Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds were little changed while the estimate of euro area inflation in April was revised down but the latest Commission consumer confidence indicator showed an improvement.
- Gilts made gains at the longer end of the curve, and saw a negative yield at auction for the first time, as BoE Governor Bailey refused to rule out sub-zero policy rates and UK inflation fell sharply.
- Thursday will bring the flash PMIs for May.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.693	+0.001
OBL 0 04/25	-0.665	+0.001
DBR 0 02/30	-0.470	-0.004
UKT 0½ 07/22	-0.025	+0.010
UKT 0⅝ 06/25	0.054	-0.001
UKT 4¾ 12/30	0.233	-0.010

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

Headline inflation falls to near-4-year low

As expected, revised April inflation figures from the euro area today delivered a modest downwards revision. In particular, headline inflation fell a further 0.1ppt from the flash estimate to 0.3%Y/Y, down 0.4ppt from March and the softest rate since August 2016. Like in the preliminary release, a positive impulse came from inflation of food, alcohol and tobacco, which rose to 3.6%Y/Y, the most since 2008. But other major components fell sharply in April, with energy inflation providing the largest downwards pressure as the price drop of 9.7%Y/Y was the steepest since September 2009. Services inflation fell to 1.2%Y/Y, with costs related to transport and recreational activities inevitably sharply lower. And while unrevised from the flash estimate, non-energy goods inflation was down to just 0.3%Y/Y, with weaker sales impacting clothing prices which fell compared with a year earlier for the first time in more than a year. Overall, core inflation stood at 0.9%Y/Y in April, down 0.1ppt from March and within a whisker of being revised lower too.

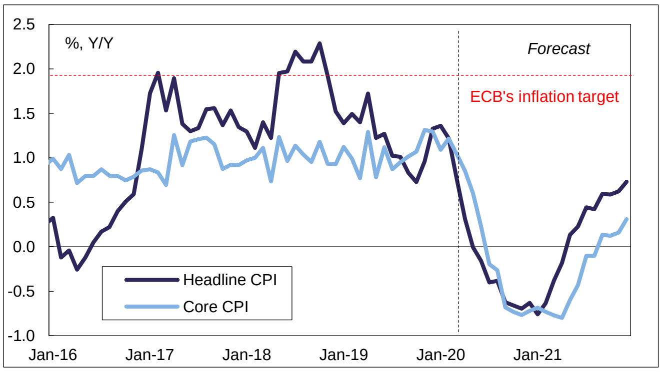
Inflation heading into negative territory

With lockdowns easing only gradually, a significant jump in joblessness having massively increased spare capacity in the labour market, and demand set to remain very subdued as the path of the pandemic remains highly uncertain, underlying price pressures are highly likely to weaken further over coming quarters. Indeed, we forecast core inflation to fall into negative territory from Q3 onwards through to the middle of next year. And with energy inflation set to provide a more significant drag this month, we expect headline inflation to fall to zero or below in May and then remain in negative territory into the second quarter of 2021. Moreover, despite the costs associated with supply-side disruptions, massive fiscal policy support, and the likely expansion of the ECB's asset purchases in due course, we strongly expect output to remain below its pre-covid-crisis-level for a number of years to come. As such, headline and core inflation will remain well below the ECB's near-2% target well into the medium term too.

Modest improvement in consumer confidence

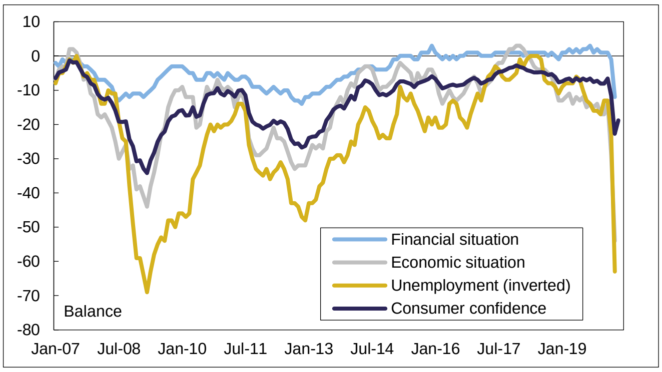
With lockdown measures gradually starting to ease across the euro area, today's Commission flash consumer confidence indicator predictably posted a modest improvement in May, rising 3.2pts to -18.8. This still represents a particularly weak reading and remains more than 12pts below the pre-crisis level, reflecting not least the sharp increase in permanent and temporary joblessness across the region over recent months. In this context, weekly figures published by the labour ministry in France today showed that 12.7mn of workers are now registered under the government's partial unemployment wage subsidy scheme. And against the backdrop of ongoing heightened uncertainty, today's survey suggests that household expenditure will also remain considerably weaker than the pre-crisis level too.

Euro area: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: EC consumer confidence survey*



**Headline figure for May is flash estimate. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

The day ahead in the euro area and US

While some European markets will be closed tomorrow for the Ascension Day holiday, we will still see the release of the flash PMIs for May, arguably the most noteworthy sentiment survey of the week. Led by Germany, and tallying with today's consumer confidence indicator, the PMIs are expected to point to some modest improvement in conditions from the record lows recorded in April, when the headline euro area composite PMI fell more than 16pts to just 13.6. Nevertheless, the PMIs across the euro area are likely to remain at very weak levels and point to a further sharp contraction in activity across the board.

In the US, we will also get the release of the preliminary PMIs for May, which, unsurprisingly, are expected to signal ongoing contraction in activity albeit at a less severe pace than in April. Similarly, the May Philly Fed indices of business activity and the Conference Board's Leading Indicators are likely to remain at weak levels. In terms of hard data, yet more dire weekly jobless numbers can be expected as well as a further fall in the existing home sales data for April. Elsewhere, Fed Chair Powell will give opening remarks at a virtual 'Fed Listens' event, while Vice-Chair Williams and Clarida will participate in online discussions on the US economy. In the markets, the Treasury is due to sell $12bn of 10Y TIPS.

UK

Inflation falls below 1%

Broadly in line with expectations, UK inflation fell sharply in April. In particular, the headline CPI rate fell 0.7ppt – the most in more than eight years – to just 0.8%Y/Y, the weakest rate since August 2016. The principle driver in April was, of course, the sharp drop in energy inflation, down 8.5ppt to -9.3%Y/Y, the steepest decline since 2015. Household energy inflation fell significantly thanks to the adjustment to electricity and gas price caps by the regulator OFGEM. And average petrol prices posted the steepest monthly decline since the current series for unleaded/ultra-low sulphur fuel was introduced 30 years ago. Food and drink inflation provided some support, rising 0.3ppt to a four-month high of 1.7%Y/Y on firmer demand, with whisky and lager notable examples in this respect. Prices of toys and other recreational items were also higher as the housebound sought entertainment during the lockdown. But weak sales added further downwards pressure to inflation of several other goods, with clothes prices falling further on increased discounting online. And thanks not least to lower prices of transport, services inflation fell 0.5ppt to just 2.0%Y/Y, the bottom of the historical range. So, core inflation fell back too, declining 0.2ppt to 1.4%Y/Y, similarly the lowest since 2016.

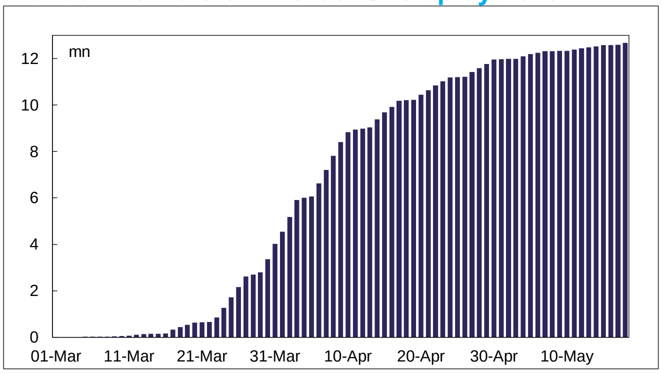
Price pressures set to weaken further

Looking ahead, with significant amounts of spare capacity having opened up in the economy, wage growth to slow significantly, and lower energy prices to continue to weigh, we expect underlying price pressures to weaken further over coming quarters. Headline inflation might just about remain in positive territory, before base effects from the recent shifts in the oil price allow a gradual increase from Q221. The costs associated with Brexit – and a probable depreciation of sterling – are likely to add a positive impulse too. However, given the very weak outlook for economic activity, we expect inflation to remain well below the BoE's 2% target for a considerable time to come. As such, we fully expect the BoE to ease policy further over the near term. Indeed, at the next MPC meeting in mid-June, we think all members of the MPC will vote for a £100bn increase in the BoE's bond purchases. And while we do not expect Bank Rate to be cut below zero, with Governor Bailey today stating that it will keep all policies under review, we would not rule out the BoE following the ECB's TLTRO-iii example by applying a negative rate to its Term Funding Scheme at some point too.

The day ahead in the UK

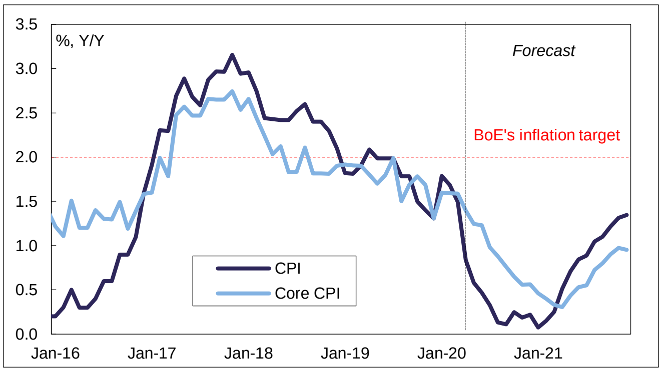
Like in other major economies, tomorrow brings the release of the UK preliminary PMIs for May. Following April's record weakness when the composite PMI fell more than 22pts to just 13.8, the flash PMIs are likely to suggest a modest improvement in conditions in May as firms found ways to work around the lockdown measures, and the government encouraged workers in manufacturing and construction in England to resume activity from 11 May. Nonetheless, the headline measures are likely to remain well below the key-50 level, signaling a continued contraction in activity. Thursday will also bring the CBI's latest industrial trends survey for the same month. On the supply side, the DMO will auction longer-dated fixed rate and index-linked bonds.

France: Workers on "Partial Unemployment"



Source: French Labour Minstry and Daiwa Capital Markets Europe Ltd.

UK: Inflation



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 CPI (core CPI) Y/Y%	Apr	**0.3 (0.9)**	0.3 (0.9)	0.7 (1.0)	**-**
	Preliminary consumer confidence	May	**-18.8**	-22.0	-22.7	**-22.0**
UK	CPI (core CPI) Y/Y%	Apr	**0.8 (1.4)**	0.9 (1.3)	1.5 (1.6)	**-**
	PPI input prices (output prices) Y/Y%	Apr	**-9.8 (-0.7)**	- (-0.5)	-2.9 (0.3)	**-3.1 (-)**
	ONS house price index Y/Y%	Mar	**2.1**	1.5	1.1	**2.0**

Auctions	
Country	Auction
Germany	sold €3.4bn of 0% 2030 bonds at an average yield of -0.47%
France	sold €2.5bn of 0% 2023 bonds at an average yield of -0.51%
	sold €2.0bn of 1.75% 2023 bonds at an average yield of -0.53%
	sold €2.1bn of 1% 2025 bonds at an average yield of -0.33%
	sold €3.5bn of 0% 2026 bonds at an average yield of -0.28%
	sold €204mn of 0.1% 2025 index-linked bonds at average yield of -0.46%
	sold €746mn of 0.7% 2030 index-linked bonds at an average yield of -0.57%
	sold €297mn of 0.1% 2036 index-linked bonds at an average yield of -0.39%
UK	sold £3.75bn of 0.75% 2023 bonds at an average yield of -0.003%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's results

Economic data					
Country	BST	Release	Period	Market consensus/ Daiwa forecast	Previous
EMU	09.00	Preliminary manufacturing (services) PMI	May	38.0 (23.8)	33.4 (12.0)
	09.00	Preliminary composite PMI	May	23.7	13.6
Germany	08.30	Preliminary manufacturing (services) PMI	May	39.0 (24.0)	34.5 (16.2)
	08.30	Preliminary composite PMI	May	33.0	17.4
France	08.15	Preliminary manufacturing (services) PMI	May	36.0 (24.0)	31.5 (10.2)
	08.15	Preliminary composite PMI	May	37.0	11.1
UK	09.30	Preliminary manufacturing (services) PMI	May	35.0 (20.0)	32.6 (13.4)
	09.30	Preliminary composite PMI	May	16.0	13.8

Events & auctions		
Country	BST	Event / Auction
UK	10.00	Auction: £1,25bn of 0.125% 2028 index-linked bonds
	10.00	Auction: £2bn of 4.25% 2032 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.