Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Shorter-dated Gilts made gains but longer-dated Gilts made losses as the BoE hiked Bank Rate by 25bps, raised the possibility that the peak could be near, but also committed to keeping policy “sufficiently restrictive for sufficiently long”.
- Longer-dated Bunds made losses even as euro area goods price pressures continued to diminish and the final July services PMIs reaffirmed that growth in the sector is probably slowing.
- Friday will bring euro area retail sales and German factory orders figures, as well as the latest European construction PMIs.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	2.988	-0.003
OBL 2.4 10/28	2.595	+0.050
DBR 2.6 08/33	2.598	+0.074
UKT 0⅝ 06/25	4.915	-0.030
UKT 1⅝ 10/28	4.448	+0.024
UKT 3¼ 01/33	4.461	+0.068

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

UK

BoE hikes by 25bps on signs of inflation persistence despite weak growth momentum

As expected by a majority of observers, ourselves included, the BoE today slowed the pace of its monetary tightening to 25bps, from 50bps in June, taking Bank Rate to 5.25%. Six members of the MPC voted in favour of the decision. Two members – hawkish Haskel and Mann, both external representatives – preferred another hike of 50bps. And the other – dovish Dhingra, also an external member – again preferred no change. Recent upside surprises to wage growth and services inflation were considered by the majority of the MPC to imply that some upside risks to the inflation outlook were crystallising and consistent with more persistent second-round effects. As such, they motivated today’s rate hike. At the same time, signs of some weakening of economic demand momentum, as well as the better-behaved June inflation data, recent slight increase in the unemployment rate and drop in the ratio of vacancies-to-unemployment, explained the smaller rate hike compared to June.

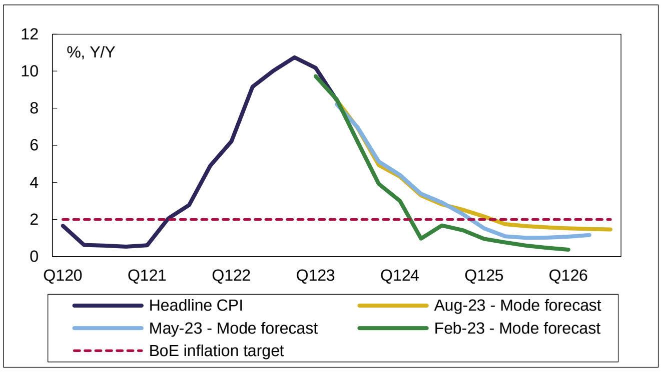
MPC commits to keeping policy sufficiently restrictive for sufficiently long

The MPC’s decision represented the fourteenth successive hike and took the cumulative increase in Bank Rate this cycle to 515bps. Given that significant tightening of monetary conditions over the past twenty months, the MPC judged that its policy stance is now restrictive and hence bearing down on economic growth and underlying inflation. Keen to influence the yield curve, it also pledged to keep Bank Rate “sufficiently restrictive for sufficiently long” to return inflation sustainably back to target. But it made clear that policy will remain data dependent. Indeed, the MPC maintained its forward guidance that “If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required”, unsurprisingly leaving the door open to additional rate hikes.

BoE’s baseline projection foresees inflation back below target in the medium term

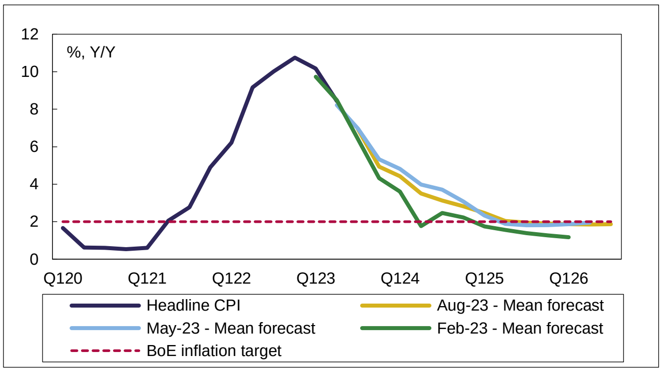
In his press conference, Governor Bailey insisted that the MPC has an open mind with respect to the future path of Bank Rate. Indeed, the BoE’s updated projections make clear that a range of possible profiles for interest rates could be consistent with achievement of its inflation target over the medium term. Certainly, inflation should continue steadily to decline. Given the reduction in the household energy price cap in July, and larger reduction likely in October, headline inflation is expected to drop just below 7.0%Y/Y in Q3 and slightly below 5.0%Y/Y in Q4. And assuming that monetary policy remains restrictive, it should continue to fall thereafter, albeit with the pace of decline dependent in part on the tightness of the labour market, and persistence of high wage growth and services inflation. According to the BoE’s modal projection – i.e.

UK: BoE modal inflation forecasts comparison*



**Based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.*

UK: BoE mean inflation forecasts comparison*



**Based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.*

the forecast it considers most likely – inflation is expected to decline to the 2% target or below by mid-2025, and to just below 1.5%Y/Y by the end of the projection horizon in mid-2026. Given the recent evidence of inflation persistence, however, that represented an upwards revision of roughly ½ppt from the May forecast, despite the significant monetary tightening since then.

Upside skew to risks likely to call for one or two further hikes before terminal rate is reached

Once again – and appropriately so given recent upside surprises in the data for pay and services prices – the MPC also continues to see the risks to the inflation outlook to be skewed to the upside. So, the BoE's mean projection path remains somewhat higher than the mode, albeit with inflation still expected to decline below 2.0%Y/Y by late 2025 and into 2026. Notably, the medium-term inflation outlook is judged to be little different whether the projections are conditioned on an assumption of Bank Rate unchanged over the horizon at the current level of 5.25%, or a market-implied path whereby Bank Rate rises to a peak of just over 6% but then falls below 6% by end-2024 and is cut further to average just under 5½% over the next three years. In our view, that suggests that the peak in Bank Rate this cycle is now within reach. However, the ongoing strength in private sector pay and stickiness in services inflation, and associated risks of inflation persistence, means that one or two further hikes are likely to be required before the MPC is satisfied. We maintain our baseline forecast that Bank Rate will peak at 5.75% in November before being cut from the second half of 2024.

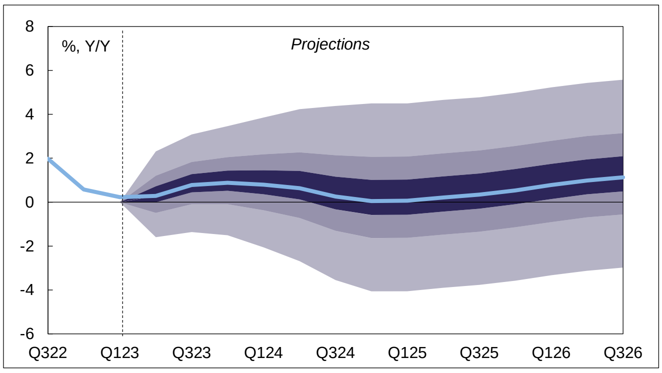
GDP expected to flatline in the course of 2024 with unemployment expected to rise gradually

Of course, the outlook for inflation and rates will also depend on the path of economic output. Over the near term, the BoE expects underlying GDP growth to remain close to 0.2%Q/Q supported by the pickup in real incomes thanks to both stronger pay growth and slower inflation. But with monetary policy to remain restrictive and further restrain demand and push unemployment steadily higher, growth momentum is expected to evaporate. Indeed, GDP is projected to be barely better than flat in the four quarters from Q224, with a non-negligible risk of recession over that period. Overall, the BoE's modal projection for GDP growth in 2024 and 2025 was nudged down respectively by ¼ppt to ½%Y/Y and ½ppt to ¼%Y/Y. And the unemployment rate is projected to rise from 4.0% in the three months to May to 4¾% in 2025.

Acceleration in pace of QT likely to be agreed in September

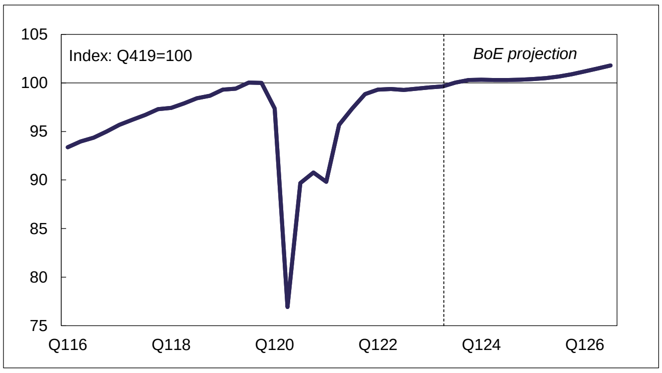
Finally, the MPC did not discuss quantitative tightening (QT) today. However, it will do so at its September policy meeting. And in line with the preference expressed recently by Deputy Governor Ramsden, we expect the MPC next month to agree to increase the pace of balance sheet reduction over the twelve months from October. Certainly, with the Gilt market having

UK: BoE GDP growth forecast*



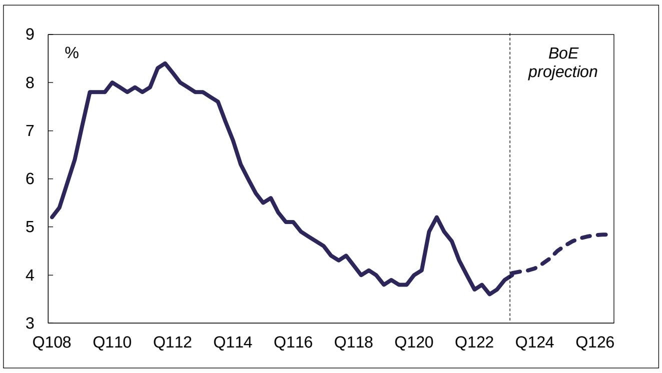
**Light blue line represents modal projection based on market-implied Bank Rate that peaks just over 6% and average just under 5½% over the next three years. Source: BoE and Daiwa Capital Markets Europe Ltd.*

UK: GDP level*



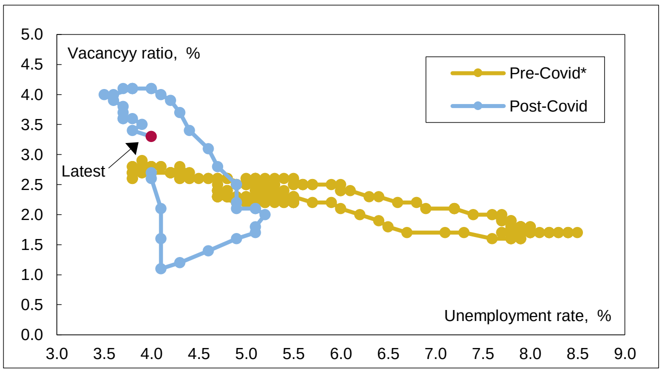
**BoE modal projection. Source: BoE, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

UK: BoE unemployment rate forecast



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Beveridge curve



**2001-2020. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

been untroubled by QT since the BoE started active sales last November, we would not be surprised to see the intended annual rate of reduction increased from about £80bn in the year to September to £100bn. With automatic run-off of the BoE's bond-holdings set to rise from £35bn in the current period to £50bn over the twelve months from this October, active Gilt sales would still increase modestly in the new period, by £5bn also to £50bn. And given Ramsden's stated views, particularly if the Committee was keen to support rates across the yield curve, the risks to that forecast could be skewed to the upside.

The day ahead in the UK

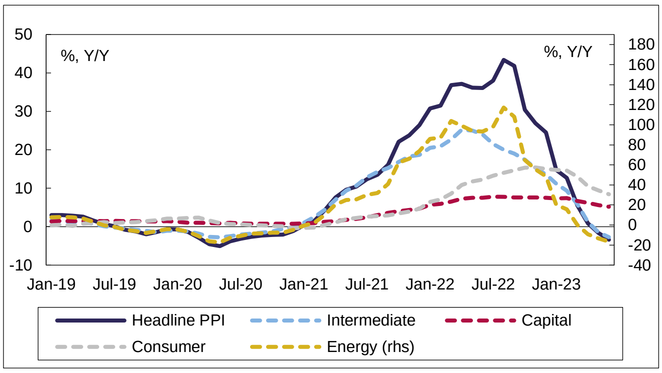
The end of the week in the UK will bring the construction PMIs and new car registrations data for July. Like in the euro area, the construction PMIs are expected again to indicate that activity in the sector is contracting.

Euro area

Producer price inflation increasingly negative, but services price pressures remain elevated

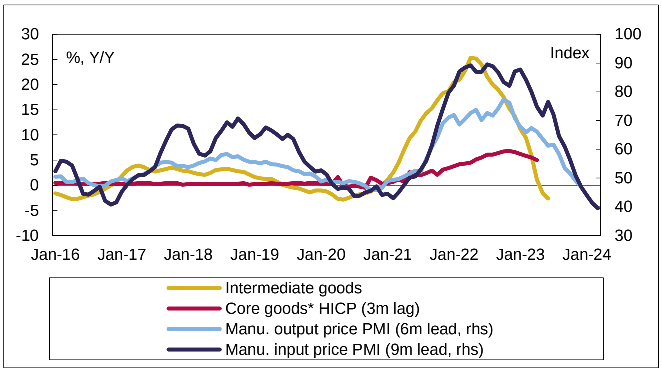
Today's euro area producer price figures once highlighted the impact of the global downtrend in industrial sector costs, which should continue to feed through to consumer goods inflation over coming months. Indeed, producer prices declined in June for the eighth month out of the past nine (-0.4%M/M), to leave the headline PPI rate at a three-year low of -3.4%Y/Y. While energy prices fell for a sixth consecutive month (-0.5%M/M) to be down 16.5%Y/Y, the decline also reflected prices of industrial non-energy goods. Reflecting an easing of supply-chain strains and softer global demand, prices of intermediate goods fell for the seventh month out of eight (-0.7%M/M) to be down 2.7%Y/Y. Consumer goods prices also fell (-0.2%M/M) to leave the annual rate moderating to a sixteen-month low of 8.4%Y/Y. Meanwhile, prices of capital goods were little changed (0.1%M/M), so that the respective annual rate slowed to an eighteen-month low of 5.2%Y/Y. Reflecting developments in wholesale markets, the manufacturing PMIs suggested that input costs and output prices charged fell in July to a fourteen-year low. And we expect producer goods price inflation to fall further into negative territory over coming months. Of course, the ECB remains more concerned about the stickiness of inflation in the services sector. And in that respect, today's final services PMIs for July suggested that price pressures in the sector remain elevated by historical standards. While the services input costs PMI edged slightly lower in July (down 0.3pt to 61.0), it remained above the long-run average, while the survey's prices charged PMI fell just 0.1pt to 56.2, still some 5½pts above the long-run average.

Euro area: Producer price inflation



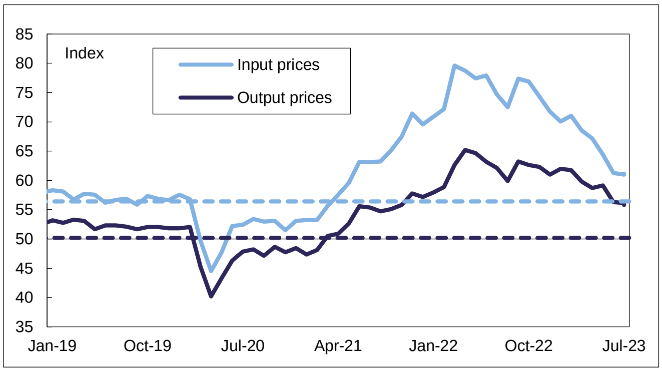
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Goods price inflation indicators



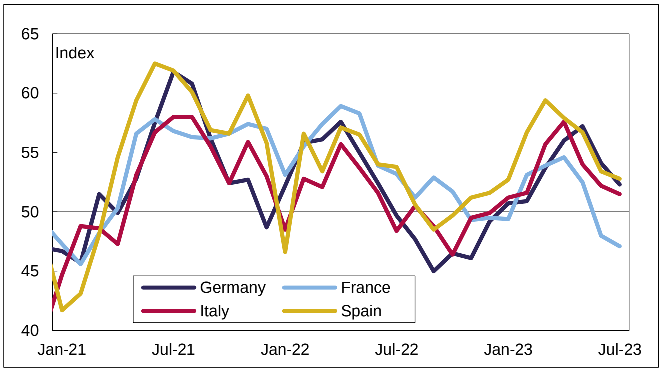
**Non-energy industrial goods. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area: Services price PMIs*



**Dashed lines represent pre-pandemic averages. Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.*

Euro area member states: Services activity PMIs



Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area services PMI deteriorates to a 7-month low, consistent with slowdown in expansion

While euro area GDP registered moderate growth in Q2 (0.3%Q/Q), the PMIs have signalled a marked slowdown in recovery momentum over recent months. The final euro area composite output PMI for July, published today, was revised a touch lower from the flash release to an eight-month low of 48.6, a second-successive sub-50 ‘contractionary’ reading. While the weakness remained more pronounced in the manufacturing sector (42.7), recovery momentum in the services sectors also slowed sharply, with the respective activity index down for a third consecutive month, by 1.1pts to 50.9, implying the softest growth in the sector for seven months. And today’s survey suggested a steeper pace of contraction in new business in services than previously estimated, with a deterioration in both domestic and overseas demand. The PMIs suggested that services activity was weakest in France, for which the respective index (47.1) was the lowest since November 2020. But this contrasts markedly with the findings of INSEE’s latest business survey, which is often the more reliable guide to conditions in the sector and suggested that the business climate remained broadly stable at the start of Q3. And despite falling to their lowest levels since the start of the year, the respective indices from Germany (52.3), Italy (51.5) and Spain (52.8) remained consistent with ongoing expansion. Moreover, with the exception of Italy, firms continued to report ongoing jobs growth in the sector.

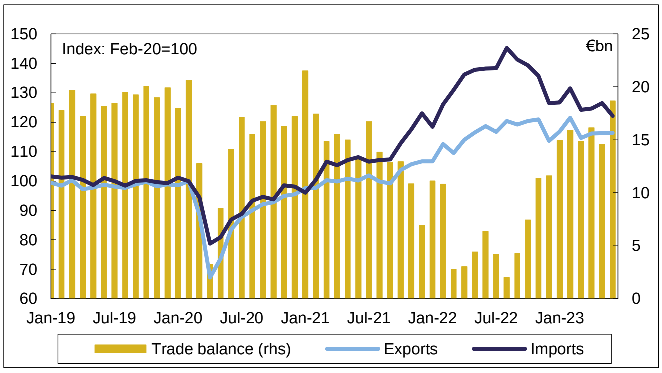
German goods trade likely subtracted from GDP in Q2 even as surplus rose to 29-month high

The value of German goods exports extended its broad sideways trend in June, rising 0.1%M/M for a second successive month. While that left them down 1.2%3M/3M, they were also down just 0.1%3M/Y. And with the value of imports down 3.4%M/M, Germany’s goods trade surplus widened €4.1bn in June to €18.7bn, the largest since January 2021. Of course, the widening of the trade surplus reflects the continued reversal of the shock to Germany’s terms of trade – the value of goods imports was down a steep 9.4%3M/Y as import prices fell for the tenth successive month in June to be down a similar 9.2%3M/Y. Export prices were down for a sixth successive month but were still up 0.3%3M/Y. Adjusting for price changes, goods export volumes were also up 0.1%M/M in June but were down 0.2%3M/3M. In contrast, goods import volumes fell 2.2%M/M but – due to strength in the prior two months – were up 2.3%3M/3M. As such, despite the significant widening of the trade surplus over the quarter, net goods trade appears to have subtracted from German GDP growth in Q2.

Shipments of consumer and intermediate goods weak, but capital goods exports growth firm

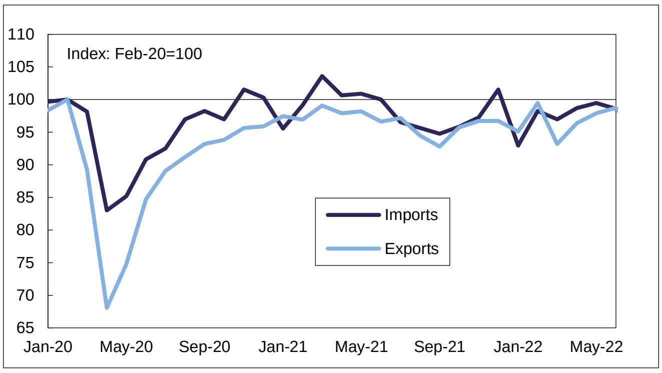
The overall sideways German export trend inevitably masks significant contrasts by sub-sector. With manufacturers having adjusted production in the face of last year’s energy shock, the value of exports of chemicals and related products (including

Germany: Goods trade values



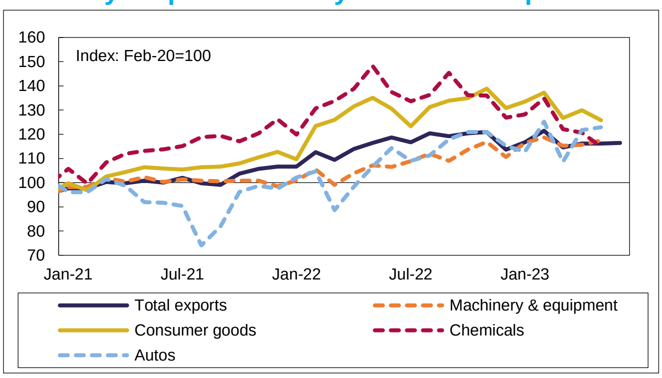
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Goods export & import volumes



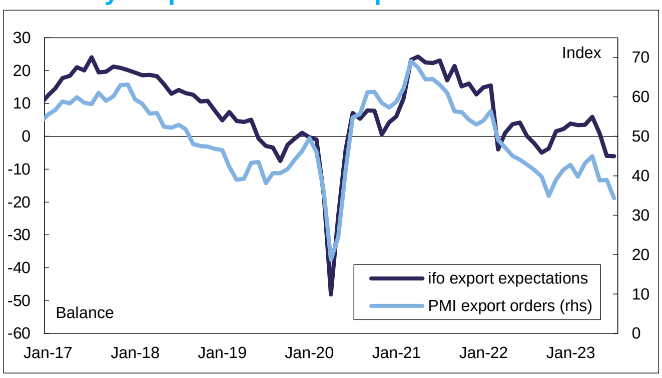
Source: *Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Germany: Export values by selected component



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Germany: Export orders & expectations indices



Source: Refinitiv Datastream, S&P Global and Daiwa Capital Markets Europe Ltd.

pharmaceuticals) fell for a third successive month in May to be down 22.5%Y/Y, having previously seen strong growth ahead of the Russian invasion of Ukraine. Shipments of consumer and intermediate goods, meanwhile, were both down more than 6%Y/Y that month. In marked contrast, benefiting from the repair of supply chains as well as still relatively firm investment demand in certain sub-sectors, the value of machinery exports was up almost 10%Y/Y while shipments of motor vehicles were up 15.1%Y/Y that month on the same basis. While surveys suggest that supply constraints in the factory sector continue to ease at the start of Q3, they also suggest that exports are likely to remain lacklustre amid weakening demand for manufactured goods and lower order backlogs.

The day ahead in the euro area

Tomorrow brings the release of euro area retail sales data for June, which are expected to reveal that overall spending in the region remains lacklustre. While German retail sales dropped 0.8%M/M and Italian sales fell 0.2%M/M, French consumer spending on goods rose 0.9%M/M, and euro area sales might yet have increased modestly. And with sales in May likely to be revised up from the previous estimate of zero growth, euro area sales are likely to have been little changed over Q2 as a whole and could avoid a sixth successive quarterly contraction. In terms of the manufacturing sector, tomorrow will bring French, Italian and Spanish IP data for June, as well as German factory orders data for that month. Whilst industrial production is expected to have ticked lower in each of those member states in June, growth in euro area manufacturing output at the start of the quarter should ensure that the sector positively contributed to GDP growth in Q2. German factory orders are likely to have dropped in June following a surge in May related in part to one-off factors. Meanwhile, the euro area construction PMIs for July will likely point to an acceleration in the pace of contraction as higher interest rates continue to take their toll.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final services (composite) PMI	Jul	**50.9 (48.6)**	*51.1 (48.9)*	52.0 (49.9)	-
	PPI Y/Y%	Jun	**-3.4**	-	-1.5	-1.6
Germany	Trade balance €bn	Jun	**18.7**	15.0	14.4	14.6
	Final services (composite) PMI	Jul	**52.3 (48.5)**	*52.0 (48.3)*	54.1 (50.6)	-
France	Final services (composite) PMI	Jul	**47.1 (46.6)**	*47.4 (46.6)*	48.0 (47.2)	-
Italy	Services (composite) PMI	Jul	**51.5 (48.9)**	52.3 (49.3)	52.2 (49.7)	-
	Retail sales M/M% (Y/Y%)	Jun	**-0.2 (3.6)**	-	0.7 (3.0)	0.6 (-)
Spain	Services (composite) PMI	Jul	**52.8 (51.7)**	-	53.4 (52.6)	-
UK	Final services (composite) PMI	Jul	**51.5 (50.8)**	*51.5 (50.7)*	53.7 (52.8)	-
	BoE Decision Maker Panel, 1Y ahead CPI expectations Y/Y%	Jul	**5.4**	-	5.7	-
	BoE Bank Rate %	Aug	**5.25**	*5.25*	5.00	-

Auctions

Country	Auction
France	sold €5.81bn of 3.00% 2033 bonds at an average yield of 3.09%
	sold €1.86bn of 1.25% 2038 bonds at an average yield of 3.37%
	sold €1.33bn of 4.00% 2060 bonds at an average yield of 3.51%
Spain	sold €1.92bn of 1.50% 2027 bonds at an average yield of 3.238%
	sold €1.55bn of 0.60% 2029 bonds at an average yield of 3.281%
	sold €2.25bn of 3.55% 2033 bonds at an average yield of 3.605%
	sold €535mn of 0.65% 2027 index-linked bonds at an average yield of 0.866%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain		Unemployment change '000s	Jul	**-11.0**	-	-50.3	-
Auctions							
Country		Auction					
Germany		sold €1.25bn of 1% 2038 bonds at an average yield of 2.67%					
		sold €750mn of 0% 2036 bonds at an average yield of 2.61%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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
Auctions and events						
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.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs