

Euro wrap-up

Overview

- Bunds rallied as the euro area flash PMIs and German ifo indices suggested no new economic momentum in Q2.
- Gilts again made significant gains as announcement of Theresa May's resignation plans were still expected to come by the end of the week.
- Theresa May's future might well be resolved on Friday, when UK retail sales data are due for release.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.617	-0.011
OBL 0 04/24	-0.525	-0.021
DBR 0¼ 02/29	-0.120	-0.034
UKT 1½ 01/21	0.649	-0.045
UKT 1 04/24	0.713	-0.063
UKT 1½ 10/28	0.956	-0.059

*Change from close as at 4.30pm BST.

Source: Bloomberg

Euro area

PMIs suggest little new momentum in Q2

The flash euro area PMIs for May suggest no significant new economic momentum has emerged in Q2. The composite PMI rose a negligible 0.1pt to 51.6, effectively unchanged from the Q1 average but consistent with a softening of GDP growth in the current quarter to our own forecast of 0.2%Q/Q. While the manufacturing output PMI rose 1pt to a three-month high, at 49.0 this also merely matched the first-quarter figure and continued to signal falling production and declining new orders. It also suggested a drop in employment in the sector for the first time in five years. There were also suggestions from the survey that persistent weakness in manufacturing is weighing on services, for which the activity PMI fell 0.3pt from April to 52.5, also nevertheless in line with the Q1 average, with the respective expectations index dropping to the lowest since 2014. In terms of prices, there was also little for the ECB to cheer, with input cost inflation reportedly moderating to the second-softest in 2½ years, while the output price PMI fell to the lowest since July 2017, with renewed weakness in services and manufacturing.

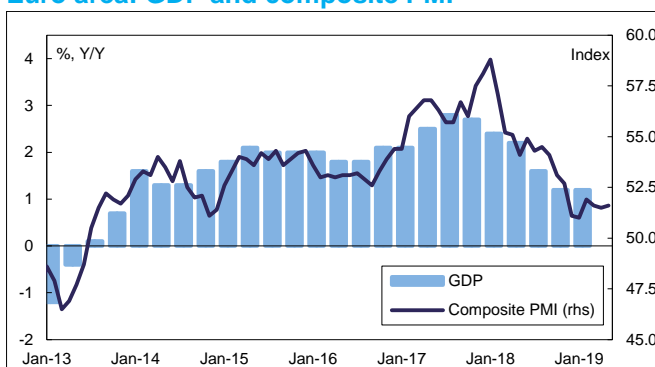
Implied weakening in Southern Europe

At the country level, the flash PMIs suggested slightly firmer activity in May in Germany (composite PMI up 0.2pt to a three-month high of 52.4), albeit with ongoing significant contraction in manufacturing where the auto sector remains a notable drag. They also suggested improvement in France in services and manufacturing alike (composite PMI up 1.2pts to a six-month high, albeit still just 51.3). However, while Markit does not release flash PMIs for other member states, it reported that the survey suggested the weakest growth in business activity in the rest of the euro area – by implication Italy and Spain – since 2013.

German ifo survey suggests notable deterioration in May

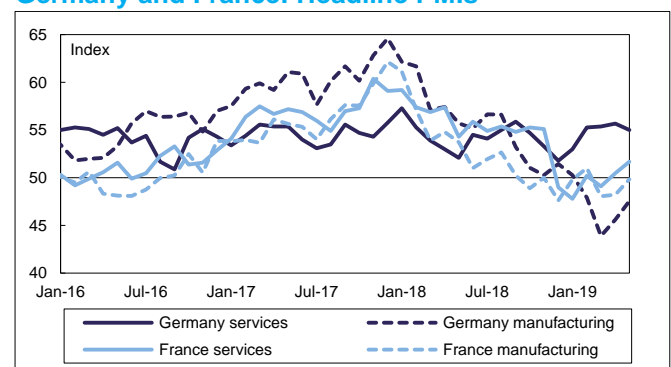
Of course, the PMIs are not the only top-tier economic survey indicators published in the euro area. And today's national business sentiment indices provided an alternative take on conditions in the middle of Q2. Most notably, the German ifo survey for May gave a far more downbeat impression than the PMIs, with the headline business climate index down more than 1pt to 97.9, the lowest level since 2014. That reflected a marked downgrade in business assessments of current conditions, down 2.8pts, the most since 2013, to a near three-year-low. While that partly reflected a further slight deterioration in manufacturing (where chemicals firms were most notably more upbeat) and wholesale/retail trade, services downgraded their assessments substantially. Business expectations of the outlook, meanwhile, remained unchanged, with the respective index close to the bottom of the range of the past six years. The detail suggested that, with the exception of construction, firms

Euro area: GDP and composite PMI



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

Germany and France: Headline PMIs



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



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remain very wary of the outlook. And, overall, the ifo survey points to a weakening of German GDP growth in Q2. As for the euro area as a whole, we currently forecast growth in Germany at 0.2%Q/Q.

In contrast to the ifo survey, and perhaps reassuringly, today's INSEE French business survey – which typically provides a more reliable guide to growth in the euro area's second-largest member state than the PMIs – reported an improvement in manufacturing confidence to a six-month high. And with above-trend sentiment in services and construction maintained, the INSEE indices suggested no weakening in economic growth in the current quarter.

German household savings ratio up again

Germany's detailed Q1 national accounts, released for the first time today, confirmed that growth of 0.4%Q/Q last quarter was underpinned by domestic demand. In particular, household consumption growth accelerated to 1.2%Q/Q in Q1, the strongest rise since 2011, to more than fully account for all of GDP growth. Following several quarters of subdued spending, that still left it up just 1.1%Y/Y despite continued strong growth in real disposable income thanks to vigorous wage growth and a further rise in employment. So, the household savings ratio rose to a new high. Meanwhile, private sector fixed capex was stronger across the board in Q1, rising 1.1%Q/Q (3.3%Y/Y) with machinery and equipment investment up 1.2%Q/Q and construction investment up 1.9%Q/Q, the firmest rate for two years. But after a strong increase at the end of last year, government consumption fell in Q1. Furthermore, for a second quarter, there was another notable drag from inventories, subtracting a hefty 0.6ppt from growth. Finally, exports posted their strongest rise for five quarters (1.0%Q/Q), while imports were up 0.7%Q/Q. So, net trade made the first positive contribution to German GDP growth since 2017.

ECB watching drop in market inflation expectations

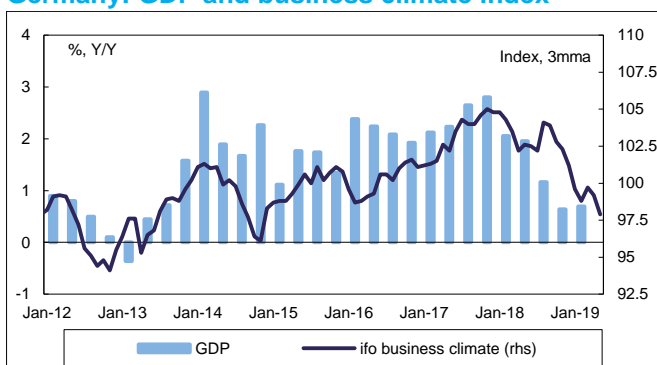
Today also brought the account of the ECB's April policy meeting, where the Governing Council's forward guidance – that key rates are expected to remain at current levels “at least through the end of 2019” – was left unchanged. Draghi also confirmed there that the pricing of the forthcoming TLTRO-III operations would be announced in June when policymakers would also “consider whether the preservation of the favourable implications of negative interest rates for the economy requires the mitigation of their possible side effects, if any, on bank intermediation”. The account of the meeting failed to give significant clues to the pricing of the TLTROs-III. While some members of the Governing Council suggested the pricing of the operations should be set only so “that they would primarily serve as a backstop, providing insurance”, others suggested that the “TLTRO-III operations should also be seen as a potential tool for adjusting the monetary policy stance”. The latter would call for particularly generous pricing (i.e. negative rates) if the economic outlook is judged to merit additional stimulus when the ECB updates its forecasts next month.

The ECB's updated outlook will take stock of recent data, including upside surprises to Q1 GDP and April inflation, and increased downside risks posed by the US-China trade war and UK politics. It will also reflect other indicators, including market-based measures of inflation expectations, such as those derived from the 5Y5Y forward inflation-linked swap rate, the deterioration in which, today's account revealed, was a cause for concern last month on the Governing Council. The further drop in that 5Y5Y rate since the meeting, down today to 1.32%, the lowest level since September 2016, would support the case next month for accommodative pricing (i.e. a negative rate for those boosting lending) on the TLTRO-III operations.

The day ahead in the euro area and US

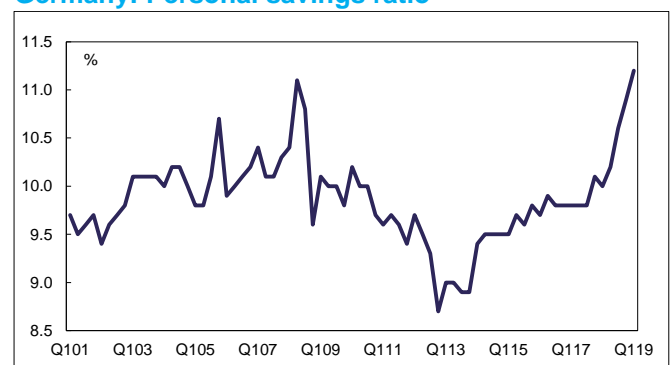
The week is set to end on a quiet note for euro area economic data with no top-tier releases due. In the US, preliminary durable goods orders figures for April are due on Friday. Recent soft data from the manufacturing sector point to the likelihood of a subdued reading for core orders, while Boeing's troubles will result in a sharp decline in the volatile aircraft category.

Germany: GDP and business climate index



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

Germany: Personal savings ratio*



*Four-quarter moving average. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK

May's demise seemingly assured

While she managed yesterday to avoid being forced to resign immediately, Theresa May's Brexit plans appear dead in the water (with plans to present her Withdrawal Agreement Bill tomorrow now dropped) and her demise as Prime Minister seems assured. Plenty of questions remain, however, including precisely when she'll confirm her resignation as party leader. But today it appeared most likely that she would make that announcement as soon as tomorrow when she is set to meet Sir Graham Brady, chair of the key backbench 1922 Committee which sets the Conservatives' leadership rules. (Indeed, reports today suggested that Brady would allow a new vote of no-confidence in her leadership unless she makes that announcement tomorrow.) What that would mean for her precise date of departure from Downing Street however is also uncertain – after all, May will want to hold out for at least six more days as Prime Minister to overtake her predecessor-but-one Gordon Brown's tenure, while Parliament is now in recess until 4 June.

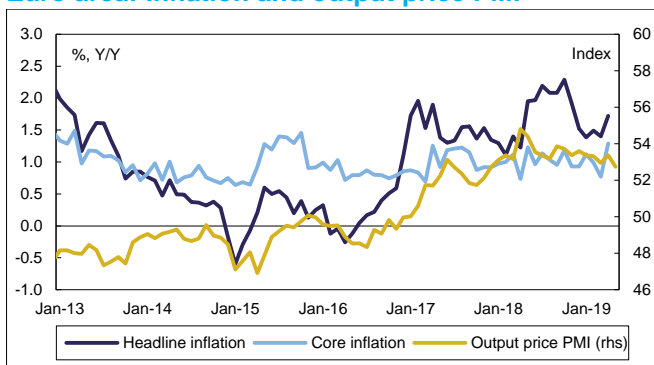
Gove well placed to unite Parliamentary Conservative Party?

The matter of who will take over from May will not be resolved for longer still. The length of the party's leadership contest will likely be somewhere between two to eight weeks, depending on the number of serious candidates and extent of differences of view between its MPs. Advocates of a no-deal Brexit – former Foreign Secretary Boris Johnson, who appears to have the momentum, and former Brexit Secretary Dominic Raab – are by some margin the bookmakers' favourites, reflecting the bewilderingly high popularity among the Tory rank-and-file of that damaging policy stance and their peculiar personalities. However, the somewhat more balanced Environment Secretary Michael Gove might be better able to unite the parliamentary Conservative party, not least given his more effective performances in the House of Commons allied with his Brexit credentials as joint-leader of the Leave campaign in the referendum. Indeed, with a chance that MPs will resolve the matter for themselves without having to go to a ballot of party members, Gove looks a decent bet to us to be next leader, particularly given current best odds of 12/1. Whoever eventually takes over, however, will find it no easier to resolve the Brexit deadlock, not least since they will not be able to change the parliamentary arithmetic without a general election.

The day ahead in the UK

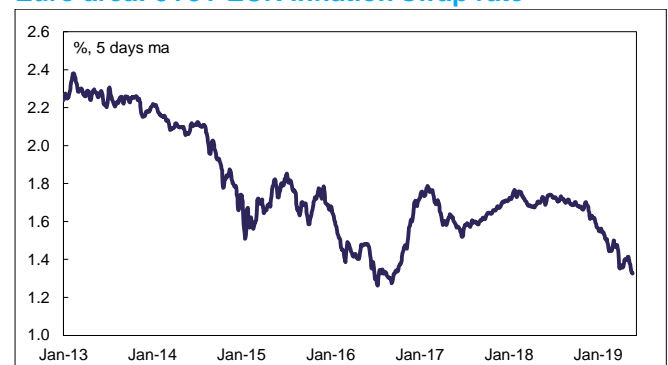
While attention will remain first and foremost on any announcements about her future from Theresa May, tomorrow will also bring the UK's April retail sales figures. After strong growth in March of 1.0%M/M, which capped a vigorous rebound over the first quarter as a whole, retail sales might have slipped back a touch. However, the timing of the Easter holiday and unseasonably warm weather will have given a boost, and so the annual growth rate will likely remain strong at more than 4.0%Y/Y. Meanwhile, the CBI's Distributive Trades Survey will give a guide to the strength of sales in May.

Euro area: Inflation and output price PMI



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

Euro area: 5Y5Y EUR inflation swap rate














Source: Bloomberg and Daiwa Capital Markets Europe Ltd.





European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Preliminary manufacturing PMI	May	47.7	48.1	47.9	-
	 Preliminary services PMI (composite PMI)	May	52.5 (51.6)	53.0 (51.7)	52.8 (51.5)	-
Germany	 Final GDP Q/Q% (Y/Y%)	Q1	0.4 (0.7)	0.4 (0.7)	0.0 (0.6)	-
	 Preliminary manufacturing PMI	May	44.3	44.8	44.4	-
	 Preliminary services PMI (composite PMI)	May	51.7 (51.3)	55.2 (51.9)	55.7 (52.2)	-
	 Ifo business climate index	May	97.9	99.2	99.2	-
	 Ifo current assessment balance (expectations)	May	95.3 (100.6)	103.6 (95.2)	103.3 (95.2)	95.3 (103.4)
France	 Business sentiment indicator	May	106	105	105	106
	 Manufacturing confidence (production outlook) indicator	May	104 (4)	101 (-2)	101 (-2)	-
	 Preliminary manufacturing PMI	May	50.6	50.1	50.0	-
	 Preliminary services PMI (composite PMI)	May	51.7 (51.3)	50.7 (50.2)	50.5 (50.1)	-



Auctions

Country	Auction
Spain sold	 €1.1bn of 0.25% 2024 bonds at an average yield of 0.023%
	 €1.5bn of 1.45% 2029 bonds at an average yield of 0.839%
	 €1.3bn of 1.85% 2035 bonds at an average yield of 1.466%
UK sold	 £1.25bn of 0.125% of index-linked 2028 bonds at an average real yield of -2.326%


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
UK	 09:30	Retail sales excluding auto fuel M/M% (Y/Y%)	Apr	-0.5 (4.3)	1.2 (6.2)
	 09:30	Retail sales including auto fuel M/M% (Y/Y%)	Apr	-0.4 (4.5)	1.1 (6.7)
	 11:00	CBI distributive trades survey, total retail sales %	May	8	13

Auctions and events

Country	BST	Auction / Event
EU	 -	Election to the European Parliament held in the member states on various days from 23-26 May

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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<http://www.uk.daiwacm.com/ficc-research/recent-blog>

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