Euro wrap-up

Overview

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- As Governing Council members stated their preference for "gradual normalisation", Bunds followed USTs higher even as the account of the ECB's latest policy meeting underscored the likelihood of a first ECB rate hike in July and further hikes thereafter.
- Gilts were little changed as a UK industrial survey was more upbeat than expected.
- Friday will bring new data for UK retail sales, euro area and UK consumer confidence, and German producer prices and exports.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.342	-0.015
OBL 0 04/27	0.668	-0.061
DBR 0 02/32	0.933	-0.092
UKT 1 04/24	1.452	+0.016
UKT 1¼ 07/27	1.563	-0.007
UKT 4¼ 06/32	1.849	-0.012

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

Euro area

ECB account reinforces expectation that policy normalisation will be underway soon

With a large number of Governing Council members having over recent weeks signalled their preference for a prompt end to net purchases and a first rate hike shortly thereafter, the account of the ECB's 14 April monetary policy meeting, which was published today, is unlikely to have changed expectations that policy normalisation will get underway soon. Indeed, the only uncertainty is the pace at which policy will be tightened, with seemingly an increasing number of policymakers now in favour of relatively swift and sustained normalisation. Certainly, the account noted that the view that net asset purchases should end sooner rather than later in the third quarter (or indeed at the end of Q2) was "widely expressed". And, as President Lagarde had noted following the meeting, it underscored that the first rate hike could come as soon as one week after the end of net purchases. So, certainly, we expect to see a first hike in the deposit rate, of 25bps to -0.25%, in July. Importantly, however, the account noted that members "voiced some nuances" related to the appropriate pace of the gradual normalisation, leaving much to be determined at next month's policy meeting and beyond.

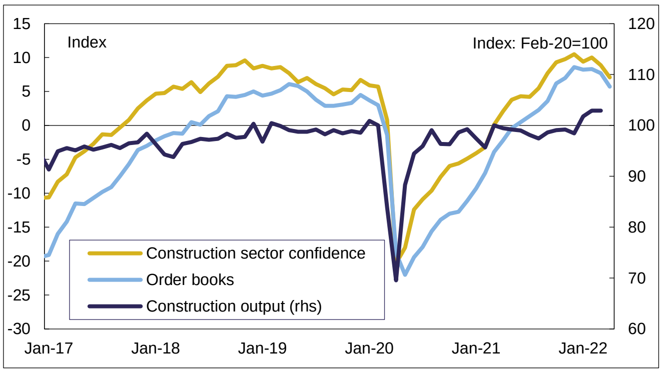
Governing Council preoccupied with inflation despite risks to growth

While events in Ukraine were expected to weigh on economic activity, the account highlighted that Governing Council members were (arguably appropriately) preoccupied by concerns over high inflation not growth, particularly as price pressures were judged to have extended well beyond energy. There was "broad consensus" that stubbornly high inflation increased the risk of second-round effects arising through wage costs. Views differed on the extent to which such risks were likely to materialise. But there were particular concerns that high inflation was becoming entrenched in price expectations, not least as surveys suggested that inflation expectations had become an important factor in determining companies' future selling prices. Some members therefore judged it important to "act without undue delay" in order to demonstrate the Governing Council's determination to achieve price stability, judging the current monetary policy stance inconsistent with the inflation outlook. But others argued that adjusting the monetary policy stance too aggressively could be counterproductive, as it would merely lower growth without addressing the immediate causes of high inflation or result in financial market turbulence.

What will "gradual normalisation" mean in practice?

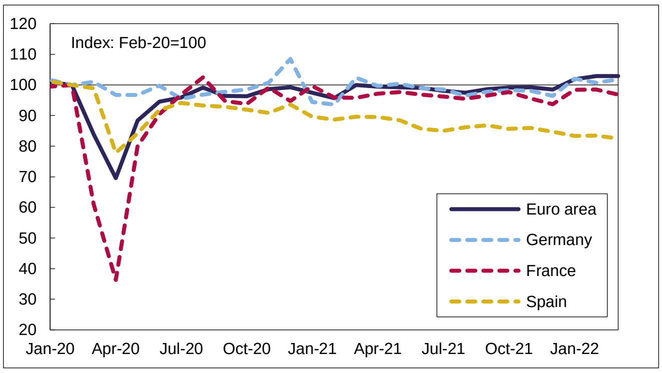
Therefore, for the time being, it was agreed to proceed with further actions "very carefully", and a shift "to a more aggressive and accelerated tightening did not seem justified", at least not yet. Indeed, it was cautioned that the euro area's natural interest rate was probably still negative in real terms so that even relatively small steps might be sufficient to turn the current

Euro area: Construction output, orders & sentiment



Source: European Commission, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction output by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

accommodative monetary policy stance into a restrictive stance. And overall, the Governing Council agreed that a “gradual normalisation” remained appropriate. The question remains, however, what “gradual normalisation” will mean in practice. Hikes in increments of 50bps – advocated earlier this week by Dutch Governor Knot – can hardly be considered gradual. But successive hikes of 25bps at each meeting, rather than every quarter, might at a stretch fit the bill. So, we now expect a series of hikes to be signalled at the June meeting. And, particularly if the normalisation of this summer’s tourist season helps to avoid a recession, a hike of 25bps at each of the four policy meetings to be held in the second half of the year now seems plausible.

Euro area construction moves sideways in March as supply-side challenges weighed

A relatively quiet day for euro area top-tier economic data brought construction activity figures for March. Following a solid start to the year, these suggested that construction stalled at the end of the first quarter, likely reflecting more acute supply challenges amid the Ukraine war and Chinese lockdowns as well as payback for firm growth in prior months. Indeed, while the pace of expansion in February was revised lower (by 0.8ppt to 1.1%M/M), construction was still up a sizeable 3.4%Q/Q in Q1, building on the near-1%Q/Q increase in Q4 and leaving the level of output some 2.9% higher than in February 2020 and last higher in June 2010. The weakness reflected a modest drop in building activity (-0.1%M/M), while civil engineering (+3.7%M/M) rose to its highest level since February 2011. Among the member states that have published data, the performance was mixed, with German activity up 1.1%M/M in March to be 4.0% higher in Q1, while French output fell 1.7%M/M but was still up 2.4%Q/Q. In marked contrast, however, construction in Spain continued to fall sharply, with output down a further 1.2%M/M in March, to be some 17½% lower than the pre-pandemic level. The European Commission’s survey signalled a further modest easing in sentiment in the sector at the start of Q2 to an eight-month low as order books narrowed slightly amid elevated material costs and persisting supply bottlenecks. But conditions are still judged to be relatively favourable by historical standards and should remain consistent with ongoing expansion as and when supply constraints ease.

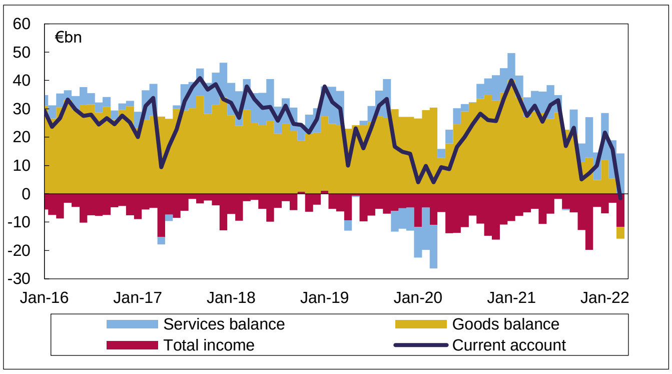
Euro area external current account records first deficit since 2012

Given the sharp blow out of the goods trade deficit in March, the ECB’s latest balance of payments figures today confirmed the euro area’s first current account deficit since 2012. Indeed, the current account balance deteriorated from a surplus of €15.7bn in March to a deficit of €1.6bn. This left the cumulative balance over the past year at €219.21bn (1.8% of GDP), down from €294bn (2.6% of GDP) a year ago. According to the ECB’s measure, the goods trade balance recorded the biggest monthly decline (down €9.5bn to a deficit of €4.2bn) since April 2020, on the back of surge in the value of imports and a drop in exports, notably to Russia. But there was also a narrowing in the primary income surplus (down €6.0bn to €520mn). In contrast, there was a pickup in the services trade surplus (€14.2bn), which was last higher in June 2018. But while this should widen further as tourism resumes, goods trade will remain adversely impacted by high prices of imported fuel. And so, we expect the current account balance to remain in deficit for the time being, adding to the case for euro depreciation.

The day ahead in the euro area

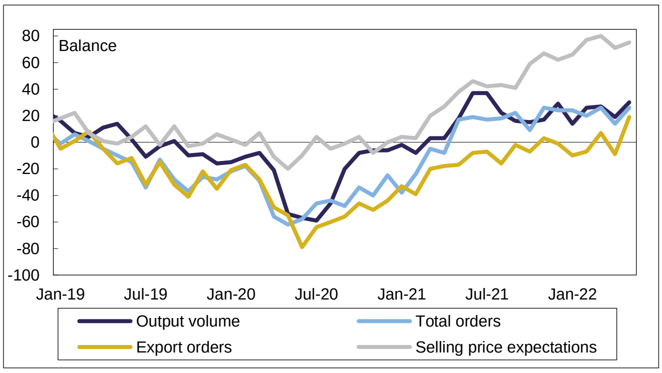
The euro area’s data calendar ends the week with the European Commission’s flash consumer confidence survey for May. With inflation at a euro-era high, wage growth still subdued and uncertainty about the global economic outlook elevated, we expect household sentiment to have remained extremely subdued this month, with the indicator forecast to be little improved from April’s two-year low (-22.0). German PPI data are also expected to report a further sizeable increase in producer prices last month to leave the headline inflation rate edging further above March’s series high of 30.9%Y/Y. Finally, tomorrow will also bring preliminary figures for German exports to non-EU countries in April.

Euro area: Current account balance



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

UK: CBI industrial trends indices



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

CBI manufacturing survey suggests stronger output in May, but conditions remain challenging

Ahead of the coming week's flash PMIs, today's UK CBI industrial trends survey offered a more upbeat assessment for output growth in the manufacturing sector in the three months to May, with the relevant indicator rising 11ppts to +30%, a ten-month high. There was a further improvement in new orders too, and a sizeable pickup reported in overseas demand, with the relevant index perhaps surprisingly rising to its highest since the start of 2018. However, reflecting ongoing supply bottlenecks in the sector, manufacturers continued to see demand outpace supply. And with the share of firms signalling an increase in selling prices rising this month – up 4ppts to 75% close to March's record high of 80% – cost pressures in the sector remain acute. And so, overall confidence in the sector fell further in the three months to May, with investment plans remaining weak too.

The day ahead in the UK

It will be a busy end to the week for UK top-tier data, with April's retail sales figures to be accompanied by the latest GfK consumer confidence survey. This week's labour market report confirmed that real wage growth remained firmly in negative territory in March, while yesterday's CPI report saw inflation jump to a near-four-decade high in April. So, with consumer confidence close to record lows, and retail surveys signalling a poor performance at the start of Q2, retail sales are expected to have declined in April for the third consecutive month, with consensus expectations for a drop of around ½%M/M.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Current account balance €bn	Mar	**-1.6**	-	20.8	**15.7**
		Construction output M/M% (Y/Y%)	Mar	**0.0 (3.3)**	-	1.9 (9.4)	**1.1 (8.9)**
UK		CBI industrial trends survey, total orders (selling prices)	May	**26 (75)**	-	14 (71)	**-**

Auctions

Country		Auction
France		sold €3.44bn of 0% 2025 bonds an at average yield of 0.63%
		sold €3.44bn of 0% 2026 bonds an at average yield of 0.77%
		sold €4.62bn of 0.75% 2028 bonds an at average yield of 1.06%
		sold €738mn of 0.1% 2031 index-linked bonds an at average yield of -1.18%
		sold €527mn of 0.1% 2032 index-linked bonds an at average yield of -1.11%
		sold €232mn of 0.1% 2036 index-linked bonds an at average yield of -0.85%
Spain		sold €1.35bn of 0% 2025 bonds an at average yield of 1.03%
		sold €1.12bn of 0.8% 2027 bonds an at average yield of 1.383%
		sold €1.99bn of 0.7% 2032 bonds an at average yield of 2.046%
		sold €1.02bn of 1% 2042 bonds an at average yield of 2.403%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Economic data						
Euro area		15.00	Flash European Commission consumer confidence	May	-22.0	-22.0
Germany		07.00	PPI M/M% (Y/Y%)	Apr	1.4 (30.4)	4.9 (30.9)
UK		00.01	GfK consumer confidence	May	-38	-38
		07.00	Retail sales including fuel M/M% (Y/Y%)	Apr	-0.3 (-7.2)	-1.4 (0.9)
		07.00	Retail sales excluding fuel M/M% (Y/Y%)	Apr	-0.3 (-8.5)	-1.1 (-0.6)
Auctions and events						
UK		08.30	BoE Chief Economist Pill scheduled to speak			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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