Euro wrap-up

Overview

- While the ECB extended its forward guidance into 2020, shorter-dated Bunds made losses today as the details of its TLTRO-III conditions were not quite as generous as had been expected.
- Gilts followed USTs higher on a quiet day for UK economic news.
- Tomorrow brings German and French IP and trade figures for April, along with German labour cost numbers. A UK labour market survey is also due.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.654	+0.026
OBL 0 04/24	-0.580	+0.027
DBR 0¼ 02/29	-0.234	-0.009
UKT 1½ 01/21	0.546	-0.026
UKT 1 04/24	0.595	-0.026
UKT 1⅝ 10/28	0.829	-0.034

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

Euro area

ECB not quite as dovish as expected

When its latest policy meeting concluded today, the ECB was not quite as dovish as the markets had expected. So, the euro strengthened somewhat and yields on most shorter-dated euro area government bonds rose. However, the Governing Council was certainly not inactive, with an amendment made to its forward policy guidance, while scope for negative interest rates on the forthcoming TLTRO-III operations was confirmed. And in his press conference, Draghi's comments implied that the next ECB policy action was more likely to be an easing than a tightening.

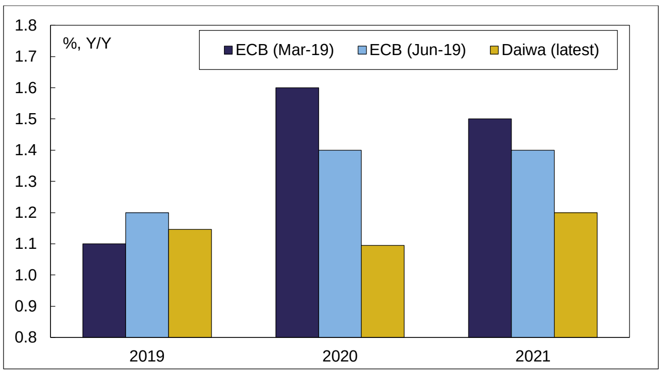
Forward guidance extended with an apparent easing bias

First in terms of the detailed policy announcements, the ECB extended its forward guidance. It now expects its key interest rates to remain unchanged at least through the first half of 2020, rather than to end 2019 previously. That guidance, however, will not tie the hands very tightly of Draghi's as-yet unidentified successor as ECB President when he or she takes over at the start of November. Indeed, in his press conference, Draghi repeated that, if downside risks to the economic outlook crystallise, the Governing Council remains ready to adjust all of its instruments. And he stated that a further cut in the deposit rate and/or additional QE were both raised in the Governing Council meeting as possible next steps. He also confirmed that, at present, the Governing Council was not overly concerned about the adverse impact of negative rates on financial conditions, although future action (such as tiering) to mitigate such side-effects remained possible.

But TLTRO-III not as generous as TLTRO-II

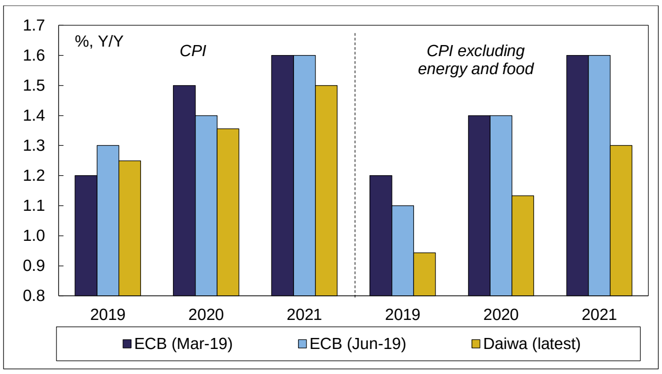
In terms of the forthcoming TLTRO-III operations, however, the ECB announced that the conditions attached will not be as generous as those applied to the previous TLTROs-II. That reflects the Governing Council's intention for the new operations merely to represent a backstop to prevent a tightening of financial conditions when the TLTRO-II funds mature next year, rather than a new monetary policy instrument to stimulate the economy. Indeed, the ECB is keen to avoid the TLTRO-III funds being used merely as a source of funds for carry trades. So, the maximum rate will be 10bps above the average refi rate over the lifetime of the respective operation, i.e. at most 0.10% in the event that the main interest rates remain unchanged through to 2023. And for banks whose net lending exceeds a benchmark, the rate to be applied in the TLTROs-III will be lower, and at a minimum at the average deposit rate prevailing over the life of the operation plus 10bps, i.e. at least -0.30% if rates remain unchanged through to 2023. Moreover, the amount of funds which banks can borrow under the TLTROs-III will be reduced by any amount still outstanding from the funds previously borrowed under TLTRO-II. While banks will be able to borrow up to a

Euro area: GDP forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

total of 30% of the stock of eligible loans at 28 February 2019, the amount that banks can borrow in each of the seven TLTROs-III will be limited to, at most, 10% of that stock of eligible loans – presumably to reduce the risks of future significant funding cliff-edges when the TLTROs-III mature. In addition, also unlike the TLTROs-II, banks will not be able to repay the TLTRO-III funds before maturity.

ECB forecasts little changed

The ECB's updated economic forecasts suggest that little has changed over the past three months. While GDP surprised on the upside in Q1, the Governing Council expects a moderation in Q2 and Q3 before a pickup in growth again at the turn of the year. And while the full-year GDP forecast for 2019 was revised up 0.1ppt to 1.2%Y/Y, the forecasts for 2020 and 2021 were nudged lower to 1.4%Y/Y in each year. The amendments to the ECB's inflation outlook were minimal too. The expectation for the headline rate in 2019 was nudged up 0.1ppt to 1.3%Y/Y, but the equivalent forecast for core inflation was revised down by 0.1ppt to 1.1%Y/Y. And, importantly, the forecasts for both headline and core inflation at the end of the horizon in 2021 were left unchanged at 1.6%Y/Y, below the ECB's target.

Inflation expectations and the euro among new ECB concerns

Unsurprisingly, however, the Governing Council emphasised that the risks to the outlook remain skewed to the downside. Draghi recited familiar risks related to geopolitics, protectionism and emerging market economies. And he made clear that, while the chances of recession or deflation were low, the Governing Council was mindful of the recent marked decline in market-based measures of inflation expectations – indeed, the closely watched 5Y5Y inflation swap forward rate fell below 1.25% to a new record low. Draghi also noted concerns about the potential impact of future Fed easing on exchange rates. As such, he implied that a cut in the fed funds rate might in due course have to be followed by a loosening of ECB policy, although quite what form that action would take would have to be decided at the moment in time.

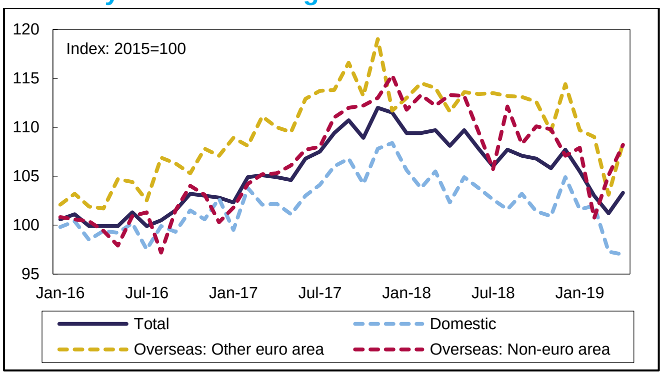
German factory orders remain subdued

Data-wise, ahead of tomorrow's German IP report for April, today brought the release of factory orders figures for that month. These showed only very modest growth at the start of the second quarter, with total German orders up 0.3%M/M in April, following an upwardly revised increase (0.8%M/M) in March. Given the considerable weakness at the start of the year, this still left them down more than 5%Y/Y. When excluding major orders, the improvement in April was at face value more impressive, with orders up more than 2%M/M, the largest increase since November 2017. But this followed declines of a similar magnitude in the previous three months, to leave the level in April broadly in line with the Q1 average, which itself was the weakest since Q416.

Domestic orders particularly weak

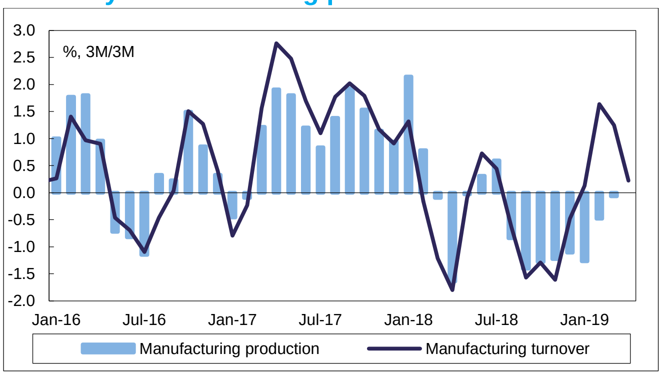
Within the detail, the pickup in April was driven by overseas orders with those (excluding major orders) from the euro area up more than 5%M/M (largely offsetting the decline in March). Other foreign orders increased for the second successive month and by almost 3%M/M. But domestic orders remained weak, falling for the third month out of the past four to their lowest level since November 2014, weighed particularly by orders of intermediate goods (down more than 2%M/M) while capital goods orders remained sluggish following a steep drop in March. So, overall, despite the more positive headline figure, today's data reinforced the downbeat messages from recent manufacturing surveys which have signalled ongoing weakness in orders and production alike in Q2. Indeed, today's reports also showed that manufacturing turnover declined 0.6%M/M in April, following growth of just 0.1%M/M previously. So, having risen in the previous two months, production in the sector seems likely to have declined in April, with the consensus expectation for tomorrow's release to show a drop of ½%M/M, fully reversing the increase in March.

Germany: Manufacturing orders*



**Excluding major orders. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Germany: Manufacturing production and turnover



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area GDP growth led by domestic demand in Q1

There were no major surprises from today's final estimate of euro area Q119 GDP, which confirmed growth of 0.4%Q/Q, up from 0.2%Q/Q previously. While that was the strongest quarterly rate since Q218, it was only sufficient to leave the annual rate unchanged from Q418 at 1.2%Y/Y, the weakest rate since Q413. The expenditure detail, published for the first time, confirmed that growth was broad-based. Benefiting from steady growth in employment – confirmed at 0.3%Q/Q and again led by Spain (up 0.7%Q/Q) – private consumption saw its firmest growth in six quarters (up 0.5%Q/Q albeit still just 1.1%Y/Y). Fixed investment was again vigorous at 1.1%Q/Q taking the annual rate to 4.8%Y/Y, the best in almost three years. Net trade also made a positive contribution to GDP growth. But for the second successive quarter, inventories subtracted significantly. We forecast a softer rise in consumption and investment, but less of a drag from stocks, to result in a moderation in GDP growth in Q219 to 0.2%Q/Q – the rate also now forecast by the ECB.

The day ahead in the euro area and US

The week will end with a busy euro area economic diary, with several notable releases from Germany. As noted, we expect the April industrial production report to confirm a decline of about 0.5%M/M in German manufacturing production. German trade data for the same month are expected also to show a drop of close to 1.0%M/M in exports, and a smaller decline in imports, to result in a narrowing in the trade surplus back below €20bn. French industrial production and trade data for April are due, with the former more likely to show positive growth following a weak end to Q1. German unit labour cost figures for Q1 will be watched for signs of underlying price pressure, although gains in productivity have kept them contained over the past year despite higher wage growth. And Italian retail sales figures for April are also scheduled for release.

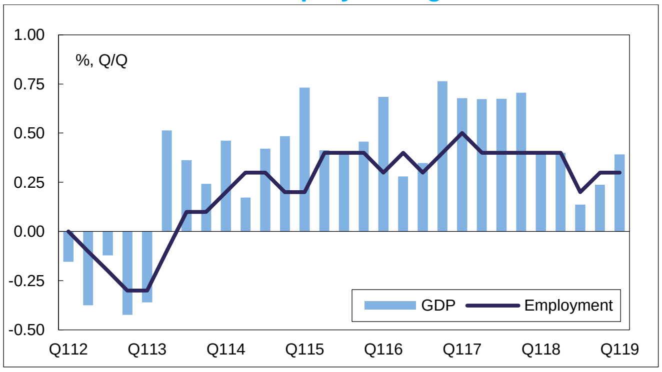
All eyes will be on the US labour market report for May. Expectations are for a slowdown in nonfarm payroll growth from 263k in April to close to 180k (Daiwa America's forecast is currently 160k), with the private sector ADP figure (just 27k) suggesting that the risks might be skewed to the downside. Meanwhile, the unemployment rate might tick up 0.1ppt to 3.7% while the annual rate of growth in average hourly earnings growth is expected to remain unchanged at 3.2%Y/Y. Wholesale trade and inventories data for April are also due.

UK

The day ahead in the UK

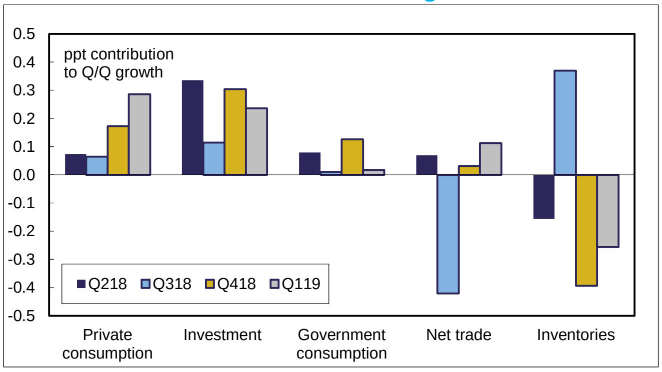
After an uneventful Thursday with no new economic figures published, the week in the UK will end on a relatively quiet note with the latest KPMG/REC report on jobs the most notable scheduled data release and likely to further emphasise the downside risks to near-term jobs growth in light of continued Brexit uncertainty. The Halifax house price report for May is also due.

Euro area: GDP and employment growth



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to GDP growth



Source: 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 GDP Q/Q% (Y/Y%)	Q1	**0.4 (1.2)**	0.4 (1.2)	0.2 (1.2)	-
		Final employment Q/Q% (Y/Y%)	Q1	**0.3 (1.3)**	0.3 (1.3)	0.3 (1.3)	-
		ECB Main Refinancing rate %	Jun	**0.00**	*0.00*	0.00	-
		ECB Marginal Lending Facility rate %	Jun	**0.25**	*0.25*	0.25	-
		ECB Main Deposit rate %	Jun	**-0.40**	*-0.40*	-0.40	-
Germany		Factory orders M/M% (Y/Y%)	Apr	**0.3 (-5.3)**	0.1 (-5.6)	0.6 (-6.0)	**0.8 (-5.9)**

Auctions

Country		Auction
France sold		€875mn of 2.75% 2027 bonds at an average yield of -0.08%
		€4.0bn of 0.5% 2029 bonds at an average yield of 0.14%
		€2.5bn of 1.25% 2036 bonds at an average yield of 1.16%
		€1.6bn of 1.5% 2050 bonds at an average yield of 0.66%
Spain sold		€1.3bn of 0.05% 2021 bonds at an average yield of -0.361%
		€1.1bn of 0.25% 2024 bonds at an average yield of -0.096%
		€476mn of 1% 2030 index-linked bonds at an average yield of -0.283%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Industrial production M/M% (Y/Y%)	Apr	-0.5 (-0.4)	0.5 (-0.9)
		07.00	Labour costs Q/Q% (Y/Y%)	Q1	-	-0.1 (2.0)
		07.00	Trade balance (current account) €bn	Apr	19.5 (-)	22.6 (30.2)
		07.00	Exports (imports) M/M%	Apr	-0.9 (-0.2)	1.6 (0.6)
France		07.45	Industrial production M/M% (Y/Y%)	Apr	0.3 (1.0)	-0.9 (-0.9)
		07.45	Trade balance (current account) €bn	Apr	-4.7 (-)	-5.3 (-1.3)
Italy		09.00	Retail sales M/M% (Y/Y%)	Apr	-	-0.3 (-3.3)
UK		08.30	Halifax house prices M/M% (3M/Y%)	May	-0.2 (5.0)	1.1 (5.0)

Auctions and events

Country	BST	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.