Euro wrap-up

Overview

- Bunds made gains and BTPs sold off on reports that the Italian parties negotiating a coalition deal considered demanding debt forgiveness from the ECB and reforms to allow countries to leave the euro.
- Gilts made modest gains as the BoE survey highlighted downside risks from Brexit on UK exports.
- The focus will remain on Italian politics, while upcoming data include euro area construction output, car registrations (tomorrow) and trade (Friday).

Chris Scicluna +44 20 7597 8326
Mantas Vanagas +44 20 7597 8318

Daily bond market movements

Bond	Yield	Change*
BKO 0 03/20	-0.567	-0.019
OBL 0 10/22	-0.124	-0.026
DBR 0½ 02/28	0.617	-0.027
UKT 2 07/20	0.824	-0.015
UKT 0¾ 07/23	1.184	-0.021
UKT 4¼ 12/27	1.507	-0.010

*Change from close as at 4.00pm BST.
Source: Bloomberg

Euro area

Leaked report illustrates risks of reckless Italian policy

At the time of writing, there was still no conclusion today to the ongoing negotiations to form an Italian coalition government. However, BTPs sold off once again, with the 10Y spread over Bunds widening about 18bps to close to 150bps, the highest since January. The catalyst was the Italian Huffington Post website, which published what it said was a draft policy document under negotiation between the populist Five Star Movement (M5S) and nationalist League. While M5S leader Di Maio subsequently insisted that the draft had changed a great deal as discussions between the two parties evolved, the naïve and reckless policies contained within – which some participants in the negotiations had evidently judged were appropriate for consideration – illustrated why we take such a dim view of the outlook for Italian government bonds.

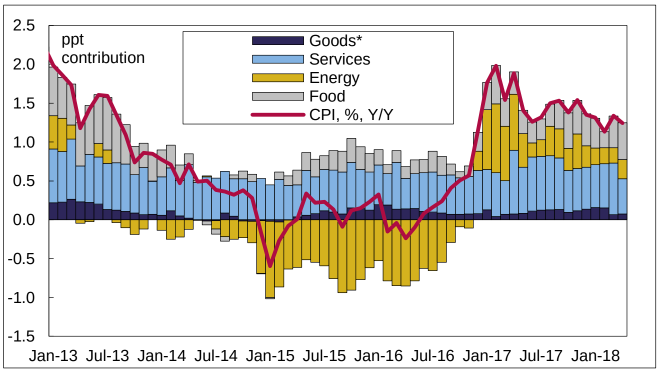
Confrontation and fiscal irresponsibility ahead?

Much attention was placed on the proposal to request the ECB to write off about €250bn of its holdings of Italian debt purchased under its QE programme – a non-starter given the EU Treaty’s ban on direct monetary financing of deficits and ‘no bail-out’ clause. Perhaps more concerning was fresh evidence of the parties’ lack of commitment to euro membership, with the draft report suggesting the government should press for "specific technical procedures of an economic and judicial nature" to allow individual member states to exit the euro and "recover their monetary sovereignty” – a foolhardy (if ultimately unachievable) objective that would explicitly undermine the single currency’s essential irreversibility. And consistent with the parties’ irresponsible fiscal policy pledges (including a form of flat tax, a minimum basic income, and reversal of pension reforms, all of which got a mention) and confrontational stance towards its euro area partners, the document also called for the euro’s budgetary rules – the Stability and Growth Pact – to be “radically changed”. That policy will also fail to gain traction. Indeed, many of the initiatives within the draft will be dropped or will fail to find the necessary support in the Italian parliament or elsewhere in the euro area. However, the report left the lingering sense that, if agreement between the parties is eventually reached, Italian economic policy under a government led by M5S and the League might be no more appropriate than Greek economic policy under the first Syriza government. That’s bad news for Italian asset prices. And, since it’s likely to reinforce the reluctance in Germany to develop new fiscal measures to strengthen the euro area policy framework, it’s bad news for the asset prices of other Southern euro area member states too.

April fall in inflation confirmed

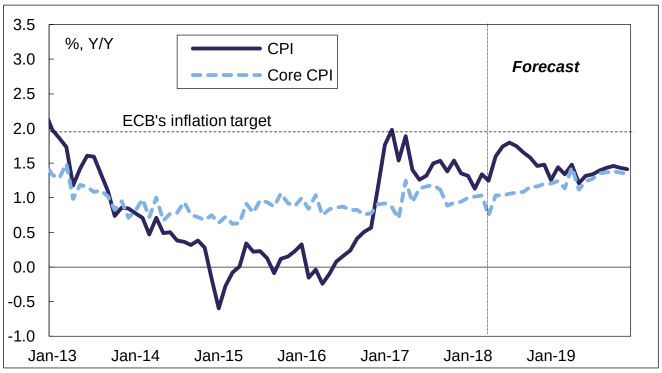
Datawise, the final April inflation figures from the largest member states were all left unrevised from their respective

Euro area: Inflation



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

Euro area: Inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

preliminary estimates. So, predictably, today's final estimate of euro area inflation also fully aligned with its flash estimate of 1.2%Y/Y, down 0.1ppt from February and the second-lowest rate since the start of last year. Minimal changes were made to the major components. For example, the steep drop in services inflation, from 1.5%Y/Y to a thirteen-month low of 1.0%Y/Y was confirmed. This, of course, was driven by the post-Easter adjustment to certain holiday-related categories such as flights (for which inflation fell from 6.8%Y/Y to -4.5%Y/Y) and package holidays (from 3.1%Y/Y to -1.3%Y/Y). Meanwhile, non-energy industrial goods inflation was also left unchanged at 0.3%Y/Y, close to the bottom of the range of the past year. As a result, the core inflation rate also held steady at 0.7%Y/Y, a level last seen in March 2017 (a month similarly distorted by the timing of Easter). Meanwhile, inflation in the non-core categories – food and energy – saw very small offsetting revisions from the previously reported 2.5%Y/Y pace. Indeed, the former was revised down 0.1ppt, still marking the highest rate in fourteen months, while the latter was revised 0.1ppt higher.

Energy prices will drive inflation higher

Going forward, the energy component looks set to drive overall euro area inflation higher from now until the end of the summer. With crude oil prices having maintained their recent upward trend, the energy price index should rise notably over the near term, with base effects related to declines in oil prices a year ago set to provide an additional boost to the annual rate of inflation. Indeed, energy prices also pose some upside risks to the ECB projections – the current Brent crude price of around USD78/bbl is USD13/bbl (20%) higher than the assumed average level for this year in the set of forecasts endorsed by the Governing Council in March. So, we expect the June monetary policy meeting to see the ECB revise up its forecast for average CPI inflation in 2018 by 0.1ppt to 1.5%Y/Y. Meanwhile, although most action will relate to energy prices, we expect the core inflation rate to bounce back up to 1.0%Y/Y this month as the Easter effect falls out of the calculation. However, beyond that, we expect core inflation to move higher only very gradually, not least as recent exchange rate moves will have little impact: while the euro is down against the US dollar by almost 5% over the past month, the broad effective exchange rate is little changed given the marked depreciation of several currencies of emerging markets with which the euro area conducts a large share of trade.

The coming two days in the euro area and US

All eyes tomorrow will remain on Italy as an agreement between M5S and the League is still anticipated. It should be a relatively quiet day on the economics front tomorrow, with only second-tier releases – construction output data for March and new car registration figures for April – due. In March, the latter declined 1.0%Y/Y, one of the weakest readings in recent years, but this was partly driven by base effects from a year ago, and a positive reading this time seems to be on the cards. Meanwhile, on Friday, the focus will be on the latest euro area trade and current account figures.

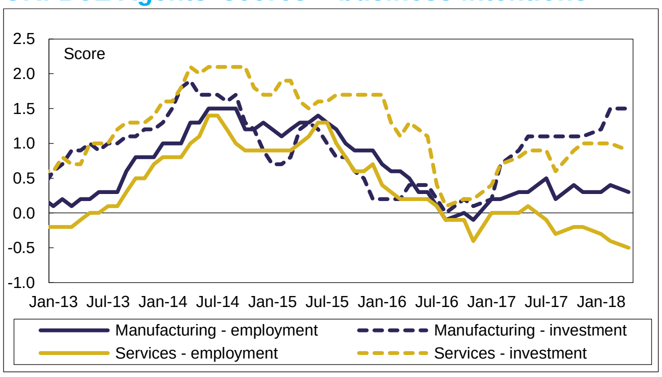
Tomorrow the dataflow in the US brings only the latest weekly jobless claims data, the Philadelphia Fed business sentiment survey and the Conference Board leading indicator. There are no notable data releases due on Friday.

UK

BoE finds Q1 activity hampered by snow

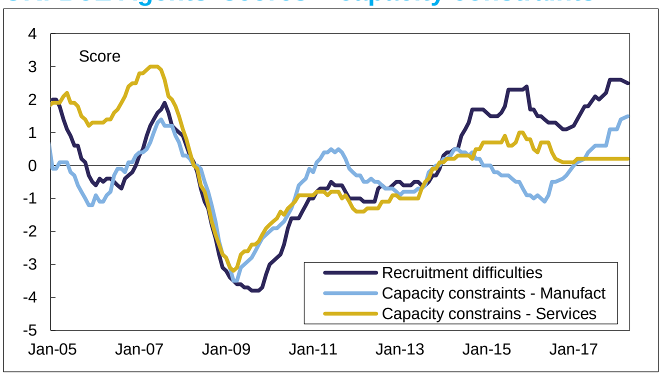
The disruption to activity from an unusually harsh winter was a recurrent theme throughout the BoE's latest regional Agents' Summary of Business Conditions. The research, conducted between mid-February and mid-April highlighted a significant impact on retail, consumer services, manufacturing and the construction sector. Such evidence may be inclined to make the MPC view the weakness of growth seen in Q1 as short-lived – although the data for the start of Q2 have yet to provide clear evidence of a bounce-back. Meanwhile, the report claimed broad-based recruitment challenges, with some citing a lack of EU migrant labour, and rising unit labour costs. The agents reported pay settlements in the range of 2.5-3.5%Y/Y, consistent with rising real incomes, which may provide ammunition to the more hawkish members of the MPC. The report focussed in detail

UK: BoE Agents' scores – business intentions



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

UK: BoE Agents' scores – capacity constraints



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

on exports, and noted that the boost from the post-referendum depreciation of sterling was now wearing off. However, it said that export volumes to the EU remained robust and there was "limited evidence of reluctance to award longer-term contracts to UK companies." But it was notable that, when surveyed, companies claimed that uncertainty around the UK's future trading arrangements was likely to have the largest negative effect on exports over the next year. There were also greater concerns about the impact of changes to supply chains due to Brexit, and possible relocation of production - highlighting the pressing need for clarification over the UK's approach to customs arrangements.

The coming two days in the UK

There are no major UK data scheduled for release on Thursday and Friday.

In the absence of significant developments the next edition of the Euro wrap-up will be published on 18 May 2018.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Final CPI (final core CPI) Y/Y%	Apr	**1.2 (0.7)**	*1.2 (0.7)*	1.3 (1.0)	-
Germany	Final EU-harmonised CPI Y/Y%	Apr	**1.4**	*1.4*	1.5	-
Italy	Final EU-harmonised CPI Y/Y%	Apr	**0.6**	*0.6*	0.9	-

Auctions

Country	Auction
Germany sold	€1.6bn of 0.5% bonds 2028 (15-Feb-2028) at an average yield of 0.62%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10:00	EU27 new car registrations Y/Y%	Apr	-	-5.3
	10:00	Construction output M/M% (Y/Y%)	Mar	-	-0.5 (0.4)
Italy	09:00	Trade balance €bn	Mar	-	3.1

Auctions

Country	GMT	Auction / Event
France	09:50	Auction: To sell 0% 2021 bonds (25-Feb-2021)
	09:50	Auction: To sell 0% 2023 bonds (25-Mar-2023)
	10:50	Auction: To sell 1.1% 2022 index-linked bonds (25-Jul-2022)
	10:50	Auction: To sell 1.85% 2027 index-linked bonds (25-Jul-2027)
Spain	09:30	Auction: To sell 0.35% 2023 bonds
	09:30	Auction: To sell 5.9% 2026 bonds (30-Jul-2026)
	09:30	Auction: To sell 1.4% 2028 bonds (30-Apr-2028)
UK	17:00	BoE's Haldane scheduled to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's data releases

Economic data					
Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	09:00	Current account balance €bn	Mar	-	35.1
	10:00	Trade balance €bn	Mar	21.1	21.0
Germany	07:00	PPI M/M% (Y/Y%)	Apr	0.3 (1.8)	0.1 (1.9)
Auctions					
Country	GMT	Auction / Event			
		- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
http://www.uk.daiwacm.com/ficc-research/recent-blog

Follow us
@DaiwaEurope