Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds made gains at the longer end, and govvies from France, Italy and Spain outperformed, as Governing Council members from Finland and Slovakia stated that the ECB would cut rates or restart QE if necessary.
- Gilts made losses and the curve flattened as the latest UK labour market data beat expectations.
- Wednesday should be uneventful for European economic news but Thursday will bring updates on euro area IP and German inflation.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.668	+0.005
OBL 0 04/24	-0.589	+0.001
DBR 0¼ 02/29	-0.231	-0.013
UKT 1½ 01/21	0.585	+0.030
UKT 1 04/24	0.629	+0.022
UKT 1⅝ 10/28	0.853	+0.014

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

Euro area

French business survey suggests steady growth in Q2

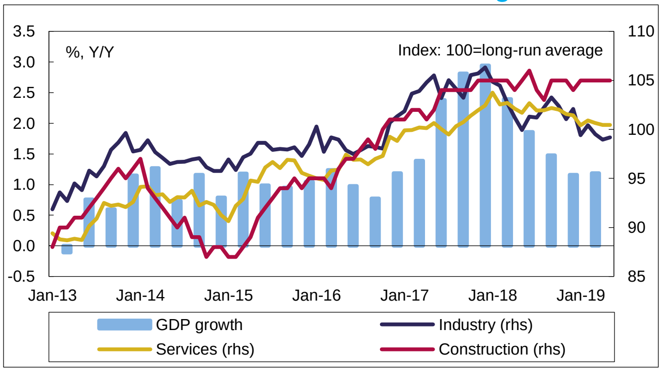
On a relatively uneventful day for economic news from the euro area, the most noteworthy release was the Bank of France's latest business survey, which suggested that conditions remained broadly stable in May. Admittedly, the headline indicator for industrial sector sentiment was a touch weaker than expected, moving sideways at 99, the lowest level since October 2016 and just below the long-term average. But manufacturers still reported a pickup in production last month, with the chemicals, IT and electronics sub-sectors seemingly buoyant. And they expect output to remain little changed in June. The headline survey indices for services and construction firms, which had a similar assessment of the production outlook for the current month, were also unchanged at 100 (the lowest since July 2017) and 105 respectively. As such, the Bank of France left unchanged its Q2 GDP forecast at 0.3%Q/Q, the same as in Q1 and a rate that matches our own forecast.

The coming two days in the euro area and US

The most noteworthy new euro area economic data over the coming two days will be April's industrial production release on Thursday. Despite the strength in France and Spain in April, the weakness in Germany and Italy will likely see aggregate IP (excluding construction) fall for the second successive month and by a slightly steeper pace than the 0.3%M/M drop in March. Ahead of this, tomorrow will bring final inflation figures from Spain, which are expected to align with the preliminary release that showed the EU-harmonised CPI measure declining 0.7ppt to 0.9%Y/Y. Likewise, final German CPI figures (due Thursday) are likely to confirm the 0.8ppt drop in the EU-harmonised rate to 1.3%Y/Y, a thirteen-month low.

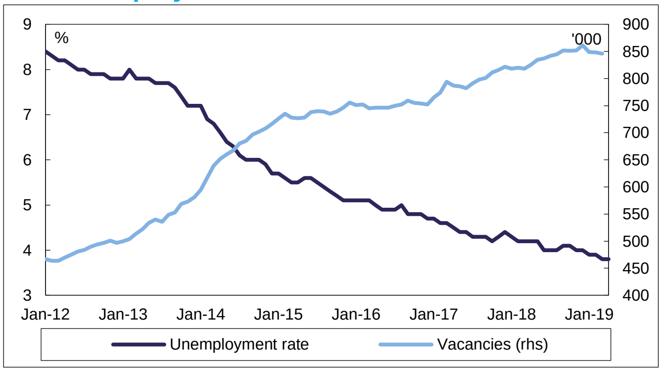
Beyond the economic data, the Eurogroup meeting on Thursday afternoon will be interesting not least given the Commission's recommendation last week to launch a new Excessive Deficit Procedure (EDP) against Italy, although that disciplinary process will not be explicitly on the agenda. Instead, ahead of the Euro Summit on 21 June, Finance Ministers are due to reach agreement on the key features and timing of the planned euro area Budgetary Instrument for Convergence and Competitiveness (BICC), which will represent the first common fiscal policy tool for the single currency. The BICC is highly likely initially to be very small in size, and targeted on supporting structural reforms and public investment rather than boosting demand. However, if the design features are sufficiently flexible in terms of the possible use of funds, and can allow for a significant future increase in size, then the BICC might eventually prove a useful basis for a single euro area budget to be used to support demand in the event of the next recession and/or financial crisis.

France: Business conditions and GDP growth



Source: Bank of France, Bloomberg, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Unemployment rate and vacancies*



**3-month moving averages. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Indeed, in his post-Governing Council meeting press conference last week, ECB President Draghi emphasised that fiscal policy would have to play a more substantive role in boosting economic activity if and when the downside risks to the euro area economic outlook crystallise. If it is designed appropriately, the BICC might eventually have a useful part to play. If not, with the ECB's deposit rate already deeply negative and limits to the extent of any future new QE programme, euro area policymakers are likely to find that the policy tools at their disposal are inadequate to sufficiently support demand and boost inflation to target.

Elsewhere, ECB President Draghi and Vice-President de Guindos will speak publicly tomorrow at an ECB conference, although the focus will be on central, eastern and south-eastern European countries and so might be of little relevance to the debate on the monetary policy outlook. In the markets, Germany will sell 10Y Bunds tomorrow, while Italy will sell 3Y, 7Y and 15Y BTPs on Thursday.

In the US, all eyes tomorrow will be on CPI inflation figures for May. Against the backdrop of weaker energy inflation, the annual rate of headline CPI is expected to have edged back below 2%Y/Y, while core inflation is likely to have moved sideways at 2.1%Y/Y. Tomorrow will also bring the Federal monthly budget statement, followed on Thursday by the weekly jobless claims figures, as well as the latest monthly import and export price indices. In the markets, the US Treasury will sell 10Y notes tomorrow and 30Y bonds on Thursday.

UK

Labour market remains firm

While UK GDP weakened significantly in March and April, the labour market appears to have remained broadly firm. Having declined in February and March, employment rebounded in April to a new series high. However, the increase in employment on a three-month basis of 32k3M/3M was the smallest since August. By the same token, although the unemployment rate increased 0.21ppt in April to a four-month high of 3.95%, on a three-month basis it remained at 3.8%, still the lowest since the 1970s. Average weekly earnings growth slowed to a seven-month low of 3.1%3M/Y principally reflecting softer growth in bonuses, excluding which wages rose a stronger 3.4%3M/Y in line with the average of the past six months. Real growth in total pay thus eased back to a six-month low of 1.2%%3M/Y, a rate that if sustained should nevertheless be consistent with ongoing solid growth in private consumption. Finally, the level of vacancies inched down for a third consecutive month to a seven-month low of 846k, still however very high by historical standards.

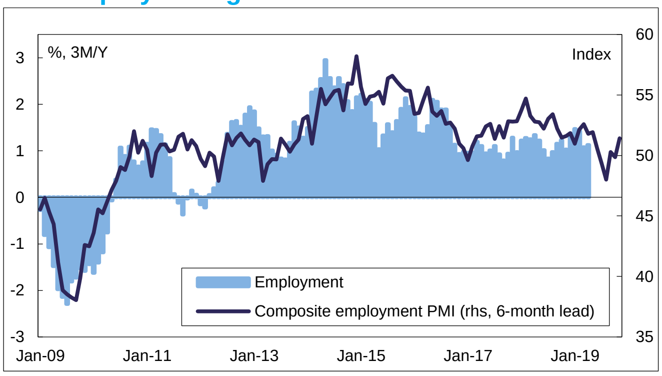
Jobs and wage data broadly in line with BoE expectations

Today's labour market data are consistent with the BoE's expectations expressed in its May Inflation Report. In particular, as suggested by survey indicators, the BoE had expected employment growth to slow in Q2, and the unemployment rate to edge down from the Q1 average of 3.9%, further below the MPC's estimate of the 'equilibrium' rate of 4¼% that it judges would be consistent with maintaining inflation at target over the medium term. The BoE had also expected total pay to average close to 3¼%Y/Y on a four-quarter basis (the latest equivalent figure was 3.21% on this basis). While GDP in Q2 is likely to be weaker than the BoE expected – we now forecast a contraction – the labour market data imply a deterioration of productivity and an increase in unit labour cost growth, which was already above its historical average. As such, they arguably support the MPC's recent judgement that, if and when excess demand emerges once Brexit uncertainty has lifted, domestic inflationary pressures are expected to firm.

We expect labour market momentum to fade

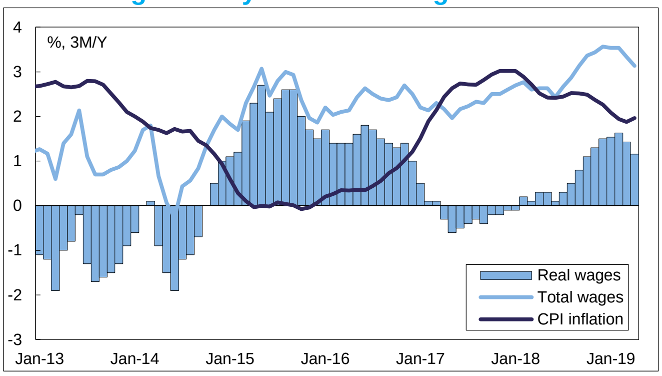
Not least given the absence of a realistic and coherent Brexit policy, and lack of diplomatic skills, being offered by the main contenders for the Conservative Party leadership, however, we do not expect Brexit uncertainty to lift for a while yet. And, if

UK: Employment growth and PMI



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

UK: Average weekly labour earnings and inflation



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

and when Brexit has been resolved one way or the other, we think that UK economic activity will remain relatively subdued, not least given the likely softening of global demand growth over the next year or so. Therefore, while the BoE expects the unemployment rate to continue to edge lower to 3½% by the end of its forecast horizon, and the latest survey evidence is admittedly mixed (e.g. with the REC/KPMG jobs report suggesting a further loss of momentum in May but the employment PMI pointing to an improvement) – we expect the unemployment rate to move sideways for a while yet before edging back up to 4.0% by mid-2020. And we expect no meaningful acceleration in wages.

The coming two days in the UK

The remainder of the week will be quiet for economic releases from the UK, with just the RICS house price survey for May due on Thursday. Of course, of greater interest that day will be the first elimination ballot for the Conservative Party leadership challenge. The ten candidates will each require the votes of at least 5% of the parliamentary party (17 MPs) to stay in the race – should that threshold be achieved by all candidates, the one with the least votes will be eliminated. Further votes among Conservative MPs will then be held on Tuesday, Wednesday and Thursday next week in order to identify the two candidates to be subject to a vote of all party members. The winner of the contest to become Conservative leader, and hence Prime Minister, will then be announced in mid-July.

Populist gaffe-prone former Foreign Secretary Boris Johnson and current Foreign Secretary Jeremy Hunt – both of whom would initially seek to renegotiate Theresa May's Brexit deal with the EU if they became Prime Minister – currently seem most likely to be the two names submitted to a vote among party members. And Johnson (current best odds of 4/6) is the clear favourite among bookmakers to become the next Prime Minister. While both have claimed to be open to the notion of a no-deal Brexit, we would continue to expect Parliament to prevent either of them succeeding in that respect should they seek such a path. Indeed, today in the House of Commons the Labour party tabled a cross-party motion that would hand control of the parliamentary agenda to MPs on 25 June. If that motion passes, MPs will then be given the opportunity to introduce legislation seeking to prevent a no-deal Brexit.

In the markets, the DMO will sell 30Y index-linked bonds tomorrow.

In the absence of significant news, the next edition of the Euro wrap-up will be published on 13 June 2019

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Bank of France business sentiment	May	**99**	100	99	-
UK	ILO unemployment rate 3M%	Apr	**3.8**	3.8	3.8	-
	Employment change 3M/3M '000s	Apr	**32**	4	99	-
	Average weekly earnings (excl. bonuses) 3M/Y%	Apr	**3.1 (3.4)**	3.0 (3.2)	3.2 (3.3)	**3.3 (-)**
	Claimant count rate % (change '000s)	May	**3.1 (23.2)**	-	3.0 (24.7)	**- (19.1)**

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
Spain	08.00	Final CPI (EU-harmonised) Y/Y%	May	0.8 (0.9)	1.5 (1.6)

Auctions and events

Country	BST	Auction / Event
EMU	-	ECB's Draghi and de Guindos scheduled to speak in Frankfurt
Germany	10:30	Auction: to sell €3bn of 0.25% 2029 bonds
UK	10.30	Auction: to sell £700mn of 0.125% 2048 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	Industrial production M/M% (Y/Y%)	Apr	-0.5 (-0.6)	-0.3 (-0.6)
Germany	07.00	Final CPI (EU-harmonised) Y/Y%	May	1.4 (1.3)	2.0 (2.1)
UK	00.01	RICS house price balance %	May	-21	-23

Auctions and events

Country	BST	Auction / Event
EMU	-	Eurogroup meeting
Italy	10.00	Auction: to sell 1.0% 2022 bonds
	10.00	Auction: to sell 2.1% 2026 bonds
	10.00	Auction: to sell 3.35% 2035 bonds
UK	-	First Conservative Party leadership ballot to be held

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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