

# Euro wrap-up

## Overview

- Bunds made losses as ECB President Lagarde signalled that two interest rate hikes should be expected in Q3, with additional tightening likely to be required thereafter.
- Gilts also made losses despite commentary from Governor Bailey that future BoE policy tightening would need to make allowance for the hit to demand from higher living costs.
- Tomorrow brings the key flash PMI survey results for May from the euro area and UK.

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### Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.384	+0.071
OBL 0 04/27	0.719	+0.073
DBR 0 02/32	0.992	+0.055
UKT 1 04/24	1.564	+0.056
UKT 1½ 07/27	1.660	+0.060
UKT 4¼ 06/32	1.959	+0.066

\*Change from close as at 4:00pm BST.  
Source: Bloomberg

## Euro area

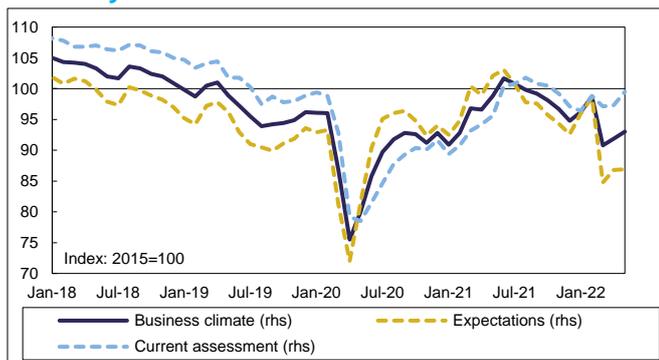
### Lagarde all but pre-commits to hikes in July and September

The account of the ECB's April monetary policy meeting, published last week, made clear that the Governing Council planned to embark soon on a "gradual normalisation" of monetary policy. But it failed to offer insights into what such a process might entail. So, the near-term path for interest rates remained uncertain and hence open to speculation regarding the timing, frequency and magnitude of hikes to come. However, following a meeting of the Governing Council on Friday – which had ostensibly been about non-monetary policy matters, but might now appear to have gone wider than that – ECB President Lagarde today published a blog that went as far as possible to pre-committing to two rate hikes in the third quarter and the likelihood of additional tightening beyond. Making it clear that she was signalling the likely next steps for rates, Lagarde wrote that it had become "more important to clarify the path of policy normalisation that lies ahead". Despite acknowledging the "uncertain growth outlook", she added that the higher inflation outlook meant that higher nominal interest rates "would not constitute a tightening of monetary policy; rather, leaving policy rates unchanged in this environment would constitute an easing of policy, which is not currently warranted". So, Lagarde stated that she expects "net purchases under the APP to end very early in the third quarter... [to] allow us a rate lift-off at our meeting in July", and "we are likely to be in a position to exit negative interest rates by the end of the third quarter." In other words, expect a hike of 25bps in the deposit rate to -0.25% in July, and a further hike of 25bps to zero percent in September.

### ECB prepared for tightening to neutral and maybe beyond

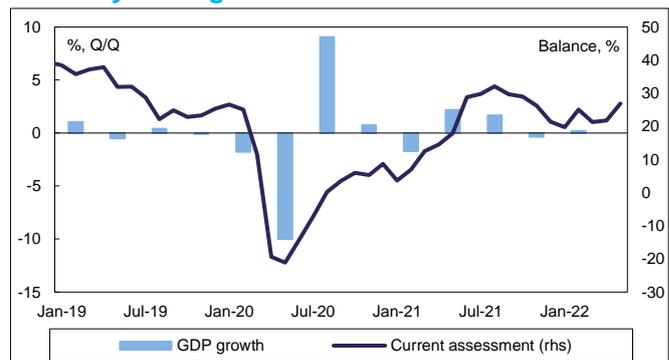
Lagarde did not pre-commit to a path of rates in the fourth quarter and beyond, instead stating that policy would still "need to be guided by the evolution of the medium-term inflation outlook" as well as her previous watchwords of "gradualism, optionality and flexibility". But, unless economic activity and the labour market weaken to the extent that inflation expectations fall back significantly, a pause in the process of normalisation would seem highly unlikely to be on the agenda. Instead, Lagarde made clear that if – as now – the ECB's updated projections in September suggest that inflation is still expected to stabilise at 2% over the medium term, "a progressive further normalisation of interest rates towards the neutral rate will be appropriate". Moreover, if the economy is judged to be overheating due to stronger demand, "it would make sense for policy rates to be raised sequentially above the neutral rate". She acknowledged that the "neutral rate is unobservable and depends on many factors, [so] we will only truly know where it is once we get there." And the range of feasible estimates for the euro area neutral rate is wide – as noted recently by Bank of France Governor Villeroy, current estimates would suggest a range of between 1-2%. On balance, we suspect that the economic outlook will have cooled by year-end. So, while we now expect the deposit rate to end 2022 at 0.5% with the refi rate at 0.75%, we think the ECB will

### Germany: ifo sentiment indicators



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

### Germany: GDP growth and ifo current conditions



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

struggle to get rates up to the mid-point of Villeroy's neutral range. However, given the countless uncertainties and range of possible shocks to come, we certainly do not rule out the possibility that rates could get there and beyond.

### German firms more upbeat about current conditions, but concerns about the outlook remain

The ECB's confidence that the euro area economy will avoid a near-term contraction should have been bolstered by today's German ifo survey, which beat expectations, suggesting that activity is holding up relatively well despite persisting supply bottlenecks, rising cost burdens and heightened economic uncertainty. Certainly, according to the ifo institute, German firms were more upbeat about current conditions, with the respective index up 2.2pts in May to 99.5, a seven-month high. The improvement this month principally reflected greater optimism among services as the lifting of Covid restrictions continued to give a boost, with the respective survey balance up to the highest since February 2020. With their confidence having slumped to a twelve-month low in April, retailers were once again more upbeat about the current situation. Additionally, the current assessments of manufacturers and construction firms stabilised having slumped in April. But the survey also highlighted that firms remain extremely wary about the outlook for the coming six months, with the headline expectations index up just 0.1pt in May to 86.9, more than 1½pts lower than in February before the Russian invasion of Ukraine and some 16pts below last summer's peak. Indeed, while the manufacturing balance rose 6pts in May, it was still firmly in negative territory and the second-weakest reading since the initial pandemic wave, as firms expressed concerns about a slowing in demand. Likewise, the majority of construction firms remained pessimistic about the outlook, perhaps reflecting the prospect of higher mortgage rates on the horizon as well as persisting cost and supply-chain pressures. And no doubt due to the rise in the cost of living, firms in the services and retail sectors reported no improvement in their expectations for the near-term outlook.

### The day ahead in the euro area

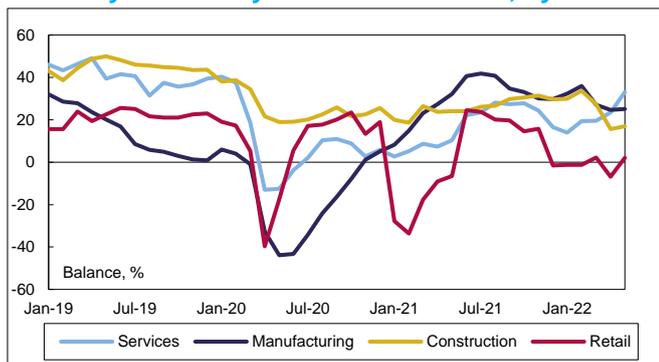
Focus in the euro area tomorrow remains on economic sentiment surveys with the key preliminary PMIs for May due. The headline euro area services activity PMI is expected to point to continued expansion this month, with the index expected to move broadly sideways (57.7) as the sector continues to normalise after the latest pandemic wave. In contrast, the manufacturing output index is likely to remain close to 50, implying still challenging conditions amid persisting supply constraints and elevated costs. Overall, the composite PMI is forecast to fall 0.7pt to 55.1, still nevertheless consistent with ongoing expansion. And following today's improved ifo survey, the flash German PMIs might well surprise on the upside. Meanwhile, the INSEE business confidence survey for May, also due to be published tomorrow, is expected to suggest that French business sentiment continues to trend lower, albeit remaining above its long-run average.

## UK

### The day ahead in the UK

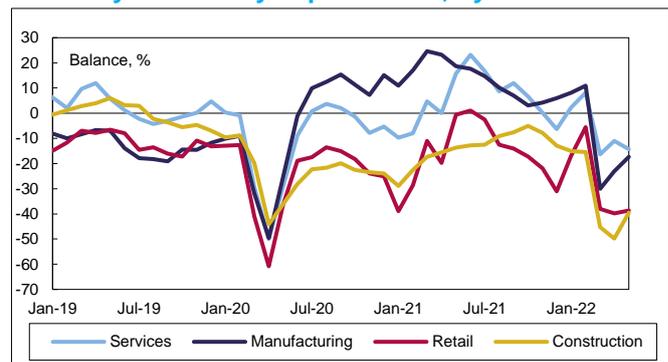
After a quiet start to the week, Tuesday will bring the week's only UK economic data of note. Like in the euro area, we will get the publication of the flash manufacturing and service sector PMIs for May, which are expected to suggest some loss of recovery momentum – albeit continuing to point to a steady expansion in activity – as the cost of living crisis and heightened global economic uncertainty took their toll. In particular, the headline services index is expected to fall almost 2pts in May, after declining to a three-month low of 58.9 in April. And as a result, the composite PMI is similarly forecast to decline almost 2pts to a four-month low of 56.5. Similarly, following the surprise pickup in [retail sales](#) in April, the latest CBI distributive trades survey is likely to point to weakening activity on the high street this month given the increasing squeeze on household budgets from high inflation. Finally, public finance figures for April are also due to be published.

Germany: ifo survey current conditions, by sector



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

Germany: ifo survey expectations, by sector



Source: Refinitiv, ifo 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
Germany	 Ifo business climate index	May	93.0	91.4	91.8	91.9
	 Ifo current assessment (expectations) balance	May	99.5 (86.9)	96.8 (86.5)	97.2 (86.7)	97.3 (86.8)
UK	 Rightmove house price index M/M% (Y/Y%)	May	2.1 (10.2)	-	1.6 (9.9)	-

#### Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

### Tomorrow's releases

#### Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area		09.00 Preliminary manufacturing (services) PMI	May	54.7 (57.5)	55.5 (57.7)
		09.00 Preliminary composite PMI	May	55.1	55.8
Germany		08.30 Preliminary manufacturing (services) PMI	May	54.0 (57.1)	54.6 (57.6)
		08.30 Preliminary composite PMI	May	53.9	54.3
France		07.45 INSEE business confidence	May	105	106
		07.45 INSEE manufacturing confidence (production outlook)	May	107 (-7)	108 (-5)
		08.15 Preliminary manufacturing (services) PMI	May	55.2 (58.5)	55.7 (58.9)
		08.15 Preliminary composite PMI	May	56.9	57.6
UK		07.00 Public sector net borrowing, excluding banks £bn	Apr	18.9	18.1
		09.30 Preliminary manufacturing (services) PMI	May	55.0 (57.0)	55.8 (58.9)
		09.30 Preliminary composite PMI	May	56.5	58.2
		11.00 CBI distributive trades survey, reported sales	May	-30	-35

#### Auctions and events

Euro area		19.00 ECB President Lagarde gives opening remarks at Europe's Global Role dinner, Davos
Germany		10.30 Auction: €2bn of 1% 2038 bonds
UK		10.00 Auction: £750mn of 0.125% 2039 index-linked bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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