

Euro wrap-up

Overview

- Bunds were little changed while the estimate of core inflation in April was revised down.
- Gilts made gains as UK inflation picked up broadly in line with expectations.
- Thursday will bring data for euro area construction output and German producer prices as well as a survey of UK manufacturers.

Chris Scicluna

+44 20 7597 8326

Daily bond market movements

| Bond | Yield | Change |
|---|--------|--------|
| BKO 0 03/23 | -0.667 | -0.006 |
| OBL 0 04/26 | -0.511 | -0.001 |
| DBR 0 02/31 | -0.113 | -0.007 |
| UKT 0 ¹ / ₈ 01/23 | 0.061 | -0.017 |
| UKT 0 ¹ / ₈ 01/26 | 0.365 | -0.017 |
| UKT 4 ³ / ₄ 12/30 | 0.840 | -0.026 |

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

Source: Bloomberg

Euro area

Core inflation in April softer than previously thought

As expected, the final estimates of inflation in April confirmed the 0.3ppt rise in the headline rate to 1.6%Y/Y, the highest since April 2019. However, the detailed data were revised slightly from the initial estimates to suggest even greater underlying weakness than previously thought. Of course, the rise in headline inflation was still driven principally by energy inflation, which – largely due to base effects associated with the plunge in oil prices a year ago – accelerated 6.1ppts to 10.4%Y/Y, 0.1ppt above the initial estimate and the highest since October 2018. As a result, energy prices contributed 1.0ppt to the headline rate of inflation. In contrast, food inflation fell 0.5ppt to 0.6%Y/Y, slightly further than previously thought and the lowest since October 2016. Prices of non-energy industrial goods rose just 0.4%Y/Y, less than the initial estimate and up just 0.1ppt from March, underscoring that the supply-side pressures highlighted in recent survey indicators continue to be largely absorbed by margins. And with pandemic restrictions continuing to hit activity, services inflation fell 0.4ppt to a four-month low of 0.9%Y/Y. As a result, core inflation moderated more than previously thought, dropping 0.2ppt to 0.7%Y/Y, bang in line with the average of the preceding twelve months.

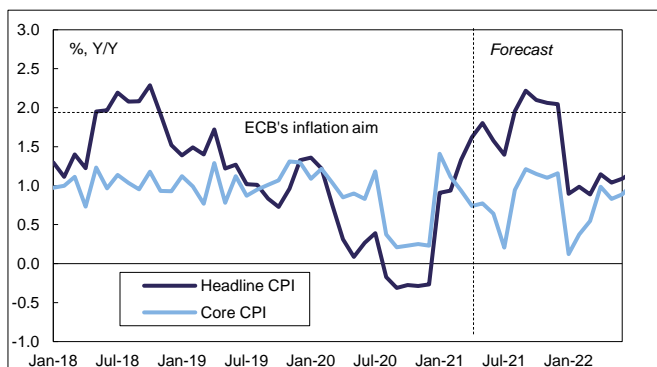
Inflation outlook still looks subdued

Looking ahead, energy inflation will rise again in May, probably to above 12%Y/Y. And so, while core inflation is likely to remain steady, headline CPI will increase further, probably to around 1.8%Y/Y next month. Changes to the timing of sales in certain countries will likely inject some volatility over the subsequent couple of months. And base effects associated with last year's cut in German VAT will likely push inflation up further to 2.0%Y/Y or above between August and December. Thereafter, policymakers will hope that the economic recovery will allow firms to rebuild margins and push prices higher. However, with large amounts of slack likely to persist in the labour market, wage pressures will likely remain subdued. And there is little evidence that firms will dare to pass price pressures from supply bottlenecks onto consumers in any substantive way. So, the ECB will judge the current rise in inflation to be transitory, and will expect both headline and core inflation to fall back in January and remain well below the ECB's current target of close to 2.0%Y/Y thereafter. And, even if the conclusions of the ECB's ongoing strategic policy review do not mimic the Fed in calling for a period of above-target inflation, the outlook will still merit highly accommodative policy – including ongoing net asset purchases – throughout next year and probably beyond.

French retail sales down sharply in April on tighter restrictions

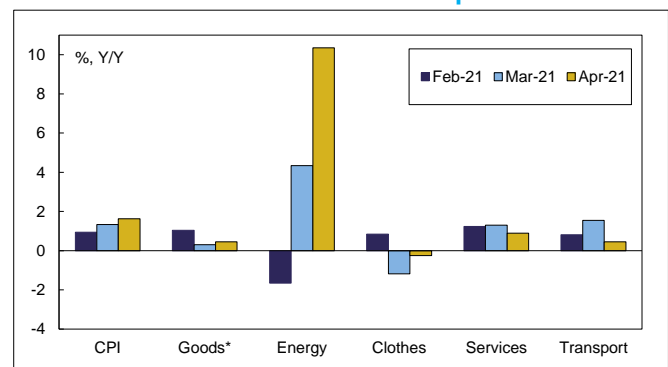
Perhaps inevitably, the latest French retail sales survey from the Bank of France pointed to renewed weakness last month in response to the tightening of pandemic containment measures. In particular, the survey's measure of sales was down

Euro area: Inflation forecast



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation – selected components



*Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

7.1%M/M in April after rising almost 1.0%M/M in March. Sales of non-food items were down a steep 25.7%M/M last month after rising 1.2%M/M in March. In contrast, food sales rose 2.1%M/M in April having dipped 0.7%M/M the prior month. Within the detail, sales of furniture fell a sharp 46.8%M/M last month while those of textiles and clothing were down 26.3%M/M. Compared to the pre-pandemic level in January 2020 overall sales were down 7.6%, representing a far more modest retrenchment than seen in other “lockdown” months (e.g. sales had dropped 24.4% on the same basis in November 2020 and 33.8% in April last year). And given the reopening of non-essential stores from today, we expect to see a rebound in total sales in May and June.

Euro area new car registrations still well below pre-pandemic levels in April

Meanwhile, as suggested by the national data, having near-doubled in March compared to a year earlier, car registrations in the euro area rose a whopping 265%Y/Y last month according to the ACEA manufacturers’ association. However, at 741.8k units, the level of new registrations was still almost 25% lower than in the same month in 2019, and about 16% below the April average in the decade ahead of the pandemic. The picture was similar across the large member states, e.g. with registrations in Germany (up 90.0%Y/Y) and France (up 568.8%Y/Y) still down about one quarter from the level in April 2019 and about one fifth below the average level for the month throughout the 2010’s. Indeed, on a seasonally adjusted basis, the ECB estimates that new car registrations were little changed in April for a second successive month, dropping 0.4%M/M following a rise of just 0.2%M/M in March. And that left them 0.6% below the average level in Q1, when they dropped almost 20% from Q4.

The day ahead in the euro area

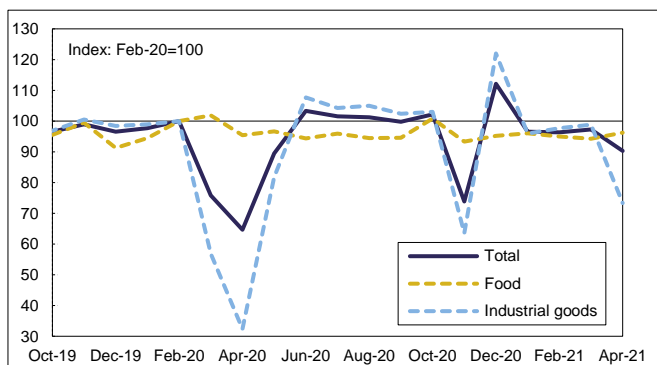
Tomorrow brings the release of German producer price data for April and euro area construction output figures for March. The headline German PPI is expected to jump 1.4ppts to 5.1%Y/Y, the highest level in ten years, thanks primarily to higher energy prices. But core inflation is also expected to rise, reflecting higher prices of raw materials and intermediate goods, particularly of metals, which have been boosted by firmer demand, increased global prices of iron ore and ongoing supply-chain challenges. Meanwhile, following a drop of 2.1%M/M in February, we will see a rebound in euro area construction output in March. Indeed, construction output in Germany rose more than 10%M/M that month. But the growth in March will likely result in activity in the sector being little changed over Q1 as a whole compared with Q4 when construction output rose 0.7%Q/Q. In other news, ECB President Lagarde and Chief Economist Lane will both speak publicly on separate panel discussions tomorrow.

UK

Inflation up to 13-month high on energy and clothes prices

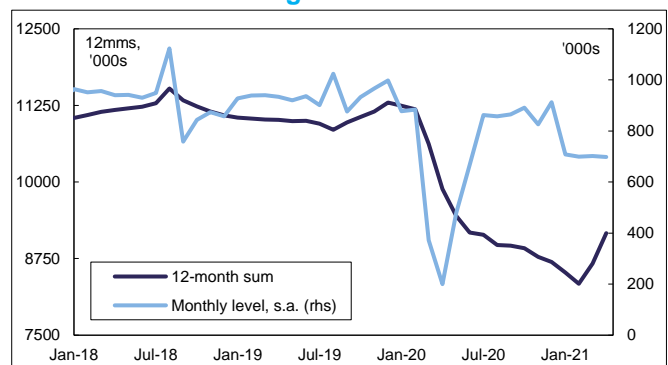
Broadly in line with expectations, UK CPI inflation rose a hefty 0.8ppt in April to a 13-month high of 1.5%Y/Y. The increase was partly due to higher domestic energy bills following the increases in Ofgem’s regulated price caps. Indeed, electricity inflation rose more than 8ppts to 5.5%Y/Y while gas inflation rose more than 10ppts, albeit remaining in negative territory at -4.1%Y/Y. In addition, petrol prices were up more than 15%Y/Y, an increase of 11.5ppts from March, not least reflecting base effects from April last year when pump prices fell by a record monthly amount. So, having dropped more than 4½%M/M in April last year, energy prices rose more than 5%M/M last month, pushing the annual rate for the component almost 10ppts higher to a 2-year high of 7.4%Y/Y. Clothes prices also made a contribution to the increase in inflation in April, rising 4.0ppts to 0.5%Y/Y, the highest in more than a year, as retailers brought prices more closely in line with norms for the time of year, and consumers were able to return to the shops and look forward to reopening of hospitality and leisure activities. So, inflation of non-energy industrial goods rose 0.4ppt to 1.1%Y/Y. And with inflation of services edging up 0.1ppt to 1.6%Y/Y, core inflation increased 0.2ppt to 1.3%Y/Y. That, however, was bang in line with the average of the previous twelve months, suggesting that underlying inflation remains relatively subdued.

France: Bank of France retail sales indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: New car registrations



Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

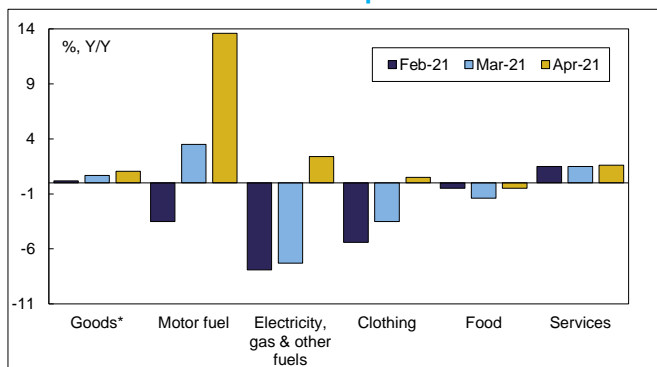
Clear upside risks over the near term, but inflation should be close to target at end-2022

We expect a similar combination of higher energy and clothes components to push headline inflation up further in May to 1.8%Y/Y, which would be the highest since January last year. And a rise in headline inflation above 2.0%Y/Y from August into the first few months of next year seems highly likely too as the impacts of last year's hospitality VAT reduction and Eat Out to Help Out scheme reverse. Indeed, CPI inflation on a constant tax basis rose in April to a nine-year high of 3.25%Y/Y. In addition, producer price inflation rose ahead of expectations in April, with the output PPI rate up 1.6ppts from an upwardly revised March reading to a 2½-year high of 3.9%Y/Y, and input PPI inflation up 3.5ppts from a similarly upwardly revised March reading to a 4-year high of 9.9%Y/Y. With the economic recovery becoming increasingly vigorous as firms continue to reopen, there appear clear upside risks to the near-term outlook for goods and services inflation if and when firms become emboldened to pass on some of their increased costs to consumers. However, unless we see second-round effects on wages and price expectations, we would fully expect headline and core inflation to fall back close to the BoE's 2.0%Y/Y target by the end of next year.

The day ahead in the UK

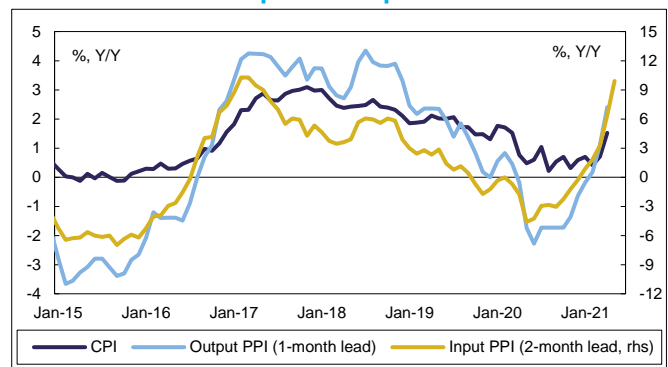
Looking ahead, tomorrow brings the release of the CBI Industrial Trends Survey, which is expected to reveal a further improvement in manufacturing optimism in the three months to May, as the phased reopening in the UK has lifted the mood among firms. In particular, the measures of new orders, employment and investment plans are all likely to improve. However, the survey is again also expected to highlight firms' concerns about rising costs.

UK: Inflation – selected components



*Non-energy industrial goods. Source: ONS, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Consumer and producer price inflation








Source: Refinitiv and Daiwa Capital Markets Europe Ltd.



European calendar

Today's results

Economic data

| Country | Release | Period | Actual | Market consensus/ <i>Daiwa forecast</i> | Previous | Revised |
|---------|---|--------|------------------|--|-----------|------------------|
| EMU |  EU27 new car registrations Y/Y% | Apr | 218.6 | - | 87.3 | - |
| |  Final CPI (core CPI) Y/Y% | Apr | 1.6 (0.7) | 1.6 (0.8) | 1.3 (0.9) | - |
| UK |  CPI (core CPI) Y/Y% | Apr | 1.5 (1.3) | <u>1.6 (1.5)</u> | 0.7 (1.1) | - |
| |  PPI input prices (output prices) Y/Y% | Apr | 9.9 (3.9) | 8.5 (3.4) | 5.9 (1.9) | 6.4 (2.3) |
| |  House price index Y/Y% | Mar | 10.2 | 7.7 | 8.6 | 9.2 |


Auctions

| Country | Auction |
|---------|--|
| Germany |  sold €3.36bn of 0% 2031 bonds at an average yield of -0.09% |
| UK |  sold £2.5bn of 0.625% 2035 bonds at an average yield of 1.264% |












Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

| Country | BST | Release | Period | Market consensus/ <i>Daiwa forecast</i> | Previous |
|---------|---|--|--------|--|-------------|
| EMU |  09.00 | ECB current account balance €bn | Mar | - | 25.9 |
| |  10.00 | Construction output M/M% (Y/Y%) | Mar | - | -2.1 (-5.8) |
| Germany |  07.00 | PPI Y/Y% | Apr | 5.1 | 3.7 |
| UK |  - | CBI industrial trends survey, total orders | May | 0 | -8 |

Auctions and events

| | | |
|--------|---|--|
| EMU |  10.00 | ECB Chief Economist Lane participates in a panel discussion at the Institute of International and European Affairs |
| |  13.00 | ECB President Lagarde participates in a panel discussion on 'Gender, Money and Finance' |
| France |  09.50 | Auction: 0% 2027 bonds |
| |  09.50 | Auction: 0% 2024 bonds |
| |  09.50 | Auction: 0.75% 2028 bonds |
| |  10.50 | Auction: 0.1% 2032 index-linked bonds |
| |  10.50 | Auction: 0.1% 2036 index-linked bonds |
| Spain |  09.30 | Auction: 0% 2024 bonds |
| |  09.30 | Auction: 0% 2028 bonds |
| |  09.30 | Auction: 0.1% 2031 bonds |
| UK |  10.05 | Deputy BoE Governor Cunliffe to speak at the Law Society |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

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

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited. Daiwa Capital Markets Europe Limited is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange and Eurex Exchange. Daiwa Capital Markets Europe Limited and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of Daiwa Capital Markets Europe Limited and its affiliates may have positions and effect transactions in such securities or options and may serve as Directors of such issuers. Daiwa Capital Markets Europe Limited may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended for investors who are MiFID 2 Professional (or equivalent) Clients and should not therefore be distributed to such Retail Clients. Should you enter into investment business with Daiwa Capital Markets Europe's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

Daiwa Capital Markets Europe Limited has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at <http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory>. Regulatory disclosures of investment banking relationships are available at <https://daiwa3.bluematrix.com/sellside/Disclosures.action>.