Daiwa Capital Markets

Europe Monthly

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Overview

After a robust start to the year, euro area GDP looks to have grown in Q2 close to the average for the economic recovery to-date. Consumer spending has likely remained firm on the back of an improving labour market, with unemployment falling steadily. But while inflation in the euro area is soon set to pick up, subdued growth in labour costs means that it is likely to remain well below the ECB's target for the foreseeable future. So, even without a new negative shock, the ECB might still be expected to extend its asset purchase programme beyond March 2017.

While some of the vigour of the UK economic recovery has dissipated in recent quarters, fears of a particularly abrupt slowdown look overdone so far. We expect the UK to vote on 23 June to remain in the EU. But a vote to leave the EU, which still cannot be ruled out, would likely hit the UK economy hard. Over the near term, a recession might well be expected, triggering rate cuts and possibly more QE from the BoE. And over the longer term, UK GDP growth would likely be sluggish. Euro area GDP growth over coming quarters would be affected too, while political fault-lines across Europe would be put under intense pressure with consequences for the pricing of risk.

Key issues

- Over recent weeks, as the **UK's referendum on EU membership** approached, investors became increasingly jittery with Sterling volatility the most obvious manifestation of concerns. But euro area asset prices were affected too, with the main stock market indices down on average by more than 7% in the first two weeks of June and 10Y German government bond yields below zero for the first time. Investor sentiment has since improved after the opinion polls suggested an increase in support to remain in the EU. That shift in support appears to be matching the trend of the Scottish referendum whereby there was a swing back towards the status quo in the days ahead of the poll as voters appeared to become more averse to the risks of dramatic change. The increase in support to remain might also be partly a reaction to the murder of the (Remain campaign's) MP Jo Cox and distaste at the dog-whistle tactics related to immigration employed by some of the Leave campaign. However, given the statistical margins of error and the possibility of a late swing in opinion, the referendum is still likely to be close. So, an outcome in favour of the UK leaving the EU cannot be ruled out.

- A vote to leave would likely hit the UK economy hard. Over the near term, a recession might well be expected, triggering rate cuts and possibly more QE from the BoE. And over the longer term, GDP growth would likely be sluggish, as economic, financial and political uncertainty continued to reign, and barriers and/or deterrents to trade, investment flows and the movement of people were eventually re-imposed. While the precise magnitude of the likely impact is difficult to predict, the 'adverse' scenario published in an IMF study on 17 June looks credible. In particular, that report suggests that UK GDP might be more than 5½% lower by 2019, while the government's finances would be significantly weaker, with deficits persisting across the forecast horizon and the unemployment rate persistently higher.

- But while the UK would obviously be most significantly impacted, euro area economic growth over coming quarters would be affected too, hit directly through trade links with the UK and indirectly via increased uncertainty and harmed business confidence, which would weigh on investment. Again the IMF report is informative in this respect. Looking at direct spill-overs, given its significant economic and financial integration with the UK, Ireland is estimated by the IMF to be worst hit, with GDP almost 2% lower by 2019 under the adverse scenario, while the Netherlands and Belgium would also see GDP more than ½% lower than it otherwise would be by then but other countries less affected. However, the IMF's estimates do not factor in the impact of any re-pricing of risk, which we think might be sizeable across the EU and would more significantly harm the economies of member states in Southern as well as Central and Eastern Europe. Overall, the full economic and financial impact of Brexit on the euro area would prompt the ECB into easing monetary policy further.

- Over time, however, the most profound consequence of Brexit on the euro area could be via politics, demonstrating that the EU institutions (including therefore the single currency) are reversible, placing existing fault-lines under much greater pressure and raising the risk of copy-cat referendums. Populist and Eurosceptic parties across the EU would take heart and perhaps more support. In this respect, the Spanish general election on 26 June is likely to see another strong showing from the radical Podemos party. And partly as a result, the recent Spanish policy paralysis, whereby no workable majority coalition government has been able to be formed since December, seems likely to persist. Elsewhere, following a strong showing for the Eurosceptic Five Star Movement in Italian mayoral elections on 19 June, the country's referendum on constitutional reform scheduled for October should also be closely watched.

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Euro area

- After euro area GDP growth in the first quarter was confirmed at 0.6%Q/Q, the strongest rate in a year and reassuringly underpinned by both consumption (contributing 0.3ppt to quarterly growth) and investment (contributing 0.2ppt), euro area industrial production marked a stronger-than-expected start to the second quarter (up 1.1%M/M in April) thanks to a firm performance from manufacturers in each of the three largest member states. Most encouraging was a disproportionate gain in output of capital goods (up almost 2%M/M) suggesting that the gradual recovery in business investment continues. A jump in production of durable consumer goods (up more than 2%M/M) similarly suggested that firms judged households to be increasingly amenable to making big-ticket purchases, a view supported by the continued growth in new car registrations in the first two months of Q2.

- Cause for cautious optimism has also been provided by some recent economic surveys, with the Commission's euro area economic sentiment index rising in May to the highest level since January and closer to the average for last year. But other surveys, such as the PMIs, have been less upbeat. Indeed, the euro area composite PMI has moved sideways since February at the lowest levels since January 2015 suggesting that the underlying growth trend of the economic recovery has not notably improved. And there are other good reasons to expect GDP growth to moderate in the current quarter. While most recent data have been positive, a few have disappointed, e.g. euro area retail sales were flat in April having fallen back the previous month. And while economic output in Q1 was flattered by mild weather supporting construction activity, the current quarter has seen disruptive flooding in large member states and industrial unrest in France.

- Therefore, we forecast euro area GDP growth in Q2 to ease to about 0.3%Q/Q, close to the average of the economic recovery to-date. While Spain has likely remained the strongest growing large member state with growth of about 0.6%Q/Q, we think German growth will have slowed to about 0.3%Q/Q, with growth in France and Italy also slowing to about 0.2%Q/Q.

- The ECB appears to share that view of a likely moderation of GDP growth in the second quarter. Indeed, its latest forecasts published earlier in June made clear that it is hardly overconfident about the economic outlook, like us forecasting GDP growth in 2016 of 1.6%Y/Y, down slightly from 2015, and predicting rates only a touch firmer next year and in 2018. Likewise, despite the recent increase in the oil price which should allow headline inflation to rise steadily from -0.1%Y/Y in May to close to 1%Y/Y by year-end, with core CPI (0.8%Y/Y in May) and labour cost growth (1.7%Y/Y in Q1) low it rightly expects inflation to remain some way below its target of close to 2% well into 2018.

- Having earlier this month made its first purchases of non-bank corporate bonds, on 22 June the ECB will launch the last of its new policy initiatives with the first operation under its new special liquidity 'TLTRO II' programme, offering an effective subsidy worth up to 40bps to banks able to increase lending above a certain benchmark. Thereafter, the ECB would ideally like to sit back and watch passively as its measures allow the economic recovery to gain traction and underlying inflation to pick up. But even without any new harmful shock, the ECB will likely eventually need to extend the end of its asset purchase programme by a further six months to end-September 2017 at the earliest to avoid a harmful premature tightening of financial conditions. An adverse economic or financial shock such as that represented by Brexit, meanwhile, could prompt the ECB into easing monetary policy again sooner rather than later.

UK

- After UK GDP growth slowed in Q1 to 0.4%Q/Q, the bottom of the range of the past three years, there were concerns that uncertainty over the referendum on EU membership would weigh heavily on growth in the second quarter. Those fears, however, might have been a touch overdone with some recent data surprising on the upside. For example, the PMIs were improved in May, most notably with the services index rising more than 1pt to 53.5, only a touch below the March level. In addition, consumer spending looks to have remained firm, with retail sales rising sharply for a second consecutive month in May, by almost 1%M/M, to leave annual growth at 6.0%Y/Y, the highest since September, and the level in April and May on average up 1.8% from Q1. In April, manufacturing production surged by 2.3%M/M, the most since July 2012, while construction output rose 2.5%M/M, the most since January 2014. And the NIESR nowcast for GDP growth in May was 0.5%3M/3M, the most since January. Nevertheless, we do not expect Q2 GDP growth to be firmer than in Q1, and expect full-year growth to slow to about 1.9%Y/Y in 2016, a touch softer than the BoE's forecast and down from 2.3% last year.

- With respect to inflation, headline CPI was weaker than expected in May, remaining unchanged at 0.3%Y/Y. Inflation of goods (excluding energy and food) dropped to -1.0%Y/Y, the lowest in eight months, but this was broadly offset by higher services prices, up by 2.6%Y/Y, to leave core inflation also unchanged, at 1.2%Y/Y. As the base effects of past shifts in energy prices wear off, we expect CPI to rise gradually to about 1%Y/Y around the turn of the year. But with wage growth having remained relatively subdued – while the three-month unemployment rate declined to 5.0% in April, regular earnings growth rose only to 2.3%3M/Y despite the introduction of the National Living Wage – we expect CPI to rise only gradually further next year to about 1½%Y/Y by end-2017. As such, assuming that the referendum confirms the UK's membership of the EU, we see the BoE leaving rates unchanged over the coming couple of years with non-negligible risks of easing if growth cools and/or if underlying inflation remains persistently subdued. And with the MPC having judged that a vote to leave would hit demand, quite possibly weaken long-term GDP growth, and have large adverse effects on asset prices, a rate cut would be a near-certainty in that event.

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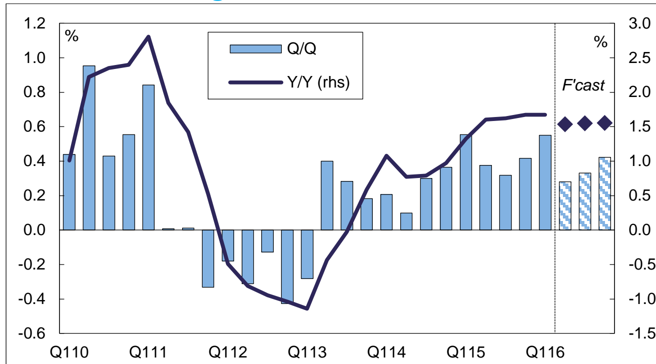
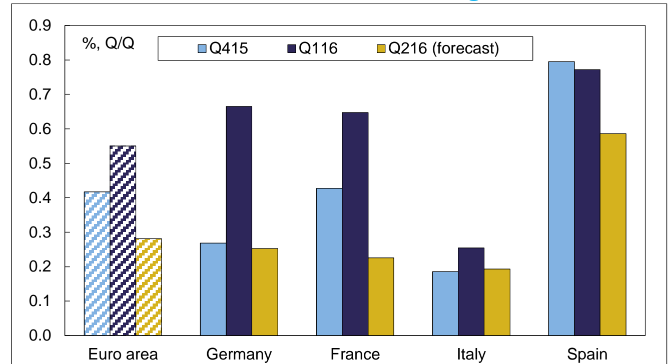
Euro area: GDP growth and forecast



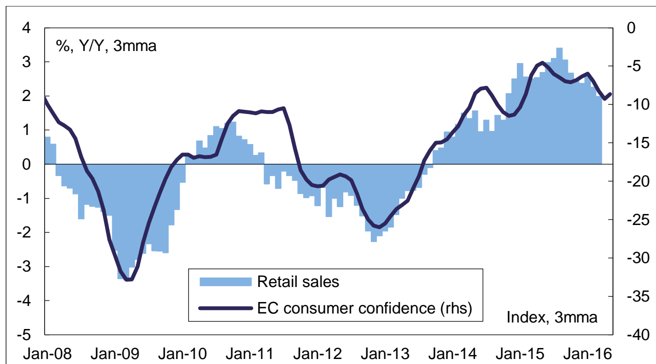
Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area and member states: GDP growth



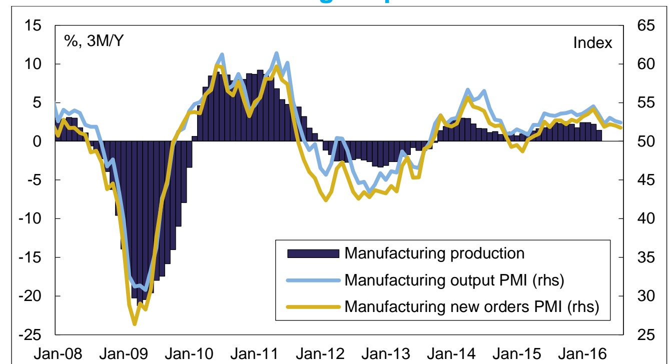
Source: Thomson Reuters, Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales and consumer confidence



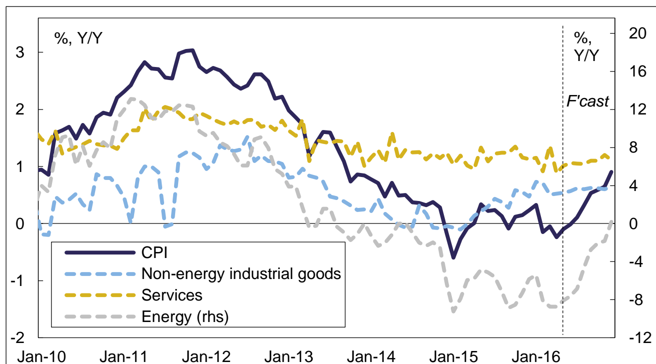
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output and PMIs*



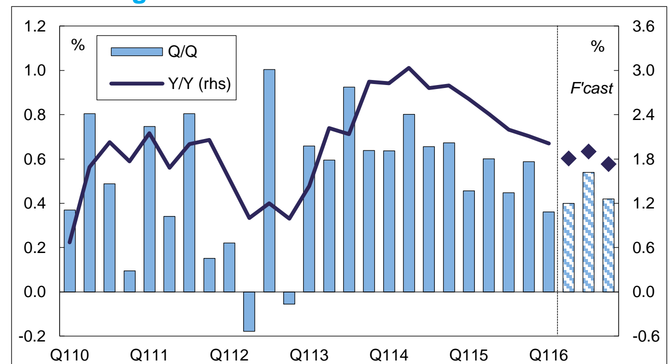
**3M lead.*
Source: Thomson Reuters, Markit and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation and forecast



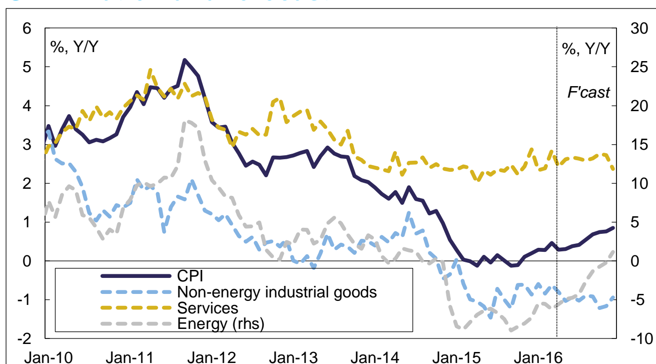
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd

UK: GDP growth and forecast



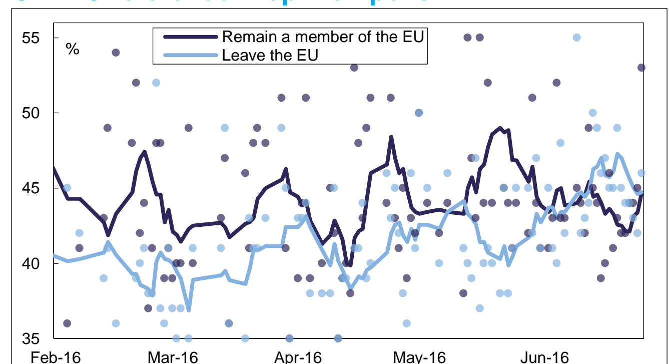
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation and forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: EU referendum opinion polls *



**The dots show individual polls and the lines are seven-poll moving averages.*
Source: whatukthinks.org and Daiwa Capital Markets Europe Ltd..

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Economic Research
Key contacts

London

Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Associate Economist	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Danielle Pettet*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Junjie Tang*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

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