Daiwa Capital Markets

Euro wrap-up

Overview

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- Gilts sold off, particularly at the short end of the curve, as the BoE raised Bank Rate by 25bps but signalled the possibility of bigger rate hikes ahead.
- Most euro area government bonds followed Gilts lower as euro area labour costs accelerated, although BTPs made further gains in the aftermath of yesterday's ECB announcement of plans for a new anti-fragmentation tool.
- Friday will bring the final estimates of euro area inflation in May.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	1.125	+0.082
OBL 0 04/27	1.519	+0.092
DBR 0 02/32	1.694	+0.061
UKT 1 04/24	2.075	+0.143
UKT 1¼ 07/27	2.150	+0.100
UKT 4¼ 06/32	2.506	+0.043

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

UK

BoE raises Bank Rate by 25bps, warns of possible bigger hikes ahead

As expected, the BoE raised Bank Rate for the fifth successive meeting. The hike of 25bps to 1.25% was also as expected, with six MPC members in favour. As they had done at the previous meeting, the other three members (Haskel, Mann and Saunders – all externals) voted for a bigger hike of 50bps. However, the MPC appeared more concerned than before about the risks that domestically generated inflation might become entrenched. Indeed, it hinted that hikes of a larger magnitude could gain majority support in future, stating that it "will be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response". As such, Gilts sold off sharply across the curve, which also flattened. And the swaps curve almost fully priced-in a further 50bps of rate hikes by year-end compared to yesterday's close. That suggested the expectation of hikes of at least 50bps at each of the following two meetings with a further 25bps at the final policy meeting of the year in December, to take Bank Rate to 3.0%. In light of the new guidance, we also now expect a 50bps hike in August. However, we think Bank Rate is more likely to end the year closer to 2.5%, although much will depend on the BoE's updated forecasts due in August.

MPC not overly concerned about weakening economic activity

With respect to economic activity, the MPC's assessment was not particularly upbeat, acknowledging that GDP growth in Q1 (0.8%Q/Q) had been softer than it expected, and also revising down its Q2 forecast from positive growth to our own prediction of a contraction of 0.3%Q/Q. Nevertheless, the BoE's Agents had suggested that, while there were some signs of a slowing in underlying growth, demand had remained mostly robust. And Bank staff estimated that the government's recent fiscal policy decision to provide an extra £15bn of support to households, with initial payments from the start of Q3, could push GDP 0.3% higher in the first year than it otherwise would have been. Admittedly, the MPC had not been able to take stock of the additional downside risks to the outlook for external demand posed by the Fed's more hawkish turn this week. However, it made clear that it did not view prospects for underlying GDP growth as materially worse than last month.

Domestically-generated price pressures ringing alarm bells at the BoE

It is obviously inflation, not GDP growth, that is driving current BoE policy. And on that front the MPC seemed more concerned than last month, when it had expected the headline CPI rate to decline to only slightly above the 2% target in two years' time, and to be well below target in three years' time. To some extent, the increased concerns relate to externally-generated pressures on prices of energy, food and tradeable goods, due not least to the persisting war in Ukraine and supply-chain disruption. But the MPC also sees some of the increased pressures as being related to domestic factors, including the labour market that it still considers to be tight and where it judges wage growth to be above levels consistent with the achievement of the inflation target over the medium term. That was considered to be a factor behind the rise in services inflation to 4.7%Y/Y in April. The MPC also highlighted that core consumer goods price inflation in the UK (almost 8%Y/Y) is now higher even than in the US and euro area suggesting that it might need to rival the Fed in terms of hawkishness. Admittedly, a pending decision by the ONS on the statistical treatment of government energy subsidies should in due course reduce the peak. However, the MPC stated that it now expects CPI inflation to rise beyond the path set out in its forecasts last month, to above 11%Y/Y in October when Ofgem's regulated household energy price cap will next be hiked. With business inflation expectations also higher, suggesting additional upside risks to inflation from pricing behavior as well as wages, the MPC is understandably extremely concerned.

The day ahead in the UK

The week will end quietly in the UK, with no key economic data scheduled for release tomorrow, with the official retail sales report for May now scheduled to come one week later than originally scheduled, on 24 June.

Euro area

Labour cost growth picks up in Q1

While it is now more mindful of the associated risks of market fragmentation, the ECB remains intent on monetary policy normalisation not least due to concerns of second-round effects of high inflation via price expectations and the labour market. So, at face value, today's labour cost numbers might appear to provide cause for concern. Whole economy hourly labour costs accelerated 1.3ppt in Q1 to 3.2%Y/Y, above the range in the decade ahead of the pandemic. Similarly, business labour cost growth picked up 1.4ppt to 3.5%Y/Y, the highest since Q408. While private sector wage growth picked up 1.5ppts to 3.2%Y/Y and non-wage costs accelerated 0.9ppt to 4.3%Y/Y. Wage growth was stronger in industry (2.6%Y/Y), and especially so in services (4.0%Y/Y) and construction (3.8%Y/Y). And the acceleration in labour costs was seen in all of the large member states, of which the steepest growth was in Germany (4.5%Y/Y) and France (3.7%Y/Y).

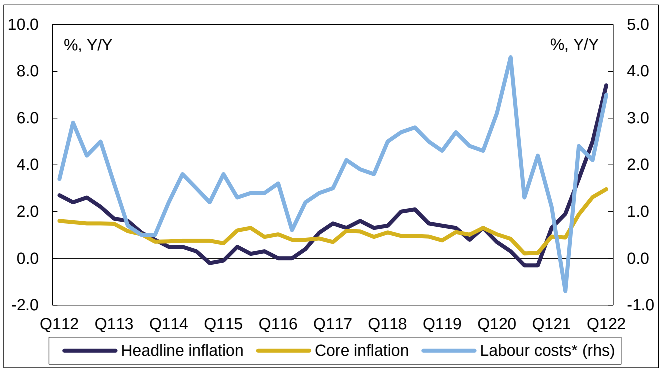
Wages are accelerating, but no signs of a wage-price spiral

To some extent, the pickup in labour cost growth reflects base effects and distortions related to job retention schemes. Particularly in Germany, higher wages also in part reflecting special payments associated with the pandemic. But given elevated inflation, increased national minimum wages and historically tight labour markets, wage growth seems highly likely to pick up further. That was illustrated yesterday by the settlement for Germany's steel workers in its key IG Metall union – a rise of 6.5%Y/Y over 18 months as well as an extra one-off payment for energy costs. However, that is not indicative of a wage-price spiral. And in other member states, labour markets are less tight and wage pressures are commensurately more modest. Indeed, while the euro area unemployment rate is at a record low and job vacancies rose again in Q1, the ratio of vacancies to unemployed workers remains well below equivalent levels in the US and UK, and underemployment is also far higher. And overall labour market slack remains sufficient to keep aggregate wage growth in check. Like in 2021, the ECB expects compensation per employee to rise above 4.0%Y/Y this year and next. But it then expects a slowdown to 3.7%Y/Y in 2024. With labour productivity growth expected to be somewhat stronger then, it forecasts unit labour cost growth to slow from 3.3%Y/Y this year, to below 3.0%Y/Y next year and further in 2024 to just 2.0%Y/Y – consistent with its inflation target.

The day ahead in the euro area

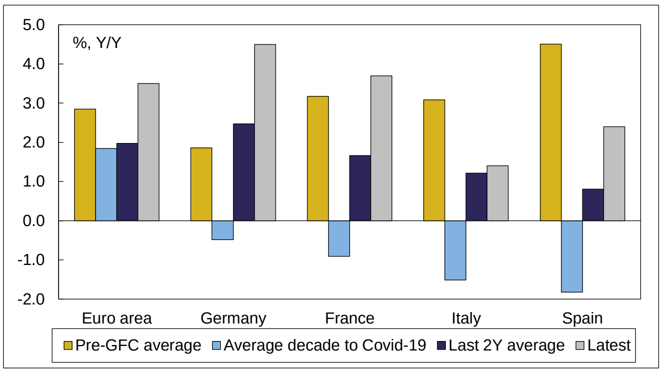
Tomorrow will bring the final release of euro area consumer price inflation data for May. According to the preliminary estimates, the headline HICP rate rose 0.7ppt to a new series high of 8.1%Y/Y. While energy and food prices inevitably played a role, the pressures were broad-based, pushing core inflation up a further 0.3ppt to a new high of 3.8%Y/Y.

Euro area: Labour costs and HICP inflation



*Business economy labour costs.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Labour cost growth*



*Business economy. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	🇪🇺	EU27 new car registrations Y/Y%	May	**-11.2**	-	-20.6	-
	🇪🇺	Labour costs Y/Y%	Q1	**4.7**	-	4.4	-
Italy	🇮🇹	Final CPI M/M% (Y/Y%)	May	**0.8 (6.8)**	*0.9 (6.9)*	-0.1 (6.0)	-
	🇮🇹	Final EU-harmonised CPI M/M% (Y/Y%)	May	**0.9 (7.3)**	*0.9 (7.3)*	0.4 (6.3)	-
Spain	🇪🇸	Trade balance €bn	Apr	**-6.4**	-	-4.6	-
UK	🇬🇧	BoE Bank Rate %	Jun	**1.25**	*1.25*	1.00	-

Auctions

Country		Auction
France	🇫🇷	sold €2.73bn of 0% 2025 bonds at an average yield of 1.59%
	🇫🇷	sold €3.49bn of 0.75% 2028 bonds at an average yield of 2.01%
	🇫🇷	sold €2.09bn of 0.5% 2029 bonds at an average yield of 2.02%
	🇫🇷	sold €3.19bn of 0.75% 2028 bonds at an average yield of 2.01%
	🇫🇷	sold €730mn of 1.85% 2027 index-linked bonds at an average yield of -0.79%
	🇫🇷	sold €270mn of 0.1% 2036 index-linked bonds at an average yield of 0.21%
	🇫🇷	sold €500mn of 1.8% 2040 index-linked bonds at an average yield of 0.38%
Spain	🇪🇸	sold €2.21bn of 0% 2027 bonds at an average yield of 2.345%
	🇪🇸	sold €1.01bn of 1.95% 2030 bonds at an average yield of 2.684%
	🇪🇸	sold €1.29bn of 0.85% 2037 bonds at an average yield of 3.26%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	🇪🇺	10.00	Final CPI M/M% (Y/Y%)	May	*0.8 (8.1)*	0.6 (7.4)
	🇪🇺	10.00	Final core CPI Y/Y%	May	*3.8*	3.5
Italy	🇮🇹	10.00	Trade balance €bn	Apr	-	-0.08

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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