Euro wrap-up

Overview

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- Bunds made losses as data confirmed firm growth in German manufacturing and construction output in Q1.
- Longer-dated Gilts followed the global trend lower ahead of the BoE's policy announcement.
- The BoE rate decision and updated economic projections will be the main focus on Thursday.

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	2.922	+0.030
OBL 2.1 04/29	2.496	+0.041
DBR 2.2 02/34	2.459	+0.042
UKT 0⅛ 01/26	4.286	-0.001
UKT 0½ 01/29	4.014	0.000
UKT 4⅝ 01/34	4.137	+0.015

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

Euro area

Manufacturing output grew in Q1 on lower energy prices & expectations of firmer consumption

Consistent with yesterday's turnover data, today's figures confirmed that German manufacturing output fell in March for the first month in three. The decline was a relatively modest 0.4%M/M, which followed growth of 1.9%M/M in February. And given the firm start to the year, manufacturing production rose 0.8%Q/Q in Q1, marking the first positive quarter of growth in a year. Reflecting expectations of increased private consumption ahead, growth in the factory sector in Q1 was driven in part by output of consumer goods, which rose for the first time in six quarters, and by a vigorous 4.4%Q/Q, with increases in both durable and non-durable categories. In addition, production of intermediate items was also firm (2.2%Q/Q), buoyed in particular by a strong rebound in chemicals (6.6%Q/Q), which grew for the first quarter since Q421, before Russia's invasion of Ukraine triggered the extraordinary shock to energy prices. Indeed, with wholesale gas inventories trending above last year's elevated levels, and power prices down to the lowest levels since 2021, production of energy-intensive items overall also rose for the first quarter in nine (4.8%Q/Q). The exception in the factory sector to the positive story in Q1 was capital goods (-1.6%Q/Q) with a fifth successive decline in machinery and equipment (-1.7%Q/Q) accompanied by the first drop in motor vehicles (-4.7%Q/Q) in two quarters, while railway and aerospace equipment provided some offset.

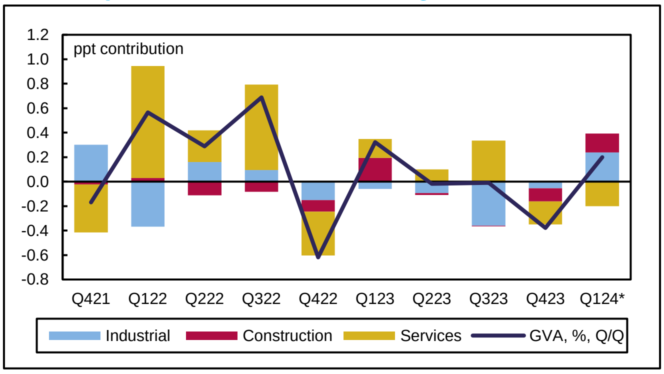
Weather-assisted surge in construction more than offset renewed weakness in energy generation

Like manufacturing output, total German industrial production also fell 0.4%M/M in March. But its growth over the first quarter as a whole was stronger, at 1.0%Q/Q, to more than fully account for all of the rise in GDP (0.2%Q/Q). Not least due to mild weather, energy generation fell in each month of Q1 to be down 5.8%Q/Q. Indeed, the level of energy generation in March was a six-month low and thus the second-lowest since reunification. But, similarly thanks to the unseasonably mild weather, and defying the downbeat surveys of firms in the sector, construction output rose for three successive months to be up in the first quarter by 3.9%Q/Q, marking the first quarterly increase since Q123. The bulk of construction growth in Q1 was in infrastructure, with civil engineering output up 8.2%Q/Q, representing the best quarter in more than a decade. Tallying with the still-subdued real estate market and pessimistic sentiment among firms in the sub-sector, however, building work was up a far more modest 0.9%Q/Q. And while construction output in March rose to a thirteen-month high, it was still 3.2% below the pre-pandemic level, with building work more than 11% below the equivalent benchmark.

Upturn in factory output should be sustained but near-term IP growth to be relatively subdued

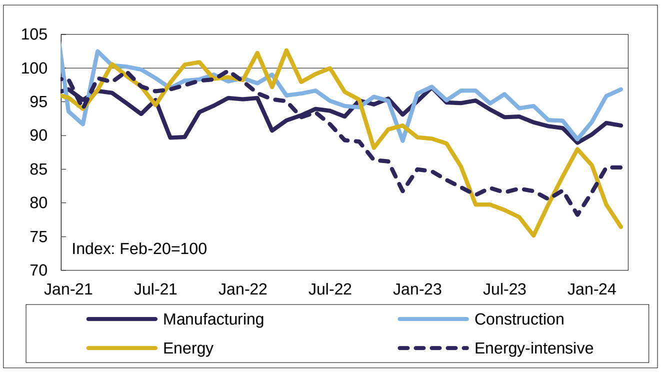
Following the modest decline in March, manufacturing output at the end of Q1 was still down 3.6%Y/Y and 8.5% below the pre-pandemic level in February 2020, with the equivalent figures for overall industrial production (-3.4%Y/Y and 8.8% below

Germany: Contributions to GVA growth



**Q124 contributions are Daiwa estimates based on available monthly data.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

the pre-pandemic benchmark) within the same ballpark. However, leading indicators, such as the truck-toll mileage index, which rose 0.9%MM in April, point to renewed growth in April. Likewise, the manufacturing output PMI rose in April to its second-highest level in eleven months (45.4) while the ifo manufacturing expectations index was the best in one year. Among the various sub-sectors, lower energy prices have given a boost to sentiment in chemicals, where production expectations have recently risen back to the top of the range since the Russian invasion of Ukraine. According to the ifo survey, production expectations are also positive among manufacturers of transport equipment ex-autos, as well as a range of items from computers and electronics to pharmaceuticals and food and beverages. But perhaps reflecting the relatively downbeat outlook for business capex, manufacturers of machinery and equipment, as well as motor vehicle, are still negative about the production outlook. And while we do expect manufacturing output to continue to trend higher from here, yesterday's soft data for new factory orders – which fell in each month of the first quarter to be down 4.2%3M/3M in March – point to a relatively subdued near-term outlook for the sector. Likewise, with orders and building permits – particularly for residential work – well down on levels a year ago, the surge in construction output in Q1 looks set to be followed by a dip in Q2. So, while we forecast another quarter of growth in Q2, overall industrial production is likely to offer much less support to GDP growth than it did at the start of the year.

The day ahead in the euro area

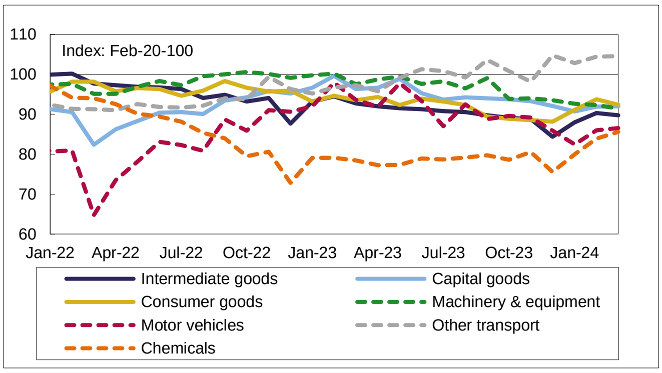
With certain markets closed for Ascension Day holiday, it will be a quiet day for euro area economic data on Thursday.

UK

The day ahead in the UK: All eyes on the BoE

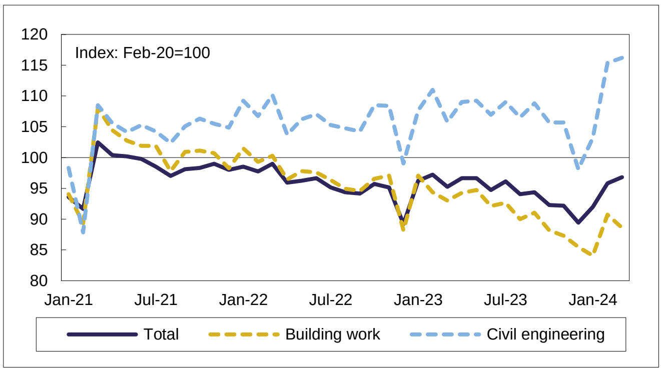
After a day with no top-tier UK economic data today, all eyes tomorrow will be on the BoE's latest monetary policy decision, which will be accompanied by the publication of its updated macroeconomic projections in the May Monetary Policy Report. At the previous meeting in March, for the first time since September 2021, no one on the MPC voted for a rate hike, suggesting that the mood on the Committee is becoming more dovish. However, as services inflation and wage growth still remain elevated by historical standards, the MPC's updated projections are highly unlikely to provide sufficient comfort for a rate cut this month and the MPC seems bound to leave Bank Rate unchanged at 5.25% for a seventh successive meeting. Indeed, while there is a possibility that Deputy Governor Ramsden might join uber-dove Dhingra in supporting some monetary easing, another 8-1 vote in favour of the status quo is likely. Nevertheless, the policy statement and press conference should make it clear that, as far as the majority of its members are concerned, the Committee is gradually moving closer to easing policy. Indeed, the possibility of a rate cut as soon as June is unlikely to be explicitly ruled out.

Germany: Manufacturing output



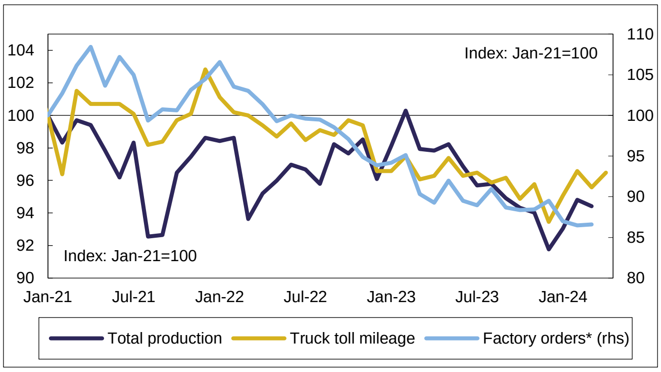
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Construction output



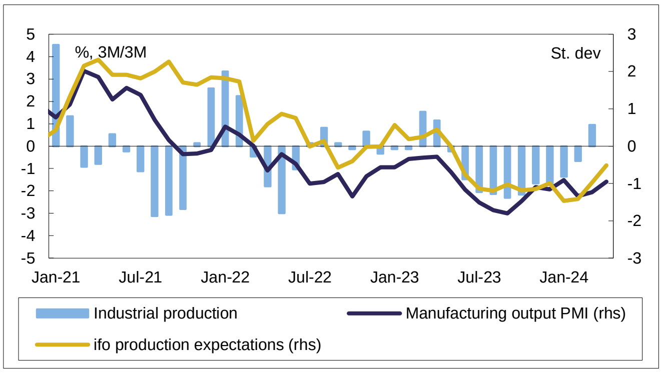
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Production, orders & truck toll mileage



**Excluding major items. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Germany: Production & sentiment indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Market-implied path of interest rates has shifted significantly higher since February

Importantly, since the last MPR, the market-implied path for Bank Rate has shifted significantly higher, a move that will have a marked impact on the MPC's baseline projection. Indeed, while the baseline projection in February assumed that Bank Rate would be cut by 100bps in 2024 and about 75bps further in 2025, a similar convention this time around would imply only around 50bps of cuts by year-end and perhaps no more than 100bps two years' ahead. Other things being equal, the higher path for rates would imply a significantly softer profile for both GDP and inflation.

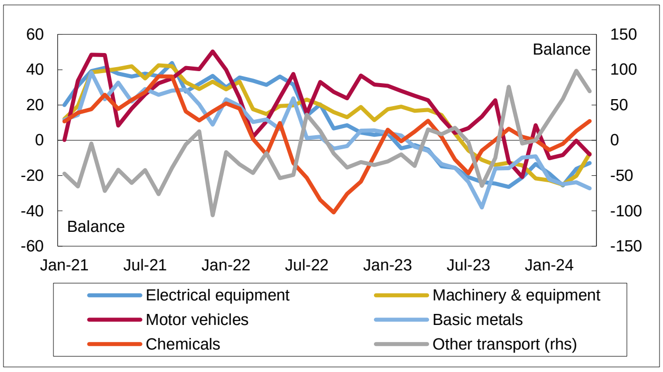
MPC to revise up its near-term GDP growth projection

Despite tighter financial conditions, however, the MPC is likely to revise up its projected near-term profile for GDP growth. Admittedly, the contraction of economic output in Q4 (-0.3%Q/Q) was a much weaker performance than the BoE's baseline projection of a flat quarter. However, while the early timing of Easter this year might have adversely affected activity in March, data due on Friday should reveal that GDP grew at least 0.3%Q/Q in Q1, which would be the strongest rate in two years and 0.2ppt above the BoE's previous baseline projection. Moreover, surveys suggest that GDP growth in the current quarter might be as strong as in Q1, again surpassing the MPC's market-based projection of 0.1%Q/Q. So, the level of GDP at the end of Q2 could be 0.2% above that previously projected by the Committee. And with real household disposable incomes supported by cuts to National Insurance Contributions and the Ofgem energy price cap at the start of April, the housing market looking more resilient to past rate hikes, and external demand firmer than previously anticipated, the MPC's updated projection of economic growth this year seems bound to exceed the BoE's previous baseline forecast of just ¼%Y/Y, perhaps by up to ½ppt. The case for revising up the growth projection for 2025 (previously ¾%) looks weaker, however. And the MPC should still judge that full-year growth will remain below the economy's potential rate, and so a degree of spare capacity should still emerge, helping wage and price pressures to dissipate further.

Labour market, wages and prices broadly in line with MPC's projection in Q1

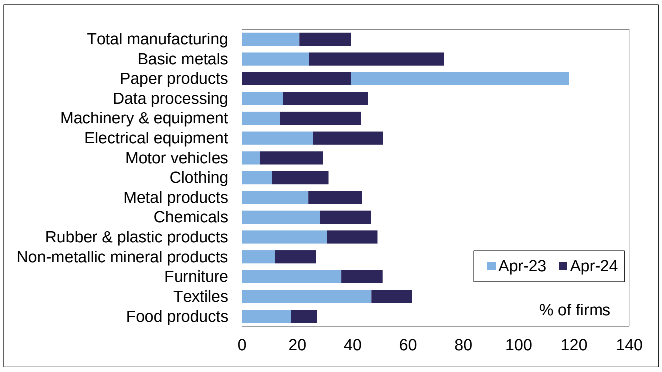
The underlying tightness of the labour market, wage growth and services price inflation will remain the most important variables in the MPC's reaction function for determining the future path of Bank Rate. Due to data inadequacies and the use of new methodologies, the condition of the jobs market has been difficult to gauge with any confidence. But while it has appeared to loosen, Governor Bailey recently judged that it was still broadly consistent with 'full employment', and the MPC will likely still judge it to be relatively tight by historical standards. Nevertheless, while there is significant uncertainty about the impact of the approximately 10% rise in the National Living Wage in April, private sector wage growth appears to be moderating broadly in line with the MPC's projection. And while headline inflation (3.2%Y/Y) and the services component

Germany: ifo production expectations indices



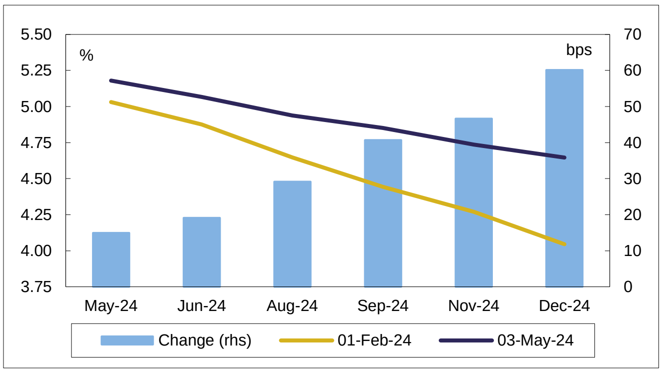
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Shortage of orders liming production



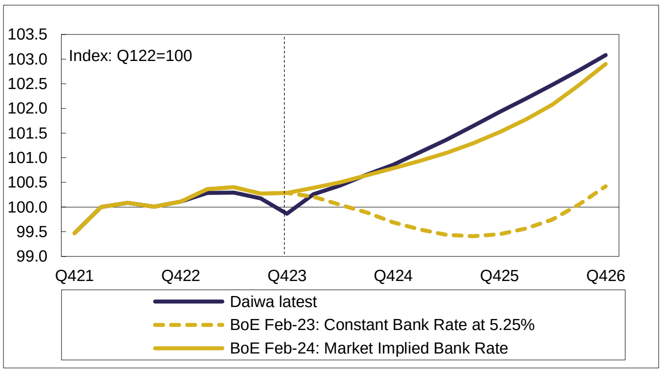
Source: ifo, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Market-implied path for Bank Rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: GDP forecast



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

(6.0%Y/Y) in March slightly exceeded the MPC's projection, special factors including the timing of Easter likely played a role. Moreover, the respective Q1 average rates were consistent with the BoE's expectation.

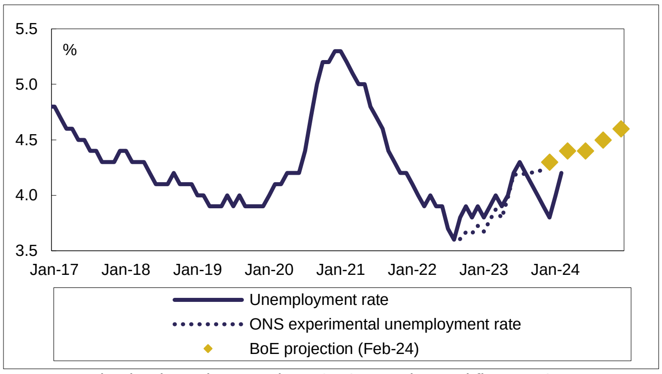
Inflation to fall below target in Q2 & rebound only moderately in H224

The MPC's updated projections will need to accommodate all policy changes announced in the Government's March Budget, including the cancellation of the planned 5p increase in fuel duty and a delay to the planned uprating of alcohol duties, which together will subtract about 0.2ppt from the inflation forecast for twelve months from April but add about 0.1ppt to the projection from March 2025. And while the PMIs reported a pickup in input costs at the start of Q2, the survey also signalled limited pass-through to consumers. Moreover, given the marked cut in the regulated energy price cap in April, inflation is still likely to fall below the 2.0% target this quarter and perhaps also below the BoE's most recent projection. The Ofgem price cap currently looks likely to be cut further in July – perhaps by more than 7% – which should help limit the rise in inflation back above target in Q3 that the MPC previously anticipated. Nevertheless, given recent market moves, the price cap would seem likely to be hiked again in October. And with crude oil prices currently implied by the markets to remain higher for longer than the MPC assumed in February, inflation might be expected to pick up in Q4.

MPC to reduce upside skew & extent of persistence in its projection

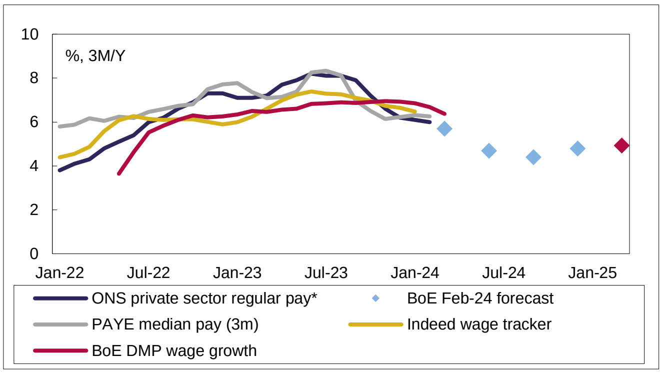
Thereafter, however, the path of inflation will depend on the extent of wage and price persistence. At the time of the previous MPC meeting in March, there were significant differences of opinion among MPC members about the risks of persistent inflationary pressures. The more hawkish members were still concerned that wage growth remained too high and that services inflation would not fall sufficiently rapidly. And given some lingering upside risks, the majority of members had wanted to see further evidence of fading inflation persistence before being ready to advocate a shift in monetary policy. Recent comments by BoE Chief Economist Pill suggest that he is yet to be convinced that the persistent momentum in underlying inflation has stabilised and considers that 'the time for cutting Bank Rate remains some way off'. But Deputy Governor Ramsden recently signalled greater confidence that the upside risks to domestic inflationary pressures are receding. And Governor Bailey has certainly become less concerned about second-round effects on inflation from the labour market, judging that the UK price outlook is more aligned with the current disinflationary profile of the euro area rather than the inflation persistence of the US. As we suspect that Deputy Governor Broadbent will share that view, we see a strong probability that the MPC will this month remove the upside skew and reduce the extent of inflation persistence built into its projection. And on the assumption of the current market-implied path for Bank Rate, we see a significant probability that the MPC will project inflation to fall below target over the policy horizon, a profile that might normally call for an easing of policy.

UK: Unemployment rate*



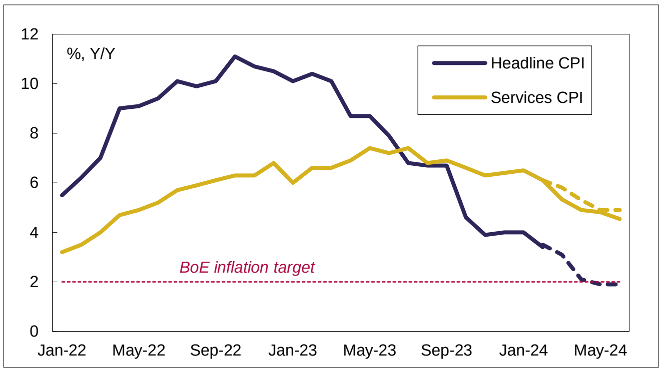
*BoE projection based on previous ONS experimental figures. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Measures of wage growth



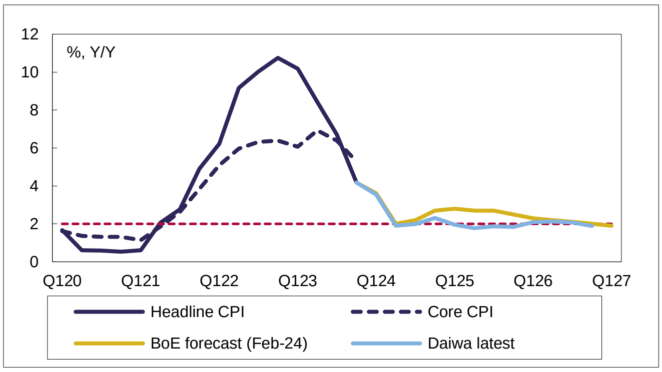
*Data between January and November 2022 are BoE staff estimates of underlying private sector regular pay growth. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & services inflation*



*Dashed lines represent BoE forecast from Feb-24 MPR. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Inflation forecast*



*BoE projection based on market-implied interest rates. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany		Industrial production M/M% (Y/Y%)	Mar	**-0.4 (-3.3)**	-0.7 (-3.6)	2.1 (-4.9)	1.7 (-5.3)
Italy		Retail sales M/M% (Y/Y%)	Mar	**0.0 (2.0)**	-	0.1 (2.4)	-
Spain		Industrial production M/M% (Y/Y%)	Mar	**-0.7 (-1.2)**	-	0.7 (1.5)	- (1.3)
Auctions							
Country		Auction					
UK		sold £2.5bn of 1.5%% 2053 green bonds at an average yield of 4.545%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		00.01	RICS house price balance %	Apr	-1	-4
		12.00	BoE Bank Rate	May	*5.25*	5.25
		14.00	DMP 1Y ahead CPI (3M output price) expectations Y/Y%	Apr	-	3.2 (4.1)
Auctions and events						
Euro area		13.15	ECB Vice President de Guindos scheduled to give remarks and participate in Q&A session at an event in Madrid			
UK		12.00	BoE monetary policy statement, minutes and Monetary Policy Report published			
		12.30	BoE Governor Bailey to present updated Monetary Policy Report at press conference			
		17.15	BoE Chief Economist Pill to participate in a virtual Q&A session			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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