

Euro wrap-up

Overview

- Bunds followed USTs higher as euro area inflation was confirmed at the 2% target in July while the number of job vacancies in the region continued to fall.
- Gilts outperformed as a larger-than-expected increase in UK inflation in July was attributed to the timing of the school summer holidays.
- Thursday will bring the flash PMIs and Commission consumer confidence index for August, as well as euro area construction output data for June and UK public finances figures for July.

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Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	1.925	-0.028
OBL 2.2 10/30	2.272	-0.031
DBR 2.6 08/35	2.716	-0.032
UKT 3½ 03/27	3.918	-0.051
UKT 4% 03/30	4.078	-0.056
UKT 4½ 03/35	4.676	-0.062

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

Euro area

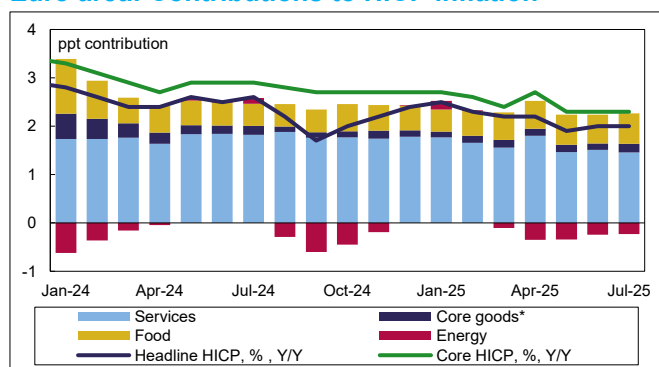
As expected, euro area inflation stayed on-target for a second-consecutive month

With the member state data having provided no significant revisions, the final euro area inflation figures for July predictably also aligned with their flash estimates. So, headline inflation remained at the ECB's 2% target for a second consecutive month – albeit only marginally, having edged up 0.05ppt to 2.04%Y/Y. Core inflation also moved sideways, in that instance precisely to two decimal places (2.31%Y/Y). The accompanying detail also offered little surprise, with the food and energy components both accounting for the minimal increase in headline inflation. In particular, extra pressure in meat, fruit and coffee pushed food inflation up 0.4ppt to 2.7%Y/Y, the highest since February 2024. And a slight increase in petrol prices reduced the drag from energy inflation by 0.2ppt to -2.4%Y/Y. More importantly, among core items, higher inflation of goods was offset by a softening in services. Seasonal discounting in non-energy industrial goods (-2.4%M/M), particularly clothing, was less emphatic than has previously been the norm in July. So, core goods inflation rose 0.3ppt to a 15-month high of 0.8%Y/Y. In contrast, services inflation edged down 0.1ppt to 3.2%Y/Y, matching the recent low in May and March 2022 before that. Alongside a moderation in insurance, softer inflation in hotels and package holidays (both to the lowest rates in more than 3½ years) contributed to the drop in the services component.

Labour costs ticked higher in Q2, but vacancies consistent with rising slack & ongoing disinflation

Looking ahead, food prices pose a clear upside risk to the inflation outlook while energy base effects will continue to become less favourable over the near term. However, the prospects of subdued global demand and diversion of goods – particularly from China – away from the US to Europe point to downwards pressure from core goods inflation over coming quarters. And while some weakness in holiday-related items in July might prove temporary, we expect services inflation to maintain its downwards trajectory, supported by ongoing loosening in the labour market. Nevertheless, today's preliminary labour costs data for Q2 reported a 0.3ppt pickup to 3.7%Y/Y (1%Q/Q). The increase was broad-based, but most pronounced in industry (up 0.9ppt to 3.4%Y/Y) after a soft first quarter in that sector. Services labour cost growth also picked up to a three-quarter high (4.5%Y/Y) reflecting pressures in hospitality and professional services sectors. Friday's Q2 negotiated wage data seem likely also to report an uptick after a soft Q1. But as these data should remain consistent with the ECB's wage tracker, we maintain that the Governing Council will continue to expect a renewed slowdown in pay growth by year-end. And Q2's flash vacancies data remained consistent with softening labour demand, with the headline euro area rate paring 0.1ppt to 2.3%, its lowest level since Q121, led by a drop in services. Unsurprisingly, the pullback in vacancies among the member states was steepest in Germany, where the labour market appears to have its largest amount of slack since Q320. Indeed, despite the record low unemployment rate in Q2 (6.2%) amid continued employment growth in Spain, the ratio of vacancies to unemployed also continued to shrink at the aggregate euro area level, falling to its lowest level since Q321.

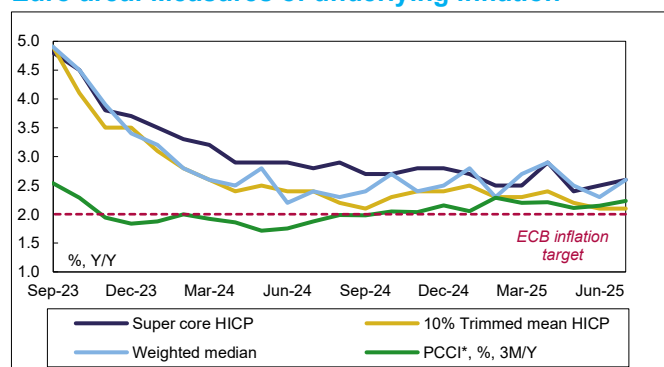
Euro area: Contributions to HICP inflation



*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Measures of underlying inflation



*Principal Common Component of Inflation.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

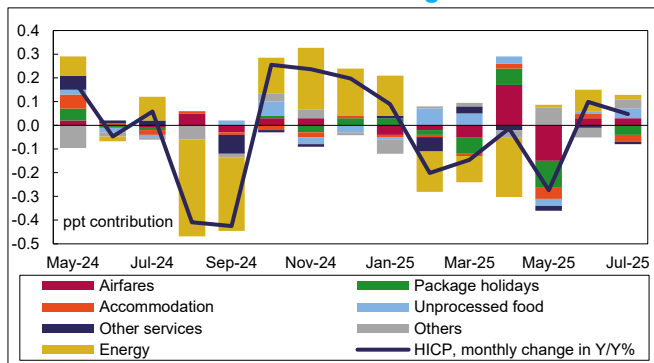
Thursday will bring the August flash PMIs, which will be closely watched for signs of a pickup in momentum at the start of Q3. We caution that its coincidence with the holiday season makes August's flash survey especially prone to eventual revisions. However, the euro area composite PMI rose in July to a four-month high (50.9), led by an improvement in the services sector (51.0). That principally owed to ongoing strength in the euro area's periphery. But services activity in Germany also reported a first expansion since March (50.6), contrasting a deterioration in France (48.5). Among other things, the August flash PMIs will provide insights into any initial impact from last month's provisional EU-US trade agreement, particularly with respect to demand in the manufacturing sector. Reduced uncertainty might be viewed as positive for households' willingness to spend, although we expect little change in the August flash Commission consumer confidence index amid ongoing uncertainty about events in Ukraine and diminished expectations for additional ECB rate cuts. Meanwhile, despite the likelihood of a fall in June, tomorrow's euro area construction production data will be expected to confirm a positive contribution to GDP growth in Q2 from the sector. Indeed, while construction output contracted in Germany (-2.3%Q/Q) and France (-1.1%Q/Q), the inexplicably large jump reported in Spain (32.6%Q/Q) would be consistent of growth in the euro area in excess of 2%Q/Q.

UK

Inflation up a touch more than expected on school holiday-related services & non-core goods

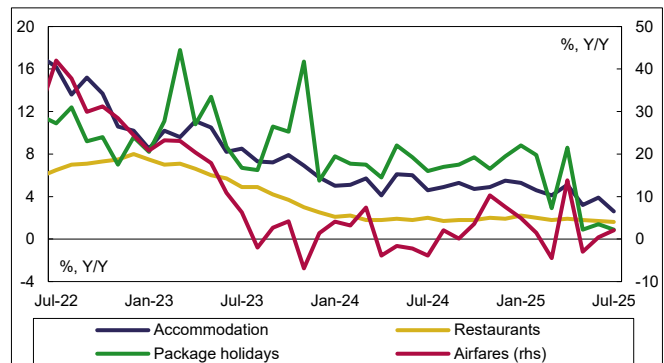
Unlike in the euro area, inflation in the UK rose further in July, with the headline CPI rate up 0.2ppt to an 18-month high of 3.8%Y/Y. That was a touch above the consensus on the Bloomberg survey and our own forecast. But it aligned with the BoE's updated projection published earlier this month. Within the detail, core goods inflation reversed the prior month's increase, returning to 1.6%Y/Y thanks to the clothing and furniture components. All other major components picked up, however. With this July's cut in the Ofgem household electricity and gas price cap smaller than the reduction a year earlier, and prices of petrol higher, energy inflation returned to positive territory (1.4%Y/Y) for the first time in two years. Given continued pressures in certain items, from beef to fruit juice, coffee, chocolate and vegetables, inflation of food and non-alcoholic beverages rose for a fourth successive month and by almost ½ ppt to a 17-month high (4.9%Y/Y). And most importantly, services inflation rose 0.3ppt to a three-month high of 5.0%Y/Y, slightly above the BoE's projection. The cause of that increase, however, was a pickup in holiday-related items, which likely reflects the earlier-than-usual start to the school summer vacation period. Strikingly, airfares rose more than 30%M/M, the most in any July on the series, to cause the annual rate to jump 15ppts from June. And together with higher sea ferry fares, flight costs added almost 0.1ppt to headline inflation. Higher hotel and restaurant prices also added about 0.1ppt, principally due to the accommodation component.

Euro area: Contributions to change in inflation



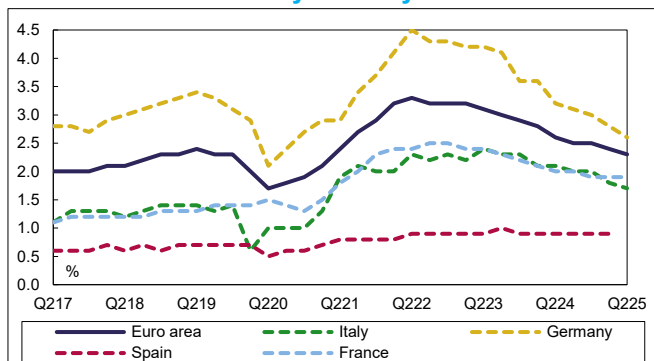
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected consumer services inflation



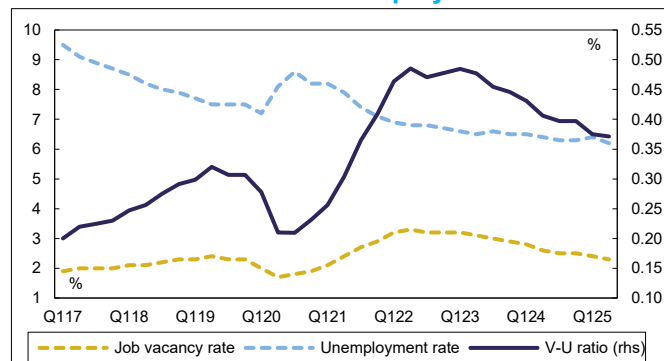
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Job vacancy rates by member state



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Vacancies to unemployment ratio



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

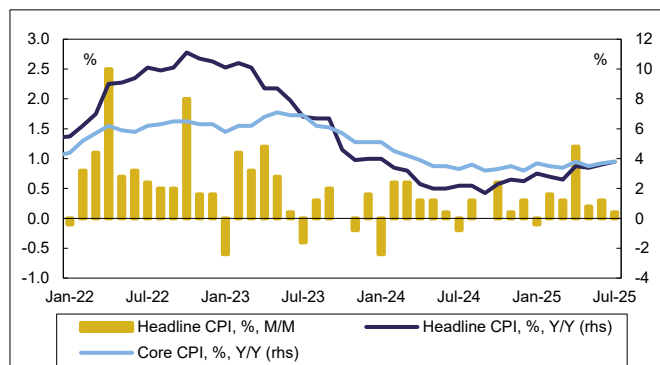
Holiday effects to reverse in August but inflation likely to peak in September on energy base effects

With holiday-related services pressures more than outweighing the impact of lower non-energy industrial goods prices, core inflation edged up 0.1ppt to 3.8%Y/Y, matching April's 12-month high. However, the airfare and hotel components should fall back in August as the timing effect reverses. And we take comfort from the fact that various measures of underlying inflation suggest no deterioration in July. Among other things, the NIESR 10% trimmed mean inflation rate was steady at a target-consistent 1.9%Y/Y. And a measure of underlying services inflation excluding indexed and volatile items fell 0.3ppt to 4.0%Y/Y, matching the lowest level since October 2021. Admittedly, like the BoE, we expect headline inflation to pick up a little further over the near term to peak at about 4.0%Y/Y in September. In part, that will reflect unfavourable base effects in energy, and core inflation is likely to be broadly steady over the near term before easing back from Q4 on. But, the MPC's hawks will remain concerned about the impact of recent high inflation, particularly in administered services and food, on expectations. And with wage growth still above levels consistent with target inflation, uncertainty persisting (due in part to data quality concerns) about the precise extent of labour slack, and economic activity firmer than expected (and arguably above-potential) in the first half of the year, the four MPC members who voted for no change to rates in August are likely to continue to do so over the remainder of the year. But by the same token, with wage growth moderating and the BoE's inflation projection – which, like our own updated forecast, envisages a return to target in 2027 – remaining valid, in the absence of new significant shocks we continue to expect a slim majority on the MPC to back a further rate cut in November. We acknowledge, however, that the risks of no further monetary policy easing this year have risen. And the extent to which the government tightens fiscal policy in the autumn budget might have a significant bearing on the outcome.

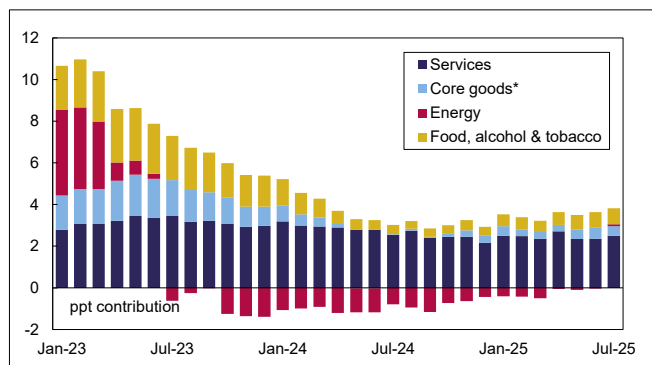
The day ahead in the UK

As in the euro area, the flash UK PMIs will provide an update on the strength of private sector activity over the summer. July's composite output PMI pointed to a slight weakening in momentum at the start of Q3 (51.5), albeit falling just 0.5pt from June's nine-month high and still 1.2pts above the Q2 average. While the modest expansion continued to be led by the dominant services sector (51.8), manufacturers reported the mildest contraction in their output (49.5) since the respective index dipped below 50 in October last year. Beyond the activity indices, the price and employment PMIs will remain in focus for signals about future price pressures and firms' employment intentions. But overall, we expect the composite output PMI to edge slightly higher this month, supported by August's latest cut to Bank Rate and subsiding uncertainty relating to US trade relations. The CBI's industrial trends survey will provide another perspective on manufacturers' optimism tomorrow. Separately, fiscal risks will remain firmly in view amid growing speculation about the form of revenue-raising measures to be announced in the autumn to maintain compliance with the Chancellor's fiscal rules. As such, tomorrow's public finance statistics, providing an update through to July, will be closely scrutinised.

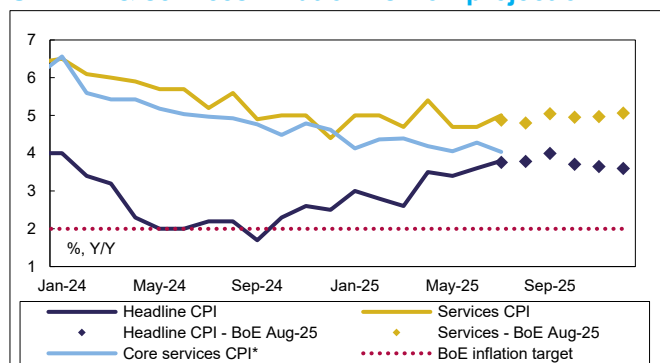
UK: CPI inflation



UK: Contributions to headline inflation

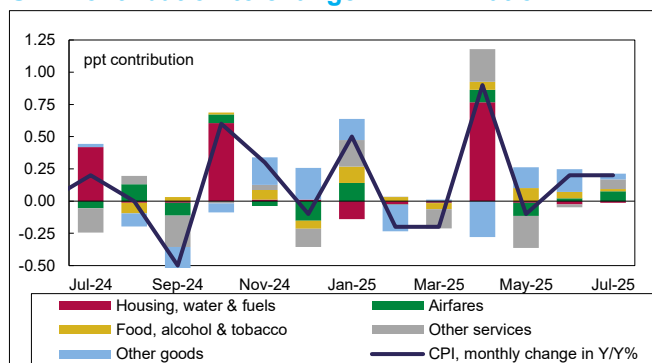


UK: CPI & services inflation vs BoE projection



*Services excluding indexed and volatile components, rents and foreign holidays measure. Source: Macrobond and Daiwa Capital Markets Europe Ltd.







UK: Contribution to change in CPI inflation





European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Final headline (core) HICP Y/Y%	Jul	2.0 (2.3)	<u>2.0 (2.3)</u>	2.0 (2.3)	-
	 Preliminary labour costs Y/Y%	Q2	3.7	-	3.4	-
	 Preliminary job vacancy rate %	Q2	2.3	-	2.4	-
Germany	 PPI Y/Y%	Jul	-1.5	-1.4	-1.3	-
UK	 Headline (core) CPI Y/Y%	Jul	3.8 (3.8)	<u>3.7 (3.7)</u>	3.6 (3.7)	-
	 House price index Y/Y%	Jun	3.7	-	3.9	2.7


Auctions

Country	Auction
Germany	 sold €747m of 2.5% 2046 bonds at an average yield of 3.18%
	 sold €1.15bn of 2.5% 2054 bonds at an average yield of 3.28%



Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Tuesday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 ECB current account €bn	Jun	35.8	-	32.3	31.8













Auctions

Country	Auction
Germany	 sold €3.424bn of 2.2% 2030 bonds at an average yield of 2.32%
UK	 sold £1.6bn of 1.125% 2035 inflation-linked bonds at an average yield of 1.728%



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area		09.00 Preliminary services (manufacturing) PMI	Aug	<u>51.0 (49.6)</u>	51.0 (49.8)
		09.00 Preliminary composite PMI	Aug	<u>50.8</u>	50.9
		10.00 Construction output M/M% (Y/Y%)	Jun	-	-1.7 (2.9)
		15.00 Preliminary Commission consumer confidence indicator	Aug	<u>-14.9</u>	-14.7
Germany		08.30 Preliminary services (manufacturing) PMI	Aug	50.3 (48.8)	50.6 (49.1)
		08.30 Preliminary composite PMI	Aug	50.2	50.6
France		08.15 Preliminary services (manufacturing) PMI	Aug	48.5 (48.1)	48.5 (48.2)
		08.15 Preliminary composite PMI	Aug	48.5	48.6
UK		07.00 Public sector net borrowing £bn	Jul	-	20.7
		09.30 Preliminary services (manufacturing) PMI	Aug	<u>52.3 (48.5)</u>	51.8 (48.0)
		09.30 Preliminary composite PMI	Aug	<u>52.0</u>	51.5
		11.00 CBI industrial trends survey – total orders (selling prices) % balance	Aug	-28 (20)	-30 (21)

Auctions and events

France		09.50 Auction: to sell up to €10.5bn of 2.4% 2028, 2.5% 2030 and 2.7% 2031 bonds
		10.50 Auction: to sell up to €1.25bn of 3.15% 2032, 1.8% 2040 and 0.1% 2053 inflation-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

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