Euro wrap-up

Overview

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- Bunds made gains as the ECB raised its main policy rates by 25bps but kept open its options for its September policy meeting.
- Gilts made gains at the short end of the curve but losses at the long end despite a weak UK retail survey.
- Friday will bring first estimates of July inflation and Q2 GDP from Germany, France and Spain.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.033	-0.052
OBL 2.4 10/28	2.536	-0.037
DBR 2.6 08/33	2.467	-0.010
UKT 0⅝ 06/25	4.980	-0.021
UKT 1⅝ 10/28	4.409	-0.005
UKT 3¼ 01/33	4.301	+0.029

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

Euro area

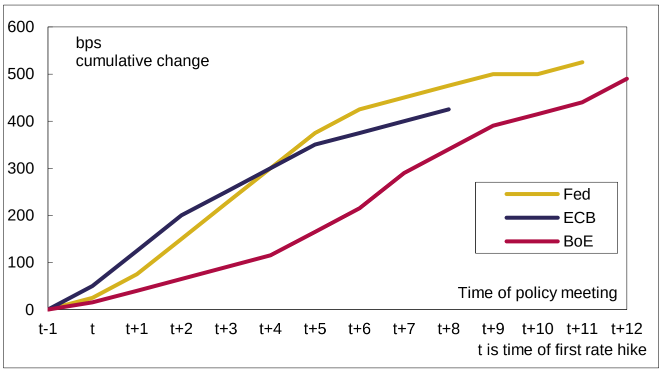
ECB hikes by 25bps again but keeps options open for September

As it had signalled last month, and like the Fed yesterday evening, the ECB today raised its main policy rates by 25bps once again. That took its Deposit Facility Rate to 3.75%, and the cumulative tightening over the nine consecutive meetings starting last July to 425bps. Once again, the Governing Council also stated that future rate decisions would be data dependent. But crucially, also like Fed Chair Powell, in her press conference ECB President Lagarde stated that the Governing Council was keeping its options open with respect to the September monetary policy decision. Indeed, she stated that either a further rate hike or a pause in tightening was now possible at the next and subsequent policy meetings. And the judgement not to give clear guidance on the likely outcome of the September policy meeting was unanimous on the Governing Council, suggesting that differences of opinion between hawks and doves have narrowed. The opening of the door to a pause in September was reflected in the policy statement wording, which implied that the monetary stance might (or might not) now at last be sufficiently restrictive to return inflation to target over the medium term. And in her press conference, Lagarde no longer insisted that the ECB had "further ground to cover", instead preferring to sit on the fence when asked.

September rate hike call increasingly looks a coin-toss

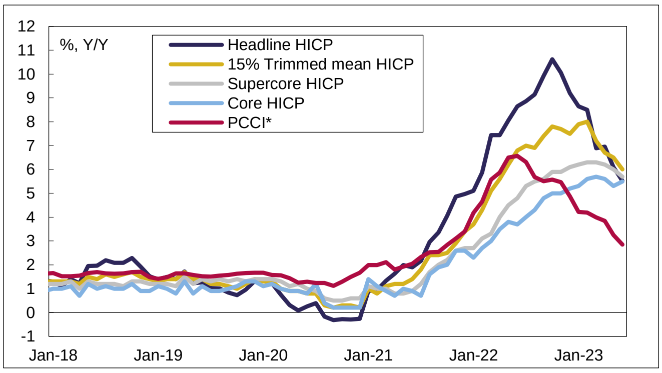
Today's rate hike reflected the continued view of the Governing Council that inflation was still likely to remain too high for too long. But the decision also to leave policy options open for September reflected its judgement that, with headline inflation down more than 5ppts from October's peak and certain measures of underlying inflation also off their highs, the ECB has already made some progress towards restoring price stability. It also recognized the lagged effects of recent monetary tightening still to be felt on the real economy. Moreover, in a notable contrast to the Fed yesterday, the ECB considered that the near-term economic outlook has deteriorated, with domestic demand softening in response to high inflation and monetary tightening, manufacturing additionally suffering from weakness in external demand, and housing and business investment also under pressure. While services were still considered to be more resilient thanks not least to strong tourism demand, the ECB saw momentum slowing in that sector too. Therefore, with the outlook evolving, Lagarde was clear that the September policy decision would depend crucially upon both the forthcoming data and the ECB's updated macroeconomic projections to be completed ahead of that meeting. On balance, as we do not think economic data will deteriorate markedly between now and then, expect core inflation to remain above 5.0%Y/Y until September, and think the ECB will continue to project it to remain above 2.0%Y/Y into early 2025, for now we continue to pencil-in one final 25bps rate hike this cycle at the next meeting. However, we also admit that, after today's meeting, that rate call looks increasingly like a coin-toss. And regardless, even if it doesn't hike in September, the Governing Council will not call the end to the tightening cycle at that meeting, and will instead leave the door open to further tightening thereafter.

ECB, Fed, BoE: Cumulative rate hikes this cycle



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



**Persistent and common component of inflation. Source: ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Interest rate on required reserves cut to zero percent to have modest impact

Finally, while the ECB hiked its main interest rates by 25bps today, it also made a technical adjustment, cutting its interest rate on minimum bank reserves from the Deposit Facility Rate back to zero percent, its level in place from April 2016 until August 2022. The change will take place from the start of the reserve maintenance period starting on 20 September. With credit institutions required to hold at the ECB an amount equivalent to 1% of certain liabilities, mainly customer deposits, minimum reserves currently stand at €165bn. (According to a Reuters report this afternoon, the Governing Council also today considered but rejected a proposal to doubling the minimum reserve coefficient to 2%, its original level in place until 2012.) So, the decision will have cost banks roughly €6bn in foregone interest. In her press conference, Lagarde insisted the policy would have no material impact on the ECB's monetary stance. Instead, by reducing the amount of interest to be paid to banks, it aimed to increase the efficiency of policy (i.e. the cost to the ECB) while facilitating the full pass-through of rate decisions to money markets. Overall, we expect little material impact, although, at the margin, some banks (not least those with a track record of low profitability) might seek to compensate with higher interest rates on loans.

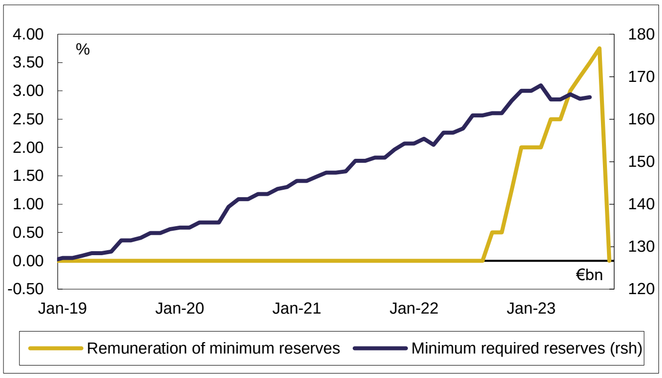
German consumer confidence stabilises on firmer income expectations

Data-wise, while German business surveys have suggested a notable deterioration of conditions at the start of Q3, today's GfK survey results beat expectations, suggesting that consumer confidence has stabilised. Indeed, the headline GfK sentiment indicator – presented as a forecast for August – fully reversed the prior month's decline to rise 0.8pt to -24.4, matching June's 14-month high. That left it broadly equidistant between the long-run average and the series low reached last October in the wake of the record surge in natural gas prices. According to the detail for the current month, the improvement was largely related to stronger expectations regarding future incomes, which rose to a 17-month high, while assessments of the economic outlook were unchanged and marginally positive. Expectations of lower inflation to come were maintained, albeit not quite as much as in June when the survey measure hit a 32-month low. Moreover, willingness to buy rose for a second successive month to edge back close to the top of the range of the past year, albeit remaining well below the long-run average to suggest that private consumption growth will remain subdued in the current quarter.

Italian manufacturers signal contraction concerns but other sectors remain upbeat

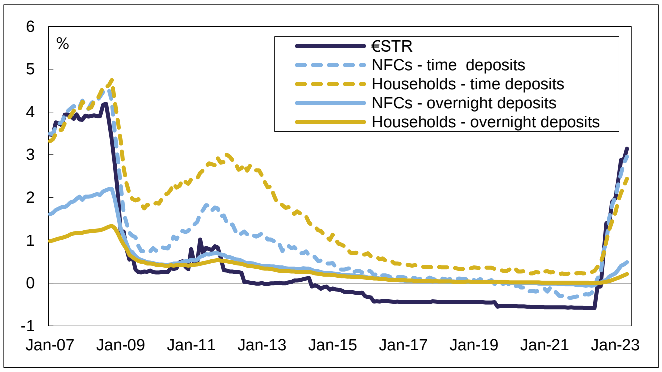
In contrast to the modest improvement in Germany, today's ISTAT survey results suggested that Italian consumer confidence softened somewhat in July. However, the drop of 1.9pt left the headline index still at its second-highest level since the Russian invasion and above the long-run average. While conditions were judged to have deteriorated somewhat at the start of Q3, expectations with respect to the outlook for the economy and personal finances were judged to have improved, also

Euro area: Minimum required reserves



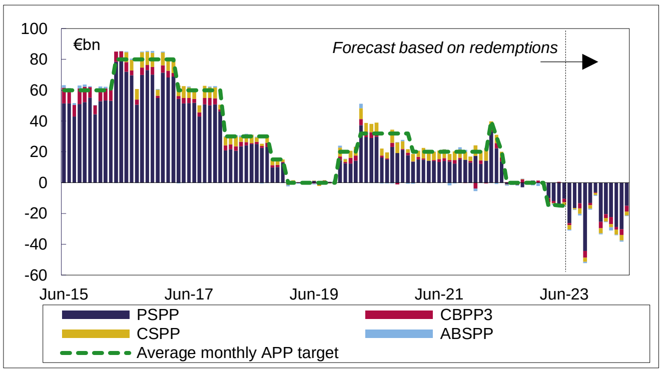
Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Interest rates on loans and deposits



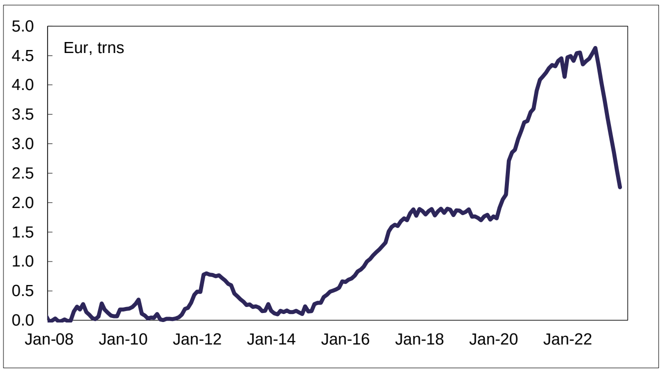
Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Net asset purchases under APP



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Excess liquidity



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

remaining well above the respective norms. And willingness to purchase durable goods also increased, similarly to be still well above the long-run average. In terms of business sentiment, manufacturers were the most downbeat in 2½ years with firms in the sector expecting to cut output amid declining orders. However, services sentiment improved to the second highest level since end-2021, suggesting that the release of pent-up demand continues to support activity over the summer months. Retail sector sentiment also improved further above the long-run average and construction sector sentiment picked up again from a high level on a brighter assessment for new orders. So, overall, while hard data point to a softer second quarter for Italian GDP following firm growth of 0.6%Q/Q in Q1, surveys point to possibilities of a renewed acceleration in Q3.

The day ahead in the euro area

Following today's monetary policy announcement, tomorrow will bring some key economic data releases from euro area member states, including the flash July inflation estimates from Germany, France and Spain. The German and French headline HICP rates are expected to have eased slightly this month, by 0.2ppt to 6.6%Y/Y and 0.3ppt to 5.0%Y/Y respectively. The equivalent Spanish figure, meanwhile, is expected to have edged higher, albeit still likely remaining below 2%Y/Y. Preliminary inflation data from Belgium and Ireland are also due.

Friday will also bring the first insights into Q2 GDP. Of the larger member states, Germany's economy is expected to have emerged from its mild technical recession, with output expected to have increased 0.1%Q/Q in Q2, albeit still leaving it down around ½%Y/Y. In France and Spain, growth is expected to have moderated from Q1, with our expectation for French GDP growth of 0.1%Q/Q from 0.2%Q/Q previously, while Spanish GDP is expected to have increased 0.3%Q/Q from 0.6%Q/Q previously. Among the other member states, given its often significant extremely volatile profile, the Irish estimate – whereby GDP slumped 2.8%Q/Q in Q1 – will also be closely watched.

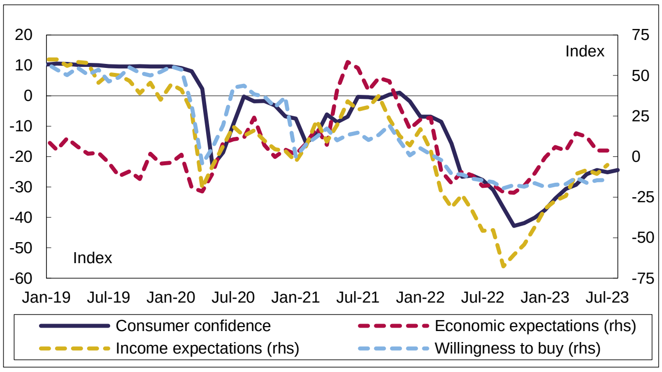
Finally, the European Commission's consumer and business sentiment surveys will provide insight into economic activity and price expectations at the start of Q3. While the flash consumer confidence index reported a further improvement, business sentiment is likely to have softened further in line with the flash PMIs.

UK

CBI retail survey suggests a marked decline in sales at the start of Q3

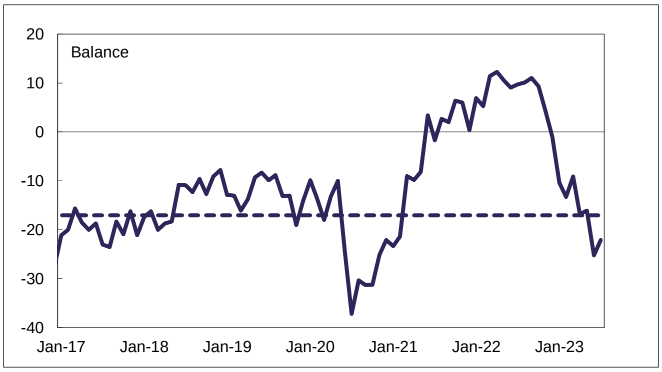
While the CBI's industrial trends survey suggested a (somewhat surprising) improvement in manufacturing conditions in July, this contrasted with the ongoing pessimism reported in the flash manufacturing PMIs. The PMIs also implied a marked

Germany: Consumer confidence indices



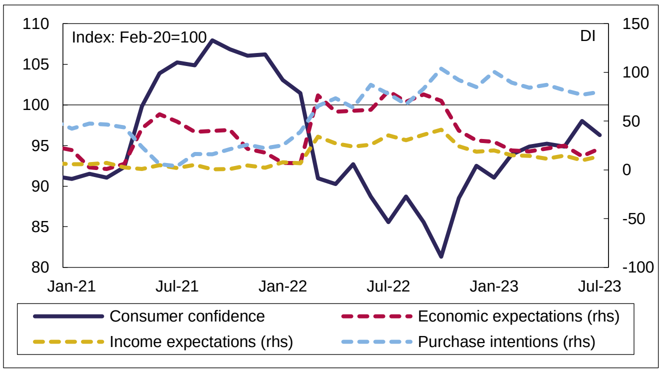
Source: GfK, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Consumer price expectations index*



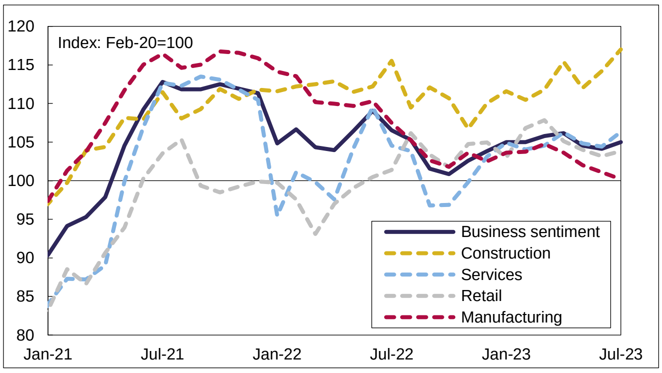
**Dashed line represents long-run average. Source: GfK, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Italy: Consumer confidence indices



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

Italy: Business confidence indices



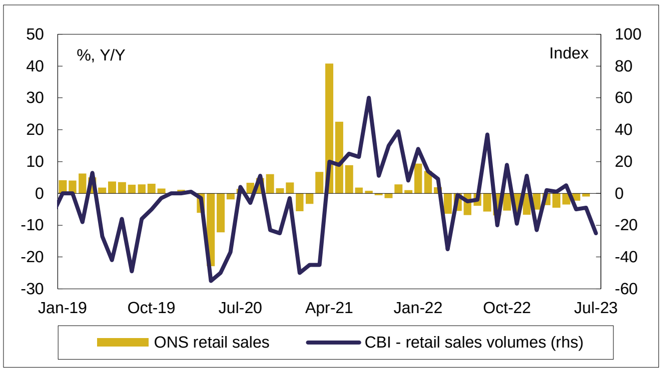
Source: ISTAT, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

slowdown in momentum in the services sector. And today's CBI distributive trades survey offered a particularly gloomy assessment of retail sector conditions at the start of Q3 too. In particular, the headline retail sales index slumped 16pts to -25, the lowest since April 2022, when the survey gauge appears to have been distorted by base effects associated with the relaxation of Covid restrictions in 2021 as well as the deterioration in consumer confidence after the Russian invasion of Ukraine. When smoothing for monthly volatility, the respective index on a three-month basis (-14) was the lowest since April 2021. Retailers also remained extremely downbeat about sales prospects in August, with orders placed at suppliers the weakest since the start of 2021. And retail stocks relative to expected sales were still considered to be at an elevated level. While this survey has been a fairly poor guide to official retail sales growth over the past year or so, we continue to expect household spending on goods to remain lacklustre over the summer. Meanwhile, having benefitted from improved supply bottlenecks earlier in the year, car dealers reported a notable decline in sales volumes in July, while orders placed with suppliers were the weakest since November and stocks relative to expected sales the highest since the start of the pandemic when showrooms were shut.

The day ahead in the UK

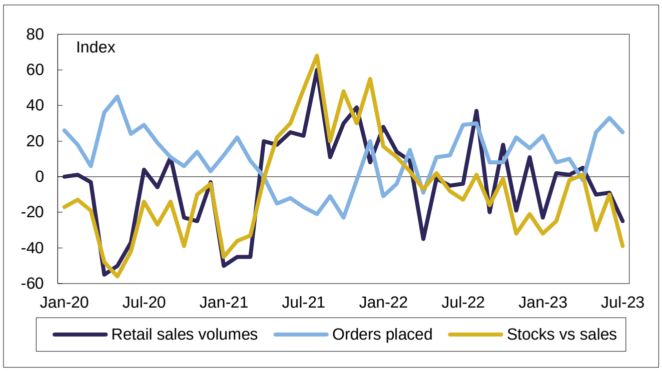
It should be a relatively quiet end to the week in the UK, with no top-tier economic data scheduled for release.

UK: Retail sales



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: CBI survey - Retail sales, orders & stocks



Source: Refinitiv Datastream 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	ECB Deposit (Refi) Rate %	Jul	**3.75 (4.25)**	*3.75 (4.25)*	3.50 (4.00)	-
Germany	GfK consumer confidence	Aug	**-24.4**	-24.8	-25.4	-25.2
Italy	ISTAT business confidence (manufacturing)	Jul	**109.1 (99.3)**	- (100.0)	108.3 (100.3)	108.2 (100.2)
	ISTAT consumer confidence	Jul	**106.7**	107.3	108.6	-
Spain	Retail sales Y/Y%	Jun	**6.4**	-	6.0	6.1
	Unemployment rate %	Q2	**11.6**	13.0	13.3	-
UK	CBI distributive trades, total reported retail sales	Jul	**-25**	-9	-9	-

Auctions

Country	Auction
Italy	sold: €3.50bn of 3.80%2028 bonds at an average yield of 3.73%
	sold €1.25bn of 2.50% 2032 bonds at an average yield of 3.98%
	sold €3.75bn of 4.35% 2033 bonds at an average yield of 4.1%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	European Commission's Economic Sentiment Indicator	Jul	95.0	95.3
	10.00	European Commission's industrial (services) confidence	Jul	-7.8 (5.3)	-7.2 (5.7)
	10.00	European Commission's final consumer confidence	Jul	-15.1	-16.1
Germany	09.00	Preliminary GDP Q/Q% (Y/Y%)	Q2	*0.1 (-0.4)*	-0.3 (-0.5)
	13.00	Preliminary HICP (CPI) Y/Y%	Jul	6.6 (6.2)	6.8 (6.4)
France	06.30	Preliminary GDP Q/Q% (Y/Y%)	Q2	*0.1 (0.4)*	0.2 (0.9)
	07.45	Consumer spending M/M% (Y/Y%)	Jun	-	0.5 (-3.6)
	07.45	Preliminary HICP (CPI) Y/Y%	Jul	5.1 (4.2)	5.3 (4.5)
	07.45	PPI Y/Y%	Jun	-	5.8
Italy	09.00	PPI Y/Y%	Jun	-	-6.8
Spain	08.00	Preliminary HICP (CPI) Y/Y%	Jul	1.6 (1.7)	1.6 (1.9)
	08.00	Preliminary GDP Q/Q% (Y/Y%)	Q2	*0.3 (1.7)*	0.6 (4.2)

Auctions and events

Country	BST	Event
Euro area	-	ECB Survey of Professional Forecasters

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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