Euro wrap-up

Overview

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- Bunds made losses as final euro area inflation data confirmed a modest pickup in headline and core rates in July.
- While UK inflation predictably jumped on higher household energy bills, Gilts made gains as a stable core print and easing input costs reinforced expectations that the BoE will leave rates unchanged for some time.
- Thursday will bring euro area construction output data for June, German PPI data for July and a UK industrial sector survey.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.860	+0.014
OBL 2.9 10/31	2.990	+0.014
DBR 3 08/36	3.261	+0.004
UKT 4⅜ 03/28	4.355	-0.018
UKT 4⅛ 03/31	4.577	-0.030
UKT 4¾ 10/35	5.043	-0.036

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

Euro area

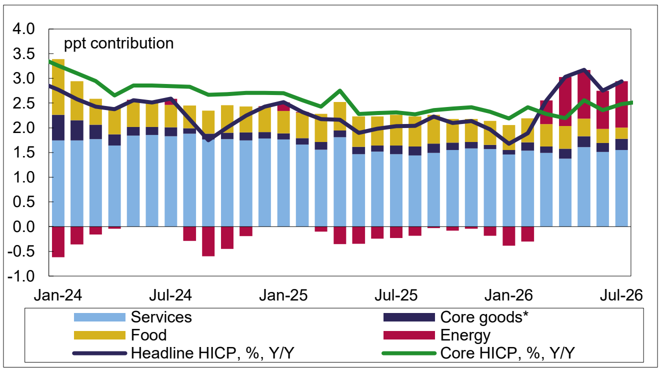
Uptick in euro area inflation confirmed while food inflation moderates to a near-five-year low

While a few member states had revised their estimates, the final euro area inflation print for July brought no surprises. Headline inflation was confirmed to have edged up to 2.9%Y/Y, albeit only just avoiding an upwards revision (2.94%Y/Y to 2 decimal places). The 0.1ppt rise in core inflation to 2.5%Y/Y was also affirmed. Given the upwards shift in wholesale oil and gas prices last month, the key driver was energy inflation, which rose just shy of its spring peak. That was due principally to rebounding transport fuel prices (17.3%Y/Y), although pressures in some member states pushed household energy inflation (5.1%Y/Y) to a 40-month high. More happily, food inflation continued to moderate, this time by 0.4ppt to 1.2%Y/Y, half of its pre-war rate and the lowest in more than five years. And the indirect effects from higher energy prices were relatively muted, which should be of some reassurance to policymakers. Transport services inflation edged down to 3.7%Y/Y, helped by a combination of favourable base effects in bundled tickets and a further deceleration in airfares helped by the 16% cut in Germany's aviation tax. Inflation of recreational (1.2%Y/Y) and financial services (2.5%Y/Y) respectively eased to five- and three-year lows. And the absence of significant pressure elsewhere meant that most measures of underlying inflation were little changed. Overall, services inflation still edged up slightly to 3.3%Y/Y, owing in part to volatility in accommodation and a further boost from communications. Strikingly, inflation in the latter category – fully target-consistent at 2%Y/Y – marked the firmest for that category for 28 years. And ICT equipment inflation was also its highest on the series, albeit concentrated in storage and information processing equipment, again flagging the effects of demand pressure in AI-adjacent sectors. Alongside a steep increase in medicine prices (also pertaining to Germany), core goods inflation rose back to 0.9%Y/Y.

Upside risks justify additional restrictiveness in September, but wage pressures remain distant

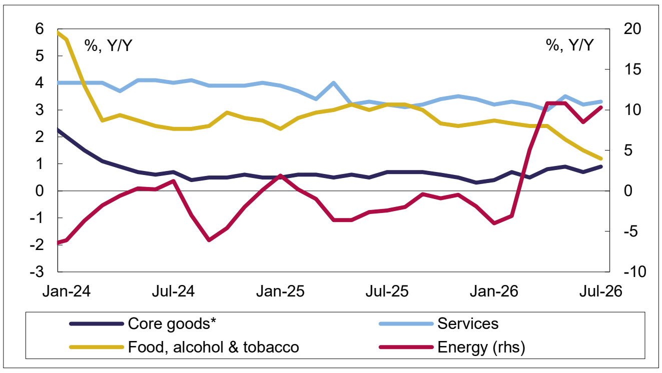
Milder indirect effects on inflation from the energy shock in July should not budge expectations that the ECB will tighten policy again in September. Headline inflation is likely to tick higher again in August principally due to higher petrol prices, and rise further still, probably to around 3½%Y/Y by year-end. Natural gas futures curves remain well above the levels assumed in the ECB's projections in June, not least as gas storage volumes in Europe remain unseasonably low, suggesting additional upside risks to energy prices in the winter. Power plant shutdowns caused by recent heatwaves and drought conditions compound those risks. And as noted by ECB Chief Economist Lane this week, the effects of recent weather events will likely be felt more acutely next year via food prices. Moreover, recalibrating policy by a further 25bps in September will merely bring the deposit rate to the upper bound of the ECB's range of estimates for a neutral stance. Of course, if energy prices fall back again soon and second-round effects on inflation remain elusive, the ECB should judge restrictiveness as unnecessary. While Friday's negotiated wage data are likely to support the assertion that pay pressures remain subdued, preliminary data today for Q2 suggested that euro area labour cost growth slowed to 3.1%Y/Y, the lowest

Euro area: Contributions to inflation



Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Major HICP inflation components



Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

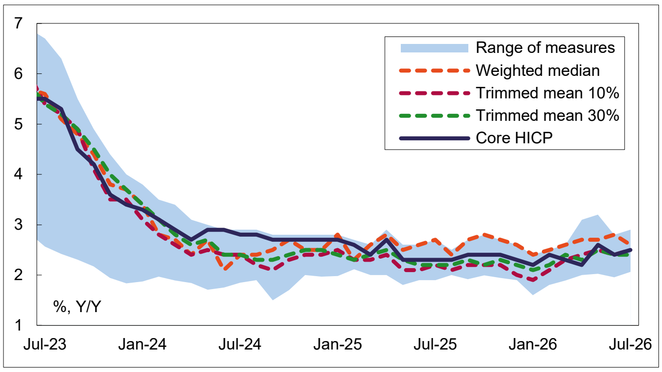
since Q421. And the job vacancy rate dropped to a more than five-year low of 2.1%, providing further reassurance that labour market conditions remain less tight and less conducive to second-round effects than during the last energy crisis.

The day ahead in the euro area

Following on from today's final consumer price data for July, tomorrow's German industrial PPI report will provide insight into underlying inflationary pressures in the industrial sector last month. In June, largely reflecting lower energy prices, German producer prices fell for the first month in four. As a result, the annual rate of PPI inflation moderated 0.4ppt to a relatively subdued 1.8%Y/Y. Non-energy prices rose just 0.2%M/M to be up 2.4%Y/Y. While that annual core PPI rate was a three-year high, pressures were largely concentrated in intermediate items most exposed to the direct impact of the shock to hydrocarbon prices, such as chemicals and rubber, and prices of ICT equipment seemingly linked to the global AI investment boom. But inflation of capital goods was well-behaved at 2.1%Y/Y while producer prices of consumer goods were down 1.7%Y/Y thanks to falling food prices. The re-escalation of tensions in the Middle East and their ramifications for energy prices will be reflected in the July PPI data. And while the impact of the reversal of the temporary VAT cut that exaggerated the rise in the CPI will be excluded from the calculation, the annual PPI rate is likely to jump above 2½%Y/Y to a three-year high, the detail should confirm that indirect effects from the energy price shock remain relatively well-contained.

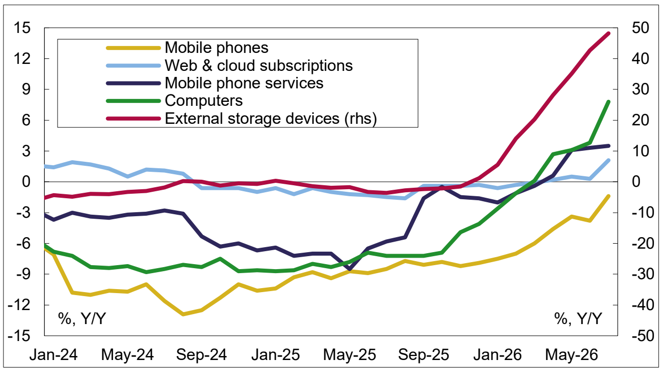
Meanwhile, euro area construction output data for June should confirm a soft end to the second quarter for the sector. German production in construction was little better than flat that month, edging up 0.1%M/M. And in France it dropped a steep 2.9%M/M amid the hottest temperatures for any June in record. Nevertheless, despite higher costs of borrowing and materials, euro area construction output in Q2 likely more than fully reversed the decline of 0.9%Q/Q in Q1 not least due to a surge in German civil engineering, which rose almost 7%Q/Q.

Euro area: Measures of underlying inflation



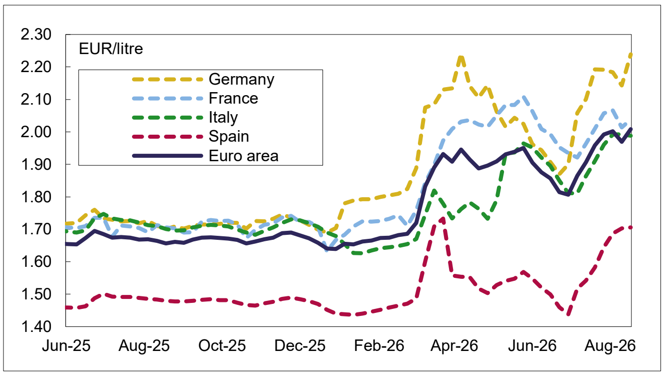
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected ICT equipment & services



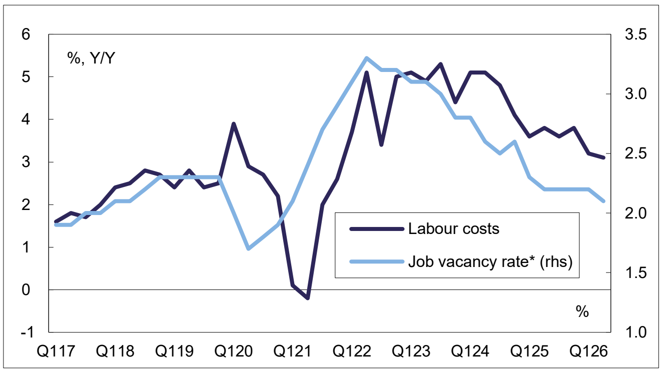
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Weekly Super-95 gasoline prices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Labour costs & job vacancy rate



**Business economy. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK

Headline inflation up to 4-month high on higher household energy bills but core rate steady

In line with the consensus, CPI inflation rose 0.3ppt in July to a four-month high of 2.9%Y/Y. That was 0.1ppt above the BoE's projection, which had been unable fully to factor in the upwards shift in wholesale oil and gas prices throughout the month. But the principal driver of the increase in inflation was the 13% hike in Ofgem's household energy price cap from 1 July, which was announced in May. So, while the auto fuel component was a touch softer than in June, energy inflation rose more than 4ppts to 9.8%Y/Y, the highest in more than three years, more than fully accounting for the increase in the headline

CPI rate. More happily, inflation of food slowed for a fourth successive month to 1.2%Y/Y, the lowest in almost five years, as last year's shocks continued to fade. And core inflation was steady at 2.6%Y/Y. Inflation of non-energy goods rose to 0.9%Y/Y due to a pickup in furniture and clothing, the latter likely due in part to the exceptionally hot weather and payback for the early start to discounting the prior month. But that rise was offset by a drop in the services component to 3.4%Y/Y, close to the bottom of the range since 2022. The softening in services largely reflected a sharp drop in airfares (-11.6%Y/Y) thanks to lower prices of short-haul and European flights. Inflation in restaurants, hotels and cultural attractions also softened, perhaps benefiting slightly from the government's modest 'Great British Summer Savings' scheme. But likewise, also probably reflecting recent policy measures and higher mortgage rates, housing rents accelerated the most in nine months (4.1%Y/Y). And given a jump in private hospital fees and health insurance prices, measures of underlying services inflation, which exclude indexed and volatile items, firmed a touch.

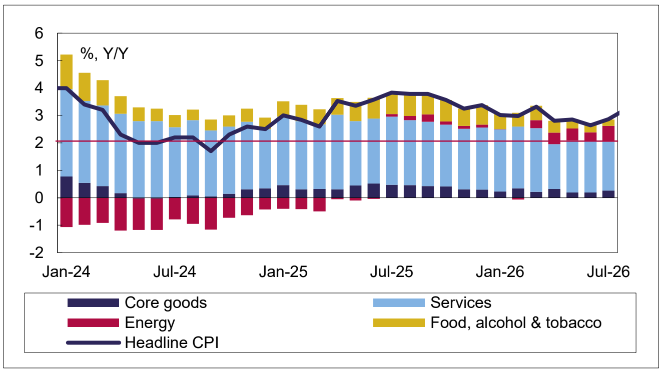
Inflation set to rise above 3% in August & remain there through to the spring

Inflation now looks bound to rise above 3%Y/Y in August not least due to higher prices of petrol at the pump, which contrast the declines a year ago. Moreover, next week Ofgem is likely to announce a further modest rise in the household energy price cap from 1 October, despite the temporary cut in VAT on electricity from that date. So, energy inflation looks likely to sit in double-digits into the new year. Consistent with survey signals, perhaps reassuringly, today's PPI data reported a second successive decline in producer input prices in July, and an easing in rates of inflation of most components except fuel. But producer output price inflation suggested some ongoing pass-through from recent cost pressures, in items from clothing to electronic products. So, we expect core goods CPI inflation to continue to edge higher. Given less favourable base effects, higher energy prices and Europe's summer drought, food inflation is likely to pick up somewhat from the autumn. And given sampling periods, inflation of long-haul airfares will likely accelerate over coming months. Of course, events in the Middle East and their impact on energy prices represent the principal source of upside risk. But on the basis on current wholesale forward prices, for the time being we expect headline CPI inflation to oscillate around 3¼-3½%Y/Y through to the spring while the core rate will also likely in due course rise above 3%Y/Y. Assuming pay settlements remain moderate, however, headline inflation could well be back below 3%Y/Y by April, and we still expect the BoE to leave rates unchanged at least through to next summer.

The day ahead in the UK

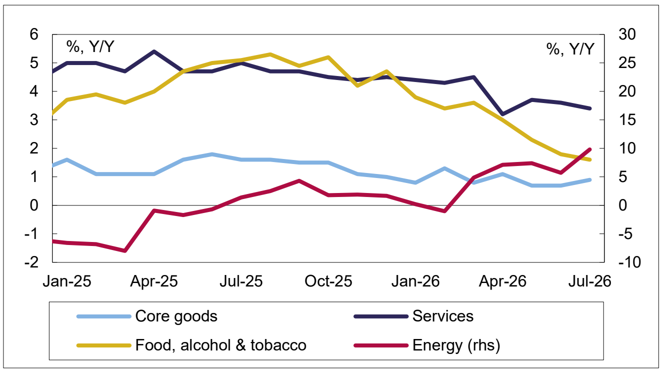
Ahead of Friday's flash PMIs for August, tomorrow's CBI Industrial Trends Survey will provide insights into conditions in the manufacturing sector this month. Over recent months, however, the CBI survey has contradicted the PMIs. While last month's PMIs suggested that manufacturing output rose at the firmest rate in almost two years amid firm growth in new orders, the CBI survey was downbeat, reporting a broad-based decline in output amid the sharpest drop in new orders in six

UK: CPI inflation & contributions*



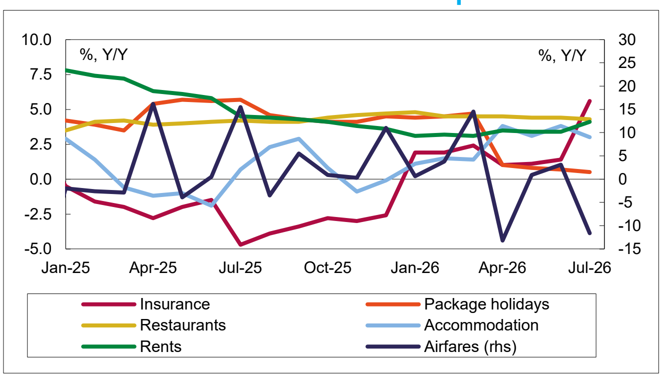
*Red line shows BoE inflation target. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Major CPI inflation components



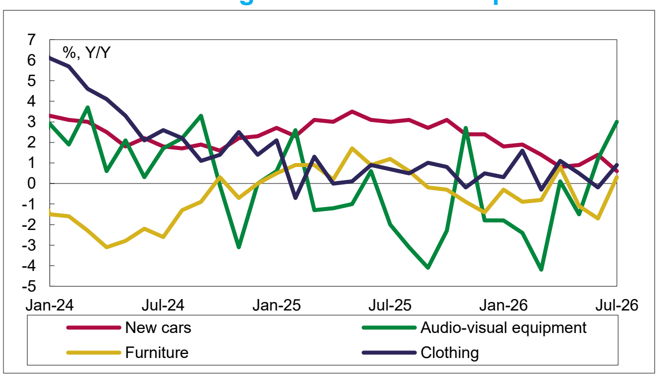
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services inflation components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected core goods inflation components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

years. Thankfully, the PMIs have provided a more reliable guide to growth in the sector, as the official ONS data suggest that production has risen in each of the past three quarters. So, perhaps the CBI survey will be most interesting in what it suggests about price pressures. Notably, last month's results reported that expectations for selling price growth were the weakest since autumn 2024, despite the strongest growth in cost pressures in the sector in almost four years. That implies that margins are being squeezed, and we expect tomorrow's results to reinforce the impression of weakening price expectations for both domestic and foreign sales.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Final headline (core) HICP Y/Y%	Jul	**2.9 (2.5)**	*2.9 (2.5)*	2.8 (2.4)	-
	Preliminary labour costs Y/Y%	Q2	**3.1**	-	3.2	-
	Preliminary job vacancy rate %	Q2	**2.1**	-	2.3	-
	ECB current account €bn	Jun	**35.1**	-	25.1	25.8
UK	Headline (core) CPI Y/Y%	Jul	**2.9 (2.6)**	*3.0 (2.6)*	2.6 (2.6)	-
	PPI – output (input) prices Y/Y%	Jul	**3.1 (4.9)**	3.2 (6.5)	3.5 (7.3)	- (7.4)
	House price index Y/Y%	Jun	**2.0**	-	2.7	3.0

Auctions

Country	Auction
Germany	sold €3.769bn of 3% 2036 bonds at an average yield of 3.26%

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	Construction output M/M% (Y/Y%)	Jun	-	0.4 (1.2)
Germany	07.00	PPI Y/Y%	Jul	2.5	1.8
UK	11.00	CBI industrial trends – total orders (selling prices) net % balance	Aug	-40 (14)	-45 (11)

Auctions and events

Country	BST	Event
France	09.50	Auction: to sell up to €12.5bn of 2.4% 2029, 2.7% 2031, 3.25% 2032 & 3% 2034 bonds
	10.50	Auction: to sell up to €1.5bn of 3.15% 2032, 0.95% 2043 & 0.1% 2047 inflation-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.