Euro wrap-up

Overview

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- Bunds made further modest gains as euro area retail sales fell and the final services PMIs pointed to a moderation in GDP growth in Q2.
- Gilts also made gains as the UK services PMIs and car registration figures signalled sluggish GDP growth in Q2.
- The main event tomorrow will be the conclusion of the ECB meeting, with details on the pricing of the forthcoming TLTRO-IIIs to be announced. Final euro area Q1 GDP figures are also due.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.671	-0.018
OBL 0 04/24	-0.597	-0.023
DBR 0¼ 02/29	-0.219	-0.012
UKT 1½ 01/21	0.578	-0.026
UKT 1 04/24	0.627	-0.025
UKT 1⅝ 10/28	0.870	-0.032

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

Euro area

Retail sales drop at start of Q2

Having risen a firm 0.7%Q/Q in Q1, euro area retail sales dropped 0.4%M/M in April to stand 1.5% higher than a year earlier, the softest annual growth rate this year. Declines were recorded at the start of Q2 in almost every category, with sales of non-food products – which had increased a vigorous 1.2%Q/Q in Q1 – and food items similarly down 0.4%M/M. Textiles and clothing (down 1.5%M/M) and online/mail order sales (down 3.1%M/M) were particularly weak in April, and we would expect these categories to rebound over the remainder of the quarter. Germany – where sales are especially volatile – led the decline among the member states with a sharp fall of 2.0%M/M, with Spain (down 0.7%M/M) also notable. Given their strong fundamentals, we likewise expect positive payback in both countries over the near term. Indeed, with unemployment continuing to fall and consumer confidence having risen to a six-month high in May, the April setback in sales looks highly likely to be temporary. And we continue to forecast positive growth in retail spending – and total private consumption – over the second quarter as a whole, albeit somewhat softer than in Q1.

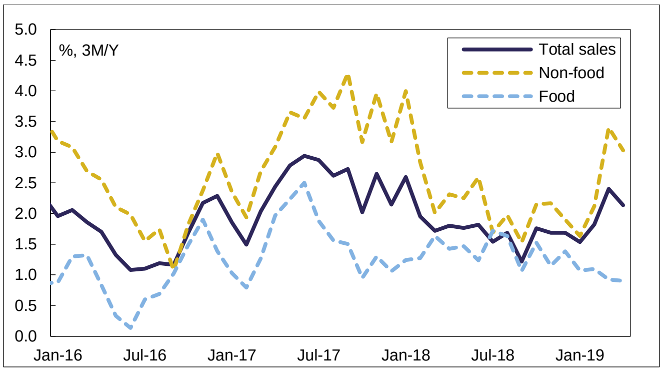
Final services PMIs suggest moderation in growth in Q2

The final services and composite PMIs for May were, on the whole, consistent with a modest improvement in momentum from April, albeit still also a moderation in economic growth in Q2 from Q1. The headline euro area services PMI was revised up 0.4pt from the flash estimate to 52.9, marking an increase in the services PMI of just 0.1pt from April and 0.5pt from the Q1 average. Given also the improvement in the manufacturing output PMI reported earlier this week (up 0.9pt in May to 48.9), the final composite PMI was revised up 0.2pt to 51.8, 0.3pt above the readings for April and Q1 alike. Most notably, however, in line with our own forecast that still implied a slowdown in GDP in Q2 to 0.2%Q/Q, half the rate of Q1. Among the member states, the German services PMI was revised up to 55.4, taking the composite PMI up to a three-month high of 52.6. And while the equivalent French indices were revised down a touch, the composite index (51.2) was still up 1.1pts from April at a six-month high. But the surveys for Italy and Spain, which were published for the first time, were disappointing. Italy's services PMI fell to a four-month low of 50.0, consistent with stagnation in the sector. And while that meant that the composite PMI rose slightly from April, at 49.9 it was still suggestive of slight economic contraction in Q2 following a return to growth last quarter. And Spain's figures (52.8 for services, 52.1 for the composite) were the lowest since 2014 and 2013 respectively, implying a notable slowdown in the euro area's fastest-growing large member state of recent years.

Commission recommends new budgetary procedure against Italy

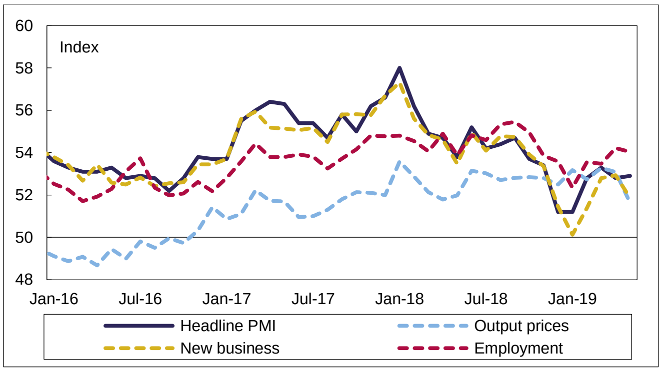
Tomorrow could well bring better news for Italy and its banks, as the ECB announces (probably generous) pricing of its forthcoming TLRTO-III operations. But Italy's economic fundamentals, politics, and public finances remain woefully poor, as highlighted today as the European Commission recommended launching a new Excessive Deficit Procedure (EDP) for breaking the euro area's budgetary rules. This was not a surprise, however. It has long been clear that Italy's fiscal policy was off track from the EU's targets last year. Indeed, while the general government deficit was within the respective EU limit by falling 0.3ppt to 2.1% of GDP in 2018,

Euro area: Retail sales



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs



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

general government debt rose to 132.2% of GDP, some 7.6ppts above the pre-specified “debt reduction benchmark”. Given the populist government’s latest stimulus measures and Italy’s ongoing weak growth performance, the Commission forecasts the deficit to rise to 2.5% of GDP this year and – on the assumption that Parliament cancels the VAT hikes currently legislated as a safeguard – 3.5% of GDP in 2020, leaving the public debt ratio on an upwards trajectory to more than 135% of GDP next year. So, we fully expect that, in due course, the EU Finance Ministers will endorse the launch of the EDP, which will call for offsetting budgetary tightening with the threat of financial sanctions for non-compliance.

Little Italian political appetite for fiscal tightening

Despite the risk of eventual financial punishment, particularly given the weak growth outlook, the current government would seem highly unlikely to agree to implement any contractionary fiscal action. Certainly, it would seem to prefer confrontation with the EU institutions. And last week’s vote in Parliament’s Lower House that the Government should explore the feasibility of issuance of special short-term securities to facilitate payments of budgetary arrears – the long-discredited “mini-BOT” proposal that Eurosceptics consider would be a step towards issuance of a parallel currency – would suggest that there is little political appetite in Italy for fiscal responsibility. But disagreements between the coalition parties over the path for the deficit, and specifically the 2020 Budget, seem highly likely to increase. And in due course, these disagreements might be used as an excuse by Salvini’s League to trigger the collapse of the government prompting an early General Election (in which the League will expect to increase significantly its representation in Parliament) by year-end. It will then be for the next European Commission – which has yet to be appointed – to decide how to respond. But, in our opinion, the concerns about Italian politics and fiscal policy are only likely to increase.

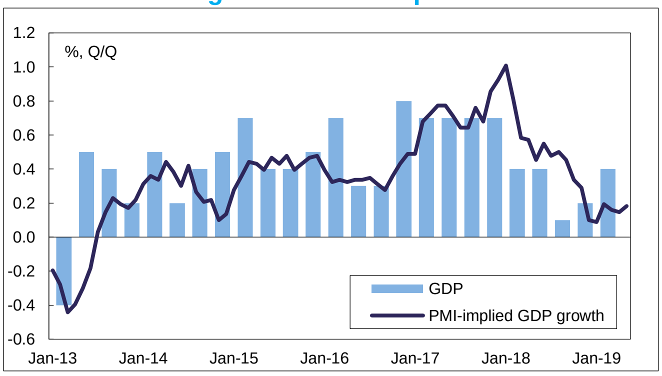
The day ahead in the euro area and US

Thursday will bring the main event of the week as the ECB’s latest policy meeting concludes. The meeting will be the first to be conducted under the ECB’s new Chief Economist Philip Lane, who replaced Peter Praet at the start of the month. Among other things, the meeting will be watched closely for the updated staff economic forecasts and additional details for the pricing of the forthcoming TLTRO-III liquidity operations, due to start in September. When the ECB initially unveiled the new TLTRO-III programme in March, it also announced significant downward revisions to its growth forecasts. Subsequently, however, Q1 GDP exceeded expectations with the 0.4%Q/Q growth rate twice the ECB’s central projection. So, this time around we might well see a modest upward revision made to its full-year growth forecast of 1.1% in 2019. But despite some improved surveys, as suggested by today’s final May PMIs underlying economic momentum isn’t necessarily materially stronger than it was three months ago. So, there would seem little case for the ECB’s (overoptimistic) projections for 2020 and 2021 (1.6% and 1.5% respectively) to be revised up significantly, and the Governing Council will likely judge that the risks to the outlook are still skewed to the downside.

Following significant volatility in prices around the Easter holiday period, the inflation outlook seems unlikely to be judged by the ECB to be substantially different from March’s assessment too, with headline and core CPI forecast to increase 1.2%Y/Y in 2019, rising to just 1.6%Y/Y in 2021. So, the ECB might well see no need to change its forward guidance at this meeting, and our expectation is that it will merely reiterate that interest rates are still expected to remain unchanged “at least through the end of 2019”. However, given the recent decline in market-based measures of inflation expectations close to record lows, Draghi will no doubt underscore the ECB’s readiness to adjust all instruments, as appropriate, to help push inflation back to target. Of course, the ECB’s willingness to take such further action – and increased expectations that it will indeed be forced eventually to do so – helped to push Bund yields down to record lows in recent days.

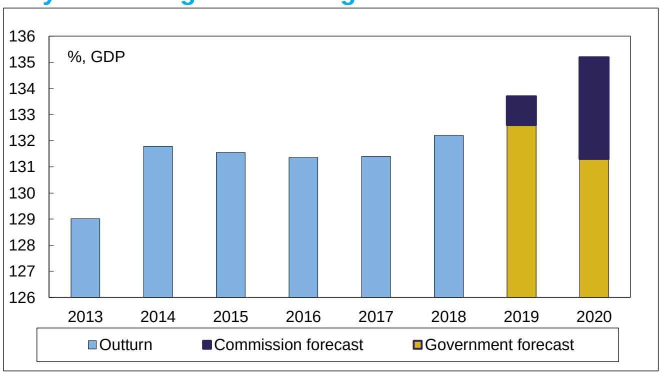
Among other factors, the ECB’s assessment of the economic outlook will help determine the pricing of its TLTRO-III operations, which were announced primarily to prevent a tightening of financial conditions that would have occurred as roughly €740bn of remaining loans issued under the previous TLTRO-II programme matured. With the inflation outlook underwhelming, we see a strong case for the ECB to announce generous pricing on its forthcoming TLTRO-III loans, no less favourable than those attached to the TLTROs-II. Under that programme, the interest rate applied to the amount borrowed was initially linked to the refi rate prevailing at the time of take-up, but could fall to as low as the deposit rate (-0.40%) for banks whose net new lending exceeded a benchmark. And with the maturity of the new TLTRO-III loans to be just two years, only half that offered under the previous framework, it would seem unhelpful to have other conditions also significantly less generous this time, not least as any adverse market reaction could further negate the intended extra policy accommodation provided. Of course, in line with its commitment made at the April policy meeting, the Governing Council will also assess whether to take any further action to mitigate the possible adverse side-effects of

Euro area: GDP growth and composite PMI



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

Italy: General government gross debt



Source: Thomson Reuters and European Commission negative interest rates on bank intermediation. However, we do not see a strong case for action in this respect (e.g. via the introduction of a tiered interest rate framework), and certainly do not anticipate new measures related to the banking sector, beyond the TLTROs-III, to be announced tomorrow.

Data-wise, tomorrow will bring the final reading of euro area Q1 GDP. While growth is expected to align with previous estimates at 0.4%Q/Q, this release will bring the first expenditure breakdown in Q1, which is expected to show that the acceleration at the start of the year was driven principally by domestic demand with a more modest positive contribution from net trade. Euro area employment figures are also expected to confirm growth of 0.3%Q/Q in Q1. Ahead of Friday's German IP data for April, tomorrow will also see the release of factory orders figures for that month. In the markets, France and Spain will auction bonds with various maturities.

In the US, tomorrow will bring April's full trade report, along with revised productivity and labour costs figures for Q1. Ahead of Friday's payrolls figures tomorrow will also see the release of Challenger job cuts figures for May and weekly jobless claims numbers. Speeches by FOMC members Williams and Kaplan will also attract attention.

UK

Services PMI ticks slightly higher…

Coming on the back of very weak manufacturing and construction surveys earlier this week, today's services PMIs provided a welcome, albeit modest, upwards surprise, with the headline index rising 0.6pt in May to 51.0, a three-month high. In addition, the new orders PMI rose back above the key-50 expansion level for the first time this year, while services firms reportedly increased their workforces by the most since November. But the survey remains weak by historical standards. For example, while the headline index in the first two months of Q2 (50.7) was a touch firmer than the average in Q1, it remained barely consistent with expansion and well below the range of the past couple of years (the services PMI averaged 54.0 in 2017 and 52.8 in 2018). So, with growth in services activity in Q1 (0.3%Q/Q) the softest for a year, we expect a similarly subdued expansion in Q2.

…but composite PMI remains consistent with limited growth

But given the findings of the manufacturing survey – the output PMI fell more than 3pts to 50.4, a near-three-year low – the composite PMI moved sideways in May at 50.9, one of the weakest readings in 6½ years. And while new orders reportedly returned to growth for the first month time this year, firms indicated that client demand remained restricted by Brexit uncertainty. Moreover, when also including the construction survey, collectively the PMIs were consistent with zero growth in economic activity so far in Q2. Of course, it is worth noting that the PMIs have underestimated GDP growth in recent quarters, and we think that underlying momentum in the UK economy might currently be slightly stronger. But not least given the likely negative contribution from stock building, we currently expect GDP growth of just 0.1%Q/Q in Q2, well down on Q1.

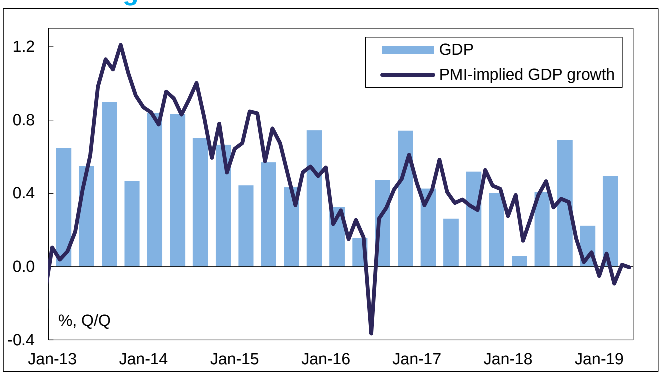
Car registrations decline further in May

The strength in the economy at the start of the year was partly driven by vigorous retail sales growth. And this in part reflected a jump in new car registrations (6.9%Q/Q) as anecdotal evidence suggested purchases were brought forward ahead of the potential Brexit cliff-edge at the end of March. Perhaps as payback, despite a very modest improvement in consumer confidence, recent figures from the car market have been weaker. Indeed, today's SMMT new car registrations data showed that the pace of decline in headline sales volumes accelerated in May to more than 4½%Y/Y, the steepest drop since September when the market contracted very sharply following the introduction of new emissions-testing standards. Registrations by private buyers were even more subdued, down 5%Y/Y. Overall, today's figures support our view that consumers remain reluctant to commit to big-ticket purchases. And if the latest BRC and CBI retail surveys are anything to go by, they scaled back significantly their spending on smaller items last month too.

The day ahead in the UK

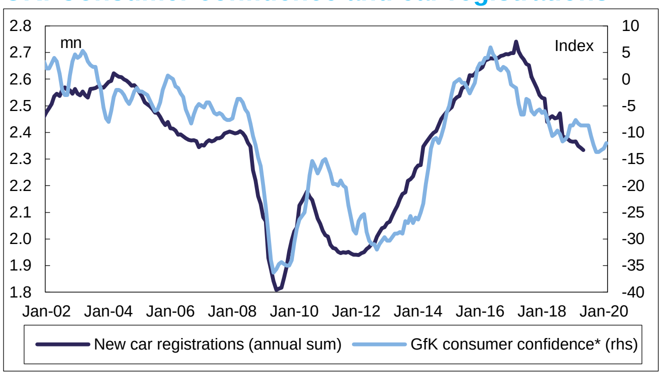
While tomorrow will be absent of top-tier UK economic data, BoE Governor Carney will speak at an Institute of International Finance conference in Tokyo.

UK: GDP growth and PMI



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

UK: Consumer confidence and car registrations



**Nine-month lead. Source: Thomson Reuters, SMMT an d Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Final services PMI (composite PMI)	May	**52.9 (51.8)**	52.5 (51.6)	52.8 (51.5)	-
		Retail sales M/M% (Y/Y%)	Apr	**-0.4 (1.5)**	-0.5 (1.5)	0.0 (1.9)	**- (2.0)**
		PPI M/M% (Y/Y%)	Apr	**-0.3 (2.6)**	0.4 (3.3)	-0.1 (2.9)	-
Germany		Final services PMI (composite PMI)	May	**55.4 (52.6)**	55.0 (52.4)	55.7 (52.2)	-
France		Final services PMI (composite PMI)	May	**51.5 (51.2)**	51.7 (51.3)	50.5 (50.1)	-
Italy		Services PMI (composite PMI)	May	**50.0 (49.9)**	49.8 (49.3)	50.4 (49.5)	-
Spain		Industrial production M/M% (Y/Y%)	Apr	**1.8 (1.7)**	0.5 (-0.2)	-1.2 (-3.1)	**- (-3.0)**
		Services PMI (composite PMI)	May	**52.8 (52.1)**	52.5 (52.1)	53.1 (52.9)	-
UK		New car registrations Y/Y%	May	**-4.6**	-	-4.1	
		Services PMI (composite PMI)	May	**51.0 (50.9)**	50.6 (50.7)	50.4 (50.9)	-

Auctions

Country	Auction
- Nothing to report -	

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	Final GDP Q/Q% (Y/Y%)	Q1	0.4 (1.2)	0.2 (1.2)
		10.00	Final employment Q/Q% (Y/Y%)	Q1	0.3 (1.3)	0.3 (1.3)
		12:45	ECB Main Refinancing rate %	Jun	*0.00*	0.00
		12:45	ECB Marginal Lending Facility rate %	Jun	*0.25*	0.25
		12:45	ECB Main Deposit rate %	Jun	*-0.40*	-0.40
Germany		07.00	Factory orders M/M% (Y/Y%)	Apr	0.1 (-5.6)	0.6 (-6.0)

Auctions and events

Country		BST	Auction / Event
EMU		13:30	ECB's post-meeting press conference
France		12.00	Auction: to sell 2.75% 2027 bonds
		12.00	Auction: to sell 0.5% 2029 bonds
		12.00	Auction: to sell 1.25% 2036 bonds
		12.00	Auction: to sell 1.5% 2050 bonds
Spain		09.45	Auction: to sell 0.05% 2021 bonds
		09.45	Auction: to sell 0.25% 2024 bonds
		09.45	Auction: to sell 1% 2030 index-linked bonds
UK		10.00	BoE's Carney scheduled to speak in Tokyo

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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