# Euro wrap-up

## Overview

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- Bunds made losses despite a downward revision to the euro area inflation estimate for March.
- Gilts made gains as UK inflation surprised on the downside.
- Tomorrow brings the latest retail sales figures from the UK and euro area current account data.

**Daily bond market movements**

| Bond | Yield | Change* |
|---|---|---|
| BKO 0 03/20 | -0.569 | +0.012 |
| OBL 0 10/22 | -0.164 | +0.023 |
| DBR 0½ 02/28 | 0.529 | +0.023 |
| UKT 2 07/20 | 0.847 | -0.037 |
| UKT 0¾ 07/23 | 1.142 | -0.036 |
| UKT 4¼ 12/27 | 1.414 | -0.022 |

*Change from close as at 4.30pm BST.
Source: Bloomberg

# Euro area

## March inflation weaker than previously thought

Following yesterday's downside revision to Italian inflation, today's equivalent figures for the euro area as a whole also brought a downside surprise. The headline inflation rate for March was revised down 0.1ppt from the flash estimate to 1.3%Y/Y. However, to two decimal places, the change was much smaller, only 0.03ppt to 1.34%Y/Y. The main components were left unchanged and therefore the core rate of inflation was confirmed at 1.0%Y/Y, which nevertheless had originally represented a downside surprise when the flash estimates were released. The cause of the downside surprise to the headline rate was slightly softer food inflation, down 0.1pt from the previous estimate to 2.1%Y/Y. So, the revision should not be a cause for great concern for the ECB. But today's data once again provide a reminder of the weakness of underlying pressures in the euro zone. The core CPI rate has merely oscillated in the 0.9-1.2%Y/Y range over the last twelve months and we would not be surprised if it does not rise above the top end of that range this year. This subdued inflation outlook means that the ECB is going to have to move only very gradually on policy.

## Evidence of a slowdown mounting

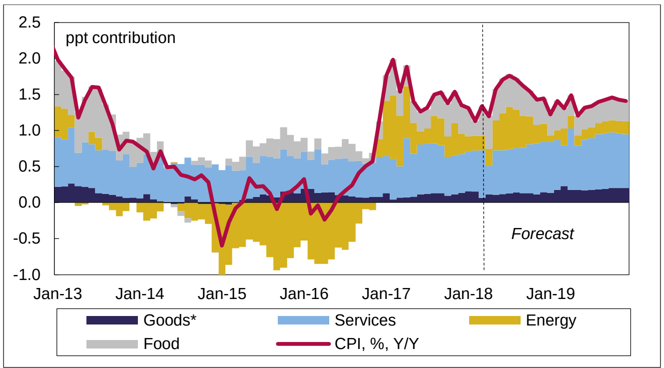
With all recent euro area economic activity indicators having moderated, today's construction output data followed suit, showing a second consecutive decline in output, of 0.5%M/M, in February. Within the detail, civil engineering activity was down by 1.7%M/M, but building construction rose very modestly, by 0.1%M/M after a fall of more than 1.0%M/M in January. Looking at construction output in Q1, the January-February monthly average so far shows a decline of 0.4% compared to Q4, suggesting that activity in this sector subtracted from GDP growth last quarter.

Finally, today's March new car registration data maintained the run of softer than expected figures from the euro area. New car sales in the euro area fell by 1.0%Y/Y in March, representing one of the weakest annual readings in recent years and a significant deterioration from last year, when sales were up by almost 5%Y/Y. Indeed, the weakness in the annual rate for this March was partly a reflection of the strength a year earlier, when registrations reached their post-crisis peak in unadjusted terms. However, new registrations were still down 0.3%M/M on a seasonally adjusted basis, representing the second successive monthly decline. Nevertheless, over the quarter as a whole, new car sales still posted an increase of 1.3%Q/Q, still a decent pace, albeit significantly softer than the rise of 2.1%Q/Q in Q4.

## The day ahead in the euro area and US

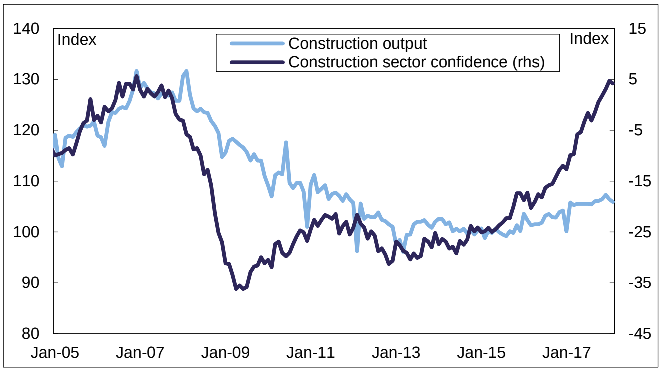
The euro area economic data flow tomorrow brings only February's current account data. The goods trade balance improved that month, with the surplus rising to €21bn. And we expect the current account surplus to have risen too, from €37.6bn in January.

### Euro area: Inflation forecast




*Excluding food and energy. Source:Thomson Reuters and Daiwa Capital Markets Europe Ltd.

### Euro area: Construction and confidence*




*European Commission construction confidence indicator. Source: EC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

It will also be a relatively quiet day on the US data front, with only the usual weekly jobless claims and the Philadelphia Fed business sentiment survey due for release. Policy-wise, FOMC members Brainard, Quarles and Mester are scheduled to speak.

# UK

## A surprise drop in inflation

UK inflation surprised significantly on the downside in March. Contrary to expectations of no change from February, the headline CPI rate fell 0.2ppt to 2.5%Y/Y, the lowest level in a year. The core CPI rate fell too, declining 0.1ppt to 2.3%Y/Y, again the lowest in a year, contrasting with the expected increase in this measure. And rounded to two decimal places, both headline and core CPI rates were very close to coming in 0.1ppt lower. The downside surprises were explained partly by weaker-than-expected services inflation, which edged up just 0.1ppt to 2.5%Y/Y to suggest that the timing of Easter had less of an impact than anticipated. Broadly in line with expectations, meanwhile, non-energy goods inflation fell 0.3ppt to 3.3%Y/Y, the lowest since late 2016, with clothing and footwear prices making the largest negative contribution.

## Increased doubts about BoE's next move

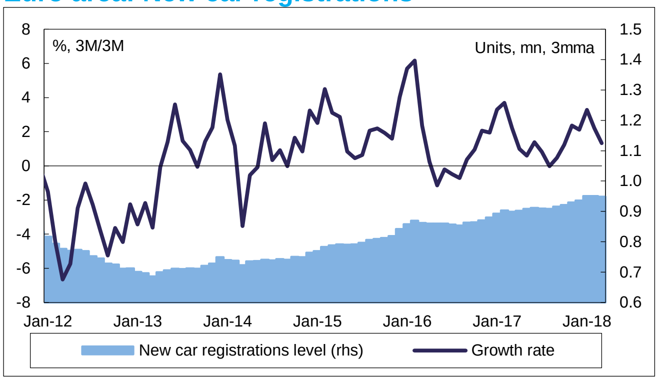
While the profile is unlikely to be smooth, not least given the recent stronger performance of sterling and clear evidence that the peak impact of post-referendum depreciation is now well behind us, we expect to see a steady downtrend in UK inflation to around the BoE's 2.0%Y/Y target by the turn of the year. That is significantly below the profile anticipated by the BoE in its last Inflation Report, which forecast CPI inflation to be 2.4%Y/Y at the end of the year (indeed, the BoE had expected inflation in February and March to have been 0.2ppt and 0.3ppt higher than the actual data at 2.9%Y/Y and 2.8%Y/Y respectively). Coming after yesterday's inconclusive labour market figures – which saw a steeper-than-expected drop in unemployment but weaker-than-expected wage growth – today's softer inflation numbers raise significant questions about whether the BoE will raise Bank Rate on 10 May. It currently seems prudent to wait for tomorrow's retail sales numbers before coming to a firm opinion on what the MPC is likely to do. But, since we think the BoE's inflation forecast should be revised down significantly when it is finalised next month, in our view the economic case for a rate hike is weak.

## Prime Minister May risks Brexit defeat

With the Easter break over, Parliament has now returned to moving through the stages that pave the way for the UK's exit from the EU on 29th March 2019 – which we detail in a separate article (see "Brexit: how the drama might unfold"). But this week might mark the start of a chain of events that derail Mrs May's plans, and ultimately her premiership. The House of Lords is currently debating the EU withdrawal bill, the legal underpinning of the UK's exit. A group of members, of several political affiliations, has sponsored an amendment calling for the government to negotiate an arrangement "which enables the United Kingdom to continue participating in a customs union with the EU". At the time of writing, this was expected to pass with a comfortable majority. Such a union, supporters argue, would both heed the calls of UK business and remove the need for a hard border between Northern Ireland and the Republic, thereby greatly reducing what has been the biggest hurdle in negotiations to date. The government is braced for a series of such defeats as the bill passes through the House of Lords over the next few weeks, where it does not have a majority. Other potential areas of contention include further issues relating to Northern Ireland and the government's plan for the UK to leave the EU on 11pm on 29 March 2019.

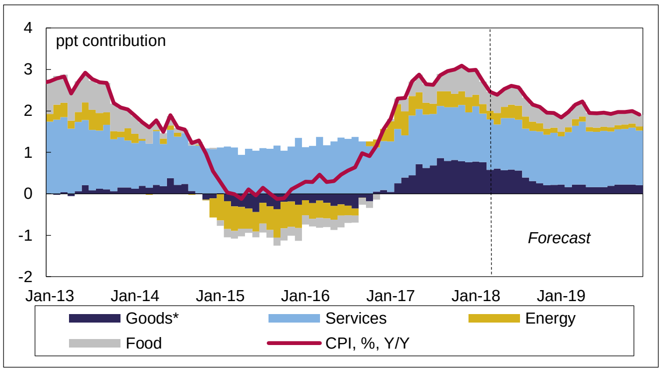
The key issue is whether this amendment on membership of a customs union will be reversed subsequently, when the bill returns to the House of Commons in about a month's time. May's official policy is to oppose remaining in the customs union, which would reduce the ability to negotiate bilateral trade deals. But as we also outlined yesterday in a separate article, the main opposition parties, along with a fair number of Conservative MPs favour membership of a customs union. (In fact, MPs there have tabled separate pieces of legislation relating to membership of a customs union, which the government has so far managed to delay). So the amendment could be upheld, and this could mean more than a change in Brexit strategy. It would heighten tensions with the 60

### Euro area: New car registrations




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

### UK: Inflation forecast




**Excluding food and energy. Source:Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

or so hardline Brexit-supporting Conservative MPs. With their party expected to bear heavy losses in the local elections on 3rd May, this could greatly increase the risk of a leadership challenge and so wider political instability.

## The day ahead in the UK

Following on from this week's inflation and labour market data, tomorrow's retail sales release for March will complete this week's trio of top-tier UK releases. The data will cover an exceptionally eventful five-week period that encompasses both the harsh weather dubbed the "Beast from the East" and a relatively early Easter. The former is likely to have significantly deterred or at least postponed retail activity. However, the latter could have boosted sales of food and home-ware in particular (and will have distorted Y/Y comparisons after Easter fell in April in 2017). Overall, we expect sales to have declined on the month, not least after a robust 0.8% M/M rise in February and as consumers remain wary of spending on non-essential items. However, a relatively weak March last year means that even a fall of 0.5%M/M would mean a rise in the Y/Y rate to about 2% from February's 1.5%

# European calendar

**Today's results**

**Economic data**

| Country | Release | Period | **Actual** | Market consensus/ *Daiwa forecast* | Previous | **Revised** |
|---|---|---|---|---|---|---|
| EMU | EU27 new car registrations Y/Y% | Mar | **-5.3** | - | 4.3 | **-** |
| | Construction output M/M% (Y/Y%) | Feb | **-0.5 (0.4)** | - | -2.2 (3.7) | **-0.8 (6.9)** |
| | Final CPI (final core CPI) Y/Y% | Mar | **1.0 (1.3)** | 1.0 (1.4) | 1.0 (1.4) | **- (1.1)** |
| UK | CPI (core CPI) Y/Y% | Mar | **2.5 (2.3)** | *2.7 (2.5)* | 2.7 (2.4) | **-** |
| | Input (output) PPI Y/Y% | Mar | **4.2 (2.4)** | 4.3 (2.3) | 3.4 (2.6) | **3.8 (-)** |
| | House price index Y/Y% | Feb | **4.4** | 4.7 | 4.9 | **4.7** |

**Auctions**

| Country | Auction |
|---|---|
| Germany sold | €2.5bn of 0.5% 2028 bonds (15-Feb-2028) at an average yield of 0.51% |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

**Tomorrow's data releases**

**Economic data**

| Country | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
|---|---|---|---|---|---|
| EMU | 09:00 | Current account balance €bn | Feb | - | 37.6 |
| UK | 09:30 | Retail sales excluding petrol M/M% (Y/Y%) | Mar | -0.4 (1.4) | 0.6 (1.1) |
| | 09:30 | Retail sales including petrol M/M% (Y/Y%) | Mar | -0.6 (1.9) | 0.8 (1.5) |

**Auctions**

| Country | BST | Auction / Event |
|---|---|---|
| France | 09:50 | Auction: To sell 0% 2023 bonds (25-Mar-2023) |
| | 09:50 | Auction: To sell 0% 2021 bonds (25-Feb-2021) |
| | 09:50 | Auction: To sell 1.75% 2024 index-linked bonds (25-Nov-2024) |
| Spain | 09:45 | Auction: To sell 0.45% 2022 bonds (31-Oct-2022) |
| | 09:45 | Auction: To sell 2.35% 2033 bonds (30-Jul-2033) |
| | 09:45 | Auction: To sell 1.4% 2028 bonds (30-Apr-2028) |
| UK | 10:30 | Auction: To sell £2.5bn of 1.625% 2028 bonds (22-Oct-2028) |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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