Europe Economic Research 28 July 2023

Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds ended the day little changed as initial figures from some of the member states pointed to a return to positive euro area GDP growth in Q2 and declines in euro area headline and core inflation in July.
- Gilts followed USTs higher at the shorter end of the curve on a quiet day for economic news from the UK.
- The coming week will bring the first estimates of euro area Q2 GDP and July inflation while the BoE will raise rates again and publish updated macroeconomic projections.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.028	-0.005
OBL 2.4 10/28	2.530	-0.006
DBR 2.6 08/33	2.480	+0.012
UKT 0⅝ 06/25	4.932	-0.049
UKT 1⅝ 10/28	4.391	-0.019
UKT 3¼ 01/33	4.315	+0.014

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

Euro area

German GDP flat in Q2 as household consumption stabilises

Ahead of the release of the initial estimate of euro area GDP in Q2 on Monday, today's first set of flash figures from the member states were a mixed bag. Having contracted in the prior two quarters, Germany's technical recession came to an end in Q2. And while the level of GDP was merely unchanged from Q1, the extent of the declines in Q4 and Q1 were revised to -0.4%Q/Q and -0.1%Q/Q (from -0.5%Q/Q and -0.3%Q/Q previously). That left German economic output down 0.2%Y/Y on a calendar-adjusted basis, but 0.2% above the pre-pandemic level in Q419. The German statistical institute Destatis provided little additional detail, but commented that household consumption had stabilised in Q2 following sharp declines over the prior two quarters.

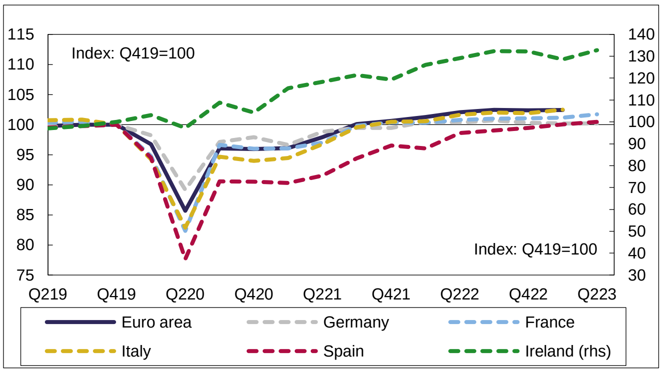
French GDP beats expectations with acceleration in Q2 on export jump

In contrast to Germany, French GDP beat expectations in Q2 with a marked acceleration of 0.4ppt to 0.5%Q/Q. That left it up 0.9%Y/Y and 1.7% above the pre-pandemic level in Q419. The improvement, however, was driven by exports, which jumped 2.6%Q/Q at least in part due to one-off effects. For example, a sharp rebound in shipments of transport equipment in part reflected delivery of a cruise ship, while exports of coke and refined oil products surged at the end of strike action. But with imports up a much more modest 0.4%Q/Q, net trade contributed 0.7ppt to GDP growth in Q2. In contrast, domestic demand remained weak. Despite ongoing recovery in spending on hospitality and transport services, household consumption declined 0.4%Q/Q in Q2, with food consumption contracting for a sixth consecutive quarter. While fixed investment eked out a modest increase in Q2 (0.1%Q/Q), household residential investment fell for a fourth consecutive quarter amid a decline in new housing construction. And inventories also subtracted 0.1ppt from GDP growth.

Expansion in Spain and surge in Ireland leaves euro area GDP on track for positive growth in Q2

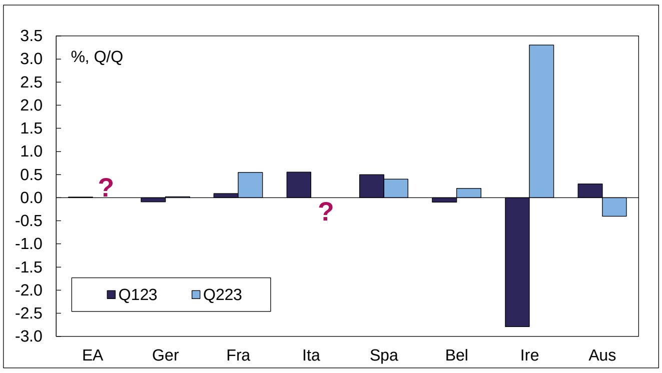
Among the other member states, GDP growth in Spain in Q2 broadly aligned with expectations at 0.4%Q/Q, a touch softer than the pace in Q1 but nevertheless still respectable. This left Spanish economic output up 1.8%Y/Y and back above the pre-pandemic level in Q419 for the first time. The detail was more encouraging too, with growth supported by the first rise in household consumption in three quarters (1.6%Q/Q) and the strongest rise in private investment (4.6%Q/Q) since the post-pandemic bounce back. In contrast, exports fell sharply (-4.1%Q/Q) seemingly as payback for strength at the start of the year. Among the medium-sized member states in the euro area's core, growth in Belgium of 0.2%Q/Q was offset by a contraction of 0.4%Q/Q in Austria. But far more significantly, at the periphery, notoriously volatile Irish GDP – which in good part reflects activities of large US multinational corporations based there for tax purposes – rebounded 3.3%Q/Q in Q2

Euro area member states: GDP levels



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area member states: GDP growth*



*Data for euro area and Italy up to Q123. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

following a drop of 2.8%Q/Q the prior quarter. On its own, that will contribute about 0.15ppt to euro area GDP growth. And so, while we see a significant risk of contractions in Italy and the Netherlands, euro area economic output is currently on track to rise between 0.2-0.3%Q/Q in Q2, with the upper end of that range bang in line with the ECB's June economic projection.

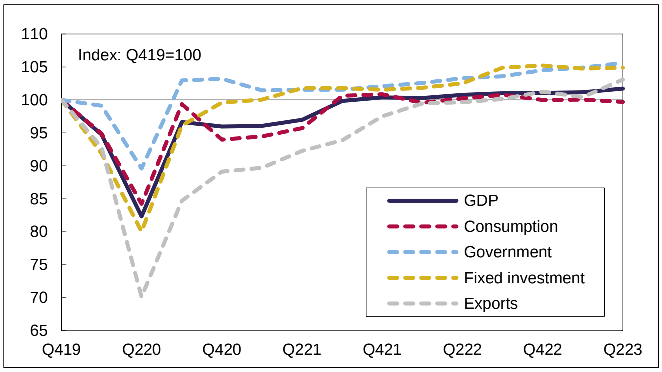
Economic sentiment down to 9-month low supporting Lagarde judgement of weaker outlook

While euro area GDP growth in Q2 therefore looks to have been close to the ECB's expectation, President Lagarde yesterday considered the near-term economic outlook to have deteriorated. That weakening of momentum in early Q3 was reflected in today's Commission business and consumer survey results. Indeed, the headline euro area economic sentiment indicator (ESI) dropped for the third successive month in July to a nine-month low of 94.5, a level consistent with stagnation rather than the ECB's most recent Q3 growth forecast of 0.3%Q/Q. Among the member states, the German ESI was particularly weak, dropping to the lowest level since July 2020, while the French and Dutch indices also fell to the lowest since the late 2022. More happily, thanks not least to strong summer tourism, conditions in the euro area periphery appear to remain more favourable. Indeed, the respective indices for Italy and Spain rose in July to be above their long-run averages and consistent with expansion. Among the various business sectors in the euro area, manufacturing sentiment fell to its worst level in more than three years as orders were judged to have deteriorated markedly and so production expectations were significantly revised down. With higher interest rates restraining demand, construction firms were the most downbeat since early 2021. But while services confidence deteriorated for a third successive month to an eight-month low, it remained consistent with growth. And with consumer confidence and willingness to spend rising to the highest level since the Russian invasion of Ukraine on improved perceptions of the economic outlook and personal finances, as well as lower inflation expectations, retail sentiment rose for the first time in three months to be above the long-run average. Employment expectations softened too, particularly in the industrial sector. But they remained above the long-run average in all of the large member states bar Germany, and particularly strong in Italy and Spain, to suggest that labour market tightness persists.

German inflation eases in July, but base effects still playing a dominant role

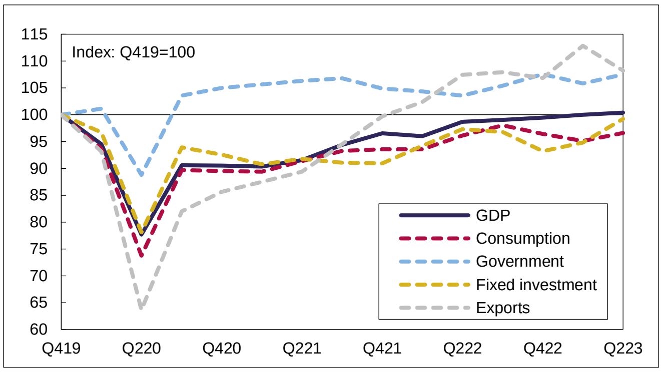
Like the GDP figures, the first set of flash inflation estimates was mixed. But on balance, the data suggested that euro area headline inflation maintained a modest downwards trend at the start of Q3. While not fully reversing the uptick recorded last month, which related to base effects associated with last year's discounted travel pass, today's flash estimates showed German inflation easing back in July, with the EU-harmonised headline rate down a slightly firmer-than-expected 0.3ppt to 6.5%Y/Y and the national rate down 0.2ppt to 6.2%Y/Y. The detail within the national figures suggested that base effects

France: GDP and expenditure components



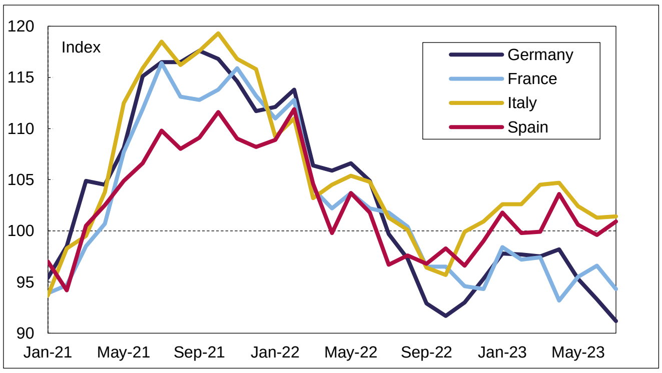
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Spain: GDP and expenditure components



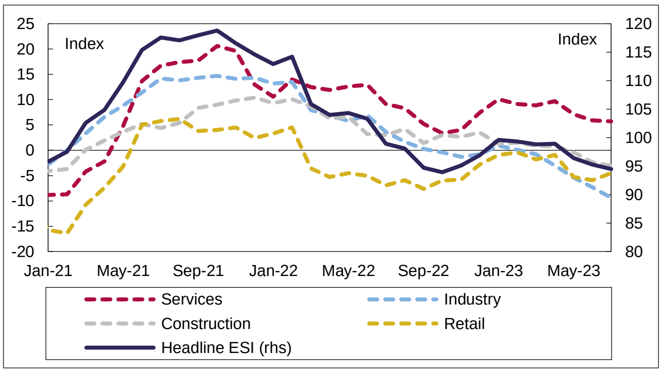
Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Economic sentiment indices by country



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

Euro area: Economic sentiment indices by sector



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

continued to play a dominant role this month. But while food inflation fell to a fourteen-month low (down 2.7ppts to 11.0%Y/Y), energy inflation ticked slightly higher (up 2.7ppts to 5.7%Y/Y) reflecting a larger decline in prices a year ago caused by the elimination of the renewable energy surcharge. But tallying with the downward trend in global manufacturing cost burdens, core goods inflation fell around ½ppt to the lowest in fourteen months. And although still inflated by last year's travel pass, services inflation also edged slightly lower, by 0.1ppt to 5.2%Y/Y. As such, the national core CPI rate largely reversed the pickup in July, easing 0.3ppt to an admittedly still-elevated 5.5%Y/Y.

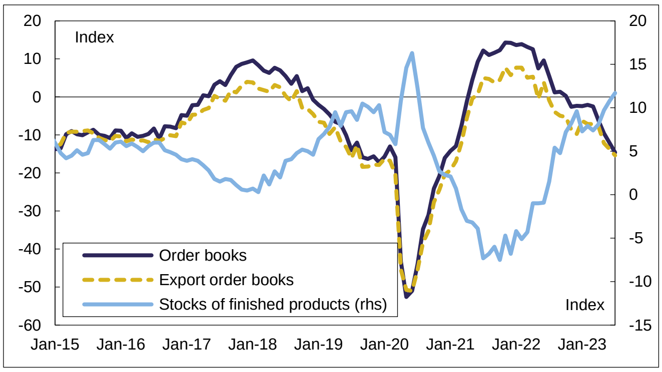
French inflation surprises to the downside, but Spanish data exceed expectations

French inflation eased to a seventeen-month low in July, with the HICP rate down 0.3ppt to 5.0%Y/Y and the national rate down 0.2ppt to 4.3%Y/Y. Like in Germany, food inflation benefitted from a high base a year earlier. And reflecting also a decline in gas prices this month, energy inflation was the most negative since January 2021. Core goods inflation also eased to its lowest in a year, due in part to the delayed timing of this year's summer clothing sales. However, services inflation ticked slightly higher suggesting that core inflation remained stickier. This was also evident in Spain, whereby the national core CPI rate – which excludes unprocessed food and energy – rose 0.3ppt to 7.2%Y/Y. Indeed, Spain's statistical office INE attributed the latest uptick to reduced summer discounting this year, as well as upwards pressures from package holidays. And with a rise in petrol prices offsetting falls in electricity and gas prices, headline inflation rose a stronger-than-expected 0.4ppt to 2.3%Y/Y, with the HICP rate up 0.5ppt to 2.1%Y/Y. While the near-term profile for inflation across the member states is likely to remain volatile over coming months, not least to due base effects, we should see a more decisive step down in headline and core inflation from September. Admittedly, today's Commission survey suggested no further improvement in services selling price expectations over the coming three months. This notwithstanding, the steady downtrend in manufacturing and construction selling price expectations was maintained, while consumer inflation expectations for the year ahead were the lowest since October 2015.

The week ahead in the euro area – July inflation and Q2 GDP still the focus

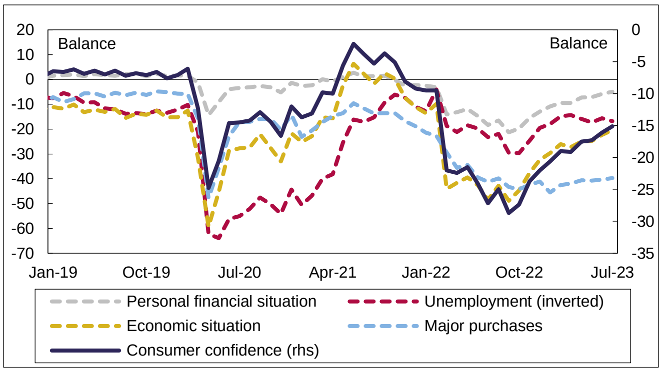
The flow of July inflation data continues at the start of the coming week, with the euro area consumer price figures due on Monday. Following today's initial estimates from Germany, France and Spain, we now expect the headline HICP inflation rate to ease for the third successive month in July, by 0.3ppt to 5.2%Y/Y, the lowest level since January 2022. In part, this should reflect another fall in food inflation due to base effects, while the energy component should be little changed despite a pickup in gasoline prices on the month. While services inflation might edge up again in July, a drop in non-energy industrial goods inflation should help the core HICP measure fall back, perhaps by 0.2ppt to 5.3%Y/Y. Meanwhile, euro area producer price

Euro area: Manufacturing orders & inventories



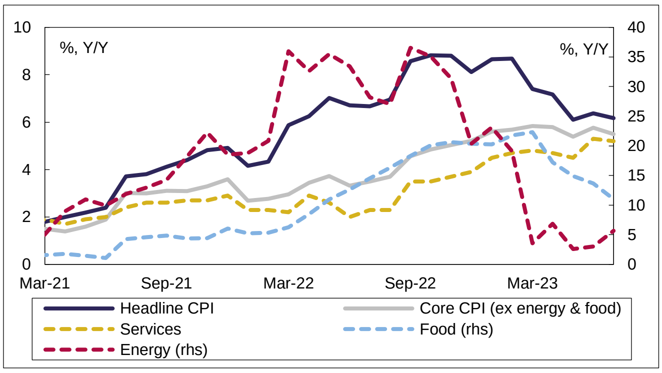
Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: Consumer confidence



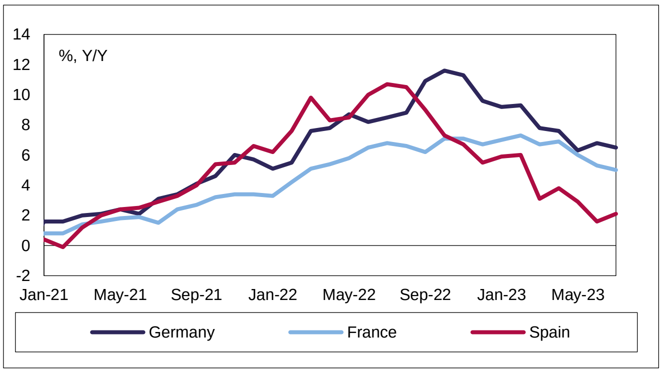
Source: EC, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Consumer price inflation*



**National measure. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area member states: Consumer price inflation*



**HICP measure. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

inflation data for June, due on Thursday, will register a further decline deeper into negative territory from the 2½-year low of -1.5%Y/Y reached in May.

In terms of economic activity, the first estimate of euro area Q2 GDP is due on Monday. Following today's data from several member states, and after economic output moved sideways in Q1, we now expect growth of 0.2%Q/Q in Q2, which would be 0.1ppt below the ECB's most recent projection. We will get additional insight into household consumption from German retail sales data for June also on Monday, followed by the equivalent euro area figures on Friday. In terms of the manufacturing sector, Friday will bring French, Italian and Spanish IP data for June, as well as German factory orders data for that month. Labour market data are also due on Tuesday, with the euro area unemployment rate likely to remain unchanged in June at the series low of 6.5% and German figures for July also to be published that day. Finally, the final manufacturing and services PMI surveys for July are due on Tuesday and Thursday respectively, followed by the construction PMIs on Friday.

UK

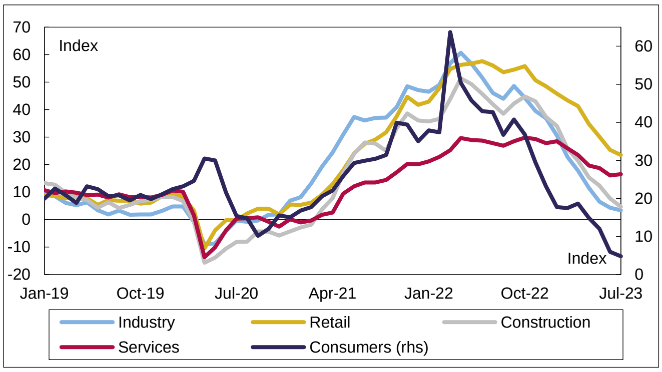
The week ahead in the UK – BoE likely to hike by 25bps amid significant forecast revisions

The main event of the coming week in the UK will be the BoE's latest monetary policy announcement on Thursday, which will be accompanied by updated macroeconomic projections in its latest Monetary Policy Report. At the previous policy meeting in June, the MPC responded to significant upside surprises in the inflation and private sector wage figures with an acceleration in the pace of hikes to 50bps, taking Bank Rate to 5.00% and the cumulative tightening over the previous eighteen months to 490bps. Since last month's meeting, the economic news flow has been mixed. Surveys have signalled a marked slowdown in economic momentum at the start of the third quarter. Headline inflation was more favourable in June too, leaving the average in Q2 (8.4%Y/Y) just 0.2ppt higher than the BoE's previous forecast published in May's Monetary Policy Report (MPR). However, the moderation in core inflation in June failed to reverse the spike in May, to leave it on average in Q2 up 0.7ppt at 6.9%Y/Y, with services inflation in June and Q2 as a whole (7.2%Y/Y) a full 0.5ppt higher than the BoE's forecast. Moreover, with private sector regular wage growth accelerating further in the three-months to May to a series high, with the exception of pandemic-related distortions, concerns of inflation persistence will remain a concern for the majority of MPC members this month.

Therefore, another hike in Bank Rate in the coming week seems a certainty. But while we might well see the more hawkish Committee members (Catherine Mann and Jonathan Haskel) vote for another increase of 50bps, we expect the majority – including new external representative Megan Greene who this month replaced uber-dove Silvana Tenreyro on the MPC – to favour the more moderate pace of increase of 25bps to take Bank Rate to 5.25%. Nevertheless, with the BoE also to set out a new Gilt sales programme for the coming twelve months alongside its September rate announcement, the MPC might at this meeting endorse a faster pace of quantitative tightening. Since September 2022, the BoE has been reducing its Gilt holdings at the rate of £80bn per year, but Deputy Governor Dave Ramsden, who is responsible for the programme, recently suggested scope for a quicker pace of QT, which could be achieved without increasing active Gilt sales.

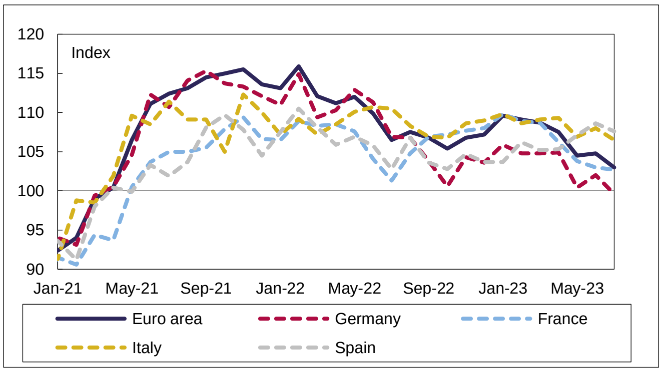
Just as important as the latest monetary policy decision will be the MPC updated guidance on the likely path of future policy, which will be determined and contextualized by the BoE's updated macroeconomic projections. The BoE's previous guidance on the future path of policy stated that "if there were to be evidence of more persistent [inflationary] pressures, then further tightening in monetary policy would be required". This might well be repeated, leaving the door open to further tightening over coming months. But it arguably leaves too much uncertainty about quite how that evidence of more persistent [inflationary] pressures might be determined, and what the MPC's precise reaction function would be to that evidence. So, market expectations for further rate hikes will likely be guided more significantly by the BoE's updated economic projections in the August MPR.

Euro area: Selling & consumer price expectations



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

Euro area: Employment expectations indices



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

Importantly, several key assumptions used in the BoE's projections will have changed substantively since the May MPR. Most notably, based on the market-implied path for Bank Rate, the terminal rate for the cycle will be assumed to be roughly 150bps higher, while the profile for sterling will be firmer. With those metrics likely to weigh more heavily not least on investment (including in construction) and exports, and recent survey data suggesting that GDP growth in Q3 will be weaker than the BoE's previous forecast (0.5%Q/Q), there will be a significant case for a downwards revision to the full projection profile for GDP. Indeed, a recession might yet be judged necessary to return UK inflation to target over the horizon.

However, with the future path for energy prices likely to be somewhat lower than previously thought, and employment and wage growth stronger than anticipated over the near term at least, the BoE's growth outlook for Q4 and early 2024 might be just as firm as it previously forecast. And so, we suspect that it's full-year growth forecasts of ¾%Y/Y in 2024 and 2025 might be revised down only moderately. At the same time, despite the higher starting point in June, the BoE might well expect headline inflation to decline over coming quarters more than previously expected, not least reflecting the lower wholesale gas prices and weakening momentum in global manufacturing prices. But with services inflation still elevated, and persisting risks of second-round effects in that sector, the BoE's expectation for core inflation might well be nudged higher. And while its modal forecast might continue to suggest again that headline inflation will on average be only slightly above 2% in 2024 and firmly below 2% in 2025, a significant upwards skew to risks might suggest that its mean inflation forecast will likely still be close to 2% into 2025, validating market expectations of a terminal Bank Rate of 5.75% or more.

The week ahead in the UK – June bank lending figures the data highlight

In terms of the coming week's data flow, the release of the BoE's monetary data (Monday) will provide an update on the impact of the MPC's aggressive monetary tightening this cycle on bank lending and deposits in June. The results from the BoE's latest Decision Maker Panel survey (Thursday) will offer an update on firms' inflation and wage expectations. The final PMI surveys for July – manufacturing (Tuesday), services (Thursday) and construction (Friday) – will also likely suggest again that price pressures remain relatively sticky in the services sector but continue to decline in manufacturing. And these indices are likely again to imply that economic activity slowed sharply in services at the start of Q3 and continued to contract in manufacturing and construction. Moreover, with the flash composite activity PMI having fallen in July to a six-month of just 50.7, the final estimates are likely to suggest minimal growth momentum overall.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	European Commission's Economic Sentiment Indicator	Jul	**94.5**	95.0	95.3	-
	European Commission's industrial (services) confidence indices	Jul	**-9.4 (5.7)**	-7.8 (5.3)	-7.2 (5.7)	-7.3 (5.9)
	European Commission's final consumer confidence index	Jul	**-15.1**	-15.1	-16.1	-
Germany	Preliminary GDP Q/Q% (Y/Y%)	Q2	**0.0 (-0.2)**	*0.1 (-0.4)*	-0.3 (-0.5)	-0.1 (-0.2)
	Preliminary HICP (CPI) Y/Y%	Jul	**6.5 (6.2)**	6.6 (6.2)	6.8 (6.4)	-
France	Preliminary GDP Q/Q% (Y/Y%)	Q2	**0.5 (0.9)**	*0.1 (0.4)*	0.2 (0.9)	0.1 (-)
	Consumer spending M/M% (Y/Y%)	Jun	**0.9 (-2.8)**	-	0.5 (-3.6)	0.6 (-3.5)
	Preliminary HICP (CPI) Y/Y%	Jul	**5.0 (4.3)**	5.1 (4.2)	5.3 (4.5)	-
	PPI Y/Y%	Jun	**3.0**	-	5.8	5.6
Italy	PPI Y/Y%	Jun	**-8.2**	-	-6.8	-
Spain	Preliminary HICP (CPI) Y/Y%	Jul	**2.1 (2.3)**	1.9 (1.8)	1.6 (1.9)	-
	Preliminary GDP Q/Q% (Y/Y%)	Q2	**0.4 (1.8)**	*0.3 (1.7)*	0.6 (4.2)	0.5 (-)

Auctions

Country	Auction
- Nothing to report -	

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/ *Daiwa forecast/actual*	Previous
Monday 31 July 2023					
Euro area	10.00	Prelimnary HICP (core HICP) Y/Y%	Jul	*5.2 (5.3)*	5.5 (5.5)
	10.00	First esitimate - GDP Q/Q% (Y/Y%)	Q2	*0.2 (0.5)*	0.0 (1.1)
Germany	07.00	Retail sales M/M% (Y/Y%)	Jun	0.1 (-0.4)	1.6 (-3.9)
Italy	09.00	First estimate - GDP Q/Q% (Y/Y%)	Q2	0.0 (0.9)	0.6 (1.9)
	10.00	Preliminary HICP (CPI) Y/Y%	Jul	6.6 (6.1)	6.7 (6.4)
UK	09.30	Net consumer credit £bn (Y/Y%)	Jun	-	1.1 (7.5)
	09.30	Net mortgage lending £bn (approvals '000s)	Jun	0.5 (48.8)	-0.1 (50.5)
Tuesday 01 August 2023					
Euro area	09.00	Final manufacturing PMI	Jul	*42.7*	43.4
	10.00	Unemployment rate %	Jun	*6.5*	6.5
Germany	08.55	Final manufacturing PMI	Jul	*38.8*	40.6
	08.55	Unemployment rate % (change '000s)	Jul	5.8 (20.0)	5.7 (28.0)
France	08.50	Final manufacturing PMI	Jul	*44.5*	46.0
Italy	08.45	Manufacturing PMI	Jul	-	43.8
Spain	08.15	Manufacturing PMI	Jul	48.5	48.0
UK	00.01	BRC shop price index Y/Y%	Jul	-	8.4
	07.00	Nationwide house price index M/M% (Y/Y%)	Jul	-0.5 (-4.0)	0.1 (-3.5)
	09.30	Final manufacturing PMI	Jul	*45.0*	46.5
Wednesday 02 August 2023					
Spain	08.00	Unemployment change '000s	Jul	-	-50.3
Thursday 03 August 2023					
Euro area	09.00	Final services (composite) PMI	Jul	*51.1 (48.9)*	52.0 (49.9)
	10.00	PPI Y/Y%	Jun	-	-1.5
Germany	07.00	Trade balance €bn	Jun	15.0	14.6
	08.55	Final services (composite) PMI	Jul	*52.0 (48.3)*	54.1 (50.6)
	-	New car registrations (production)* Y/Y%	Jul	-	24.8 (32.8)
France	08.50	Final services (composite) PMI	Jul	*47.4 (46.6)*	48.0 (47.2)
Italy	08.45	Services (composite) PMI	Jul	52.3 (49.3)	52.2 (49.7)
	09.00	Retail sales M/M% (Y/Y%)	Jun	-	0.7 (3.0)
Spain	08.15	Services (composite) PMI	Jul	-	53.4 (52.6)
UK	09.30	Final services (composite) PMI	Jul	*51.5 (50.7)*	53.7 (52.8)
	09.30	BoE Decision Maker Panel, 1Y ahead CPI expectations y/y%	Jul	-	5.7
	12.00	BoE Bank Rate %	Aug	*5.25*	5.00
Friday 04 August 2023					
Euro area	08.30	Construction PMI	Jul	-	44.2
	10.00	Retail sales M/M% (Y/Y%)	Jun	0.3 (-1.7)	0.0 (-2.9)
Germany	07.00	Factory orders M/M% (Y/Y%)	Jun	-2.0 (-5.6)	6.4 (-4.3)
	08.30	Construction PMI	Jul	-	41.4
France	07.45	Industrial production M/M% (Y/Y%)	Jun	-0.5 (1.2)	1.2 (2.6)
Italy	09.00	Industrial production M/M% (Y/Y%)	Jun	-0.3 (-2.0)	1.6 (-3.7)
Spain	08.00	Industrial production M/M% (Y/Y%)	Jun	-0.7 (-1.6)	0.6 (-0.1)
UK	09.00	New car registrations Y/Y%	Jul	-	25.8
	09.30	Construction PMI	Jul	-	48.9

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

The coming week's key events & auctions

Country	BST	Event / Auction
		Monday 31 July 2023
		- Nothing scheduled -
		Tuesday 01 August 2023
UK	10.00	Auction: £4bn of 3.5% 2025 bonds
		Wednesday 02 August 2023
Germany	10.30	Auction: €1.25bn of 1% 2038 bonds
	10.30	Auction: €750mn of 2036 bonds
		Thursday 03 August 2023
France	09.50	Auction: To sell 2033, 2038 and 2060 bonds
Spain	09.30	Auction: To sell 2027, 2029 and 2033 bonds
UK	12.00	BoE monetary policy announcement, statement, minutes and Monetary Policy Report to be published
	12.30	BoE Governor Bailey holds press conference on the BoE's latest Monetary Policy Report
		Friday 04 August 2023
UK	12.30	BoE Chief Economist briefs economic agents about the BoE's latest Monetary Policy Report

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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