

Euro wrap-up

Overview

- Bunds followed Treasuries lower while data confirmed a weak start to Q2 for euro area construction output.
- Gilts also made losses despite a decline in UK inflation.
- Thursday will bring the BoE's latest policy announcement, data on euro area consumer confidence and UK retail sales, a further stage in the UK Conservative party leadership election, and an EU leaders' summit.

Chris Scicluna

+44 20 7597 8326

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.738	+0.026
OBL 0 04/24	-0.636	+0.051
DBR 0¼ 02/29	-0.286	+0.034
UKT 1½ 01/21	0.618	+0.052
UKT 1 04/24	0.645	+0.058
UKT 1½ 10/28	0.863	+0.058

*Change from close as at 4.15pm BST.

Source: Bloomberg

Euro area

Construction output set for weak Q2

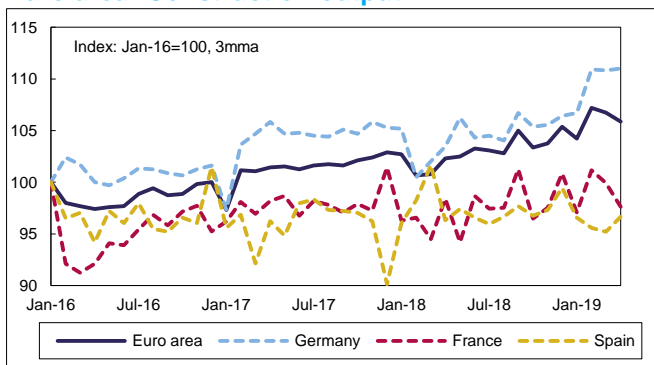
The construction sector has recently been a reliable source of economic growth for the euro area, contributing positively in each of the past four quarters. Indeed, growth in construction output in Q1 of 2.0%Q/Q marked the strongest quarter since 2013 and left it up a strong 4.9%Y/Y. However, the second quarter looks set to be much weaker. Having edged down 0.3%M/M in March, construction output fell a further 0.8%M/M in April to be up 3.9%Y/Y. Following strong growth over the previous two months, civil engineering activity was down 2.5%M/M while building work dropped for a second successive month, falling 0.5%M/M. Among the larger member states, the weakness at the start of Q2 centred on France (down 2.3%M/M) and the Netherlands (down 1.2%M/M). Elsewhere, activity was sluggish in Germany (up 0.2%M/M) and firmer in Spain (up 1.6%M/M following a drop of 2.2%Q/Q in Q1).

Reassuringly, fundamentals in the housing sector remain broadly favourable. Household incomes and house prices (with the exception of Italy) are rising. Mortgage interest rates are very low. And increased public sector investment should provide renewed support for civil engineering activity. Nevertheless, while still elevated by historical standards, construction sector confidence has moderated over recent months, with the Commission's indicator declining in May to a fifteen-month low. Some other leading indicators have weakened too, e.g. residential building permits recently fell to the lowest level in more than a year. And so, while we still expect construction output to make a positive contribution to GDP growth on average over coming quarters, activity in the sector in Q2 overall looks set to be subdued, with a contraction relative to Q1 perfectly feasible.

The day ahead in the euro area and US

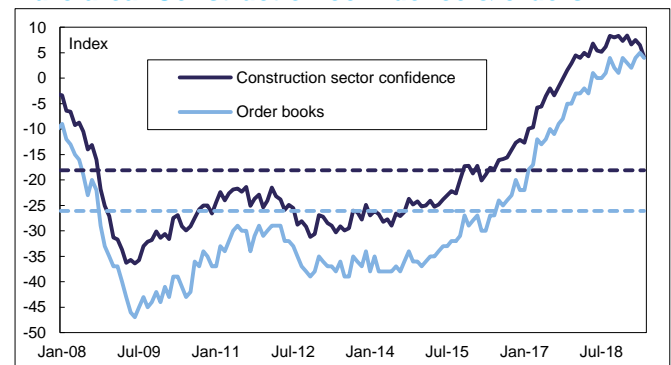
The Commission's preliminary euro area consumer confidence indicator for June will be released tomorrow. Having risen in May to a six-month high of -6.5, the current Bloomberg consensus is for no change in the current month. In addition, ECB Vice President Luis de Guindos, and Governing Council member Olli Rehn, who is a leading candidate to replace Mario Draghi, will speak publicly. In the markets, Spain and France will sell bonds of various maturities. Politics-wise, the EU leaders will meet again for their latest summit, with the appointments to the top jobs at the EU institutions (including [Draghi's successor at the ECB](#)) again on the agenda. However, we do not expect a meaningful breakthrough at this meeting, with a further summit on 30 June already set to try reach an agreement.

Euro area: Construction output



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Construction confidence & orders



Source: European Commission, Bloomberg and Daiwa Capital Markets Europe Ltd.



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In the US, as the dust settles on the Fed's policy announcement, Thursday will bring the June Philly Fed survey, current account data for Q1, the Conference Board's leading indicator for May, and the usual weekly claims figures. In the markets, the Treasury will sell 5Y TIPS.

UK

Inflation moderates in line with expectations

As expected, headline inflation edged down 0.1ppt in May back to the BoE's 2.0%Y/Y target. Lower prices for transport services, particularly air fares, more than fully accounted for the decline in headline inflation, as the upwards shift in April related to the timing of Easter reversed. As a result, overall services inflation fell 0.3ppt to 2.6%Y/Y. In contrast, however, inflation of non-energy industrial goods rose 0.2ppt to 0.3%Y/Y with lower car prices more than offset by increases elsewhere, particularly in the notoriously volatile computer game component. As a result, like the headline rate, core inflation also fell 0.1ppt, to 1.7%Y/Y, the lowest since January 2017.

Headline CPI rate to fall below target through H219

Looking ahead, with cost pressures from the labour market unlikely to intensify for as long as GDP growth remains subdued and Brexit uncertainties persist, we expect core inflation to move broadly sideways through to the end of the year. And with energy inflation set to ease due to shifts in the oil price and a reduction in the regulated domestic energy price cap in the autumn, like the BoE we forecast headline inflation to fall below 2.0%Y/Y through the second half of the year. Beyond then, the BoE's assumption of a smooth Brexit and a rebound in economic growth means that it expects inflation to pick-up next year, requiring gradual and limited rate hikes to return it to target. We, however, are more downbeat about economic growth, and therefore expect inflation to undershoot the target over the policy horizon. So, we also expect there to be no need for rate hikes. Of course, even over the near term, the profile of inflation could be impacted significantly by politics, with further weakening of sterling and – in the (still unlikely) event of a disorderly no-deal Brexit at end-October – supply shocks capable of adding (perhaps significant) upwards pressure.

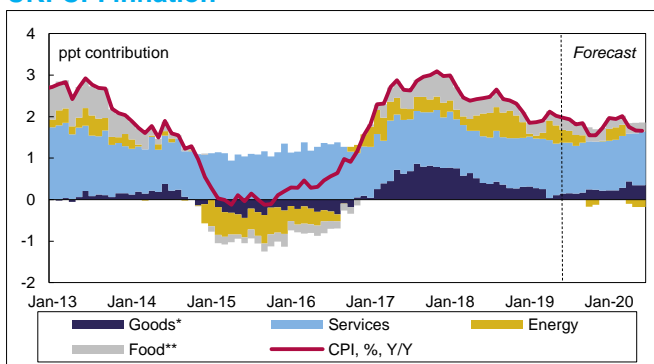
CBI survey adds to evidence of weak Q2 for manufacturing

After a sharp drop of 3.9%M/M in output in the sector in April related in no small part to the temporary closure of car plants, further evidence of weak second quarter for UK manufacturing came from today's CBI Industrial Trends survey. In particular, the survey measure of past output fell 12pts to 2, the lowest in more than three years. Meanwhile, the index of expected output moved sideways at 3, close to the bottom of the range of the past three years. Order books reportedly continue to shrink to the smallest since October 2016, with export orders in firm retreat too. Following marked inventory accumulation to the highest in a decade, stocks of finished goods were still considered to be more than adequate, albeit now broadly in line with their long-run average. Overall, manufacturing output seems highly likely to have fallen over Q2 as a whole. And while a rebound in auto production in Q3 is likely to lead to positive growth in Q3, today's survey suggests that the overall pick up in output is likely to be limited.

The day ahead in the UK

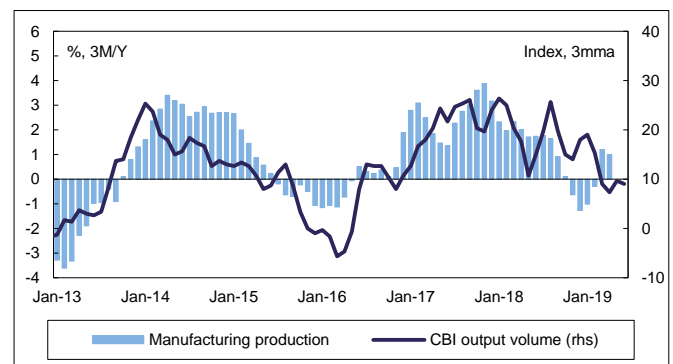
Tomorrow brings the BoE MPC's latest policy announcement. There will certainly be no change in Bank Rate, which will remain unchanged at 0.75% by unanimous vote. But the post-meeting statement and minutes will be closely watched for any amendments to the Committee's guidance on future policy that previously stated "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". Certainly, since the MPC's last policy-setting meeting at the start of May, there has been a significant transformation in the mood in global financial markets, not least associated with rising expectations of a near-term shift in Fed policy. Geopolitical tensions have intensified the downside risks to the global outlook. Domestic

UK: CPI inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output & CBI survey indicator


























Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

economic data strongly suggest much weaker UK GDP growth in Q2, with our expectation for a small contraction. And the political backdrop, including a Conservative leadership campaign that has seen no candidate propose a way forward on Brexit capable of being endorsed by both the EU and House of Commons, has further heightened the uncertainties surrounding the near-term outlook. As such, market pricing now suggests that the next move in rates will more likely be down rather than up. But while that might suggest that some adjustment to the MPC's forward guidance might be in store, data released last week implied that the [labour market](#) remains relatively tight. So, on balance, we expect no change in message tomorrow.

Data-wise, May retail sales figures are due tomorrow. Following robust growth in Q1, retail sales are likely to have weakened for a second successive month adding to evidence of a weak second quarter for GDP. On the political front, the Conservative leadership election will see MPs finally select the two candidates to be submitted for a vote among party members.

European calendar

Today's results						
Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
EMU	 Current account balance €bn	Apr	20.9	-	24.7	-
	 Construction output M/M% (Y/Y%)	Apr	-0.8 (3.9)	-	-0.3 (6.3)	-
UK	 CPI (core CPI) Y/Y%	May	2.0 (1.7)	2.0 (1.7)	2.1 (1.8)	-
	 PPI input prices (output prices) Y/Y%	May	1.3 (1.8)	0.8 (1.7)	3.8 (2.1)	4.5 (-)
	 ONS house price index Y/Y%	Apr	1.4	1.3	1.4	1.6
	 CBI Industrial Trends: Total Orders	Jun	-15	-11	-10	-
Auctions						
Country	Auction					
Germany	sold  €0.834bn of 2046 bonds at an average yield of 0.26%					

Tomorrow's data releases						
Economic data						
Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous	
EMU	 15.00	Flash consumer confidence indicator	Jun	-6.5	-6.5	
UK	 09.30	Retail sales including fuel M/M% (Y/Y%)	May	-0.5 (2.7)	0.0 (5.2)	
	 09.30	Retail sales excluding fuel M/M% (Y/Y%)	May	-0.4 (2.5)	-0.2 (4.9)	
	 12.00	BoE Bank Rate %	Jun	0.75	0.75	
Auctions and events						
Country	BST	Auction / Event				
EMU	 09.00	ECB publishes Economic Bulletin				
France	 09.50	Auction: to sell 0% 2022 bonds				
	 09.50	Auction: to sell 0% 2023 bonds				
	 09.50	Auction: to sell 0% 2025 bonds				
	 10.50	Auction: to sell 0.25% 2024 index-linked bonds				
	 10.50	Auction: to sell 0.7% 2030 index-linked bonds				
	 10.50	Auction: to sell 0.1% 2047 index-linked bonds				
Spain	 10.00	Auction: to sell 0.05% 2021 bonds				
	 10.00	Auction: to sell 0.25% 2024 bonds				
	 10.00	Auction: to sell 1.85% 2035 bonds				
UK	 12.00	BoE MPC policy announcement and meeting minutes published				
	 -	Conservative Party leadership ballot to be held				

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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