Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made losses but BTPs rallied as the ECB increased its PEPP programme after Germany's coalition partners agreed a new large-scale fiscal stimulus.
- Gilts followed USTs lower despite some further very weak UK economic data.
- Friday will bring data for German factory orders, Italian retail sales and UK consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.628	+0.023
OBL 0 04/25	-0.578	+0.010
DBR 0 02/30	-0.327	+0.030
UKT 0½ 07/22	0.006	+0.012
UKT 0⅝ 06/25	0.068	+0.017
UKT 4¾ 12/30	0.308	+0.035

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

Euro area

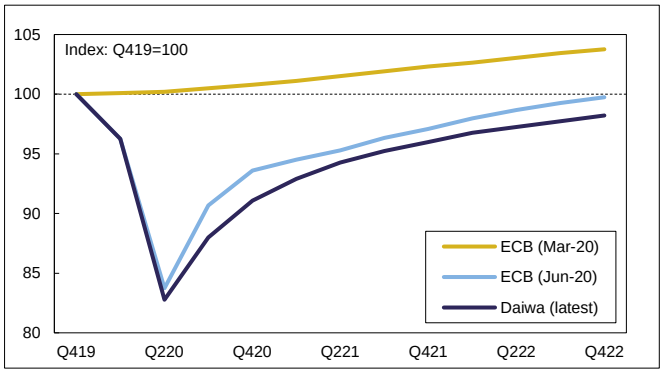
ECB gives €600bn boost to PEPP programme

As expected, at the conclusion of its latest policy meeting, the ECB today announced an increase and extension of its pandemic emergency purchase programme (PEPP). In particular, the total volume of assets to be purchased under the programme was increased by €600bn to €1.35trn. That amount was €100bn more than expected, and so BTPs rallied hard following the announcement. In addition to the increase in the PEPP envelope, the horizon of the programme was extended broadly in line with expectations to the end of June 2021 at the earliest. But the Governing Council added that the PEPP will last until it judges that the "coronavirus crisis phase" is over and so could yet be extended further. Moreover, it also announced that maturing principal payments from securities purchased under the PEPP will be reinvested until the end of 2022 at the earliest, while the subsequent roll-off of the PEPP portfolio will be managed in a way that avoids unintended consequences for the monetary stance. In terms of other policies, the ECB left its interest rate levels and forward guidance unchanged. The main disappointments were that the Governing Council failed to extend its range of securities purchased to include bonds of fallen angels, and – despite a marked recent increase in excess liquidity – also failed to increase its tiering multiplier to exempt a larger share of banks' reserves from the negative policy rate.

ECB expects to undershoot inflation target over the horizon

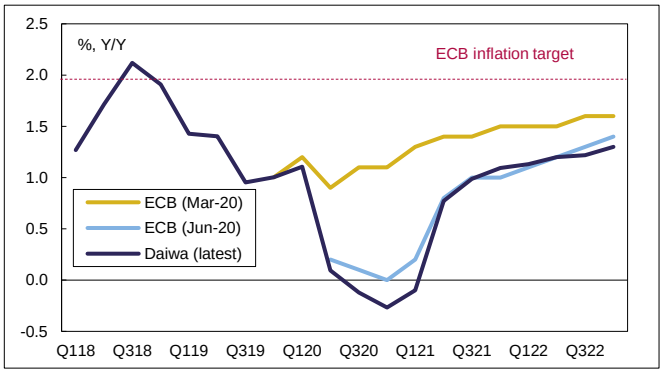
The ECB's updated projections, which were its first to take full account of the impact of the pandemic on economic activity, justified today's further easing of monetary policy. In particular, while it acknowledged that the outlook remains subject to an unusually high degree of uncertainty, the ECB revised down significantly its forecasts for GDP and inflation across the policy horizon. According to its baseline scenario, euro area economic output is forecast to drop an unprecedented 13.0%Q/Q in Q220 before rebounding 8.3%Q/Q in Q3 and gradually further over subsequent quarters. That, however, would see GDP decline a record 8.7%Y/Y in 2020, before rising 5.2%Y/Y in 2021, and 3.3%Y/Y in 2022. Importantly, the pre-coronavirus level of economic output would not be reached before 2023, with the risks still judged to be skewed to the downside. Meanwhile, the ECB's baseline scenario foresees headline inflation dropping to zero by the fourth quarter before rising from the start of 2021 as the negative impact of past falls in the oil price wears off. But due to the impact of large-scale economic slack (e.g. the unemployment rate is set to rise above 10%) core inflation is expected to decline further next year, and on average remain just 0.9%Y/Y in 2022. Headline inflation is expected to average just 1.3%Y/Y the same year, rising to just 1.4%Y/Y by Q422. So, by the end of the forecast horizon inflation, both headline and core, is strongly expected to remain well below the ECB's target of below but close to 2.0%Y/Y.

Euro area: GDP forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast



Source: ECB and Daiwa Capital Markets Europe Ltd.

Expect PEPP purchases to be increased again by year-end

In her post-meeting press conference, ECB President Lagarde emphasised that policy will continue to be determined by the inflation outlook. So, with all relevant inflation measures expected to remain well below target even by the end of 2022, the ECB's updated forecasts gave a strong signal that further policy stimulus will eventually be required. Indeed, if its purchases are maintained at the current pace, the newly increased PEPP envelope of €1.35trn will be exhausted in the course of Q121. So, we fully expect a further increase in the amount of assets to be bought under the PEPP to be announced by the end of the year, and most likely at the September meeting when the Governing Council will next update its projections. Meanwhile, one consequence of the large-scale asset purchases has been a steady rise in excess liquidity, which is currently up by more than €450bn since mid-March to close to €2.2trn. It seems bound to rise steadily further over coming quarters as asset purchases continue. So, an increase in the tiering multiplier to exempt a larger share of banks' reserves from the negative deposit rate still seems likely in due course too.

German government agrees welcome new fiscal stimulus

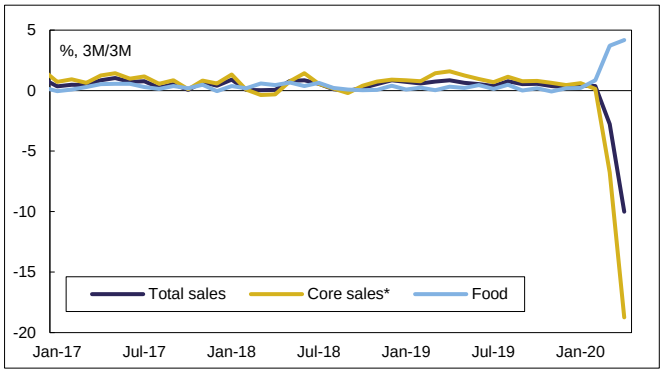
By capping yields, the ECB's asset purchases should provide member states with confidence that they can provide further fiscal support over coming quarters without provoking a bond market sell-off. Germany's government never had any fears of such a market response, and so was already able to provide the largest budgetary stimulus of all member states. And along with its better management of the health crisis, the federal government's initial €156bn supplementary budget and extra support via the economic stabilisation fund (WSF) and the national development bank (KfW) is a key reason why German economic activity has been far more resilient to the pandemic than the other large member states. Nevertheless, with unemployment set to rise further, and national GDP otherwise likely to fall by more than 6% this year, Germany's ruling coalition parties agreed last night to provide an additional stimulus of €130bn (close to 4% of annual national GDP) to be spread largely over the remainder of this year and next, with the vast majority of funds (€120bn) to be provided by the federal government. Key measures include:

- A temporary 3ppt cut in the main rate of VAT to 16% (which will apply to sales of cars among other items), and a 2ppt cut in the reduced rate to 5% (applying to items such as food), to be in place throughout the second half of this year.
- An increase in the government purchase incentives for electric and hybrid cars for cars costing up to €40k, and support to build charging stations and support battery cell production.
- A cut in the renewable energy surcharge to reduce electricity bills in 2021 and 2022.
- A one-off "children's bonus" of €300 per child to be paid to parents, as well as support for childcare, kindergartens and schools.
- With unemployment set to continue to rise, extra government support for the social security system to prevent a rise in employer and employee contributions.
- Support for hospitality businesses, cultural and non-profit organisations, and municipalities, as well as new business tax reliefs.

Will German stimulus be matched in other member states?

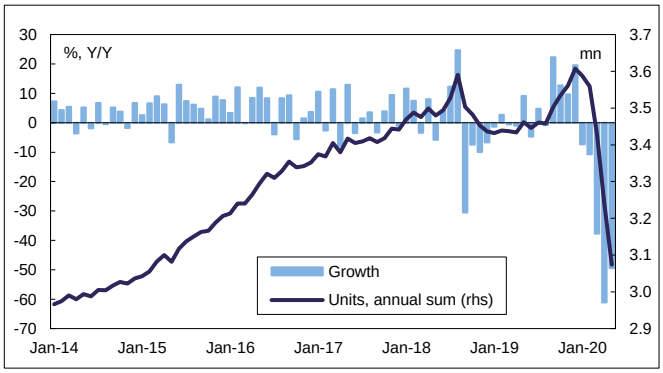
We caution that some of the extra spending, including support for SMEs, will draw from unused funds from the first stimulus package. Indeed, according to Finance Minister Scholz, some €60bn of those funds have yet to be allocated. And with the measures set to be spread over a couple of years, the extra Bund issuance required in 2020 will therefore be significantly less than the headline stimulus figure suggests. Nevertheless, the new package will provide substantive additional support to economic activity, particularly to German consumer spending. There will also hopefully be positive spillovers to demand in the rest of the euro area too. And while some (such as Italy) will remain far more constrained, other member state governments should strive to follow suit with additional fiscal stimulus of their own, particularly given the extra budgetary support likely to come over the coming few years from the forthcoming EU recovery funds. If they do, the risks to the ECB's economic projections need not be skewed quite so markedly to the downside.

Euro area: Retail sales



Excludes food and fuel. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany: New car registrations



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Retail sales post another double-digit decline

With much of the euro area in lockdown during April and only essential retailing permitted in many countries, today's retail sales figures for that month unsurprisingly reported another double-digit monthly pace of decline. While the 11.7%M/M drop was slightly smaller than had been expected, this still marked the steepest on record and left sales down 19.6% compared with a year earlier. The detail showed that spending on non-essential items predictably remained weak (-17%M/M), while fuel sales again fell sharply (-27.7%M/M) as restrictions limited the need to travel. But spending on food also reversed the more-than 5%M/M increase seen in March. As has been implied by national spending releases the weakness was widespread, with declines of about 20%M/M reported in France and Spain. While restrictions on non-essential retailers have gradually started to ease, the latest car registrations figures from various member states suggest that demand for big-ticket items remained extremely weak in May. Indeed, today's figures from Germany showed another steep annual drop in car sales last month of 49.5%Y/Y, with the 168k units marking the lowest outturn for the month of May since 1968.

Construction PMIs point to continued weakness

Today's construction PMIs from the member states provided further evidence that economic weakness remains broad-based despite the easing of lockdown measures. Admittedly, the headline indices rebounded from the lows seen in April, indicating a slower pace of contraction in Germany (up 8pts to 40.1) and France (up 28.6pts to 32.4). Meanwhile, Italy's PMI surged 46pts to 51.0, the strongest reading since April 2019, albeit still pointing to a very modest increase in activity. But new business continued to fall sharply in each of the three member states. And against the backdrop of anticipated weak demand in the face of heightened economic uncertainty, firms remained relatively pessimistic about the outlook for the year ahead too.

The day ahead in the euro area and US

The euro area's data flow tomorrow focuses principally on the manufacturing sector and is expected to confirm extreme weakness in activity at the start of Q2 as widespread factory closures added to a slump in demand both at home and from abroad. In particular, German factory orders for April are expected to have fallen around 20%M/M, while Spanish industrial production is expected to have declined 9.5%M/M in April. In addition, Italian retail sales data will confirm another sharp drop in April.

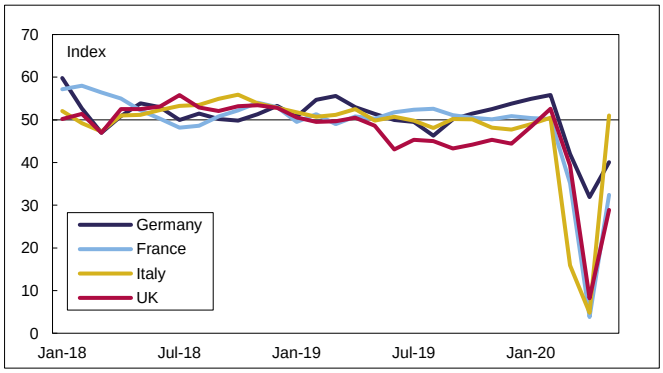
In the US, the week ends with the release of the May employment report, which is expected to show another notable drop in nonfarm payrolls, albeit to a significantly lesser extent than the decline of more than 20mn in April. As such, we expect the unemployment rate to jump close to 20%. Friday will also bring consumer credit figures for April.

UK

Car registrations record weakest May since 1952

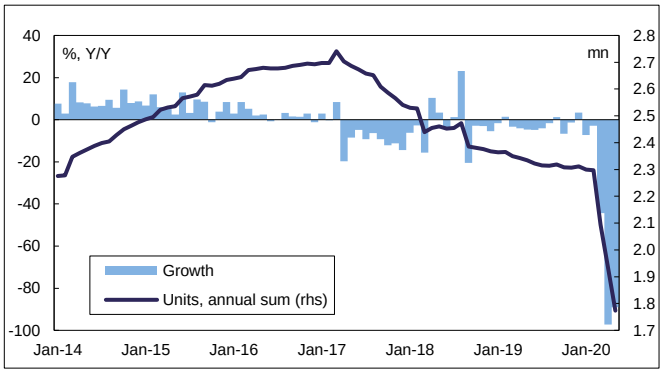
While the UK's construction and manufacturing sectors were encouraged back to work in the middle of last month, much of the country, including non-essential retailers, remained under strict lockdown measures. So, while some car dealerships offered a click-and-collect service, showrooms were closed throughout May. As a result, having fallen by more than 97%Y/Y in April, new car registrations remained extremely weak last month, down a further 89%Y/Y, at 20.2k units, the lowest level for the month of May since 1952. This by far exceeds the pace of decline seen in equivalent releases from the largest four euro area member states. And over the first five months of the year, this left UK car sales down more than 50% compared with the equivalent period in 2019 at a little more than 500k units, the lowest year-to-date number for the first five months of the year since 1971.

Europe: Construction PMIs in selected countries



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

UK: New car registrations



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Construction firms downbeat despite return to work

Despite the gradual reopening of building sites last month, today's construction PMI survey suggested that activity remained very weak. Despite the more-than 20pt rebound from April's single-digit reading, the headline index (28.9) stood at its second-lowest level since the height of the global financial crisis and below the equivalent survey indicators in the key euro area member states. Almost two-thirds of respondent firms indicated a decline in output last month, with survey indices suggesting that commercial activity declined at the steepest pace in May, albeit with all sub-sector sectors signalling a softer pace of decline than in April. New orders continued to fall at a rapid pace as potential clients pulled out of projects and new demand was absent. And so, construction firms continued to take advantage of the government's job retention scheme, with the sector's employment PMI at its third-lowest reading in the survey's 23-year history. Overall, against the backdrop of strict social distancing rules and economic uncertainty, UK construction firms remained extremely downbeat about the outlook for the coming year.

The day ahead in the UK

Tomorrow sees the final release of the GfK consumer confidence survey for May. The overall index is expected to edge lower to -34, from -33 in April, taking it just 5 points away from the record low of -39 recorded in July 2008. And with unemployment claims rising together with fears of a severe recession, we expect consumers to remain extremely cautious over coming months.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Retail sales M/M% (Y/Y%)	Apr	**-11.7 (-19.6)**	-15.0 (-20.6)	-11.2 (-9.2)	**-11.1 (-8.8)**
	ECB Main refinancing rate %	Jun	**0.00**	0.00	0.00	-
	ECB Marginal lending facility %	Jun	**0.25**	0.25	0.25	-
	ECB Deposit facility rate %	Jun	**-0.50**	-0.50	-0.50	-
Germany	Construction PMI	May	**40.1**	-	31.9	-
	New car registrations Y/Y%	May	**-49.5**	-	-61.1	-
UK	New car registrations Y/Y%	May	**-89.0**	-	-97.3	-
	Construction PMI	May	**28.9**	29.4	8.2	-

Auctions

Country	Auction
France	sold €5.1bn of 0% 2030 bonds at an average yield of 0.07%
	sold €3.7bn of 2.5% 2030 bonds at an average yield of 0.02%
	sold €2.2bn of 0.75% 2052 bonds at an average yield of 0.79%
Spain	sold €2.3bn of 0% 2023 bonds at an average yield of -0.215%
	sold €1.3bn of 0% 2025 bonds at an average yield of -0.028%
	sold €2.4bn of 0.5% 2030 bonds at an average yield of 0.55%
	sold €1.0bn of 1.85% 2035 bonds at an average yield of 0.945%
	sold €986mn of 0.15% 2023 index-linked bonds at an average yield of -0.572%

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	Factory orders M/M% (Y/Y%)	Apr	-19.9 (-29.7)	-15.6 (-16.0)
Italy	09.00	Retail sales M/M% (Y/Y%)	Apr	-20.0 (-)	-20.5 (-18.4)
Spain	08.00	Industrial production M/M% (Y/Y%)	Apr	-9.5 (-)	-11.9 (-12.2)
UK	00.01	Final GfK consumer confidence	May	-34	-33

Auctions and events

Country	BST	Auction / Event
Germany	-	German sovereign debt rating update by DBRS

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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