Euro wrap-up

Overview

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- Euro area govvies rallied hard, with BTPs significantly outperforming, as the ECB responded to the recent bond-market sell-off by announcing that it would start work on a new anti-fragmentation tool.
- Gilts followed euro govvies higher on a quiet day for UK economic news.
- Tomorrow the BoE is likely to raise Bank Rate by 25bps when its latest MPC meeting concludes, while new data include Q1 euro area labour costs.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	1.030	-0.179
OBL 0 04/27	1.421	-0.144
DBR 0 02/32	1.638	-0.107
UKT 1 04/24	1.931	-0.150
UKT 1¼ 07/27	2.049	-0.168
UKT 4¼ 06/32	2.459	-0.125

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

Euro area

ECB accelerates preparation of anti-fragmentation tool

Evidently spooked by market developments after last week's policy meeting, when its apparent complacency regarding market fragmentation risks prompted a huge sell-off in BTPs and other southern European bonds, the ECB's Governing Council held an emergency meeting today. Following the meeting, the Governing Council repeated the previous pledge to apply flexibility in reinvesting maturing proceeds of PEPP bonds. But, unlike last week, it also reported that it had asked its committees to design a new anti-fragmentation instrument for consideration at a future monetary policy meeting. The Governing Council said nothing whatsoever, however, about the outlook for interest rates.

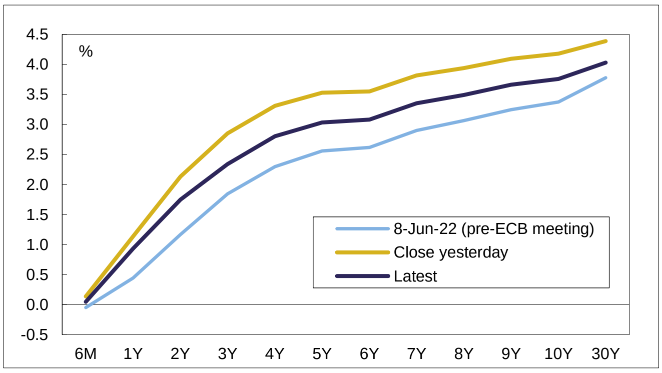
Several "known unknowns" regarding PEPP reinvestments

The Governing Council's statement today left plenty of uncertainty about its intentions and the ultimate firepower to be made available to contain spreads. Indeed, there are even many "known unknowns" with respect to its PEPP reinvestment policy. Given the lack of transparency regarding its bond holdings under the programme, the amount of maturing proceeds to be freed up for deployment to BTPs and other strained bond markets is not clear, although a rough ball-park estimate would suggest that about €200bn could be available through to end-2024. The ECB is also not transparent about which part of the yield curve would benefit from reinvestments, although the intention to support the monetary transmission mechanism would point to the need to skew purchases towards the short end of the curve.

Anti-fragmentation tool is still a blank sheet of paper

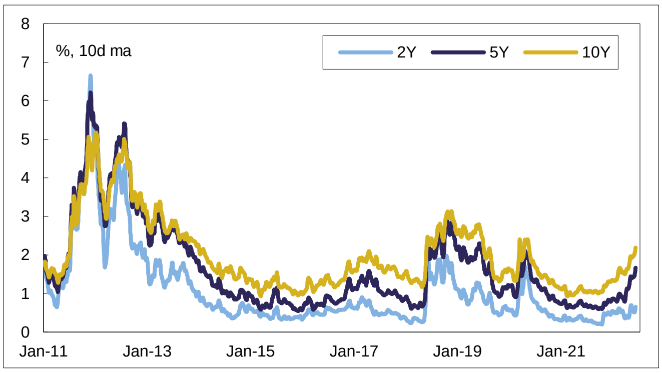
It was certainly naïve of the Governing Council last week not to foresee the market's reaction to its failure adequately to address fragmentation risks. So, at least today it started to make amends via its request to its committees to propose a design for its new anti-fragmentation tool. However, at this stage, the new tool remains little more than a blank sheet of paper. The Governing Council has yet to specify what the tool should look like, or the timetable for its design, agreement and readiness for deployment. So, just as for the PEPP reinvestments but even more so, there are uncertainties about the magnitude of central bank funds that might eventually be made available for bond market purchases, where along the curve such purchases might be conducted, and whether – and if so how – any purchases might be sterilized. Moreover, crucially for Italy where an election is due within a year, there is uncertainty about whether and if so what conditionality will be attached to the use of the instrument.

Italy: BTP yield curve



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Italy: Spread of BTPs over Bunds



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

New instrument unlikely to be free of conditionality, but could risk conflict with rate policy

All of that detail will be up for grabs in the subsequent negotiations within the Governing Council. But with Draghi's OMT instrument already available to countries that have signed up to ESM programme conditionality, the hawks are likely to fight against anything that makes life too easy for the Italian government. The hawks are also likely to argue against any policy that could eventually resemble the recommencement of expansionary QE at the same time they want interest rates to be raised to a neutral or even contractionary stance. But should BTPs ever need direct support from the ECB, the magnitude of the sums required might theoretically raise questions about consistency with its interest rate policy. Indeed, depending on the design of the policy tool, for any given desired monetary stance, the greater deployment of asset purchases towards stressed sovereigns could require higher ECB policy interest rates. By the same token, as suggested this afternoon by comments from the Governing Council's uber-dove Panetta, the persistent absence of such a tool could ultimately risk achievement of the inflation target on a sustained basis, particularly if it allowed another euro debt crisis to emerge.

IP boosted by energy output at start of Q2 but manufacturing output drops again

Data-wise, euro area industrial production (excluding construction) returned to growth in April. But the rise of just 0.4%M/M left it still 0.4% below the Q1 average. Overall IP growth was flattered by a surge in energy output of 5.4%M/M – the most in four years – thanks to a sharp timely increase in wind-generated power. In contrast, manufacturing output was weak, falling for the second successive month and by 0.5%M/M to the lowest level since September 2020. That returned it to the pre-pandemic level, 2.2% below the pandemic peak at the start of last year, and 1.2% below the Q1 average, and thus on track for contraction over Q2 as a whole. Within the detail, production of motor vehicles rose for the first time since December, but was still more than 37% below the pre-pandemic level. However, capital goods output fell for a third successive month to be down 1.7% from the Q1 average and more than 9% below the pre-pandemic level. In contrast, intermediate and consumer goods output rose at the start of Q2. By member state, the strongest growth in industrial production came from the Netherlands (5.6%M/M) and Finland (3.5%M/M), while Ireland (-9.6%M/M) and Greece (-7.4%M/M) posted sharp declines, weighing on the aggregate euro area figures as a whole.

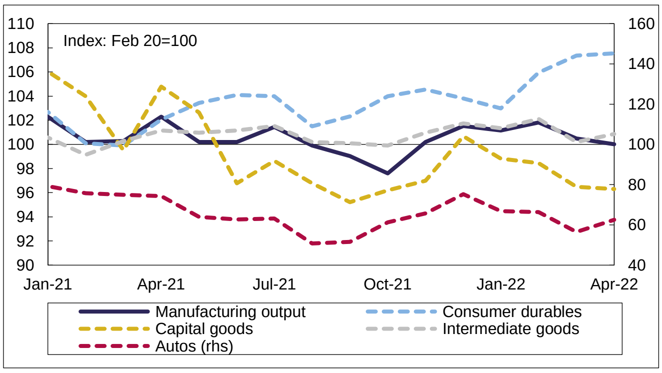
Trade deficit unexpectedly hits new record as imports surge

Contrary to expectations of a decline, the euro area's trade deficit hit a new record high in April as the value of imports significantly outpaced exports. In particular, on a seasonally adjusted basis, the trade deficit rose almost €14bn – the second highest increase on the series – to a whopping €31.7bn. Despite a drop of 7.4%M/M in (energy) imports from Russia, the rise in import values of 7.1%M/M was the strongest in a dozen years, boosted by deliveries from Norway and the UK (both up about one fifth) and other energy producers as member states sought to diversify supplies. In contrast, exports rose just 1.5%M/M, with the value of shipments weighed in particular by further declines to Russia (down 8.8%M/M due to sanctions) and China (down 5.9%M/M due to pandemic restrictions). With import price growth slowing to 1.7%M/M from 5.5%M/M in March, the rise in import values appears to in good part due to a surge in volumes, suggesting a negative contribution of net trade to GDP growth at the start of the second quarter.

The day ahead in the euro area

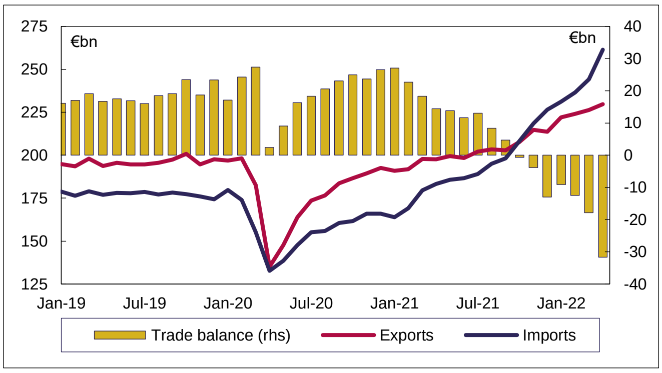
Following today's special Governing Council meeting to discuss market strains, a number of ECB policymakers will be in action. Vice President de Guindos, French Governor Villeroy de Galhau, Dutch Governor Knot, Portuguese Governor Centeno and Spanish Governor Hernandez de Cos are all due to participate at an online event with students, while dovish Executive Board member Panetta is set to speak to the European Payments Council. Data-wise, EU-27 car registrations numbers for May will be published, as well as euro area labour costs data for Q1. At the country level, Spain will publish goods trade figures April, while Italy will release final inflation figure for May, which are expected to confirm that the HICP rate accelerated 1ppt to 7.3%Y/Y while the national CPI measure rose 0.9ppt to a multi-decade high of 6.9%Y/Y.

Euro area: Manufacturing production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Trade balance



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

The day ahead in the UK

After a quieter day in the UK today, with no economic data to report, the main event tomorrow will be the BoE's latest MPC meeting, from which the policy statement and minutes will also be published. At the MPC's last meeting in May, the BoE raised Bank Rate by 25bps to 1.00%, with all nine members of the Committee voting to tighten policy. Moreover, three (external) members of the Committee voted for a larger hike of 50bps. And "most" members of the Committee judged that "some degree of further tightening in monetary policy may still be appropriate in the coming months". However, the BoE's updated projections suggested that the terminal interest rate for this cycle would be a long way below the level currently priced into markets.

Since that meeting, data showed that UK economic activity weakened further than expected in April to raise the prospect of a drop in GDP in Q2, contrary to the BoE's expectation of modest expansion. But the government's fiscal policy U-turn, providing additional support to households to cope with the next big increase in household energy bills, will likely soften the pace of contraction in Q4 while also reducing somewhat the expected peak in inflation that quarter to below 10%Y/Y. Meanwhile, the latest jobs data suggested that the labour market could be becoming a little less tight, with a pickup in unemployment and a decline in inactivity in April. But while overall wage growth eased slightly, and basic pay fell sharply in real terms, nominal labour cost growth likely remained above rates considered by the BoE to be consistent with the achievement of the inflation target over the medium term. As such, we suspect that all of the Committee members are likely to support a further rate hike this month. But the majority will probably favour a hike in Bank Rate of just 25bps to 1.25%, with perhaps just three members (all externals) likely to vote for a larger hike of 50bps. The MPC will not take any decisions about whether to start active Gilt sales at this meeting – that is a debate to be held at the August meeting instead.

Tomorrow will also see the Bank publish its Agents' summary of business conditions for Q2.

European calendar

Today's results						
Economic data						
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Industrial production M/M% (Y/Y%)	Apr	**0.4 (-1.1)**	0.5 (-1.1)	-1.8 (-0.8)	**-1.4 (-0.5)**
	Trade balance €bn	Apr	**-31.7**	-14.5	-17.6	**-17.8**
France	Final CPI M/M% (Y/Y%)	May	**0.7 (5.2)**	*0.6 (5.2)*	0.4 (4.8)	-
	Final EU-harmonised CPI M/M% (Y/Y%)	May	**0.8 (5.8)**	*0.7 (5.8)*	0.5 (5.4)	-
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/ *Daiwa forecast*	Previous
Euro area		07.00	EU27 new car registrations Y/Y%	May	-	-20.6
		10.00	Labour costs Y/Y%	Q1	-	1.9
Italy		09.00	Final CPI M/M% (Y/Y%)	May	*0.9 (6.9)*	-0.1 (6.0)
		09.00	Final EU-harmonised CPI M/M% (Y/Y%)	May	*0.9 (7.3)*	0.4 (6.3)
Spain		09.00	Trade balance €bn	Apr	-	-4.6
UK		12.00	BoE Bank Rate %	Jun	*1.25*	1.00

Auctions and events

Euro area		08.45	ECB's Villeroy scheduled to speak at online academic event
		08.50	ECB's Panetta scheduled to speak at European Payments Council event
		09.30	ECB's De Guindos scheduled to speak at online academic event
		10.30	ECB's Knot scheduled to speak at online academic event
		10.30	ECB's Centeno scheduled to speak at online academic event
		10.30	ECB's Hernandez de Cos scheduled to speak at online academic event
France		09.50	Auction: 0% 2025 bonds
		09.50	Auction: 0.75% 2028 bonds
		09.50	Auction: 0.5% 2029 bonds
		10.50	Auction: 1.85% 2027 index-linked bonds
		10.50	Auction: 0.1% 2036 index-linked bonds
		10.50	Auction: 1.8% 2040 index-linked bonds
Spain		09.30	Auction: 0% 2027 bonds
		09.30	Auction: 1.95% 2030 bonds
		09.30	Auction: 0.85% 2037 bonds
UK		12.00	BoE monetary policy announcement, summary and minutes to be published
		12.00	BoE publishes Agents' summary of business conditions – Q222

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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