Euro wrap-up

Overview

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- Despite some solid euro area economic data, Bunds made gains and 10Y yields dipped below zero for the first time as Brexit fears dominated.
- Gilts also made gains as opinion polls suggested that the Leave camp has taken the lead ahead of next week's referendum and UK inflation data remained muted.
- Wednesday brings the latest data on euro area goods trade and the UK labour market.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/18	-0.583	-0.033
OBL 0 04/21	-0.466	-0.035
DBR 0½ 02/26	-0.002	-0.025
UKT 1¼ 07/18	0.356	-0.025
UKT 1½ 01/21	0.672	-0.061
UKT 2 09/25	1.139	-0.070

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

Euro area

A solid start to Q2 for IP

Contrasting with the negative tone of developments in the financial markets, today's more notable euro area economic data provided a reminder that – notwithstanding a possible adverse shock to confidence, financial market conditions and demand from a Brexit – current conditions should be consistent with ongoing economic expansion. For example, euro area industrial production marked a stronger-than-expected start to the second quarter, rising 1.1%M/M thanks particularly to a firm performance from manufacturers in the three largest member states. Most encouraging was the gain of almost 2%M/M in capital goods output, suggesting that the gradual recovery in business investment continues. In addition, an increase of more than 2%M/M in durable consumer goods production suggests that firms believe that households are increasingly amenable to making big-ticket purchases. The growth in industrial production in April took the annual rate to a respectable 2%Y/Y. However, following two previous months of weakness, production fell short of its level in January and was little changed on a three-month basis. So, while we expect to see the euro area industrial sector chalk up another quarter of positive growth in Q2, less than half the 1%Q/Q rate in Q1 currently looks a reasonable forecast.

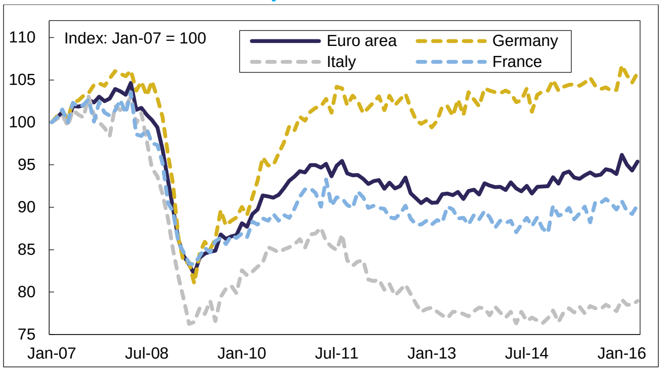
Steady jobs recovery continues

We also expect to see another quarter of steady jobs growth in Q2. Numbers for the first quarter released today confirmed that employment grew by 0.3%Q/Q and 1.4%Y/Y, representing a cumulative gain of more than 2.1mn over the past year and more than 3.8mn since the economic recovery got underway eleven quarters earlier. Germany and Spain remained the principal sources of job creation with employment up more than 180k and 150k respectively in Q1, taking the cumulative gains to more than one million in each country since Q213. Encouragingly, responding to recent labour market reforms and firmer demand, jobs growth in Italy matched the euro area average. And while it was softer in France, even that country – where the government's belatedly proposed labour market reforms have been a source of industrial and social unrest – saw employment growth maintained at 0.2%Q/Q for the fourth consecutive quarter. While the number of people in work in Germany has risen by more than 2.5mn since the Lehman crisis, in the euro area as a whole it remains more than 1.7mn below the pre-crisis peak. Therefore, even assuming continued steady jobs growth, wage growth looks set to remain subdued for several quarters to come.

The day ahead in the euro area and US

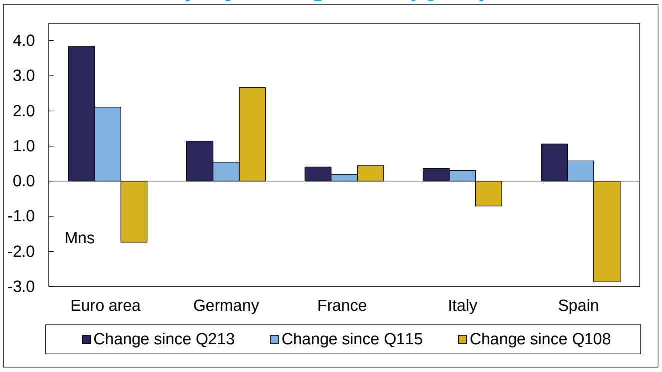
Wednesday brings the euro area trade report for April. With the German trade surplus having edged up to a new record high in seasonally adjusted terms, the euro area trade surplus is expected to remain highly elevated close to €22bn as imports

Euro area: Industrial production



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Employment growth (Q116)



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

likely remained weak while exports likely remained merely subdued. Also due are final French inflation figures for May, expected to confirm the flash estimate of zero on the EU harmonised measure. In the bond market, Germany will sell 10Y Bunds.

Most attention on Wednesday, of course, will be on the US, where the latest FOMC meeting concludes. Following what Yellen conceded with restraint was a disappointing May labour market report, a Fed rate hike looks off the table this week. Moreover, the FOMC's message in the post-meeting statement and Yellen's press conference seem more likely than not to be vague. We doubt, however, that the dot-plot chart of FOMC member views will see any meaningful shifts in the median expectations for the FFR at end-2016 and end-2017 from the ranges of 0.75-1.00% and 1.75-2.00% signalled in March. But whether the fed funds futures market – which is currently pricing in a chance of less than 15% that the FOMC will raise rates next month, less than one third that it will do so by September and roughly one half by the end of the year – will change its view about that seems doubtful. Before the Fed announcement, May's industrial production and producer price inflation data are due for release together with the June Empire manufacturing index. We expect industrial production to have been broadly flat in the latest month, with a slight increase in the manufacturing sector offset by a further contraction in mining output.

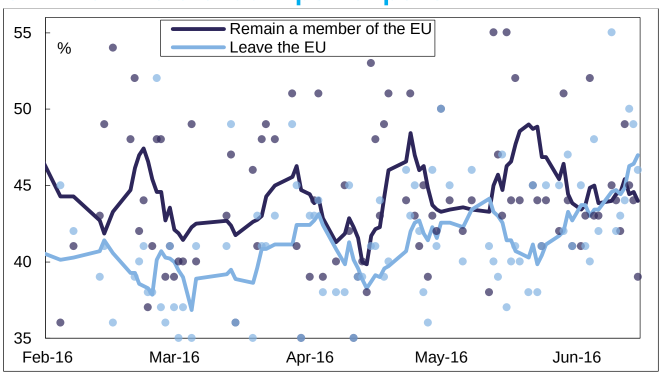
UK

Leave takes the lead

The past week has seen a big shift in the EU referendum opinion polls, with clear momentum now behind the Leave campaign. Four opinion polls (two from ICM/Guardian, and one each from Yougov/Times and ORB/Telegraph) published since late yesterday afternoon all suggest that Leave is now ahead of Remain. The ICM polls showed a 53-47 lead for Leave (when "don't knows" are excluded) on both its online and phone poll (previously phone polls had consistently shown stronger support for Remain). The YouGov poll showed 46% support for Leave against 39% for Remain (with 11% undecided), while the ORB poll had support for Leave at 49% and Remain at 48%. Moreover, the polls also pointed to a decline in the number of undecided voters, with those who are now making up their minds as the referendum draws near seemingly plumping to vote Leave. It's difficult to see quite who or what might be capable to shift the momentum. This week has seen senior Labour politicians try and invigorate what has so far been a half-hearted campaign by the party's leadership. But with Labour supporters also exercised by the issue of immigration, it is unclear to what extent the party grandees will be able to persuade sufficient supporters to vote Remain. This is going to go down to the wire, with four more polls due to be released later this week

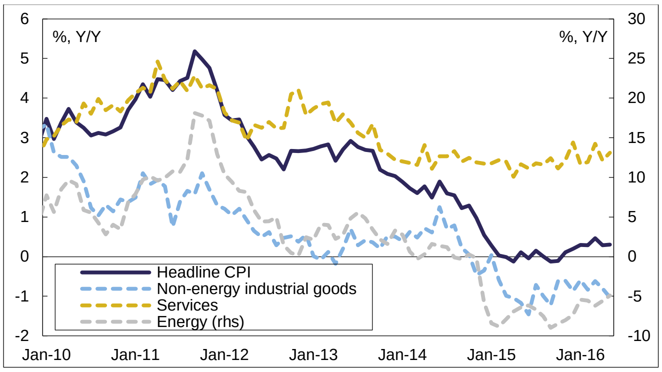
Financial markets are reacting as you would expect to the polls. As the polls have turned, so has Sterling, which has had a pretty wild time of it in what are reported to be very thin trading conditions. Gilt yields continue to hit record lows on safe-haven flows and expectations that a Leave vote will hit the economy hard and trigger rate cuts and possibly more QE from the BoE. Expect more of the same in the run up to polling day and, if it is a Leave vote, afterwards too. To support UK financial market liquidity around the time of the referendum, today the BoE today conduct the first of three special additional indexed long-term repo (ILTR) operations, although the £2.5bn take up was less than the average at the previous six regular long-term repo operations. Two other such special operations will be held on 21 and 28 June.

UK: Brexit referendum poll of polls*



*The dots show individual polls and the lines are seven-poll moving averages.
Source: whatukthinks.org and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Inflation remained unchanged in May

Meanwhile, today's headline CPI reading of 0.3%Y/Y was a downward surprise for markets, which, in line with the BoE's latest forecast, had expected an increase to 0.4%Y/Y. Within the details, goods inflation (excluding energy and food) dropped to -1.0%Y/Y, the lowest level in eight months, but this was broadly offset by higher services prices, up by 2.6%Y/Y, to leave core inflation also unchanged, at 1.2%Y/Y. Meanwhile, rising oil prices pushed transport costs up and left energy inflation at -4.9%Y/Y, the smallest fall in one and a half years. Overall, today's figures suggest that inflation is likely to undershoot the BoE's forecast for Q2 slightly, raising the probability that the MPC will need to cut interest rates to bring inflation back to target, in particular if the economy doesn't rebound quickly following the EU referendum next week.

New index suggests house price growth eased slightly in April

Today's publication of a new UK house price index, which replaced the previous indices by the ONS and the Land Registry, was also worth noting. The new house price measure suggested that UK house prices continued to rise in April at a firm 8.2%Y/Y pace after the change in Stamp Duty on second properties at the start of that month. The growth rate, however, was 0.3ppt lower than in March, and looking at England and London only, the falls of 0.7ppt and 1.0ppt to 9.1%Y/Y and 14.5%Y/Y respectively were more notable.

The day ahead in the UK

The flow of top-tier economic data continues tomorrow with the release of the latest labour market figures. In line with stronger growth in the industrial, construction and retail sectors in April, employment growth is expected to have increased that month from 44k3M/3M in March. Nevertheless, the unemployment rate is expected to have remained at 5.1% for a sixth consecutive month, having fallen by 0.5ppt in the previous six months. And the headline three-month earnings growth may have inched back below 2% in April, despite a boost from the introduction of the National Living Wage.

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	**1.1 (2.0)**	0.8 (1.4)	-0.8 (0.2)	**-0.7 (-)**
	Employment Q/Q% (Y/Y%)	Q1	**0.3 (1.4)**	-	0.3 (1.2)	**-**
Italy	Final EU-harmonised CPI Y/Y%	May	**-0.3**	*-0.3*	-0.4	**-**
Spain	Final EU-harmonised CPI Y/Y%	May	**-1.1**	*-1.1*	-1.2	**-**
UK	CPI (core CPI) Y/Y%	May	**0.3 (1.2)**	*0.3 (1.2)*	0.3 (1.2)	**-**
	House price index Y/Y%	Apr	**8.2**	-	8.5	**-**

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	**Revised**
EMU	ECB QE net purchases €bn	Weekly	**17.7**	*19.0*	17.6	**-**

Auctions

Country	Auction
Italy sold	€2bn of 0.1% 2019 bonds (15-Apr-2019) at an average yield of 0.08%
	€3bn of 0.95% 2023 bonds (15-Mar-2023) at an average yield of 0.83%
	€1.3bn of 2.7% 2047 bonds (01-Mar-2047) at an average yield of 2.49%
	€742mn of 4.75% 2044 bonds (01-Sep-2044) at an average yield of 2.44%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	Trade balance €bn	Apr	21.5	22.3
France	07.45	Final EU-harmonised CPI Y/Y%	May	*0.0*	-0.1
UK	09.30	Average earnings incl. bonuses (excl. bonuses) 3M/Y%	Apr	*1.8 (2.0)*	2.0 (2.1)
	09.30	ILO unemployment rate 3M%	Apr	*5.1*	5.1
	09.30	Employment change 3M/3M '000s	Apr	*70*	44
	09.30	Claimant count rate % (changed 000s)	May	2.1 (0.0)	2.1 (-2.4)

Auctions and events

Country	BST	Auction / Event
Germany	10.30	Auction: To sell €4bn of 0.5% 2026 bonds (15-Feb-2026)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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