four-month low of 8.4%Y/Y. The slowdown was led by food, inflation of which eased 0.8ppt to 14.6%Y/Y, similarly the lowest since February. Within that category, fresh food inflation dropped 1.5ppts to a five-month low of 15.7%Y/Y, but prices of ambient items slowed a modest 0.1ppt to 13.0%Y/Y. Non-food inflation slowed 0.4ppt to 5.4%Y/Y, also the lowest since February, with the BRC citing discounting of clothing and electrical goods among other things. We expect the picture of slowing inflation of food and core goods to be reflected in the official CPI data for June. Both components should then continue to decline steadily through the second half of the year. By Q4, core goods inflation (on the ONS measure) should have fallen from 6.8%Y/Y in May to below 5%Y/Y, with food inflation down from 15.6%Y/Y in May to below 10%Y/Y. However, the risks to that view are skewed to the upside, not least due to government policies, such as increased business rates and the planned imposition of post-Brexit border checks on food imports from the EU from October, with an associated inspection fee on such consignments also scheduled to be imposed in January. Moreover, of course, beyond the high street, not least due to strong wage growth, inflation of services looks set to remain far stickier than inflation of goods, ensuring that the BoE keeps hiking rates into the autumn.

Italy: Firms' selling price expectations indices*



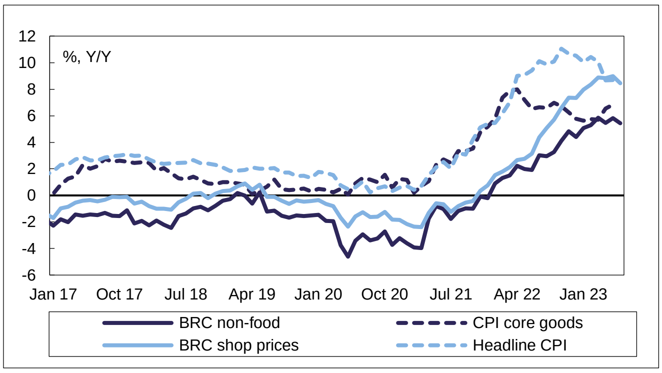
*No survey results in April 2020. Source: ISTAT, Refinitiv and Daiwa Capital Markets Europe Ltd.

Italy: Consumer confidence indices



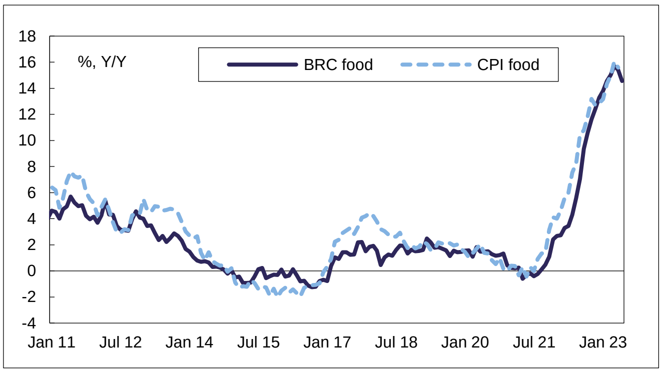
Source: ISTAT, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected BRC survey & CPI inflation indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: BRC & CPI food inflation indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

It will be a quiet day for economic data in the UK tomorrow. But following last week's bumper 50bps BoE rate hike and further horrible upside surprise to UK CPI, focus will be on the aforementioned appearance of BoE Governor Bailey on the monetary policy panel discussion at Sintra. BoE Chief Economist Pill will also join a panel discussion on 'lessons from recent experiences in macroeconomic forecasting' chaired by ECB Chief Economist Lane.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	ISTAT business (manufacturing) confidence	Jun	**108.3 (100.3)**	- (101)	108.7 (101.4)	108.6 (101.2)
	ISTAT consumer confidence	Jun	**108.6**	105.5	105.1	-
UK	BRC shop price index Y/Y%	Jun	**8.4**	-	9.0	-

Auctions

Country	Auction
Italy	sold €2.50bn of 3.4% 2025 bonds at an average yield of 3.71%
	sold €1.75bn of 1.5% 2029 bonds at an average yield of 1.59%
UK	sold £1.5bn of 0.75% 2033 index-linked bonds at an average yield of 0.602%

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%	May	1.5	1.9
Germany	07.00	GfK consumer confidence	Jul	-23.0	-24.2
France	07.45	INSEE consumer confidence	Jun	84	83
Italy	10.00	Preliminary HICP (CPI) Y/Y%	Jun	6.8 (6.7)	8.0 (7.6)
Spain	08.00	Retail sales Y/Y%	May	5.0	5.5

Auctions and events

Country	BST	Event
Euro area	09.00	ECB's de Guindos chairs session on 'Monetary policy normalisation'
	10.00	ECB's de Guindos chairs session on 'The optimal mix of fiscal and monetary policy in the context of high inflation'
	11.30	ECB Chief Economist Lane chairs session on 'Lessons from recent experiences in macroeconomic forecasting'
	13.30	Fed's Powell, ECB's Lagarde, BoJ's Ueda & BoE's Bailey to participate in policy panel at ECB Forum in Sintra
UK	10.00	Auction: £2.75bn of 3.75% 2038 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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