Daiwa Capital Markets

Euro wrap-up

Overview

- Longer-dated Bunds made modest losses as euro area industrial production data showed a softening of growth momentum at end-Q1.
- Gilts were little changed as the BoE MPC made clear its view that a UK vote to Leave the EU would significantly hit output and employment.
- Friday brings Q1 GDP estimates from Germany and Italy, April new car registration figures from the euro area and March construction data from the UK.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 03/18	-0.515	+0.003
OBL 0 04/21	-0.376	+0.007
DBR 0½ 02/26	0.150	+0.025
UKT 1¼ 07/18	0.381	+0.003
UKT 1½ 01/21	0.816	+0.009
UKT 2 09/25	1.400	+0.008

*Change from close as at 4.15pm BST.
Source: Bloomberg

Euro area

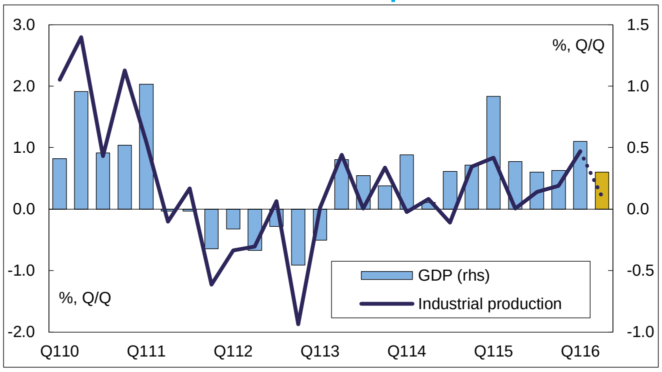
Industrial output takes a step down at end-Q1

Following the release earlier this week of data from the large member states, which most notably showed a marked retreat in Germany, it was already clear that euro area industrial production fell for the second successive month in March. In the event, today's data confirmed that output in the sector (excluding construction) fell 0.8%M/M, as sizeable declines in manufacturing production of capital, consumer and intermediate goods alike was offset only partly by a surge in energy output. Nevertheless, following an exceptionally strong start to the year with production rising in January by an upwardly revised 2.4%M/M, the strongest rate on the series, it rose in the first quarter as a whole by 0.9%Q/Q, the strongest quarterly rate in almost three years. Surveys such as the PMIs suggest that moderate rather than firm growth continues in the sector. And given the negative 'carry-over' from the end of the first quarter, a much softer rate of growth in industrial production looks to be on the cards for the second quarter. Indeed, the same likely applies for overall GDP too: we expect euro area economic growth in Q2 to slow to 0.3%Q/Q, half the rate of Q1.

Italian bank rescue fund to be better resourced?

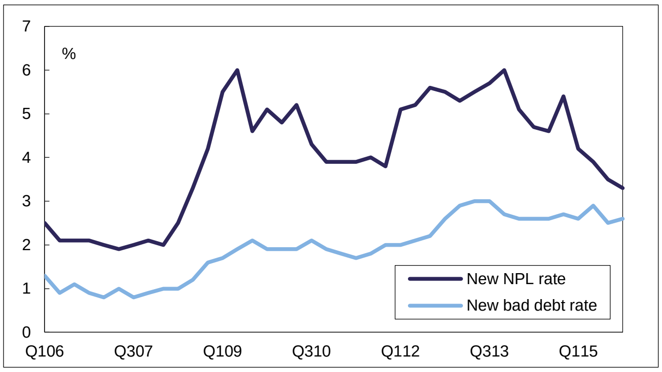
One persistent set of concerns weighing on investor sentiment relates to the state of Italy's banks, with knotty issues regarding how to address capital shortfalls among the weakest lenders and deal with the large stock of non-performing loans (NPLs), which, despite a decline in the flow over the past couple of years, still amounted to €360bn (approximately 18% of total loans) at end-2015 of which €210bn were considered bad ('sofferenze'). Last month, the Italian government facilitated the establishment of the Atlante fund by Italy's stronger banks, insurers and other institutional investors with the aim of supporting future bank capital-raising and the development of a market in securitised NPLs. Given the magnitude of estimated capital shortfalls and the stock of NPLs, however, the initial size of the fund (€4.25bn) always looked inadequate, something that was underlined by a troubled fund-raising effort by Banca Popolare di Vicenza last week that left Atlante with a controlling stake. And so, at face value, comments in London yesterday by Finance Minister Padoan that Atlante might get additional resources appeared encouraging. But the key issue would be the precise nature and origin of any additional resources provided. If the funds were simply found by reshuffling equity within the Italian banking sector, e.g. through further injections from existing Atlante shareholders, then there would be cause for concern about the health of the system as a whole. But if it represented new money provided from outside the Italian banking sector – e.g. through certain forms of leverage, perhaps with government guarantees, or from new equity injections from abroad – then the additional resources might represent a strengthening of the Italian banking sector and be a cause for cautious optimism. As ever with such banking stability issues, the devil will remain in the detail of the arrangements. Certainly, however, we remain sceptical about the prospect of Atlante attracting significant private foreign resources.

Euro area: GDP and industrial production*



Forecast for Q216. Source: Datastream and Daiwa Capital Markets Europe Ltd.

Italian banks: New NPL and bad debt rates*



Annualised quarterly flows of adjusted NPLs and bad debts relative to the stock of loans at the end of the previous quarter. Source: Banca d'Italia and Central Credit Register

The day ahead in the euro area and the US

Friday brings the second estimate of euro area GDP growth in Q116, which is expected to align with the flash reading of 0.6%Q/Q. It also brings the preliminary estimates of first-quarter GDP from Germany and Italy: growth in the former is expected to match the euro area figure, representing the strongest in five quarters and doubling the rate of Q415, with the latter expected to post an acceleration to a three-quarter high of 0.3%Q/Q up from 0.1%Q/Q previously. Meanwhile, after today saw the final estimates of French inflation in April confirm the flash figure for CPI on the EU-harmonised measure of -0.1%Y/Y, unchanged for the third month, Friday also brings the equivalent final data from Germany, Italy and Spain, which are all also expected to match their preliminary flash estimates (-0.3%Y/Y, -0.3%Y/Y and -1.2%Y/Y respectively on the EU-harmonised measure). And euro area new car registration data for April are also due for release.

In the US, meanwhile, Friday brings the most notable new economic data of the week with April's advance retail sales report, expected to suggest a moderate expansion of consumer spending at the start of the second quarter. Also due is the preliminary May University of Michigan consumer sentiment survey, as well as March business inventories figures and April producer price inflation numbers.

UK

BoE on hold yet again

There were no surprises today from the MPC, with Bank Rate left unchanged for the 86th consecutive month. Of more interest, as always, was the statement and the Bank's updated forecasts in its Inflation Report. Unsurprisingly, given that data have pointed to a marked slowdown in recent months, the MPC revised its near-term growth forecast down significantly. But, on an assumption that the EU referendum sees a vote to Remain, growth is thereafter expected to rebound, albeit at a rate consistently lower than previously forecast. And this is even after a shift in the assumed timing of the first rate increase from Q317 to Q119. The inflation profile, meanwhile, is little changed from that in the February forecast, showing inflation returning to the 2% target in two years, and, therefore, suggesting that market-based expectations of no rate hike before 2019 are about right.

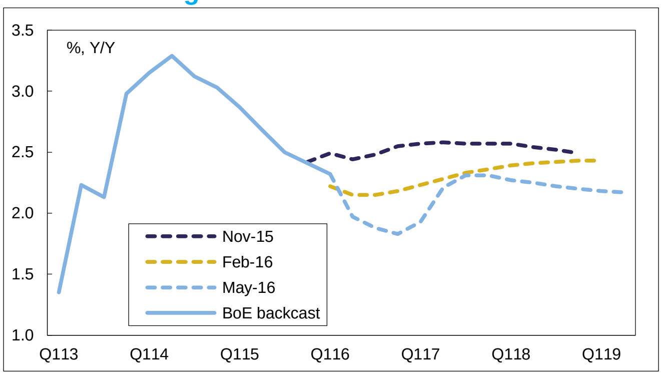
EU referendum central to the outlook

With the EU referendum on 23 June looming, and the opinion polls as close as ever, it was inevitable that the MPC's views on the likely implications of a Leave vote took centre stage. The MPC was careful not to go significantly further than it already had, acknowledging that the current slowdown was at least in part down to uncertainty surrounding the referendum. But it also, unsurprisingly, described the referendum as the most significant risk to its forecast. It expects that a vote to leave the EU would materially alter the outlook for output and inflation. Output and employment would take a negative hit, while the anticipated sharp depreciation in sterling would deliver higher inflation in the near term. And while the MPC said that it could react in either direction, the clear implication is that a vote to leave would almost certainly see it ease policy, and possibly meaningfully, not least given that weaker growth than in its central case implies that the UK would go into recession in the event of a vote to leave.

Possibility of rate cut growing

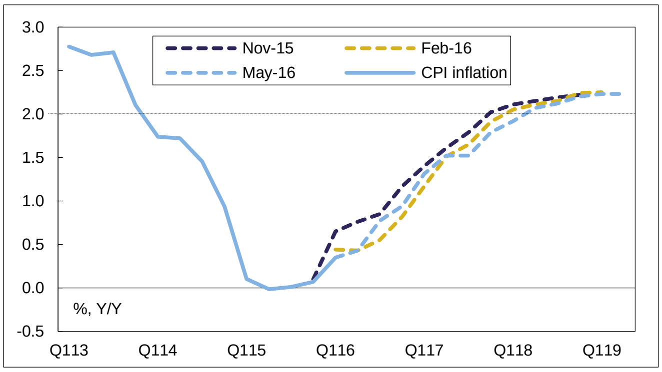
But, even on the assumption of a vote to Remain, the outlook for monetary policy is less clear than it has been for a long while. While the MPC continues to indicate that the next move in Bank Rate will be up, a scenario in which the next move is a cut is increasingly easy to envisage. The hit to growth associated with the referendum is already larger than most anticipated and, if the economy does not rebound as quickly or as strongly as anticipated in the aftermath of the referendum, then the MPC could soon find itself discussing its options to kick-start growth. Certainly, investment may take some time to recover

UK: BoE GDP growth forecasts



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

UK: BoE Inflation forecasts



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

post-referendum, not least if there are long lead times on getting projects underway. At the same time, the longer that the economy loses momentum, the greater the likelihood that the slowdown becomes self-fulfilling, particularly if the labour market remains sluggish. As such, while we continue to have a rate hike some time in 2018 as our central case, if growth does not show signs of rebounding as it currently expects in the aftermath of the referendum, we would expect the MPC to quickly move to try and bolster growth.

Housing demand fell sharply after Stamp Duty tax increase

The latest RICS Residential Survey suggested that price momentum in the housing market remained firm in April, with the headline indicator slipping only one point to 41, despite a significant fall in demand following the introduction of the Stamp Duty tax surcharge for second properties. The new buyer enquiries index dropped to the lowest level since 2008. The survey's price indicator for London, meanwhile, remained negative and moved slightly lower to -10, perhaps reflecting a more significant fall in the market activity and a more notable supply and demand mismatch – probably at least to some extent due to the looming EU referendum. Looking ahead, transaction levels in London are likely to rise after the short-term effects dissipate and prices are expected to move broadly sideways over the remainder of the year.

The day ahead in the UK

Construction figures, due tomorrow, look set to remain disappointing. Having fallen by -0.4%M/M and -0.3%M/M in January and February, output is expected to have dropped more sharply in March, to leave growth in Q1 down nearly -1.0%Q/Q.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	Industrial production M/M% (Y/Y%)	Mar	**-0.8 (0.2)**	0.0 (0.9)	-0.8 (0.8)	**-1.2 (1.0)**
France	Final EU-harmonised CPI Y/Y%	Apr	**-0.1**	-0.1	-0.1	-
UK	RICS house price balance %	Apr	**41**	35	42	-
	BoE bank rate %	May	**0.50**	*0.50*	0.50	-
	BoE asset purchase target £bn	May	**375**	*375*	375	-

Auctions

Country	Auction
Italy sold	€2.25bn of 0.1% 2019 bonds (15-Apr-2019) at an average yield of 0.04%
	€2.7bn of 0.95% 2023 bonds (15-Mar-2023) at an average yield of 0.87%
	€1bn of 3.5% 2030 bonds (01-Mar-2030) at an average yield of 1.9%
	€1.5bn of 1.65% 2032 bonds (01-Mar-2032) at an average yield of 1.99%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Yesterday's results

Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
UK		Industrial production M/M% (Y/Y%)	Mar	**0.3 (-0.2)**	0.5 (-0.4)	-0.3 (-0.5)	**-0.2 (0.1)**
		Manufacturing production M/M% (Y/Y%)	Mar	**0.1 (-1.9)**	0.3 (-1.9)	-1.1 (-1.8)	**-0.9 (-1.6)**
		NIESR GDP 3M/3M%	Apr	**0.3**	-	0.3	**0.3**

Auctions		
Country		Auction
Germany sold		€4bn of 2018 zero-coupon bonds (15-Jun-2018) 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		07.00	EU new car registrations Y/Y%	Apr	-	6.0
		10.00	GDP – second estimate Q/Q% (Y/Y%)	Q1	*0.6 (1.6)*	0.3 (1.6)
Germany		07.00	GDP – preliminary release Q/Q% (Y/Y%)	Q1	*0.6 (1.6)*	0.3 (1.3)
		07.00	Final EU-harmonised CPI Y/Y%	Apr	*-0.3*	0.1
France		07.45	Non-farm payrolls Q/Q%	Q1	0.2	0.2
Italy		09.00	GDP – preliminary release Q/Q% (Y/Y%)	Q1	*0.3 (0.9)*	0.1 (1.0)
		10.00	Final EU-harmonised CPI Y/Y%	Apr	*-0.3*	-0.2
Spain		08.00	Final EU-harmonised CPI Y/Y%	Apr	*-1.2*	-1.0
UK		09.30	Construction output M/M% (Y/Y%)	Mar	-3.2 (-2.7)	-0.3 (0.3)

Auctions and events			
Country		BST	Auction / Event
- Nothing scheduled -			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.