Euro wrap-up

Overview

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- Despite data revealing strong jobs growth in the euro area in Q1, Bunds made gains as the drop in industrial production at the start of Q2 was confirmed.
- Gilts also made gains as UK inflation was unchanged in May and PM May appeared set to avoid defeat in her latest parliamentary Brexit votes.
- Thursday's focus will be the latest policy announcements from the ECB, while UK retail sales and final German and French inflation data are due.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/20	-0.591	-0.008
OBL 0 04/23	-0.151	-0.012
DBR 0½ 02/28	0.474	-0.017
UKT 2 07/20	0.738	-0.013
UKT 0¾ 07/23	1.075	-0.029
UKT 4¼ 12/27	1.361	-0.039

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

Euro area

Manufacturing retreats at start of Q2

As the ECB's Governing Council commenced its monetary policy meeting in Riga, the latest economic data were a mixed bag. Certainly, the April industrial production report was weak, with the 0.9%M/M drop in output representing the biggest since last June. The fall, however, was led by a weather-related 5.0%M/M plunge in energy production while manufacturing production declined a more modest 0.3%M/M principally due to a 2.2%M/M retreat in output of consumer durables. Looking through recent monthly volatility, the soft reading for manufacturing output left it down 1.6%3M/3M, the worst performance on such a basis since early 2013. To some extent that weakness reflects payback for the vigorous growth in the sector throughout 2017. Indeed, surveys suggest that capacity constraints have played a role in crimping activity over recent months. And the annual rate of growth in manufacturing production was still a respectable 2.2%Y/Y, albeit down from a sparkling 5.8%Y/Y three months earlier. But new orders appear to have slowed markedly since the start of the year. And while surveys suggest that growth in the sector should resume this quarter, the trend pace of expansion seems bound to be well down on that last year.

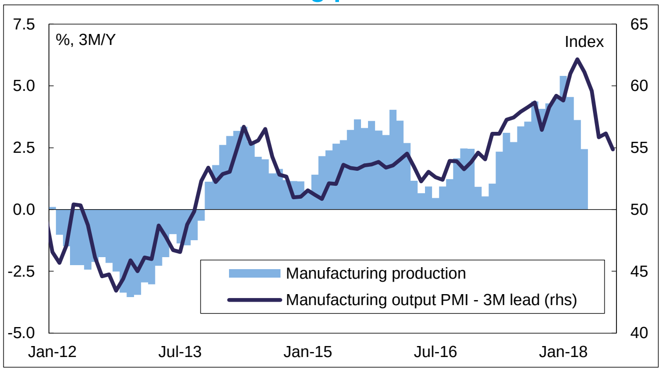
Jobs growth remained firm in Q1

Despite the moderation in the pace of economic expansion in the first quarter, labour market conditions have continued to improve. We already knew that the euro area unemployment rate declined to 8.5% in April, down 0.2ppt from the end of 2017, 0.7ppt lower than a year earlier and 3.6ppts down from the crisis peak in 2013. And today's data confirmed that job creation has remained firm, with employment up a further 587k (0.38%Q/Q) in Q1, broadly in line with the average gain of the past two years and up from a rise of 412k (0.26%Q/Q) in Q4. Once again, job growth was strongest in Germany (up almost 200k), although solid gains were also reported in France, Spain and the Netherlands. Total employment rose to a new series high more than 2.2mn compared to a year earlier and more 8.4mn up from the crisis trough. The ongoing improvement in the labour market, which has proceeded faster than the ECB anticipated and is starting to be reflected in higher negotiated wages, is a key reason why the Governing Council will tomorrow confirm that it expects inflation to rise gradually towards target over the coming couple of years.

The day ahead in the euro area and US

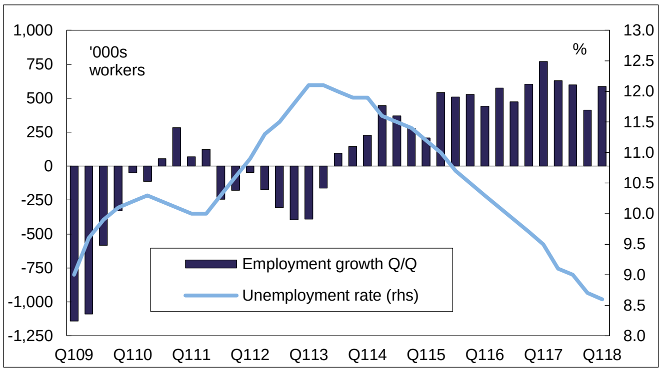
After today's focus on the Fed, all eyes on Thursday will be on the conclusion of the ECB's Governing Council meeting in Riga. We already know, from Chief Economist Peter Praet's speech last week, that the policymakers will have discussed issues related to the future of the QE programme. And we suspect that the Governing Council will judge that the updated economic forecasts are broadly consistent with an assessment that a sustained adjustment in the path of inflation towards target

Euro area: Manufacturing production and PMI



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

Euro area: Selected labour market data



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

appears to be underway “to warrant a gradual unwinding of [the ECB’s] net purchases”. But the ECB will not be complacent about recent soft economic data, which suggest that downside risks to the outlook have increased. And it will have to acknowledge that bond markets – in particular BTPs – have been volatile. So, while we expect Draghi to signal that the Governing Council now judges that the conditions are broadly in place to justify phasing out the QE programme, we also expect a final agreement and announcement of its plans of how it intends to bring its net purchases to an end to come at the July meeting. Our baseline scenario, of a gradual tapering of net asset purchases over the course of Q4 to zero by end-December – perhaps amounting to a total of about EUR30bn over the quarter – remains in place.

As far as the ECB’s updated economic forecasts are concerned, the weakening of the dataflow demands a downwards revision to its GDP forecast for this year. But perhaps that will merely be nudged lower by just 0.1ppt to 2.3%Y/Y, thus reversing the upwards revision made in March. And we think the ECB might still wish to leave its growth forecasts for 2019 and 2020 unchanged at 1.9%Y/Y and 1.7%Y/Y. Moreover, we suspect that the headline inflation forecast for this year and next might be shifted slightly higher, by 0.1ppt to 1.5%Y/Y in both years. That, however, will partly reflect the impact of the higher oil price, for which the assumed average price this year will be pushed up by more than $5 per barrel to more than $70. However, the ECB might also be tempted to push the forecast for core inflation this year higher too, while leaving the profile for future years unchanged, so that in 2020 it reaches 1.8%Y/Y – close to but below 2%Y/Y, arguably in line with the ECB’s target.

Before the ECB’s announcement, the final German and French inflation figures for May will be released. As for the Spanish numbers today (up 1.0ppt to 2.1%Y/Y on the EU-harmonised measure), we expect these to align with the respective flash estimates (2.2%Y/Y in Germany and 2.3%Y/Y in France) and so to suggest that the final euro area numbers due Friday will also be unrevised.

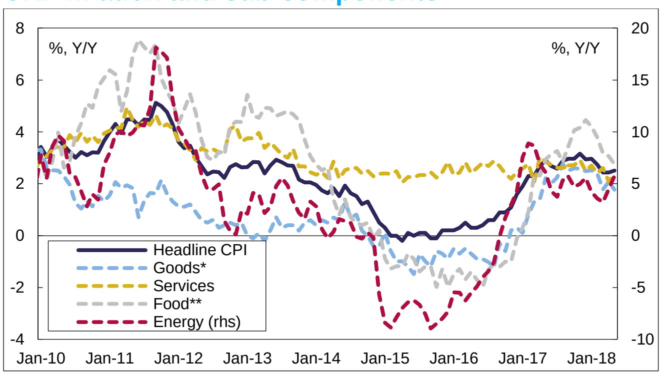
In the US, Thursday will bring the advance retail sales report for May, which will cast further light on how consumer spending is evolving in Q2. A drop in sales of autos is expected to restrain the headline figure, but solid fundamentals should lead to respectable growth in other components, although some of the ex-auto advance will likely result from higher prices of gasoline. Data for May’s export and import prices, April’s business inventories, and the latest weekly jobless claims are also due.

UK

Fuel costs fail to ignite headline inflation

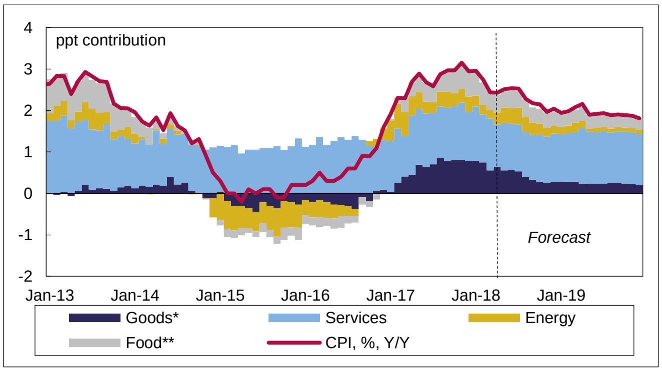
Headline inflation in May aligned with the consensus expectation, with the annual CPI rate remaining at 2.4%Y/Y in May. The details were inevitably mixed with the rise in crude prices (Brent rose $10 per barrel in the three months to the end of May) ensuring that motor fuels made the largest upward contribution. Petrol prices rose by 4.6 pence per litre between April and May. Air and ferry fares also had a large upward effect, which reflected the unwinding of a distortion caused by a relatively early Easter this year. Accordingly, transport prices rose by 4.6%Y/Y, the fastest for over a year. These upwards pressures were offset by downward pressure from price changes for games, electricity, and household goods, while food inflation also sustained its downward trajectory. The core CPI inflation rate accordingly was also unchanged at 2.1%Y/Y. These figures contained little to worry the BoE, which indicated in last month’s Inflation Report that it expected the headline rate to remain at 2.4%Y/Y, and possibly rise a little further over the next few months. Certainly, the impact of higher crude prices on costs – input price inflation jumped to 9.2%Y/Y in May from April’s 5.6%Y/Y while output price inflation was up 0.4ppt to 2.9%Y/Y – is already clear further along the supply chain. But with oil prices having recently flattened off, and with retail pricing power constrained by soft consumer demand, we still expect underlying inflationary pressures to ease further out. We continue to forecast the headline inflation rate to drop very close to the 2.0%Y/Y target by the end of the year, and to fall below this level in 2019.

UK: Inflation and sub-components



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

UK: Inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

May makes concessions to avoid Brexit defeat

Theresa May appears to have averted potentially destabilising defeats on all key amendments on the EU Withdrawal Bill in the House of Commons – but only by offering (very) last-minute compromises, and by a narrow majority. Most crucially, the amendment concerning Parliament having a meaningful vote, seen as the hardest to defeat, was discarded. But that occurred only after Theresa May offered some kind of compromise, to be tabled in the House of Lords in due course, that would potentially involve MPs having a say on Brexit negotiation strategy if there is not a deal agreed by the end of November this year. Moreover, if there's still no deal by mid-February next year, May would then have to 'follow any direction' voted upon by MPs.

Plenty of crucial detail remains unresolved

While the precise details have yet to be hammered out – and the Remainers and hardcore Brexiters within the Conservative Party have different interpretations about quite what assurances Theresa May has offered – and then accepted in a new amendment, the latest moves would appear to represent a considerable climbdown by the government. This potentially gives MPs more power over the deal, but – most notably perhaps – also seems to have reduced very significantly the possibility of a highly disorderly no-deal scenario. Many other amendments were set to be voted on over the course of today – most significantly ones concerning seeking membership of a customs union and the EEA. But similar last-minute concessions – which will effectively kick the can down the road again on key issues related to future customs arrangements and regulatory alignment with the EU – mean the government was set to be able to throw them out too. So, an imminent political crisis appears to have been averted. But May has still been forced to make adjustments to her intended strategy. And plenty of crucial detail, that will have an important bearing on the UK economic outlook, remains unresolved.

The day ahead in the UK

The majority of the UK data so far this week – in particular the IP and wages numbers – have suggested a weaker start to Q2 than the BoE had assumed in some parts of the economy. The May figures will reveal if this is also the case when it comes to retail sales. Despite April's hefty 1.6%M/M pickup, the underlying trend in spending has been almost flat. And as the list of struggling UK retailers grows, contrary to the consensus view, we expect the stagnation to have continued in May.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Industrial production M/M% (Y/Y%)	Apr	**-0.9 (1.7)**	-0.7 (2.5)	0.5 (3.0)	**0.6 (3.2)**
	Employment Q/Q% (Y/Y%)	Q1	**0.4 (1.4)**	-	0.3 (1.6)	**-**
Spain	Final EU-harmonised CPI Y/Y%	May	**2.1**	2.1	1.1	**-**
UK	CPI (core CPI) Y/Y%	May	**2.4 (2.1)**	*2.5 (2.2)*	2.4 (2.1)	**-**
	Input (output) PPI Y/Y%	May	**9.2 (2.9)**	7.6 (2.9)	5.3 (2.7)	**5.6 (2.5)**
	UK House price index Y/Y%	Apr	**3.9**	-	4.2	**-**

Auctions

Country	Auction
Germany sold	€1.54bn of 0.5% 2028 bonds (15-Feb-2028) at an average yield of 0.48%
Italy sold	€2bn of 0.05% 2021 bonds (15-Apr-2021) at an average yield of 1.16%
	€2.13bn of 1.45% 2025 bonds (15-May-2025) at an average yield of 2.37%
	€468mn of 3.25% 2046 bonds (01-Sep-2046) at an average yield of 3.42%
	€1.03bn of 3.45% 2048 bonds (01-Mar-2048) at an average yield of 3.54%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		12:45	ECB main refiancing rate %	Jun	*0.0*	0.0
		12:45	ECB marginal lending facility rate %	Jun	*0.25*	0.25
		12:45	ECB deposit facility rate %	Jun	*-0.4*	-0.4
Germany		07:00	Final EU-harmonised CPI Y/Y%	May	*2.2*	1.4
France		07:45	Final EU-harmonised CPI Y/Y%	May	*2.3*	1.8
UK		00:01	RICS house price balance %	May	-	-8
		09:30	Retail sales excluding petrol M/M% (Y/Y%)	May	0.3 (2.5)	1.3 (1.5)
		09:30	Retail sales including petrol M/M% (Y/Y%)	May	0.5 (2.4)	1.6 (1.4)

Auctions

Country		BST	Auction / Event
EMU		13:30	ECB's Draghi holds a press conference

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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