Euro wrap-up

Overview

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

- Bunds were little changed as the drop in euro area inflation close to zero in May was confirmed, as were precipitous declines in euro area car sales and construction output.
- Gilts made gains as data showed that UK inflation fell in May to its lowest level in almost four years.
- Tomorrow's UK monetary policy announcement seems bound to confirm that the BoE will buy at least £100bn of additional Gilts and corporate bonds.

Daily bond market movements

Bond	Yield	Change
BKO 0 06/22	-0.670	+0.001
OBL 0 04/25	-0.644	+0.002
DBR 0 08/30	-0.398	-
UKT 0½ 07/22	-0.057	-0.015
UKT 0⅝ 06/25	-0.012	-0.014
UKT 4¾ 12/30	0.190	-0.016

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

Euro area

Drop to near-zero inflation in May confirmed

The final estimates of inflation in May had minimal differences from the flash release and confirmed the decline of 0.2ppt in the headline rate to 0.1%Y/Y, the lowest rate since June 2016. The detail confirmed that the drop was principally due to lower energy inflation, which dropped more than 2ppts to -11.0%Y/Y, the lowest since 2009. In addition, food inflation fell back 0.2ppt from April's more-than-decade high to 3.4%Y/Y. Inflation of non-energy goods edged down 0.1ppt to an eight-month low of 0.2%Y/Y. But services inflation rose 0.1ppt to 1.3%Y/Y, and so core inflation was unchanged at April's level of 0.9%Y/Y, which had been the lowest in nine months. We continue to caution, however, that difficulties collecting data have eroded the quality of these inflation figures, with estimates of prices of more than one fifth of items, including more than one third of all services and almost one fifth of non-energy industrial goods, were imputed by the statisticians or judged to be of low reliability.

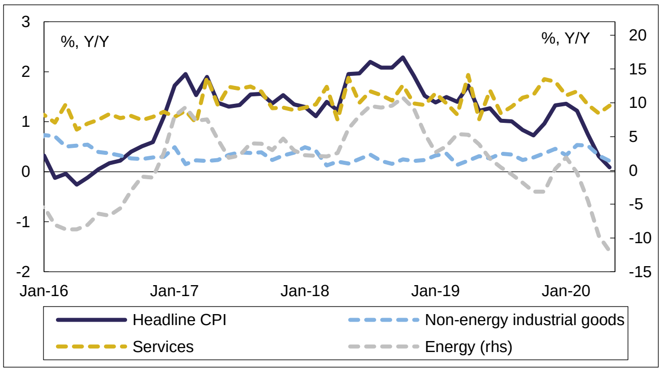
Disinflationary pressures to persist

Not least due to the low quality of the current estimates as well as the unpredictability of the pandemic and the response of businesses and consumers, the inflation outlook is more uncertain than usual. However, despite the rise in oil prices since late April, energy prices are still bound to continue to subtract significantly from the headline rate. And we expect firms, particularly in retail, hospitality and leisure, to have to offer sizeable discounts to try to attract custom. Moreover, as a significant share of workers currently furloughed is likely to become permanently unemployed, we expect wage growth to weaken significantly, further weighing on domestically generated inflation, particularly in services. So, despite supply-chain disruption and extra costs related to the need to maintain social distancing practices, disinflationary pressures will persist. We expect core inflation later this year to drop to series lows close to zero. And while the broad trend over coming months is likely to be sideways, we would not be surprised to see headline inflation dip slightly into negative territory at some point before next Spring, when energy inflation will eventually cease to act as a drag. Looking further ahead, with the level of GDP likely to remain below the pre-pandemic peak throughout 2022 and probably beyond, we expect underlying inflation to remain well below the ECB's aim of below but close to 2.0%Y/Y well into the medium term. So, the Governing Council will likely have to maintain net asset purchases well into 2022 too.

Construction collapses further in May

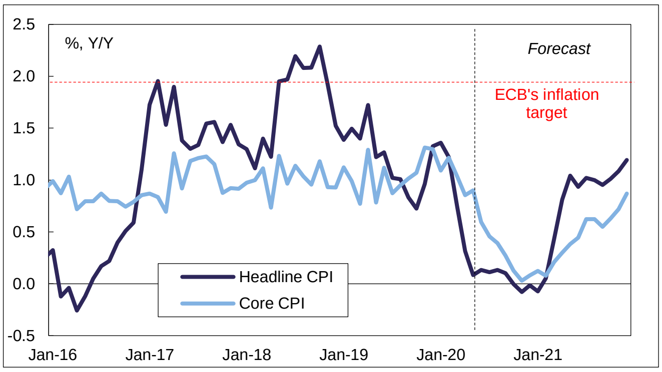
After a collapse in March (by a record -15.7%M/M), construction output in the euro area fell a further 14.6%M/M in April as lockdown measures continued to constrain activity. This left the level of output at its lowest on the 25-year series, and down

Euro area: Inflation – key components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation forecast



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

28.4% compared with a year earlier. The weakness was once again broad based, with building construction down a further 15½%M/M, while the decline in civil engineering work was somewhat more 'modest' at 10.0%M/M. Among the large member states, the steepest decline was once again seen in France (-32.6%M/M) to leave output more than 60% below January's level, while output in Spain fell a record 26%M/M. But consistent with surveys, the sector continued to fare relatively well in Germany, with output down just 4.1%M/M in April following an increase in March, to leave it merely at its lowest level since December. While the PMIs implied a more moderate rate of contraction in the sector in all member states in May, the Commission's survey suggested that orders across the region as a whole continued to plummet. And with demand for new projects expected to remain weak in the face of continued economic uncertainty, increased unemployment, weaker wage growth, more highly indebted firms and continued working from home, activity in the sector – whether in terms of residential or commercial work – seems bound to remain subdued for some time to come.

New car registrations down by more than half in May

Finally, new car registrations in the euro area remained extremely weak in May, falling 52.4%Y/Y to just 502k units, by far the lowest outturn for May since the series began in 1989. After the steeper drop of 79.6%Y/Y in April, when lockdown restrictions were most stringent, this left sales in the year to May down more than 43%YTD/Y, at just 2.8mn. Double-digit declines were seen in all member states, with Spain again worst affected among the larger member states (down 72.7%Y/Y and more than 50%YTD/Y), while declines in excess of 70%Y/Y were also seen in Portugal and Ireland. Registrations in Germany, France and Italy were all down by roughly a half from a year earlier. Higher unemployment and low consumer confidence will act as ongoing headwinds. However, sales seem bound to pick up over coming months, particularly in Germany where the 3ppt cut in VAT and incentives to purchase electric and hybrid vehicles will support demand, while Spain's government yesterday followed France by also announcing new car purchase and production subsidies.

The day ahead in the euro area and US

Tomorrow should be a fairly quiet day for euro area economic news, with just the ECB's Economic Bulletin and Italian trade data for April due for release. Meanwhile, in the markets, France and Spain will auction a number of fixed-rate and index-linked bonds. In the US, the usual weekly claims numbers will be accompanied by the Philadelphia Fed index for June and leading indicators for May. In other news, the US Treasury will sell $15bn of 5Y TIPS.

UK

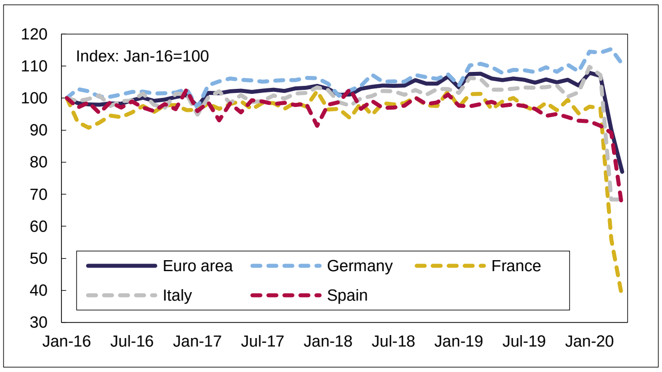
Inflation at lowest in almost four years

Broadly in line with expectations, UK inflation weakened in May as the lagged effects of earlier falls in global oil prices pushed petrol prices lower and as the pandemic weighed on prices of certain other goods. In particular, headline CPI inflation dropped 0.3ppt to 0.5%Y/Y, the lowest level since June 2016. And core inflation dropped 0.2ppt to 1.2%Y/Y, the lowest since October 2016. As elsewhere in Europe, however, restrictions on economic activity created difficulties collecting data, requiring a large number of prices to be inputed by the statisticians. Excluding such items, the ONS stated that headline inflation would have been 0.1ppt lower at just 0.4%Y/Y.

All prices subdued, except for food

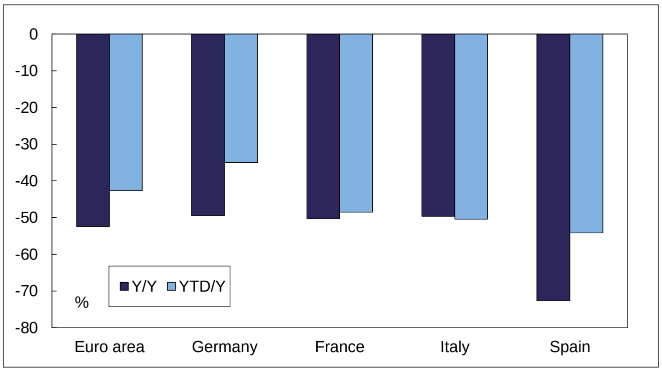
Within the detail, energy inflation dropped more than 2ppts to -11.6%Y/Y, a series low. Not least due to lower prices of computer games and consoles and other recreational items, as well as furniture and other household equipment, inflation of non-energy industrial goods fell 0.4ppt to 0.1%Y/Y. Inflation of food and beverages rose 0.4ppt to 2.1%Y/Y as higher lockdown demand provided a boost. And services inflation edged down 0.1ppt to a series low of 1.9%Y/Y, although the underlying weakness was likely greater than implied by this figure given the need for the statisticians to impute data for a large share of items.

Euro area: Construction output by member state



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Car registrations by member state*



**May 2020. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

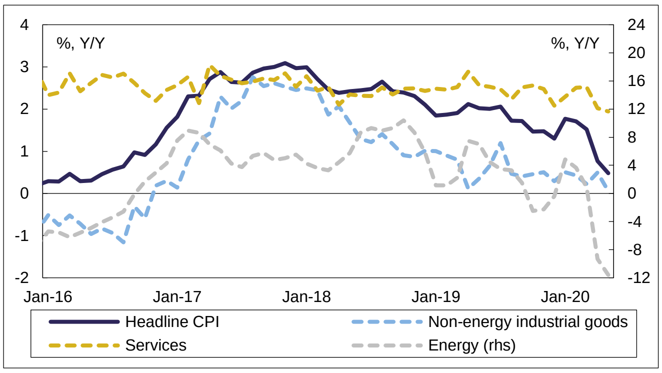
Inflation to drop over near term but post-Brexit policy represents upside from January

Looking ahead, energy inflation is likely to pick up over the near term in response to higher global oil prices. But the impact of the pandemic on demand for non-energy industrial goods and services will likely push both core and headline inflation closer to zero towards the end of the year. Thereafter, much will depend on both the profile of the pandemic and the ongoing negotiations between the UK and EU on a post-Brexit trade agreement. Failure to conclude a trade deal, resulting in the imposition of tariffs on imports from the bloc from 1st January – including a 10% rate on cars and a range of new tariffs on food items – represents a significant upside risk to UK inflation as well as a significant downside risk to UK economic growth. Our baseline forecast, however, assumes that agreement will eventually be reached on a relatively minimalist deal that sees UK PM Boris Johnson make late concessions to the EU to avoid such disruption. On that basis, headline and core inflation is expected to pick up gradually from Spring 2021, rising back above 1.0%Y/Y but still well below the BoE's target by year end. Given Johnson's repeated lack of judgement, as well as the populist urges of his closest advisers and many in his Cabinet, however, the disorderly outcome can certainly not be ruled out.

The day ahead in the UK

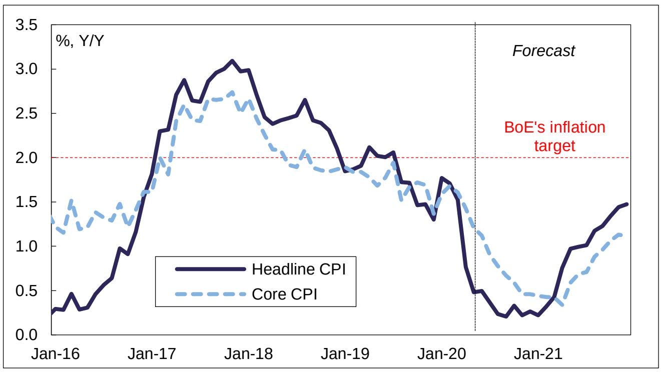
The highlight tomorrow will undoubtedly be the BoE's monetary policy announcement, now back to the usual time of 12:00 BST. While the MPC over recent months eased policy in several ways to support the economy – including reducing Bank Rate to an all-time low of 0.1%, restarting QE with an extra £200bn of purchases of Gilts and sterling corporate bonds, and implementing a new lending facility – the extreme hit to activity in March and April and weak inflation outlook would suggest that more stimulus is required. Indeed, responding to last week's GDP data, Governor Andrew Bailey stated that the Bank had to be "ready to take action". With the current asset purchase target of £645bn set to be reached by the start of next month, the MPC is highly likely to announce an extra package of at least £100bn of purchases of Gilts and sterling corporate bonds. And the risk of persistently low inflation might well intensify the debate among policy makers of the need for additional measures. So, a further cut in Bank Rate to zero on this occasion cannot be ruled out, nor can amendments to the Term Funding Scheme to support lending to SMEs. Meanwhile, Deputy Governor Broadbent and external MPC member Tenreyro will subsequently participate in a virtual workshop on the macro-prudential regulation of households.

UK: Inflation – key components



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Inflation forecast



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		EU-27 new car registrations Y/Y%	May	**-52.3**	-	-76.3	-
		Final CPI (core CPI) Y/Y%	May	**0.1 (0.9)**	0.2 (0.9)	0.3 (0.9)	-
		Construction output M/M% (Y/Y%)	Apr	**-14.6 (-28.4)**	-	-14.1 (-15.4)	**-15.7 (-17.5)**
Italy		Industrial orders (sales) Y/Y%	Apr	**-49.0 (-46.9)**	-	-26.6 (-25.2)	**- (-25.3)**
UK		CPI (core CPI) Y/Y%	May	**0.5 (1.2)**	0.6 (1.3)	0.8 (1.4)	-
		PPI input prices (output prices) Y/Y%	May	**-10.0 (-1.4)**	-8.6 (-1.2)	-9.8 (-0.7)	**-10.2 (-)**

Auctions

Country		Auction
Germany		sold €4.1bn of 2030 bonds at an average yield of -0.38%
UK		sold £3.75bn of 0.125% 2023 bonds at an average yield of 0.021%
		sold £2.25bn of 1.25% 2041 bonds at an average yield of 0.596%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Italy		09.00	Total trade balance €bn	Apr	-	5.7
UK		07.00	BoE Bank Rate %	Jun	0.10	0.10
		07.00	BoE gilt and corporate purchase bond target £bn	Jun	*745*	645

Auctions and events

Country		BST	Auction / Event
EMU		09.00	ECB publishes its Economic Bulletin
France		09.50	Auction: 0% 2023 bonds
		09.50	Auction: 0% 2025 bonds
		09.50	Auction: 0% 2026 bonds
		09.50	Auction: 0.75% 2028 bonds
		10.50	Auction: €2.5bn of 0.1% 2026 index-linked bonds
Spain		09.45	Auction: 0% 2023 bonds
		09.45	Auction: 0% 2025 bonds
		09.45	Auction: 5.9% 2026 bonds
		09.45	Auction: 1.25% 2030 bonds
UK		12.00	Bank of England interest rate and asset purchase programme target announcement

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.