Daiwa Capital Markets

Euro wrap-up

Overview

- Bunds and other euro area government bonds made substantive gains as Mario Draghi signalled a willingness to ease monetary policy further unless the inflation outlook improves.
- Gilts followed other major government bonds higher on an uneventful day for UK economic news.
- Wednesday will bring the latest data on UK inflation and euro area construction output.

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Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.760	-0.069
OBL 0 04/24	-0.687	-0.086
DBR 0¼ 02/29	-0.326	-0.083
UKT 1½ 01/21	0.578	-0.042
UKT 1 04/24	0.590	-0.047
UKT 1⅝ 10/28	0.800	-0.051

*Change from close as at 4.15pm BST.
Source: Bloomberg

Euro area

Draghi makes case for additional stimulus

Euro area government bonds made big gains and the euro weakened below $1.12 for the first time in two weeks, as Mario Draghi was predictably dovish in his speech to the ECB's Sintra Policy Forum this morning. In the face of recent declines in market-based inflation expectations, with the much-watched 5Y5Y inflation forward swap rate having fallen to a record low, Draghi stressed that the ECB remained committed to its target of achieving inflation of below but close to 2%Y/Y. He also reminded that the target was symmetrical, stating that inflation would therefore "need to be above 2% at some time in the future". But achieving such above-target inflation will be easier said than done, all the more so as Draghi acknowledged that leading indicators "point to lingering softness" and that the risks to the outlook are further tilted to the downside. So, Draghi concluded that "in the absence of improvement… additional stimulus will be required".

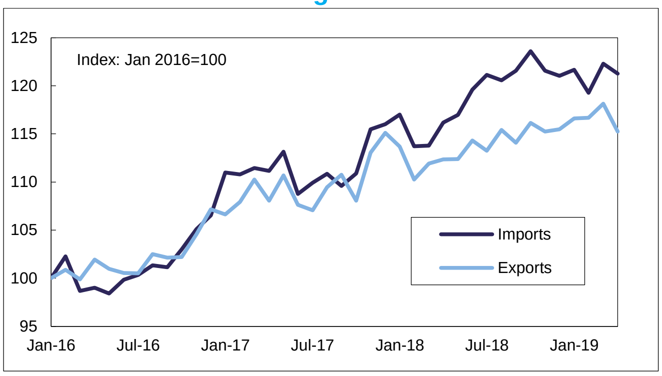
A significant probability of a rate cut before year-end

In terms of the form that such further stimulus should take, however, Draghi was relatively vague, noting that all of the ECB's tools were on the table. Further rate cuts were feasible, although mitigating action (presumably tiering) might then be needed to offset any negative side-effects. And the recommencement of QE was possible too, with the ECB having the right to lift its self-imposed issue and issuer limits should that be necessary. Of course, Draghi had already noted in his post-Governing Council press conference earlier this month that rate cuts and QE had been mentioned by policymakers as possible next steps. But while he failed to express a preference today, the narrative of his speech and subsequent unattributed reports suggested that a rate cut would be the ECB's preferred tool. While our baseline forecast currently assumes no change to rates before year-end, the probability of a 10bp cut in the deposit rate to -0.50% as soon as September (i.e. before Draghi steps down as President) is now substantive, albeit partly dependent on many things beyond the ECB's control, including Fed action and Brexit. But if the economic outlook has failed materially to improve and/or the Fed has cut rates by then, an autumn rate cut by the ECB will look a done deal.

Exports fall back at start of Q2

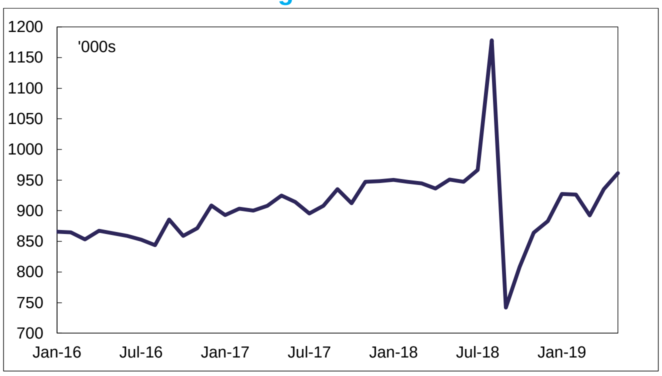
Data-wise, today's goods trade report flagged the downside risks to the economic outlook from events abroad. In particular, the value of exports in April fell 2.5%M/M, the most in fourteen months to a five-month low. A sharp decline in shipments to the UK, as the impact of precautionary stock-building ahead of the original end-March Article 50 deadline reversed, appears the principal culprit, while shipments to Turkey also fell back sharply. With imports down a more moderate 0.9%M/M, the trade surplus shrank €3.3bn in seasonally adjusted terms to a five-month low of €15.3bn. And with the level of exports 1.9% below

Euro area: Merchandise goods trade*



*Seasonally adjusted values. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations*



*Seasonally adjusted data. Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

the Q1 average but the level of imports up on an equivalent basis, net trade already looks on track to subtract from economic growth in Q2.

But car registrations stronger

While the external environment remains weak, domestic demand, however, appears to remain relatively firm. Having leapt 4.8%M/M on a seasonally adjusted basis in April, new car registrations rose a further 2.8%M/M in May, driven by a notable acceleration in Germany. So, while the level in May was still just 1.2% higher than a year earlier, the average for the first two months of Q2 was 3.6% above the Q1 average, strongly suggesting a positive contribution to economic growth from the sector in the current quarter.

May drop in inflation confirmed

There was little surprising about the final May euro area inflation report, which confirmed the flash estimates of a thirteen-month low of 1.2%Y/Y for the headline CPI rate and 0.8%Y/Y for the core measure, both down 0.5ppt from April's spike related to the timing of Easter. Services inflation – which had been most distorted by the impact of that holiday, principally due to its impact on prices of package tours, fell a touch more than previously thought, down 0.9ppt to 1.0%Y/Y. Inflation of non-energy industrial goods was confirmed at 0.3%Y/Y, up 0.1ppt from April but little stronger than the average of the past year. A measure of super-core inflation excluding prices of package holidays – which should reflect inflation of cyclically-sensitive items – edged back to 1.33%Y/Y, only marginally above the average this year and up just 0.15ppt from the average in 2018.

Labour cost uptrend remains gradual

So, a clear uptrend in underlying inflation remains absent even though the labour market is generating increased pressure on costs. Data released yesterday showed that euro area business sector labour costs in Q119 rose 2.4%Y/Y, up 0.1ppt from Q418 and the strongest rate in almost seven years. Wage growth was a touch stronger, up 2.5%Y/Y, the most since Q412. Of course, significant differences persist across the member states. Business labour cost growth in Germany (2.4%Y/Y) and France (2.8%Y/Y) was firm, and non-wage costs contributed to a spurt in Italy (3.1%Y/Y). But business labour cost growth was significantly softer in Spain and the Netherlands (both 1.4%Y/Y) and Portugal (-0.3%Y/Y). And while the ECB might take some comfort from the data, wage growth remained down on the average rate of close to 3.0%Y/Y prevailing ahead of the Global Financial Crisis, which was consistent with achievement of the ECB's inflation target.

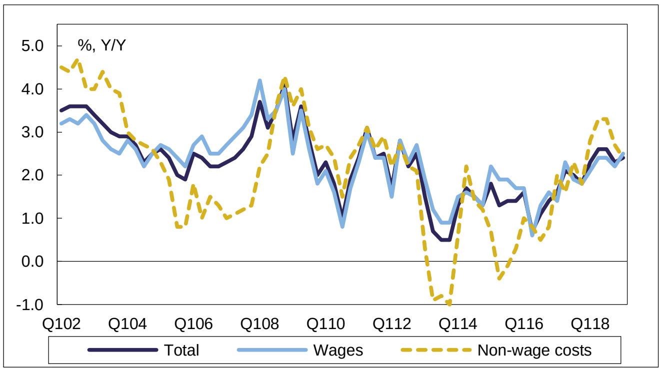
Underlying inflation to remain subdued

Looking ahead, we expect a moderate rebound in services inflation in June to push the core CPI rate back slightly above 1.0%Y/Y. But that shift looks likely to be short-lived. Indeed, we expect core inflation to fall back below 1.0%Y/Y in each month of the second half of the year before moving gradually higher again in 2020. And with energy inflation set to subside over coming months due to past shifts in the oil price, headline inflation should also fall below 1.0%Y/Y by October before ticking up again at the turn of the year. Overall, we forecast headline inflation to average just 1.2%Y/Y in 2019 and 1.4%Y/Y in 2020, and core inflation to be just 1.0%Y/Y and 1.2%Y/Y – 0.2ppt below the ECB's forecast – this year and next. With the risks to that view skewed not least to the downside, in the absence of a recovery in market-based measures of inflation expectations that is the kind of inflation outlook that would merit the rate cut flagged by Draghi today.

The day ahead in the euro area and US

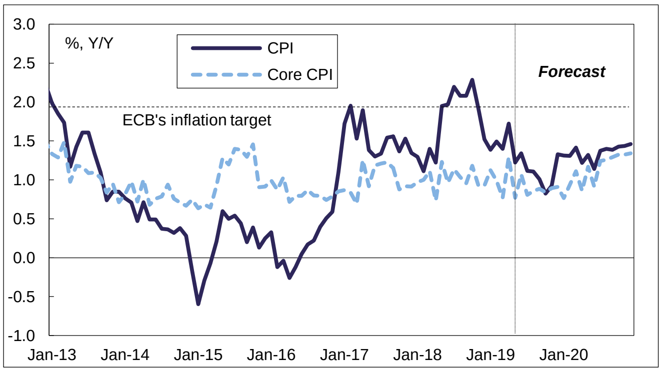
In the euro area, Wednesday will bring construction output and balance of payments data for April. With production in the sector up 0.2%M/M in Germany but down 2.3%M/M in France, a second successive monthly decline in overall euro area construction output seems highly likely. Meanwhile, the ECB's Sintra Forum on Central Banking will conclude with sessions

Euro area: Labour costs*



*Business economy labour costs. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

on the future of EMU, including a panel discussion chaired by Executive Board member Benoît Cœuré, as well as closing remarks from Mario Draghi. In the markets, Germany will sell 30Y Bunds.

Of course, the main event on Wednesday will be the announcements from the Fed, which might validate – or strongly call into question – current market pricing which implies significant policy easing in the second half of the year. While the Fed Funds Rate target range seems bound to be left unchanged at 2.25-2.50%, the updated forecasts, dot-plots, statement and press conference will be watched for clues as to the likelihood of a near-term rate cut. The status of previous language stating that the FOMC intends to be “patient as it determines what future adjustments…may be appropriate” will be key. But while that wording might well be changed to open a door to a possible easing of policy in due course, the updated language might yet fall shy of suggesting that a rate cut is imminent.

UK

The day ahead in the UK

In the UK, Wednesday will bring May inflation data. We expect the headline CPI rate to fall 0.2ppt to 2.0%Y/Y as the impact of Easter-related boost to services inflation wears off and energy inflation eases somewhat. And so, we also expect core CPI inflation to take a further small step down, by 0.1ppt to 1.7%Y/Y, which would be the lowest rate since the start of 2017. Other releases due include the latest ONS house price index and CBI industrial trends survey for June. Politics-wise, a further (but still likely inconclusive) round will be held in the Conservative party leadership election. Of course, whichever candidate is eliminated at this stage, in the absence of a major new scandal, populist Brexiteer Boris Johnson will remain highly likely to become Prime Minister next month.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		EU new car registrations Y/Y%	May	**0.1**	-	-0.4	-
		Final CPI (core CPI) Y/Y%	May	**1.2 (0.8)**	*1.2 (0.8)*	1.7 (1.3)	-
		Trade balance €bn	Apr	**15.3**	17.0	17.9	-
Germany		ZEW current conditions balance (expectations)	Jun	**7.8 (-21.1)**	6.1 (-5.6)	8.2 (-2.1)	-

Auctions

Country		Auction
UK sold		£2.337bn of 0.875% 2029 bonds at an average yield of 0.889%

Yesterday's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Labour costs Y/Y%	Q1	**2.4**	-	2.3	-
UK		Rightmove house prices M/M% (Y/Y%)	Jun	**0.3 (0.9)**	-	0.9 (0.1)	-

Auctions

Country		Auction
		- Nothing to report -

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Current account balance €bn	Apr	-	24.7
		10.00	Construction output M/M% (Y/Y%)	Apr	-	-0.3 (6.3)
UK		09.30	CPI (core CPI) Y/Y%	May	1.9 (1.7)	2.1 (1.8)
		09.30	PPI input prices (output prices) Y/Y%	May	0.8 (1.7)	3.8 (2.1)
		09.30	ONS house price index Y/Y%	Apr	1.3	1.4
		11.00	CBI Trends total orders	Jun	-11	-10

Auctions and events

Country		BST	Auction / Event
EMU		-	ECB Forum on Central Banking concludes
Germany		10:30	Auction: to sell €1bn of 2046 bonds
UK		-	Third round of Conservative Party leadership election to be held

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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