Daiwa Capital Markets

Euro wrap-up

Overview

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- Gilts made significant gains even as the BoE increased Bank Rate by a further 25bps and significantly revised up its projections for GDP and inflation.
- Bunds also made gains despite a significant increase in euro area household inflation expectations reported in the ECB's latest consumer survey.
- Friday will bring the first estimate of UK GDP in Q1 and monthly economic activity and trade data for March.

Daily bond market movements

Bond	Yield	Change
BKO 2.8 06/25	2.515	-0.044
OBL 2.2 04/28	2.164	-0.056
DBR 2.3 02/33	2.222	-0.063
UKT 0⅝ 06/25	3.708	-0.091
UKT 1⅝ 10/28	3.525	-0.090
UKT 3¼ 01/33	3.705	-0.087

*Change from close as at 5:00pm BST.
Source: Bloomberg

UK

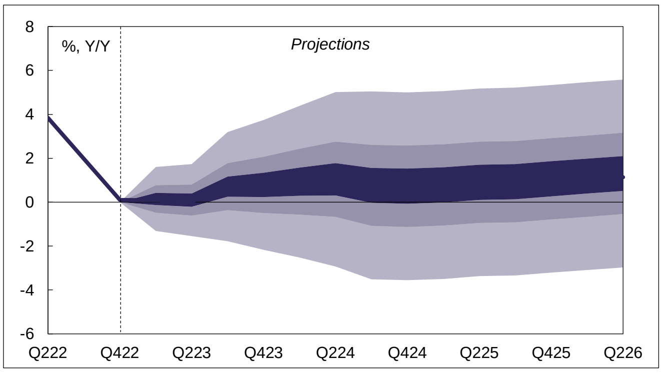
BoE hikes by 25bps, leaves guidance unchanged, and suggests no bias to policy going forward

As widely expected given recent upside surprises in the UK's inflation and wage data, the BoE's MPC today hiked Bank Rate by a further 25bps to 4.50%, taking the cumulative tightening this cycle to 440bps. The vote on the MPC was identical to that at the last meeting in March, with seven members supporting the 25bps hike and just two members (the external doves Tenreyro and Dhingra) preferring no change. The MPC's forward guidance was also identical to that specified in March, stating that "If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required". Moreover, the Committee repeated that services inflation and wages would remain among the key indicators to guide future policy decisions. In his press conference, BoE Governor Bailey was at pains to emphasise that the MPC was making no "directional steer" with respect to policy, i.e. it had no bias in the path for rates going forward. He also stated the Committee's policy guidance was conditional, so that the MPC will need to see additional evidence of more persistent pressures to justify further tightening. Nevertheless, the significant upwards revisions to the paths of GDP growth and inflation in the BoE's updated Monetary Policy Report projections suggest that, while not far away, the end of the tightening cycle has not yet been reached.

BoE revises up its GDP projection by record margin as energy shock fades

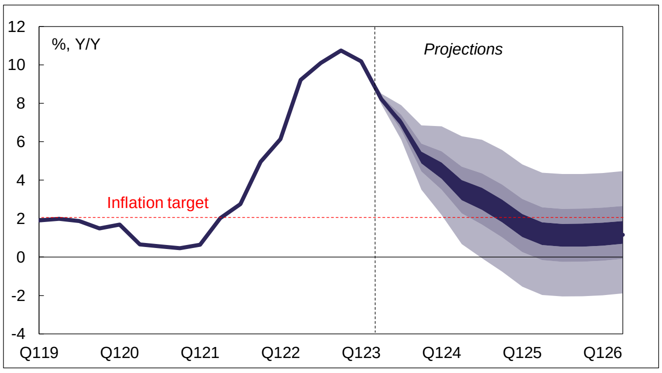
With wholesale energy prices having fallen significantly, global economic sentiment and activity firmer than previously feared, the impact on credit conditions from recent global banking sector turbulence judged to be modest, fiscal policy more supportive, and labour demand and supply both having proved stronger than the MPC had expected, the BoE revised up its UK GDP growth projection by a record amount. Indeed, its forecasts for household consumption, business and housing investment, and net exports were all pushed higher. Admittedly, given underlying weaknesses, the expected profile for UK economic activity remains subdued by historical standards. But over the near term, the BoE now thinks that GDP will be broadly flat through the first half of 2023 before picking up from the second half of this year on. And it forecasts full-year GDP growth of ¼%Y/Y and ¾%Y/Y this year and next respectively, having in February predicted contractions of ½%Y/Y and ¼%Y/Y. As a result, the level of GDP at the end of the forecast horizon is now expected to be 2¼% higher than previously thought. So, it also expects employment to be stronger and unemployment to be lower than previously thought, with the latter now forecast to rise to about 4½%, some ¾ppt lower than anticipated three months ago. As such, the amount of spare capacity in the economy is now expected by the Bank to rise only to about 1% in 2025, less than half the magnitude previously anticipated, with consequences for the path of inflation over the horizon.

UK: BoE GDP forecast*



*Forecast based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: BoE CPI inflation forecast*



*Forecast based on market-implied path for Bank Rate. Source: BoE and Daiwa Capital Markets Europe Ltd.

Inflation projection revised up significantly in 2024 and beyond

Of course, inflation, not GDP, principally dictates BoE monetary policy. And the MPC made clear that consumer price inflation – which at 10.2%Y/Y in Q1 exceeded its expectation due largely to prices of food and core goods – remains too high for its comfort. Moreover, although inflation in April will drop more sharply than it previously anticipated due to lower energy prices, the BoE expects the pace of decline in the second half of the year to be slower than it earlier expected due to persistence of food and core goods inflation. So, its modal forecast – which is based on a market-implied path for Bank Rate that peaks around 4.75% before being cut gradually to about 3.5% by the end of the horizon – now foresees inflation in Q423 at 5.1%Y/Y, up more than 1ppt from its previous projection. Given the diminished spare capacity in the economy, its modal inflation forecast was also revised up throughout 2024 and 2025, to be still above-target at 2.3%Y/Y and almost 1ppt higher than previously expected in Q424. And while its modal projection continues to foresee inflation below target throughout 2025, the BoE acknowledges the major uncertainties, which are related to a range of factors including global developments and the monetary policy-transmission and price-formation mechanisms.

Given upside skew to inflation risks we expect one more hike this cycle in June

Importantly, the MPC continues to judge that the risks to the inflation outlook are skewed significantly to the upside. Indeed, reflecting that distribution of uncertainties, while its modal inflation forecast is sub-target from Q125 on, its mean inflation projection is close to 2.0%Y/Y throughout 2025 and bang on target in 2026. Moreover, in his press conference, BoE Governor Bailey suggested that the inflation profile presented in the updated projections was not inappropriate – and by extension perhaps should not be considered undesirable – in light of the magnitude of the inflationary shocks experienced by the UK economy over the past couple of years. That might suggest that the market-implied path of rates assumed in the projections might also be considered as broadly appropriate. Indeed, as we suspect that the price and labour market data will not extinguish concerns of inflation persistence before Q3, we expect the MPC to raise Bank Rate by a further 25bps to 4.75% in June. But the steeper decline in inflation in early summer ahead of the publication of perhaps somewhat more favourable inflation projections in August should then provide the Committee with sufficient evidence to justify an end to the tightening cycle that month. Assuming global shocks continue to dissipate thereafter, conditions could then be in place for a gradual cycle of rate cuts to commence before the second half of 2024.

The day ahead in the UK

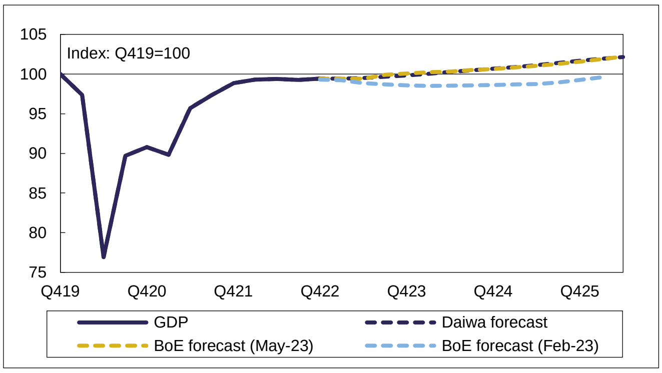
It will be a busy end to the week for UK data, with the release of the first estimate of Q1 GDP and associated monthly output and trade figures for March. Following a flat February, we think GDP fell moderately in March, albeit not as sharply as the drop of 0.9%M/M already reported for retail sales. Indeed, we forecast a drop of 0.4%M/M, with softness in services, manufacturing and construction alike due to a range of factors from wet weather to public sector strikes. That would leave GDP unchanged over Q1, with consumer spending subtracting from growth given persisting pressure on real disposable income from high inflation. The risks to that GDP forecast, however, appear skewed to the upside.

Euro area

ECB consumer inflation expectations rise significantly in March

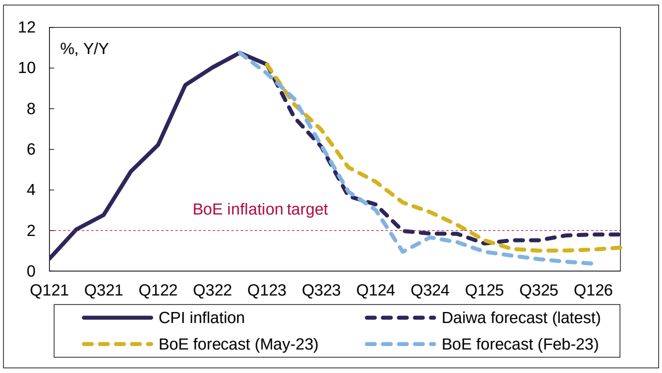
While the ECB last week slowed the pace of rate hikes to 25bps, President Lagarde emphasised that the ECB was not pausing its tightening path. The Governing Council's forward guidance suggested that it expects at least a couple more hikes this cycle. And today's results of the ECB's monthly consumer expectations survey will have strengthened the case of the hawks as they try to open the door to tightening at least through September. According to this survey, household inflation expectations increased significantly in March, with the median forecast for inflation over the next twelve months up 0.4ppt to 5.0%Y/Y, while the median rate for three years' time rose 0.5ppt to 2.9%Y/Y. The higher medium-term rate reflected a pickup in expectations in Germany, Italy and France, with the figure for the latter the highest since the (relatively short) series began in April 2020. Admittedly, the survey suggested that perceptions of inflation over the past twelve months also jumped in

UK: GDP forecasts*



**Modal forecast based on market-implied path for Bank Rate. Source: BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: CPI inflation forecasts*



**Modal forecast based on market-implied path for Bank Rate. Source: BoE, Refinitiv and Daiwa Capital Markets Europe Ltd.*

March, up more than 1ppt to 9.9%Y/Y, despite a fifth successive drop in the headline HICP rate in March to a twelve-month low of 6.9%Y/Y, some 3.7ppts below October's peak, which left the average for the past year at 8.8%Y/Y. Moreover, household expectations for economic activity remained weak, with the median forecast of nominal income growth this year (1.3%Y/Y) significantly revised down and well below expectations for inflation, suggesting that consumption growth is expected to remain very subdued.

Industrial production surprises on the downside in March, but still on track for growth in Q1

Despite the ongoing easing in supply constraints, recent economic releases continue to highlight persisting challenges in the euro area's manufacturing sector. And with orders maintaining a downwards trend, surveys suggest that firms would prefer to run down stocks rather than increase production to meet demand. The latest production results from various member states certainly surprised on the downside in March, suggesting that aggregate euro area output fell by around 3%M/M (data due for release 15 May). Admittedly, this follows solid growth in the first two months of the year and so manufacturing output should have recorded modest growth (circa ½%Q/Q) over the first quarter as a whole. But this might well be softer than initially estimated in the first estimate of Q1 GDP. As such, there is a risk of a downwards revision to GDP when the updated national accounts data are published (17 May). Furthermore, the lower base and ongoing concerns about both domestic and external demand means that the manufacturing sector is unlikely to offer significant support to the economic recovery this quarter.

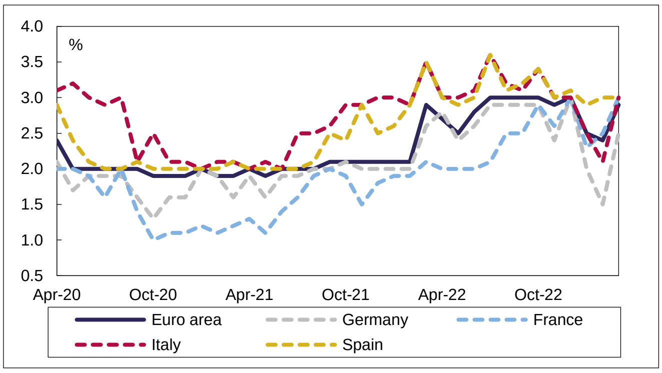
- In Germany, industrial production fell a steeper-than-expected 3.4%M/M in March, the most in a year. Despite easing supply bottlenecks, the weakness that month was driven by the autos sector, where output (-5.2%M/M) largely reversed the increase in February to be still some 10% below the pre-pandemic level. And with industrial gas usage having dipped well below the normal levels in March, production in energy-intensive subsectors also fell more than 3%M/M, to the second-lowest reading since the global financial crisis and down almost 13%Y/Y. Within this category, production of glassware fell to its lowest level since April 2020, while chemical production and basic metals resumed a downwards trend. And having risen to a near-two-year high in February, construction output fell more than 4½%M/M in March. This still left construction output up some 5½%Q/Q in Q1. Moreover, production of intermediate goods posted the first quarterly increase (2.6%) in a year. And overall, manufacturing output rose 1.8%Q/Q, the most since Q421.

- In France, industrial production fell for the second month out of the past three, by 1.1%M/M. The decline largely reflected a strike-related slump in output from the petroleum refinery sub-sector (-45.6%M/M). In contrast, autos production rose to a six-month high to be up 1.7%Q/Q in Q1. This notwithstanding, French manufacturing production contracted 1.8%Q/Q in Q1. While construction activity also contracted in March for the first month in three, it moved broadly sideways over the quarter. So, given a strong rise in energy production (4.5%Q/Q), overall industrial production was also flat in Q1.

- In Italy, industrial production declined for a third consecutive month (-0.6%M/M) to a fourteen-month low. Production of intermediate goods fell for the seventh consecutive month (-0.4%M/M) to the lowest level since July 2020, with persisting weakness in chemicals, metals and wood. Energy production also fell to the second-lowest reading in three years. In contrast, like in France, autos output accelerated more than 5%M/M to the highest level since July 2020. But while this left it up some 2%Q/Q in Q1, total manufacturing production offered no support the economic recovery in Q1, edging down 0.2%Q/Q.

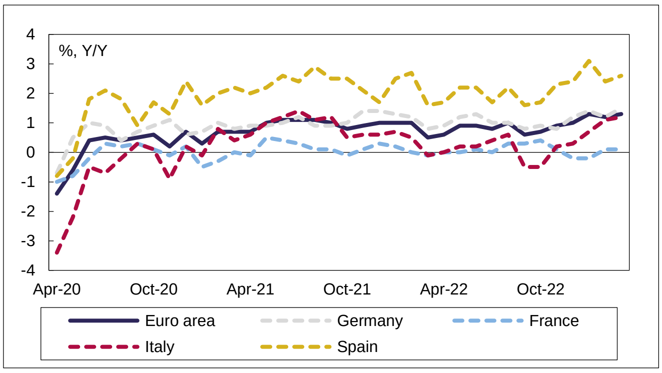
- Spanish industrial production bucked the trend, rising for the third month out of the past four in March, by 1.5%M/M, to the highest level since end-2017. Manufacturing output rose a firmer 2.6%M/M to the highest since 2008, with the strongest growth in wood products (19%M/M), ICT and electrical equipment (9%M/M). But given the weakness at the

Euro area: Consumer inflation expectations*



**Three years ahead. Source: ECB consumer expectations survey and Daiwa Capital Markets Europe Ltd.*

Euro area: Consumer nominal income expectations*



**Over coming twelve months. Source: ECB consumer expectations survey and Daiwa Capital Markets Europe Ltd.*

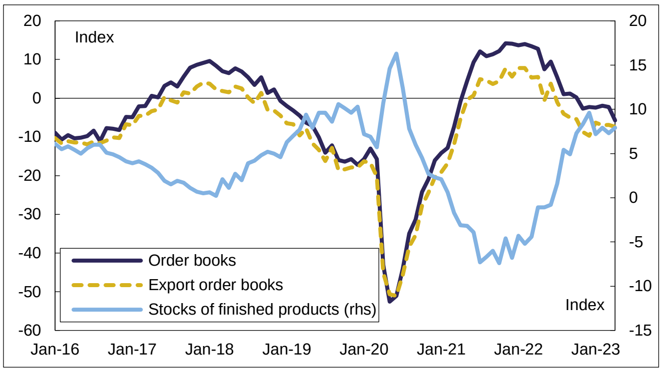
start of the year, manufacturing production was merely flat over the first quarter. Thanks to the largest quarterly increase in energy (2.6%Q/Q) since Q222, total production rose for the first quarter in three, by 0.8%Q/Q.

- Among the other member states, as is often the case, the change in Ireland's production was most extreme in March. Total output slumped a whopping 26.4%M/M, with manufacturing down an even steeper 38.1%M/M, a series record, for which the so-called "modern sector", comprising chemicals, pharmaceuticals, ICT and electronic equipment, posted a huge decline of almost 50%M/M. So, over the first quarter, Irish industrial output contracted more than 5%Q/Q. Meanwhile, Dutch manufacturing production fell 2%M/M to the lowest level in two years, leaving it down more than 4%Q/Q.

The day ahead in the euro area

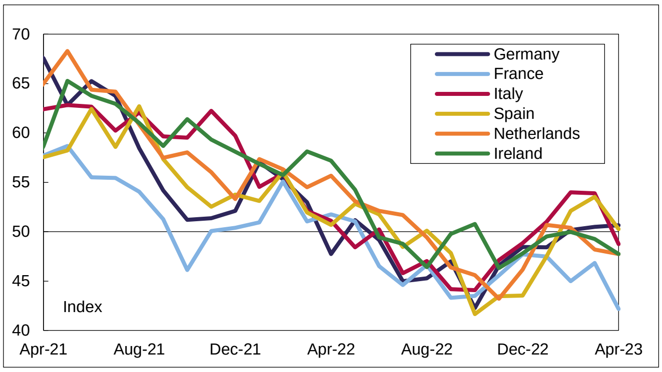
It will be a relatively quiet end to the week for euro area economic releases, with just the final readings of French and Spanish inflation in April due. The flash estimates saw headline harmonised inflation tick higher, by 0.2ppt to 6.9%Y/Y and 0.8ppt to 3.8%Y/Y respectively.

Euro area: Industrial orders & inventories



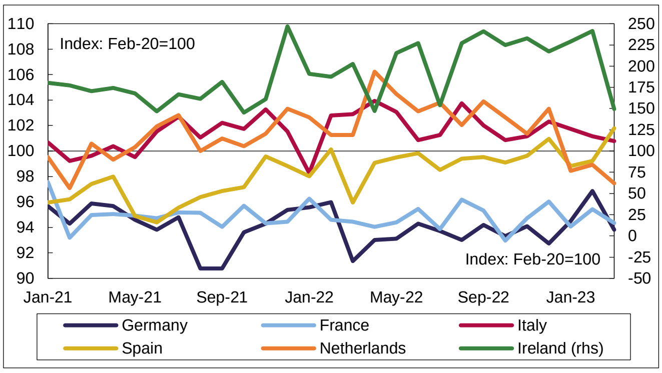
Source: EC, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area member states: Manufacturing PMIs*



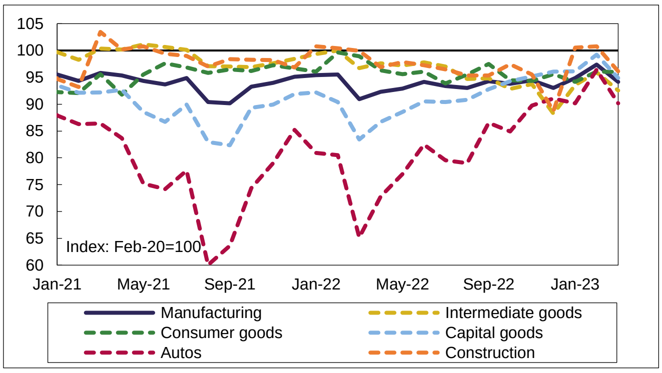
**Output indices. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

Euro area member states: Industrial production



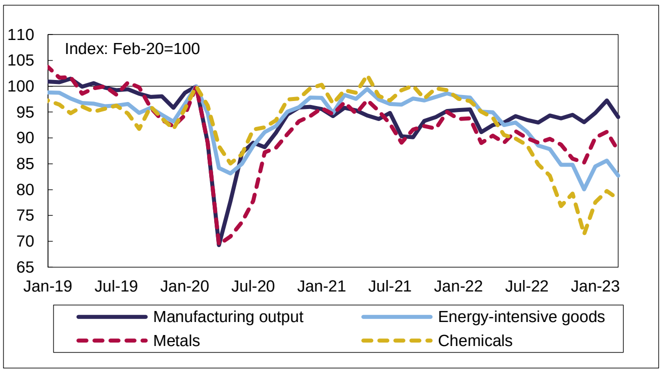
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Industrial production



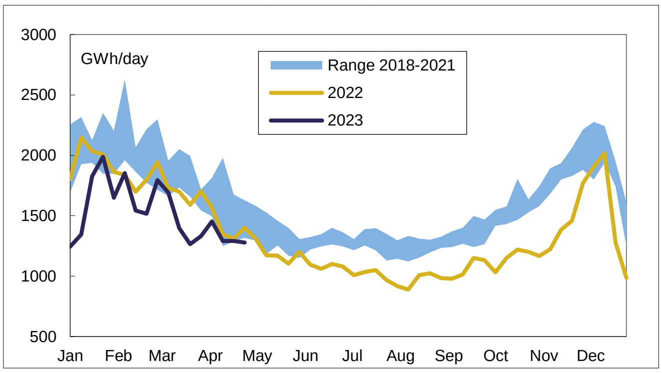
Source: Destatis, Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Energy-intensive production



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

Germany: Industrial gas usage



Source: *Bundesnetzagentur and Daiwa Capital Markets Europe Ltd.*

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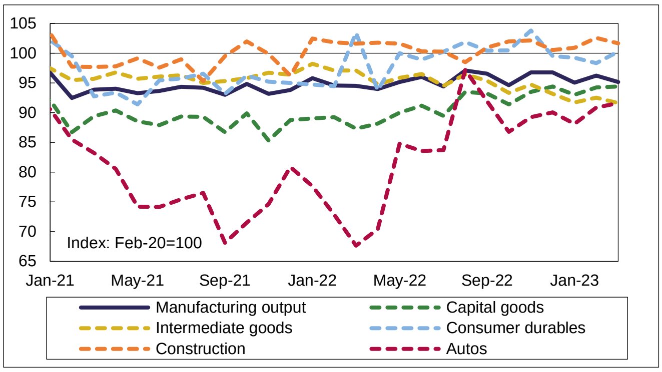
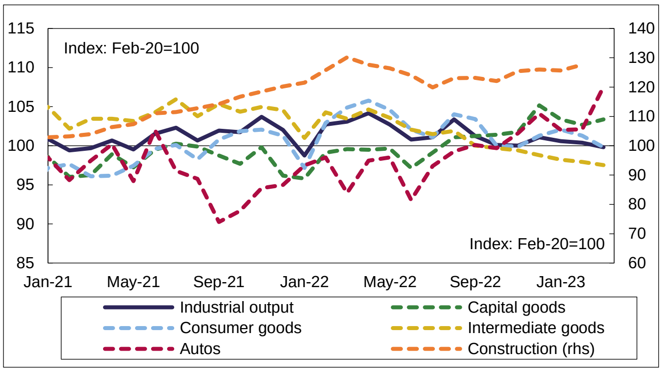
France: Industrial production



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

Italy: Industrial production



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
UK	RICS house price balance %	Apr	**-39**	-40	-43	-
	BoE Bank Rate %	May	**4.50**	*4.50*	4.25	-

Auctions

Country	Auction
Italy	sold €3.50bn of 3.80% 2026 bonds at an average yield of 3.45%
	sold €3.75bn of 3.70% 2030 bonds at an average yield of 3.94%
	sold €1.50bn of 4.45% 2043 bonds at an average yield of 4.67%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Previous days' results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
	Monday 08 May 2023					
Euro area	Sentix investor confidence	May	**-13.1**	-7.5	-8.7	-
Germany	Industrial production M/M% (Y/Y%)	Mar	**-3.4 (1.8)**	-1.5 (1.8)	2.0 (0.6)	2.1 (0.7)
	Tuesday 09 May 2023					
France	Trade balance €bn	Mar	**-8.0**	-9.3	-9.9	-9.3
UK	BRC retail sales monitor, like-for-like sales Y/Y%	Apr	**5.2**	-	4.9	-
	Wednesday 10 May 2023					
Germany	Final HICP (CPI) Y/Y%	Apr	**7.6 (7.2)**	*7.6 (7.2)*	7.8 (7.4)	-
Italy	Industrial production M/M% (Y/Y%)	Mar	**-0.6 (-3.2)**	0.3 (-1.7)	-0.2 (-2.3)	-

Auctions

Country	Auction
	Tuesday 09 May 2023
Germany	sold €4.13bn of 2.2% 2028 bonds at an average yield of 2.27%
	Wednesday 10 May 2023
Germany	sold €792mn of 0% 2050 bonds at an average yield of 2.44%
	sold €1.23bn of 1.8% 2053 bonds at an average yield of 2.53%
UK	sold £3.5bn of 3.25% 2033 bonds at an average yield of 3.849%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
UK		07.00	Preliminary GDP Q/Q% (Y/Y%)	Q1	*0.0 (0.1)*	0.1 (0.6)
		07.00	GDP M/M%	Mar	*-0.4*	0.0
		07.00	Industrial production M/M% (Y/Y%)	Mar	0.0 (-2.9)	-0.2 (-3.1)
		07.00	Manufacturing production M/M% (Y/Y%)	Mar	-0.2 (-2.6)	0.0 (-2.4)
		07.00	Index of services M/M% (3M/3M%)	Mar	0.0 (0.2)	-0.1 (0.1)
		07.00	Construction output M/M% (Y/Y%)	Mar	-0.1 (3.6)	2.4 (5.7)
		07.00	Goods trade balance £bn	Mar	-17.5	-17.5
France		07.45	Final HICP (CPI) Y/Y%	Apr	*6.9 (5.9)*	6.7 (5.7)
Spain		08.00	Final HICP (CPI) Y/Y%	Apr	*3.8 (4.1)*	3.1 (3.3)

Auctions and events

Euro area		09.00	ECB's de Guindos scheduled to speak
UK		12.00	BoE Chief Economist scheduled to speak on the BoE's latest Monetary Policy Report

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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