Euro wrap-up

Overview

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- While BoE Deputy Governor Ramsden warned of the likelihood of more rate hikes to come as the tight labour market added to inflation risks, Gilts made gains as data confirmed a marked slowdown in UK GDP over the course of Q1.
- Amid heightened global risk aversion, Bunds also made sizeable gains.
- Friday brings euro area industrial production figures for March, along with final estimates of French and Spanish inflation for April.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	0.048	-0.079
OBL 0 04/27	0.534	-0.119
DBR 0 02/32	0.867	-0.113
UKT 1 04/24	1.204	-0.083
UKT 1¼ 07/27	1.330	-0.118
UKT 4¼ 06/32	1.690	-0.135

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

UK

GDP up 0.8%Q/Q in Q1, but down in March with extra weakness to come

At face value, UK GDP growth of 0.8%Q/Q in Q1 might appear respectable, with the level of economic output pushed 0.7% above the pre-pandemic level in Q419 to be up 8.7%Y/Y. However, this was the softest pace in four quarters, and all the growth in Q1 came in January thanks principally to the relaxation of pandemic restrictions. In contrast, following a downwards revision, economic output was unchanged on the month in February. And GDP dropped 0.1%M/M in March as services and industrial output retreated (both down 0.2%M/M) while construction provided some support (up 1.7%M/M). The weakness in February and March gives a taste of what to expect from now on. With real disposable incomes falling sharply, we forecast a slight decline in GDP in Q2 and a further step down before year-end if and when the regulated energy price cap is hiked again in October. The downbeat GDP outlook is one reason why we expect the BoE to end its tightening cycle after one further 25bps rate hike in August, and why we also expect inflation to fall back steadily over the coming year. One uncertainty, however, is fiscal policy, with media reports today suggesting the possibility of the belated announcement of additional support for households in the summer, after government ministers had as recently as yesterday refused to countenance such action.

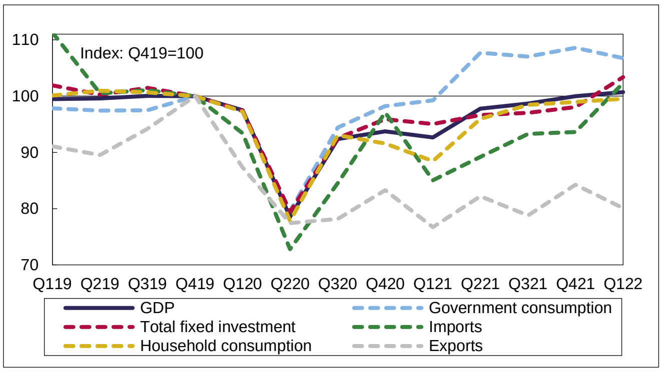
Q1 growth led by private consumption with business capex still in post-Brexit slump

A closer look at the expenditure detail in Q1 should add to concerns about the UK economic growth outlook, not least as a key driver of final demand was private consumption, which rose 0.6%Q/Q. Households increased spending on hospitality and clothes, among other things, as opportunities for socialising increased and more workers returned to their offices. But private consumption – which seems highly likely to weaken over coming quarters given falling purchasing power – was still some 0.5% below the pre-pandemic level. Public investment also gave a non-negligible boost to growth in Q1, rising at an unsustainable 23.6%Q/Q, the most in almost two decades. But despite tax incentives, business investment maintained its dire post-Brexit performance, down 0.5%Q/Q to be 9.1% below the pre-pandemic level and still more than 10% below the level in the quarter following the referendum in mid-2016. Government consumption also fell (-1.7%Q/Q) as the public health response to the pandemic started to be scaled back – a process that is continuing in Q2.

Trade deficit up to record high as exports fall back closer to Covid low

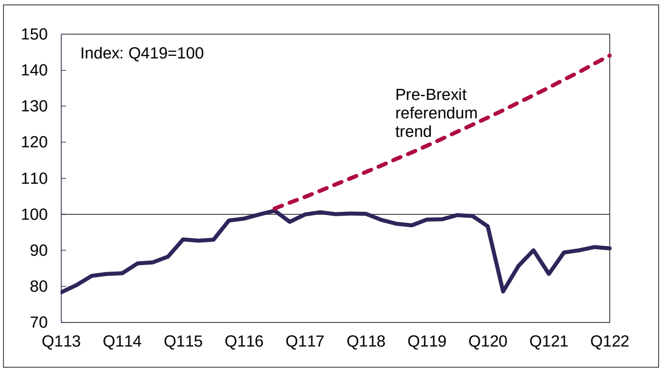
Strikingly, net exports subtracted more than 4ppts from GDP growth in Q1 as the trade deficit blew out to a record 5.3% of GDP (4.1% of GDP excluding non-monetary gold). Import volumes surged 9.3%Q/Q but exports plunged 4.9%Q/Q to be almost 20% below the pre-pandemic level in Q419 and less than 5% above the Covid-era low. In part, the additional

UK: GDP and selected expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Business investment



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

weakness of exports likely reflects the imposition of Brexit-related customs controls on shipments to the EU from January, although data collection issues complicate the picture. Regardless, exports of a range of goods and services – including the important transport equipment, machinery and financial services categories – were all down. Analysis by the LSE suggests that Brexit has already led to a significant drop in the number of trading relationships between the UK and EU, with the new barriers to trade particularly hitting the ability of the smaller firms to export and grow. And by gradually removing the UK from EU supply chains, Brexit appears to have weighed on exports beyond the EU as well as to the region itself. Certainly, unlike the other major economies, the UK missed out on last year's strong rebound on global trade, which augurs badly for the coming quarters as the global growth outlook clouds.

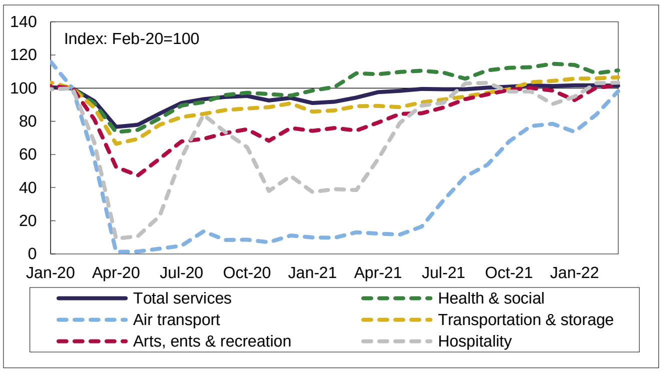
Expert in trade and Brexit impact nominated to MPC as replacement for BoE hawk

Perhaps fortuitously, inventory accumulation largely offset the negative impact on GDP growth from net trade in Q1, adding 3.9ppts as wholesalers and retailers both increased stocks – a large share of them no doubt sourced from abroad. Looking ahead, the extreme contributions from net trade and inventories are highly unlikely to be repeated over coming quarters. But over the year as a whole, just as in 2021, net trade seems bound again to subtract from GDP growth this year and next. So, in light of the continued woeful performance of exports, the UK government's ongoing threats to suspend the Northern Ireland Protocol of the Brexit Withdrawal Agreement – which imposed trade barriers between Great Britain and Northern Ireland – and risk retaliation in the form of targeted new barriers to trade with its main trading partner, the EU, would seem extremely ill-judged. And it was perhaps notable that today the Chancellor appointed an expert in trade economics and the adverse impacts of Brexit on the UK supply side – LSE Professor Swati Dhingra – as a new external member of the MPC from 9 August to replace Michael Saunders, one of the Committee's most hawkish members.

UK house price growth remains strong (for now) as supply-demand imbalance persists

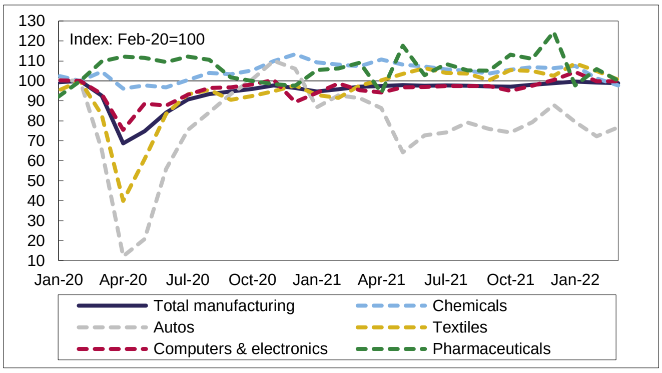
While economic growth has levelled off with GDP more than 3½% below the pre-pandemic trend, the UK economy continues to display evidence of shortfalls of supply relative to demand in several different ways. For example, in housing, despite falling household disposable incomes and an increase in borrowing costs – the latest BoE-quoted rate for a 2-year fixed 75% LTV mortgage rose in April to its highest since 2014 – the RICS residential survey today reported another month of strong house price growth in April due to the ongoing supply-demand imbalance. The headline price balance jumped 6ppts to 80%, a ten-month high, with the respective balance in London (71%) the highest for more than eight years. With new sales instructions largely stagnant in April and the average stock still near record lows, and new buyer enquiries continuing to increase (albeit modestly compared with a year ago), surveyors remained broadly optimistic about the outlook for house prices over the coming three months. But the outlook further ahead was less upbeat, with sales expectations over the

UK: Services output



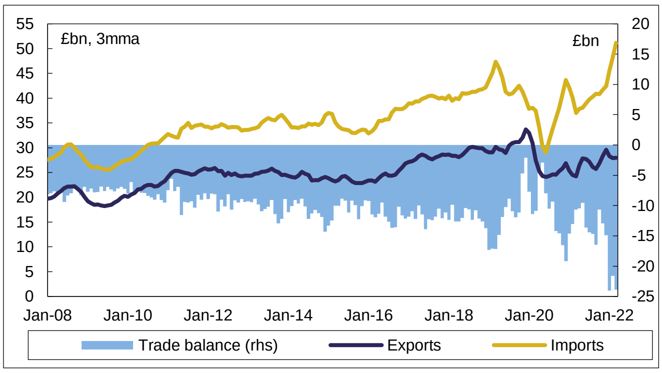
Source: Refinitiv, ONS and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output



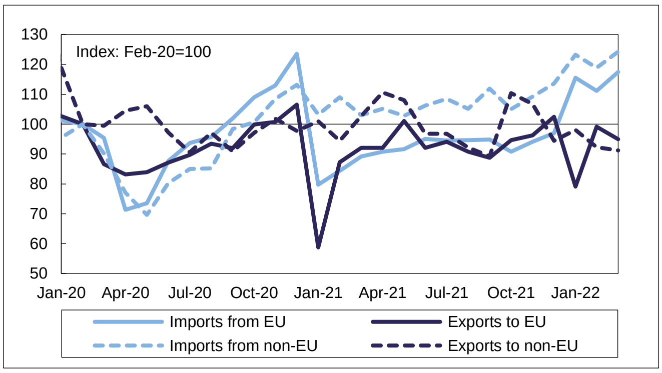
Source: Refinitiv, ONS and Daiwa Capital Markets Europe Ltd.

UK: Trade balance*



**Export and import values. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Exports and import volumes by destination



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

coming twelve months having fallen for the fourth consecutive month, while price expectations for twelve months ahead eased to the lowest since last June.

Shortage of labour supply continues to add upwards pressure on starting salaries

Meanwhile, according to the latest KPMG and REC report on jobs, the UK labour market remains very tight too, a source of domestically-generated cost pressure for businesses and consistent with the need for further monetary policy tightening. Recruitment reportedly continued to rise at a robust pace in April. But while the survey's measure of labour demand was among the strongest on the series, a shortage of candidates restricted growth in overall placements last month, with the respective index for permanent placings the lowest for thirteen months. Indeed, although the pace of decline in April was the softest for three months, overall availability of candidates fell for the fourteenth consecutive month amid fewer foreign workers and reluctance of workers to move jobs against the backdrop of heightened economic uncertainty. So, the ongoing imbalance in the labour market continued to add substantial upwards pressure to starting salaries, with the respective survey index only marginally softer than March's survey record.

The day ahead in the UK

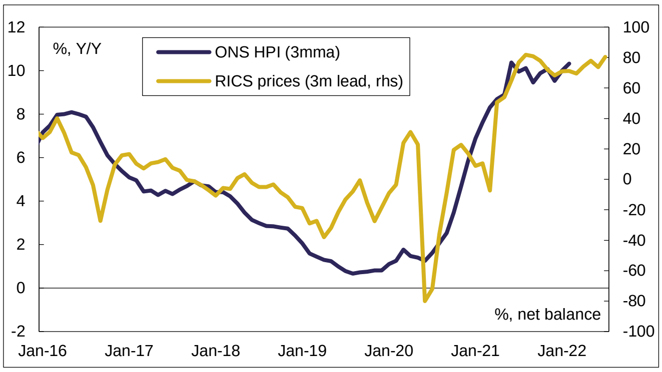
It should be a quiet end to the week for UK economic news, with no top-tier releases due on Friday.

Euro area

BoF survey points to only modest French GDP growth in Q2

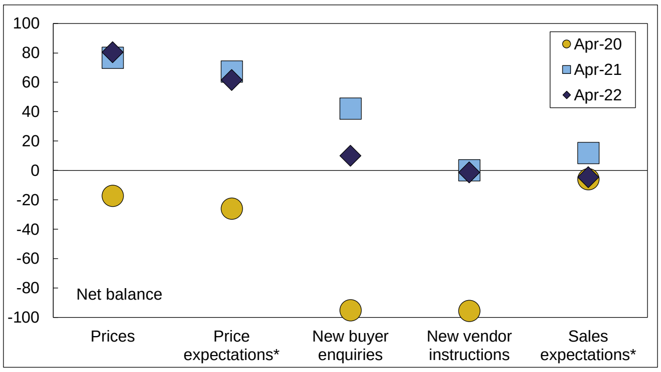
After the [euro area's second-largest economy] failed to grow in the first quarter, the Bank of France's latest monthly economic update, published yesterday, signalled a relatively subdued start to the second quarter. While manufacturing output jumped in Q1 (2.2%Q/Q), the BoF's survey suggested that activity moved broadly sideways in April and was expected to increase only slightly in May, with the impact of the Ukraine conflict and China lockdowns continuing to exacerbate supply bottlenecks. Around 65% of manufacturers and more than half of construction firms suggested that supply difficulties had limited output last month, with that share substantially higher in chemicals (+73%), aircraft (78%) and autos (85%), although the latter had eased slightly from March. And so, the survey showed autos production declining for the fourth consecutive month, while producers of electrical and general machinery were more acutely impacted by the closure of the port in Shanghai. Construction activity was also assessed to have fallen in April. In contrast, reflecting the ongoing normalisation following the latest pandemic wave and return of overseas visitors, services activity continued to improve, with hospitality and car rentals

UK: House price indicators



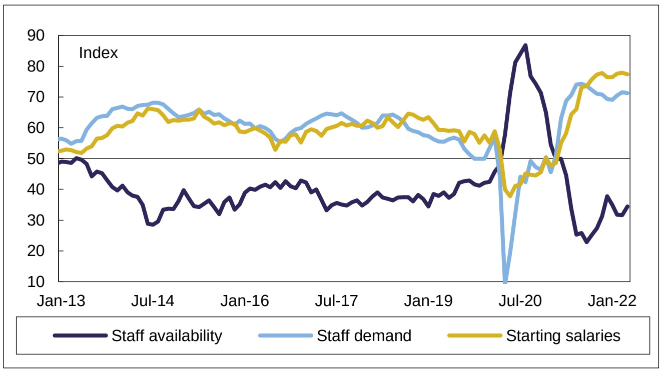
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: RICS residential survey indicators



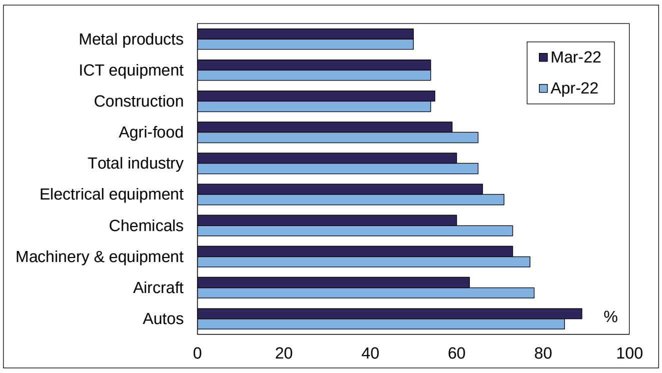
**Twelve-months ahead. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: REC/KPMG labour market survey indicators



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

France: Share of firms reporting supply difficulties



Source: BoF and Daiwa Capital Markets Europe Ltd.

recording sizeable increases. This notwithstanding, overall, the BoF's survey pointed to only modest improvement in economic activity in April and May, with its updated forecast suggesting GDP growth of just 0.2%Q/Q in Q2.

The day ahead in the euro area

Tomorrow brings euro area industrial production figures for March. Equivalent reports from Germany, Spain and France disappointed, with Italian IP merely moving sideways that month. But this was countered to some extent by solid growth in Ireland and Greece. As such, we now expect aggregate euro area industrial production to report a drop of around 0.7%M/M, which would leave it up almost 1½%Q/Q in Q1. However, when excluding Ireland – whose data at the turn of the year were extremely volatile seemingly in part due to technical issues with seasonal adjustments – the quarterly increase in euro IP in Q1 would be only about 0.2%Q/Q. Final French and Spanish CPI figures for April are also due. While the flash French HICP inflation rate unexpectedly rose 0.3ppt to 5.4%Y/Y, the Spanish HICP rate fell 1.5ppts to 8.3%Y/Y.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	RICS house price balance %	Apr	**80**	71	74	-
	Preliminary GDP Q/Q% (Y/Y%)	Q1	**0.8 (8.7)**	*1.0 (9.0)*	1.3 (6.6)	-
	Monthly GDP M/M%	Mar	**-0.1**	*0.0*	0.1	**0.0**
	Industrial production M/M% (Y/Y%0	Mar	**-0.2 (0.7)**	0.0 (0.5)	-0.6 (1.6)	**-0.3 (2.1)**
	Manufacturing production M/M% (Y/Y%)	Mar	**-0.2 (1.9)**	0.0 (2.3)	-0.4 (3.6)	**-0.6 (3.5)**
	Index of services M/M% (3M/3M%)	Mar	**-0.2 (0.4)**	0.1 (0.9)	0.2 (0.8)	**0.0 (0.6)**
	Construction output M/M% (Y/Y%)	Mar	**1.7 (4.7)**	0.2 (2.2)	-0.1 (6.1)	**0.2 (7.0)**
	Trade in goods balance £bn	Mar	**-23.9**	-18.5	-20.6	**-21.6**

Auctions

Country	Auction
Italy	sold €2.0bn of 1.2% 2025 bonds at an average yield of 1.015%
	sold €3.75bn of 2.8% 2029 bonds at an average yield of 2.39%
	sold €1.0bn of 3.45% 2048 bonds at an average yield of 3.06%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Germany	Final CPI M/M% (Y/Y%)	Apr	**0.8 (7.4)**	0.8 (7.4)	2.5 (7.3)	-
	Final EU-harmonised CPI M/M% (Y/Y%)	Apr	**0.7 (7.8)**	0.7 (7.8)	2.5 (7.6)	-

Auctions

Country	Auction
Germany	sold €3.23bn of 0% 2032 bonds at an average yield of 0.96%
UK	sold £2.50bn of 0.5% 2029 bonds at an average yield of 1.636%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		10.00	Industrial production M/M% (Y/Y%)	Mar	-2.0 (-0.9)	0.7 (2.0)
France		07.45	Final CPI M/M% (Y/Y%)	Apr	0.4 (4.8)	1.4 (4.5)
		07.45	Final EU-harmonised CPI M/M% (Y/Y%)	Apr	0.5 (5.4)	1.6 (5.1)
Spain		08.00	Final CPI M/M% (Y/Y%)	Apr	-0.1 (8.4)	3.0 (9.8)
		08.00	Final EU-harmonised CPI M/M% (Y/Y%)	Apr	-0.2 (8.3)	3.9 (9.8)
Auctions and events						
Euro area		08.00	ECB's de Guindos scheduled to speak			
		17.00	ECB's Schnabel chairs panel at International Research Forum on monetary policy			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.