Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds made gains across the curve as the final euro area inflation data for July confirmed the drop in headline inflation to an 18-month low and that summer holiday-related prices contributed to the stickiness of core inflation.
- Gilts made gains as UK retail sales fell further than expected in July.
- The coming week will bring several survey results for August including the flash PMIs while ECB President Lagarde will give a speech at Jackson Hole.

Daily bond market movements

Bond	Yield	Change
BKO 3.1 09/25	3.040	-0.053
OBL 2.4 10/28	2.622	-0.076
DBR 2.6 08/33	2.619	-0.085
UKT 0⅝ 06/25	5.148	-0.087
UKT 1⅝ 10/28	4.679	-0.063
UKT 3¼ 01/33	4.671	-0.069

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

Euro area

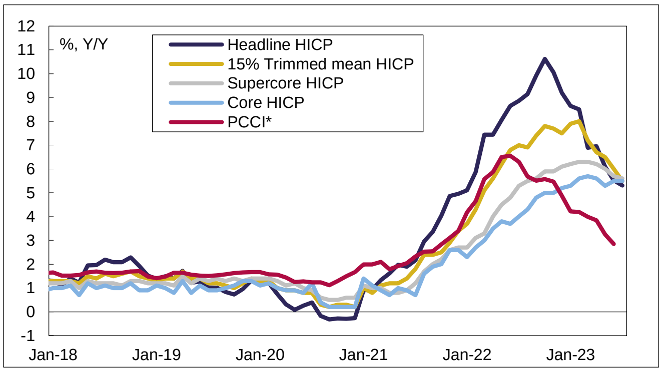
Final July inflation data confirm stickiness of core rate despite softening in goods & energy

Today's final euro area inflation estimates for July aligned with the flash figures, which had originally been a touch firmer than expectations, confirming that the headline HICP inflation rate eased a further 0.2ppt in July to 5.3%Y/Y. That marked the lowest rate since January 2022 and was exactly half the peak recorded last October. Consumer prices fell for the first month in six, albeit by just 0.1%M/M. So, base effects associated with last year's substantial shocks to energy and food prices were key drivers of the decline in the annual rate. Indeed, the monthly rise in food prices was once again above the seasonal average, but the base effect allowed the annual rate of that component to ease 0.8ppt to 10.8%Y/Y, almost 5ppts below March's peak. Despite an increase in auto fuel prices, and instead reflecting a further decline in household electricity and gas bills, energy prices also fell further this month, resulting in the steepest annual drop in the respective annual rate (-6.1%Y/Y) since December 2020. Within the core items, in part due to more aggressive summer discounting of clothing prices, the monthly change in non-energy industrial goods prices was below the seasonal norm for the first time in 28 months. So, core goods inflation moderated a further 0.5ppt to 5.0%Y/Y, the softest for a year. However, with the monthly rise in services prices (1.36%M/M) the second-strongest on the series (exceeded only by July 2018), reflecting higher prices of hotels, package holidays and air fares as a further reflection of the resilient demand for summer tourism, services inflation rose a further 0.2ppt to a new series high of 5.6%Y/Y. And as a result, core HICP inflation moved sideways at 5.5%Y/Y, just 0.2ppt below the series high reached in March.

Momentum in services inflation starting to fall

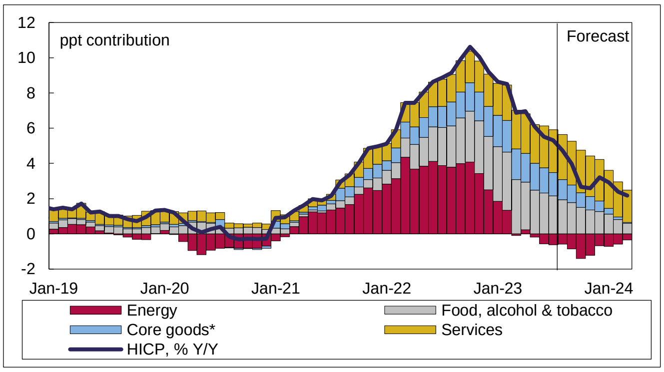
So, core inflation was sticky in July and still well above levels consistent with the ECB's inflation target. Indeed, the share of items in the inflation basket with inflation above 2.0%Y/Y rose in July to 88.2%, the highest since March. However, other measures of underlying price pressures showed further improvement. For example, the ECB's supercore measure of the most output gap-sensitive items edged down 0.1ppt to a ten-month low of 5.6%Y/Y. The 15% trimmed mean HICP rate fell 0.5ppt for a second successive month to a sixteen-month low of 5.5%Y/Y, 2.5ppts below February's peak. There were also further signs that momentum in services inflation has started to slow – the increase in seasonally-adjusted services prices in July on a three-month annualised basis (4.5%) was the softest since September. And reflecting recent favourable developments in wholesale and producer prices, the equivalent rate for momentum in core goods prices continued to fade significantly to just 2.5%.

Euro area: Consumer price inflation measures



**Persistent and Common Component of Inflation. Source: ECB, Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Consumer price inflation forecast



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Near-term stickiness in core inflation keeps door open to one last hike in September

While wholesale oil and gas prices have risen over the past month pointing to a slightly stronger August reading for energy inflation, base effects will push that component sharply lower in September and October. Base effects will also push food inflation steadily lower into next year. Producer prices and survey indicators suggest that core goods inflation will continue to decline, probably to just above 2.0%Y/Y by year-end and below that threshold in the New Year. And while it will remain sticky over the summer, services inflation will eventually fall back once base effects associated with Germany's public transport subsidies wear off in September and the boost to summer holiday-related prices fades. Nevertheless, while headline inflation is highly likely to fall below 5.0%Y/Y in August and to 3.0%Y/Y or below in Q4, core inflation could well remain above 5.0%Y/Y until October and above 4.0%Y/Y until January. As such, despite the recent deterioration in the near-term GDP growth outlook, many Governing Council members will remain concerned of inflation persistence. And so, while the forthcoming dataflow – including the August PMIs and inflation figures – might change matters, for the time being we maintain our view that the ECB will hike rates one last time this cycle at its September policy meeting.

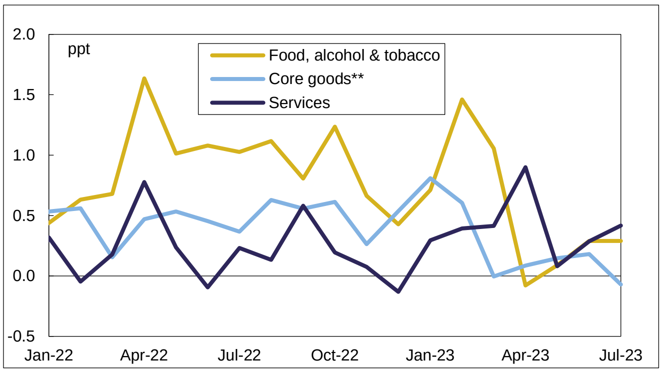
Construction output down in Q2 with further drop likely in Q3

Today's construction output data made clear that activity in the sector subtracted from GDP in Q2. Production in construction fell 1.0%M/M in June to be down 1.1%Q/Q in Q2. Continued growth in civil engineering of 0.8%Q/Q, supported in part by NGEU funds, was more than offset by the decline in building work of 1.5%Q/Q. The contraction in construction output in Germany (-1.9%Q/Q) and also probably Italy (which does not publish detailed figures along with the euro area data for reasons of confidentiality) more than offset the growth in France (0.5%Q/Q) and Spain (2.9%Q/Q). The drop in euro area construction output left it at a six-month low almost 3.0% below February's 13-year high. With higher interest rates squeezing housing affordability and impacting new business investment decisions, and residential property prices now falling in the euro area (-0.9%Q/Q to be up just 0.4%Y/Y in Q1) and particularly sharply in Germany (-3.1Q/Q to be down 6.8%Y/Y), survey indicators unsurprisingly point to the likelihood of a further contraction in building work in Q3. Indeed, with the new orders index pointing to a steep drop in demand, the euro area construction output PMI fell to a seven-month low of 43.4 in July. The housing PMI (39.3) pointed to the sharpest contraction in residential building work since the first wave of Covid-19 in April 2020 with the index for commercial work suggesting the biggest drop since January 2021.

The week ahead in the euro area

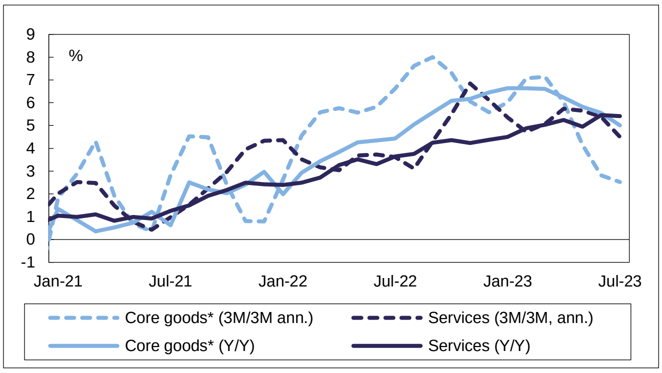
The coming week's economic data calendar is relatively quiet, with arguably the most interesting release – the preliminary August PMIs – to be published on Wednesday. The euro area PMIs have weakened markedly in recent months, implying a

Euro area: Deviation from l-r average price change*



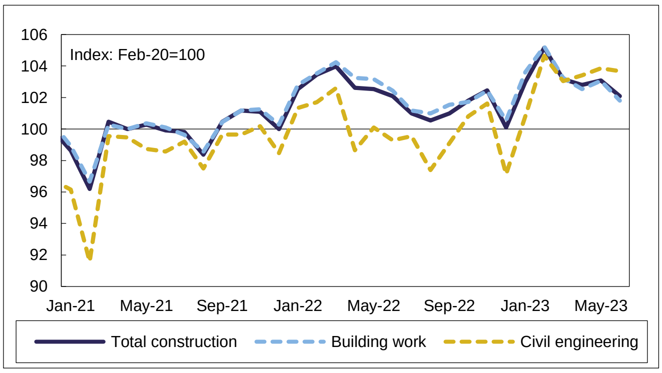
** Deviation in M/M rate of price increase from the long-run average for the month. ** Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa*

Euro area: Services & core goods* inflation



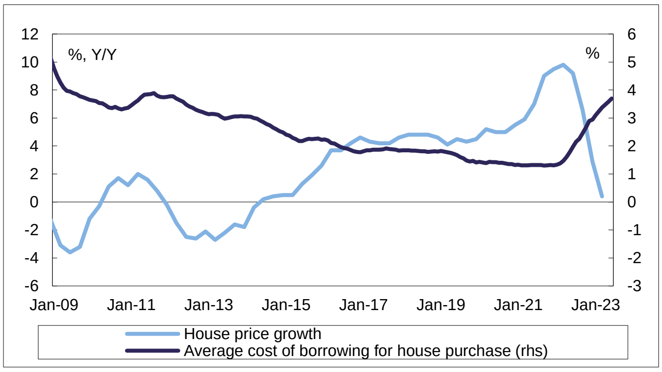
**Non-energy industrial goods. Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.*

Euro area: Construction output



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

Euro area: House prices & average mortgage rate



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

notable deterioration in economic conditions at the start of Q3. In particular, the euro area composite PMI fell for a third consecutive month in July and by 1.3pt to an eight-month low 48.6. This left the index more than 3½pts below the Q2 average and firmly in contractionary territory for the first time since Q4. At the sectoral level, the July PMIs suggested a significant loss of momentum and slight moderation of cost pressures in services, as well as a deep contraction and falling output prices in manufacturing. At the country level, the composite PMIs for both Germany and France also fell clearly below 50 in July. Other August survey results due in the coming week include the flash Commission estimate of euro area consumer confidence (also Wednesday), INSEE's French business climate indices (Thursday) and the equivalent German ifo institute indicators (Friday).

In addition to the sentiment surveys, the dataflow includes German producer price inflation numbers for July (Monday) and final German Q2 GDP data (Friday). Having risen to -0.3%Y/Y in June, Germany's headline PPI inflation rate is bound to take a big step down given the large base effect related to the rise of 5.3%M/M in July 2022, the second-highest on the series, which was related to last summer's extreme spike in wholesale energy prices. Meanwhile, the preliminary GDP release reported that German GDP was unchanged in Q2 from Q1, suggesting that Germany's technical recession came to an end, albeit perhaps only temporarily. Indeed, we would not be surprised to see GDP revised down in this latest estimate. Destatis indicated that household consumption stabilised in Q2, following sharp declines over the prior two quarters. Friday's release will provide the detailed expenditure breakdown for the first time.

Beyond the economic data, ECB President Lagarde will speak publicly on Friday at the Kansas City Fed's Jackson Hole Symposium.

UK

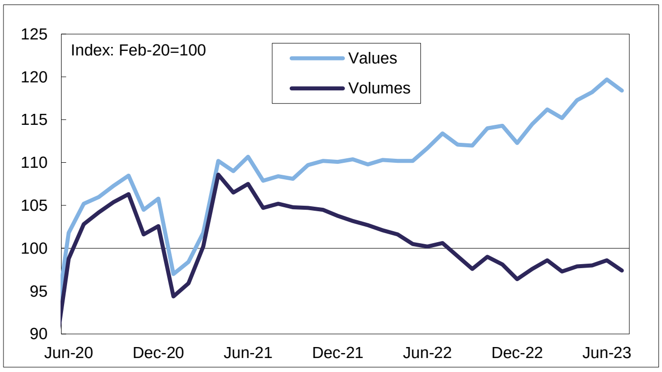
Retail sales in July hit by wet weather and high inflation

Retail sales volumes in July fell a steeper-than-expected 1.2%M/M, the most in four months as inclement weather combined with high inflation to hit spending on the high street. The plunge left sales volumes 0.8% below the Q2 average, 1.8% below the pre-pandemic level in February 2020, and at the second-lowest level since the pandemic lockdown in early 2021. Excluding auto fuel, sales were even softer, dropping 1.4%M/M. According to the Met Office, this July had the most rainfall for the month in fourteen years, and was the sixth wettest on the series dating back to 1836. So, shopping centre footfall and demand for seasonal items was unsurprisingly deterred. Sales volumes at clothes stores fell 2.2%M/M while those at department stores were down 2.9%M/M. And the rain combined with particularly high inflation in the category also to dampen spending on food, which fell 2.7%M/M. With shoppers staying home, online sales provided some offset, supported also by Amazon Prime Day and other promotions, rising 2.8%M/M to account for the highest share of total sales (27.4%) in seventeen months. With the monthly rise in prices relatively modest, the value of retail sales was also hit in July, declining 1.0%M/M. And that left the annual rate of sales values up just 1.1%Y/Y, the softest since pandemic lockdown. Some of that slowdown reflects lower prices of auto fuel, excluding which the value of sales was still up 4.4%Y/Y compared with a decline of 3.3%Y/Y in volumes terms, to leave them 18.5% above the pre-pandemic level.

Gloomy summer remains a deterrent, but higher real incomes should support autumn spending

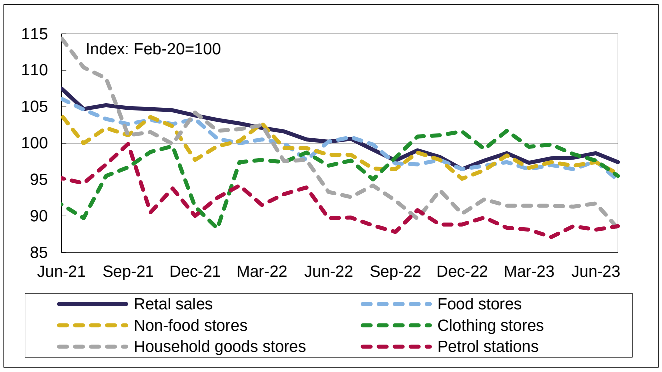
With this month also proving to be something of a damp squib weather wise, any rebound in retail sales in August is likely to be underwhelming. But with wage growth strong and real disposable incomes now rising, and mortgage rates having declined slightly over recent weeks, we think that consumer confidence firmed in August after declining to a three-month low in July. (The latest GfK survey is now scheduled for release on 25 August). So, we expect retail sales to strenghten into the autumn. And with spending on services likely still stronger than spending on goods, we expect household consumption to support GDP growth in both Q3 and Q4, having returned to positive growth (0.7%Q/Q) in Q2.

UK: Retail sales



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

UK: Retail sales volumes by type of store



Source: Refinitiv Datastream and Daiwa Capital Markets Europe Ltd.

The week ahead in the UK

Like in the euro area, the UK data highlight of the coming week will be Wednesday's flash August PMIs. As in the euro area, the UK's July PMIs signaled a weakening of momentum at the start of Q3, albeit with the composite activity index (a six-month low of 50.7) pointing to stagnation rather than outright contraction in GDP. Growth in services was also the softest in six months while the manufacturing output PMI suggested the sharpest drop in the sector since January. And cost pressures in services appeared to remain high by historical standards while manufacturing output prices were broadly stable. Other August survey results to be published in the coming week include the CBI's industrial trends (Tuesday) and distributive trades reports for August on Thursday, and the GfK consumer confidence indicators postponed from today (Friday). Beyond the sentiment indices, public borrowing figures for July will be published on Tuesday.

The next edition of the Euro wrap-up will be published on 22nd August 2023

Daiwa economic forecasts

	2023				2024		2023	2024	2025
	Q1	Q2	Q3	Q4	Q1	Q2			
GDP								%, Y/Y	
Euro area	0.0	0.3	0.1	0.2	0.2	0.2	0.6	0.8	1.6
UK	0.1	0.2	0.3	0.2	0.1	0.0	0.5	0.5	0.7
Inflation, %, Y/Y									
Euro area									
Headline HICP	8.0	6.2	4.7	2.8	2.5	2.0	5.4	2.1	1.9
Core HICP	5.5	5.5	5.3	4.4	3.1	2.1	5.2	2.1	1.8
UK									
Headline CPI	10.2	8.4	6.8	4.9	4.6	3.0	7.5	3.2	1.8
Core CPI	6.1	6.9	6.7	6.2	5.8	3.9	6.5	3.7	1.7
Monetary policy, %									
ECB									
Refi Rate	3.50	4.00	4.50	4.50	4.50	4.50	4.50	4.00	3.00
Deposit Rate	3.00	3.50	4.00	4.00	4.00	4.00	4.00	3.50	2.50
BoE									
Bank Rate	4.25	5.00	5.50	5.75	5.75	5.75	5.75	5.25	3.25

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
Euro area	Final (core) CPI Y/Y%	Jul	**5.3 (5.5)**	*5.3 (5.5)*	5.5 (5.5)	-
	Construction output M/M% (Y/Y%)	Jun	**-1.0 (-0.3)**	-	0.2 (0.1)	- (0.3)
UK	Retail sales including auto fuel M/M% (Y/Y%)	Jul	**-1.2 (-3.2)**	-0.6 (-2.1)	0.7 (-1.0)	0.6 (-1.6)
	Retail sales excluding auto fuel M/M% (Y/Y%)	Jul	**-1.4 (-3.4)**	-0.7 (-2.2)	0.8 (-0.9)	0.7 (-1.6)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Trade balance €bn	Jun	**12.5**	4.0	-0.9	0.2
Spain		Trade balance €bn	Jun	**-2.4**	-	-3.1	-
Auctions							
Country		Auction					
France		sold €3.28bn of 2.50% 2026 bonds at an average yield of 3.12%					
		sold €2.91bn of 2.75% 2029 bonds at an average yield of 3.04%					
		sold €2.25bn of 1.50% 2031 bonds at an average yield of 3.05%					
		sold €617mn of 1.85% 2027 index-linked bonds at an average yield of 0.43%					
		sold €381mn of 0.10% 2038 index-linked bonds at an average yield of 0.75%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's data calendar

The coming week's key data releases						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast/actual*	Previous
Monday 21 August 2023						
Germany		07.00	PPI Y/Y%	Jul	-0.3 (-5.2)	0.1
UK		00.01	Rightmove house price index M/M% (Y/Y%)	Aug	-	-0.2 (0.5)
Tuesday 22 August 2023						
France		-	Bank of France retail sales Y/Y%	Jul	-	-2.0
UK		07.00	Public sector net borrowing (ex banks) £bn	Jul	- (4.9)	17.7 (18.5)
		11.00	CBI industrial trends survey, total orders (selling prices)	Aug	-	-9 (18)
Wednesday 23 August 2023						
Euro area		09.00	Preliminary manufacturing (services) PMI	Aug	42.6 (50.5)	42.7 (50.9)
		09.00	Preliminary composite PMI	Aug	48.5	48.6
		15.00	European Commission's preliminary consumer confidence	Aug	-14.3	-15.1
Germany		08.30	Preliminary manufacturing (services) PMI	Aug	38.6 (51.5)	38.8 (52.3)
		08.30	Preliminary composite PMI	Aug	47.8	48.5
France		08.15	Preliminary manufacturing (services) PMI	Aug	45.1 (47.5)	45.1 (47.1)
		08.15	Preliminary composite PMI	Aug	47.5	46.6
UK		09.30	Preliminary manufacturing (services) PMI	Aug	45.0 (50.8)	45.3 (51.5)
		09.30	Preliminary composite PMI	Aug	50.3	50.8
Thursday 24 August 2023						
France		07.45	INSEE business (manufacturing) confidence	Aug	100 (99)	100 (100)
UK		11.00	CBI distributive trades survey	Aug	-	-25
Friday 25 August 2023						
Germany		07.00	Final GDP Q/Q% (Y/Y%)	Q2	*0.0 (-0.6)*	-0.1 (0.1)
		09.00	Ifo business climate	Aug	86.7	87.3
		09.00	Ifo current assessment (expectations) balance	Aug	90.0 (83.5)	91.3 (83.5)
Spain		08.00	PPI Y/Y%	Jul	-	-8.1
UK		00.01	GfK consumer confidence	Aug	-29	-30

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
Monday 21 August 2023			
- Nothing scheduled -			
Tuesday 22 August 2023			
UK		10.00	Auction: £1.5bn of 0.75% 2033 index-linked bonds
Wednesday 23 August 2023			
Germany		10.30	Auction: €3.0bn of 2.40% 2030 bonds
Thursday 24 August 2023			
- Nothing scheduled -			
Friday 25 August 2023			
Euro area		20.00	ECB President Lagarde speaks at the annual Jackson Hole economic symposium – 'Structural shifts in the global economy'
Italy		10.00	Auction: 2Y fixed-rate bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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