Euro wrap-up

Overview

- Bunds made modest losses at the long end of the curve while data confirmed strong growth in German retail sales in Q1.
- Gilts made larger losses as the BoE repeated that it would need to raise rates if the economy performs in line with its central economic forecast.
- Friday brings the flash estimate of euro area inflation in April and the UK services PMIs for the same month.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 12/20	-0.591	+0.001
OBL 0 04/24	-0.411	+0.003
DBR 0¼ 02/29	0.025	+0.012
UKT 1½ 01/21	0.778	+0.031
UKT 1 04/24	0.923	+0.038
UKT 1⅝ 10/28	1.193	+0.041

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

Euro area

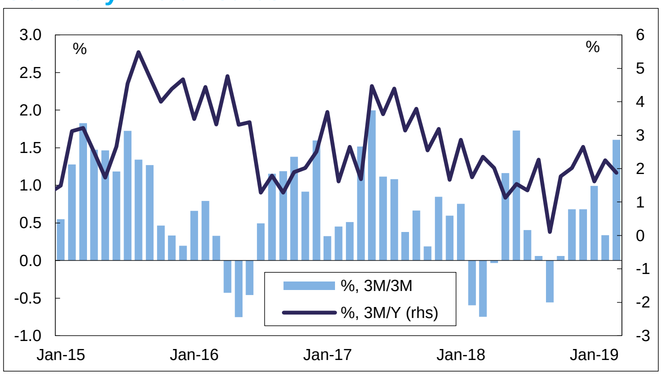
German retail sales jump in Q1

While flash Q1 GDP data were released by many member states earlier this week, the first estimates from Germany will not be published until 15 May. And so, attention today was on the latest German retail sales figures for March, for further insight into the pace of recovery in the largest euro area member state at the start of the year. As expected, these reported a decline at the end of the first quarter. However, the monthly drop by 0.2%M/M was smaller than had been expected, while the annual rate of decline of 2.1%Y/Y was exaggerated by the timing of the Easter holiday. Indeed, reflecting that impact, food sales were down more than 5½%Y/Y in March, but non-food sales were flat compared with a year earlier, with declining sales of clothing and pharmaceutical products offset by a jump in sales of household furnishings and appliances. Most notably, March's weakness followed two months of solid gains at the start of the year. So, over the first quarter as a whole, retail sales were still up 1.6% compared with Q4, the strongest pace for three quarters and the second strongest in the past four years. And combined with a surge in new car registrations last quarter (13½%Q/Q), today's release strongly suggests a solid contribution from private consumption to German GDP growth in Q1. Indeed, consistent with the stronger outturn in euro area GDP growth in Q1 (0.4%Q/Q), we expect GDP growth in Germany of 0.3%Q/Q, which would represent the first positive growth in three quarters.

Euro area manufacturing PMI remains weak

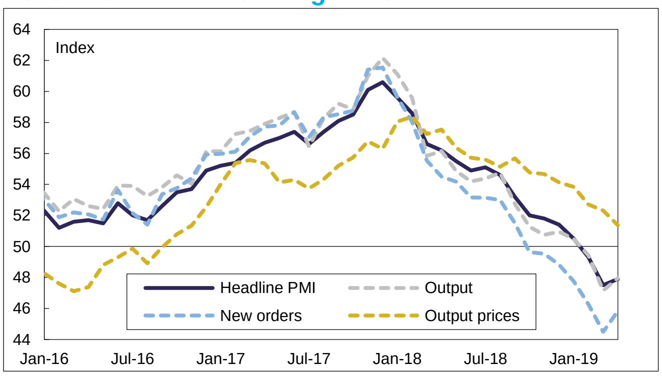
The weakness in the euro area economy over recent quarters has centred on manufacturing, and surveys suggest ongoing deterioration in conditions in that sector at the start of Q2. Indeed, despite a modest upwards revision from the flash release today's final manufacturing PMI survey for April was extremely downbeat. In particular, the headline index was nudged up just 0.1pt from the preliminary estimate to 47.9, just 0.4pt above March's near six-year low and still firmly in contractionary territory for a third consecutive month. While there were also modest tweaks to the survey components, the underlying message remained unchanged, with, for example, the output PMI (up 0.8pt from March to 48.0) still signalling a notable drop in production, reportedly particularly of capital and intermediate goods. And despite rising 1.4pts on the month, the new orders index at 45.8 also indicated further significant deterioration, in part reflecting weak external demand. This notwithstanding, manufacturers reportedly continued to expand their workforces in April, albeit at a much slower rate than in recent years. While the decline in the output price PMI was less than initially thought, it still fell 1pt on the month to 51.4, its weakest since November 2016, to suggest that underlying price pressures remain very subdued.

Germany: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing PMIs



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

Mixed manufacturing performance among member states

Among the member states, there was a modest downwards revision from the flash German manufacturing PMI by 0.1pt to 44.4, leaving it just 0.3pt above March's near-decade low and still suggesting that the largest member state had the worst performing manufacturing sector at the start of the second quarter. Indeed, despite notable increases from March, the output (45.6) and new orders (40.8) components were still very low by historical standards. And so, contrary to the flash release, German manufacturers reportedly again looked to scale back their workforces. In France, the headline index was nudged slightly higher from the initial estimate to 50.0 leaving it 0.3pt higher than March. But while the output component was similarly firmer than the flash index, at 48.3 it remained firmly in contractionary territory. This was also true in Italy, where the 1.7pts increase left the headline PMI at 49.1 while the output component was unchanged at 47.0. So, Spain remained the only top-four member state to report expansion in the sector in April, with the headline index up 0.9pt to 51.8 and the output index up 1.3pts to 52.5. Perhaps surprisingly, judging from the PMIs, manufacturing growth in Greece continued to lead the way in April, with firms reportedly enjoying the fastest pace of expansion in nearly nineteen years.

The day ahead in the euro area and US

Focus in the euro area tomorrow will be firmly on the flash CPI estimate for April. Preliminary releases from the four largest member states earlier in the week broadly exceeded expectations, particularly in Germany where the headline EU-harmonised rate was up 0.7ppt to a five-month high of 2.1%Y/Y. Principally reflecting the timing of Easter, services prices were also boosted in April pushing core inflation higher. So, tomorrow's figures are likely to show a rise in euro area headline inflation of 0.3ppt to 1.7%Y/Y and a pickup of the same amount in core inflation to 1.1%Y/Y, with the risks to both figures skewed to the upside.

Attention in the US will be on April's labour market report. While figures this week revealed an upside surprise in the ADP survey measure of private sector employment last month, the manufacturing ISM's employment component fell sharply. On balance, we continue to expect another solid gain in non-farm payrolls in April to keep the unemployment rate unchanged at 3.8%. Friday will also bring the flash goods trade report for March, as well as April's non-manufacturing ISM, with the latter expected to signal ongoing solid expansion at the start of the second quarter.

UK

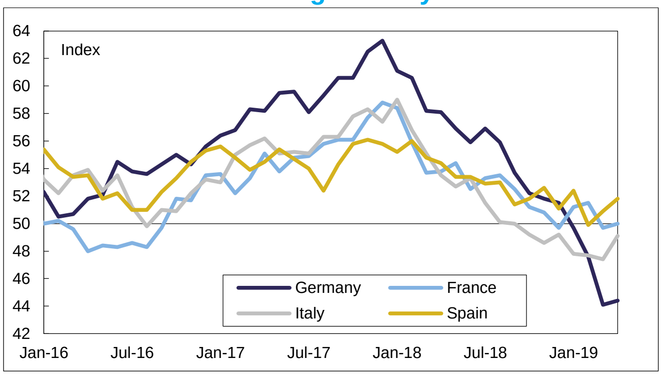
BoE on hold until Brexit uncertainty lifts?

The focus in the UK today was on the BoE's latest monetary policy announcement and Inflation Report. As expected, the MPC voted unanimously to leave Bank Rate unchanged at 0.75%. And the Committee's guidance on future policy was unchanged too, restating that "were the economy to develop broadly in line with [the] Inflation Report projections, an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate". As before, the BoE's updated economic forecasts suggested that at least two 25bp rate hikes would be required over the coming three years if events pan out in line with its central scenario. However, they also suggested no urgency whatsoever to tighten policy, with the case for doing so seemingly weak at least until Brexit uncertainty is resolved in a favourable way.

Subdued GDP and inflation expected while Brexit risks persist

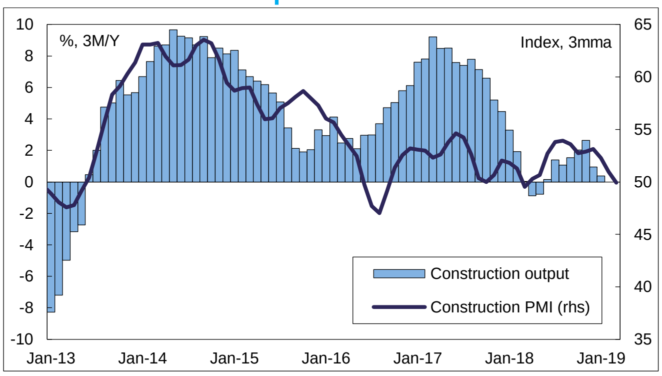
Governor Carney differentiated between two distinct phases to the economic outlook, relating to the periods before and after Brexit uncertainty might lift. In terms of the first (current) phase, the BoE revised up its forecast for Q1 GDP growth to 0.5%Q/Q, largely due to the boost from Brexit-related precautionary stock-building in the UK and EU ahead of the previous Article 50 deadlines. However, there will be negative payback over the near term for such extreme inventory accumulation, and so growth in Q2 is expected to fall back to just 0.2%Q/Q. And, not least as businesses will remain reluctant to invest for as long as Brexit uncertainty persists, GDP growth is expected to remain below potential in the second half of the year too.

Euro area: Manufacturing PMIs by member state



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

UK: Construction output and construction PMI



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

Meanwhile, inflation will briefly jump above 2.0%Y/Y in April due to the impact of the timing of Easter and the scheduled increase in the regulator's retail energy tariff cap. However, with a negative output gap set to persist and prices of fuel and household energy projected to fall later in the year, inflation is also strongly expected to move back below target from May and remain there throughout the remainder of the year.

Carney's case for tightening once firms have more certainty

Looking further ahead, however, the BoE acknowledged again that the second phase of the outlook will depend entirely on the outcome of the Brexit process. The BoE maintained its (arguably brave) assumption that the UK will eventually enter a smooth transition and that uncertainty will decline further as the UK and EU eventually agree a future relationship based on an 'average' of possible Brexit scenarios. And, although that will imply the imposition of new barriers to trade, thanks to the greater certainty provided to businesses, the BoE forecasts GDP growth eventually to move back above potential so that the output gap pushes into positive territory from Q320 on. And as that positive output gap persists, inflation is expected to rise and remain above target from Q121 on, justifying rate hikes. However, we expect GDP growth to be more subdued than projected by the BoE, as Brexit uncertainty persists for longer (e.g. we expect the Article 50 deadline eventually to be extended beyond end-October) and global demand weakens next year as the US and China economies slow. As such, we also expect inflation to remain below target into 2021, and forecast no change to Bank Rate over the horizon.

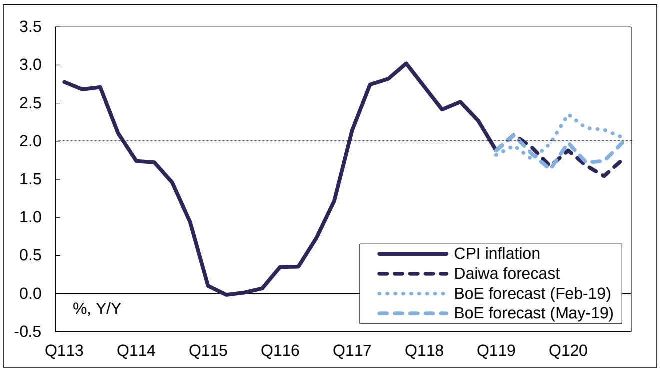
Construction sector outlook remains subdued

After yesterday's downbeat manufacturing PMIs, the April construction PMIs were slightly more positive than of late, with the headline indicator rising by 0.8pt in April to 50.5, the first above-50 reading in three months. Within the survey detail, housing activity rose at the fastest rate since the start of the year, with respondents quoting firm demand for new work in this sector. In addition, commercial and civil engineering work declined at a slower pace than in previous months. In these areas Brexit-related uncertainty and a shortage of incoming new projects was reportedly at the top of the list of builders' concerns. Among the forward-looking indicators, however, the new orders index fell to 48.6, the first reading in contractionary territory in thirteen months, while the business expectations gauge dropped to a 1½-year low. And with a strong recovery in the near future unlikely, companies appear to be downsizing their workforces, with the employment PMI signalling a decline in construction sector employment for the first time since July 2016.

The day ahead in the UK

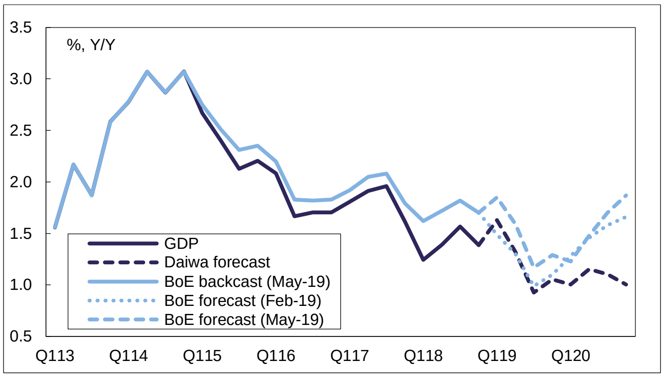
The end of the week will bring the UK services and composite PMIs for April. The headline indicator for services dipped in March to 48.9, the first sub-50 reading since the Brexit referendum. While some recovery is on the cards, the survey will almost certainly remain consistent with subdued momentum in the sector. And with the manufacturing output PMI having declined by more than 2pts last month, the composite PMIs will probably imply little or no economic growth at the start of Q2.

UK: Inflation forecasts



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

UK: GDP forecasts



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

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Final manufacturing PMI	Apr	**47.9**	47.8	47.5	-
Germany		Retail sales M/M% (Y/Y%)	Mar	**-0.2 (-2.1)**	-0.5 (2.9)	0.9 (4.7)	**0.5 (4.4)**
		Final manufacturing PMI	Apr	**44.4**	44.5	44.1	-
France		Final manufacturing PMI	Apr	**50.0**	49.6	49.7	-
Italy		Manufacturing PMI	Apr	**49.1**	47.8	47.4	-
Spain		Manufacturing PMI	Apr	**51.8**	51.2	50.9	-
UK		Construction PMI	Apr	**50.5**	50.3	49.7	-
		BoE Bank Rate %	May	**0.75**	*0.75*	0.75	-

Auctions

Country		Auction
France sold		€2.6bn of 1.25% 2034 bonds (25-May-2034) at an average yield of 0.78%
		€1.9bn of 1.75% 2039 bonds (25-Jun-2039) at an average yield of 1.04%
		€4bn of 0.5% 2029 bonds (25-May-2029) at an average yield of 0.37%

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	Flash CPI (core CPI) estimate Y/Y%	Apr	*1.7 (1.1)*	1.4 (0.8)
		10:00	PPI M/M% (Y/Y%)	Mar	0.1 (3.0)	0.1 (3.0)
UK		09:30	Services PMI (composite PMI)	Apr	50.3 (50.6)	48.9 (50.0)

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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