Euro wrap-up

Overview

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- Bunds made gains and BTPs made losses as euro area inflation fell close to zero, growth in euro area bank loans jumped further, and French spending on goods dropped the most on record.
- Gilts also made gains as data confirmed that UK car production came to a near-halt last month.
- The coming week brings the ECB's latest policy announcement along with new data for euro area unemployment and retail sales, and German factory orders.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.672	-0.020
OBL 0 04/25	-0.647	-0.028
DBR 0 02/30	-0.452	-0.030
UKT 0½ 07/22	-0.045	-0.021
UKT 0⅝ 06/25	-0.007	-0.019
UKT 4¾ 12/30	0.183	-0.027

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

Euro area

Inflation barely above zero

In line with expectations, the flash estimate of euro area consumer price inflation in May fell 0.3ppt to 0.1%Y/Y, the lowest rate since 2016. The detail confirmed that the drop was principally due to lower energy inflation, which dropped more than 2ppts to -12.0%Y/Y, the lowest since 2009. In addition, food inflation fell back 0.3ppt from April's more-than-decade high to 3.3%Y/Y. Inflation of non-energy goods edged down 0.1ppt to an eight-month low of 0.2%Y/Y. But services inflation rose 0.1ppt to 1.3%Y/Y, and so core inflation was unchanged at April's level of 0.9%Y/Y, which had been the lowest in nine months. We caution, however, that difficulties collecting data have eroded the quality of these inflation data. Indeed, prices of about 22% of items in the inflation basket (admittedly 10ppts lower than in April), including prices of one third of all services, were imputed or judged to be of low reliability, with the figures for France (where 45% of the price estimates were questionable) worst affected.

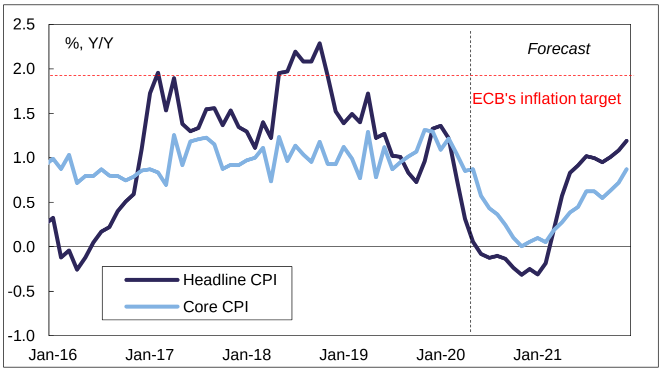
Disinflationary pressures to persist

Not least due to the low quality of the current estimates as well as the unpredictability of the pandemic, the inflation outlook is highly uncertain. However, energy prices are bound to continue to subtract significantly from the headline rate. And as restrictions on services are gradually eased, we expect firms, particularly in hospitality and leisure, to offer sizeable discounts to try to attract custom. Similarly, as a significant share of workers currently furloughed are likely to become permanently unemployed, and footfall at reopened shops is likely to remain persistently below pre-pandemic levels, we expect demand for non-energy industrial goods to remain subdued. So, despite an increase in non-wage costs from supply-chain disruption and the need to maintain social distancing practices, disinflationary pressures will persist. We expect core inflation to drop to series lows, perhaps as far as zero. And we expect headline inflation to dip slightly into negative territory next month, and to remain thereabouts into early 2021 before energy inflation ceases to act as a drag. Looking further ahead, with the level of GDP likely to remain below the pre-pandemic peak throughout 2022 and perhaps even beyond, we expect underlying inflation to remain well below the ECB's medium-term aim of below but close to 2.0%Y/Y.

Lending to businesses jumps further

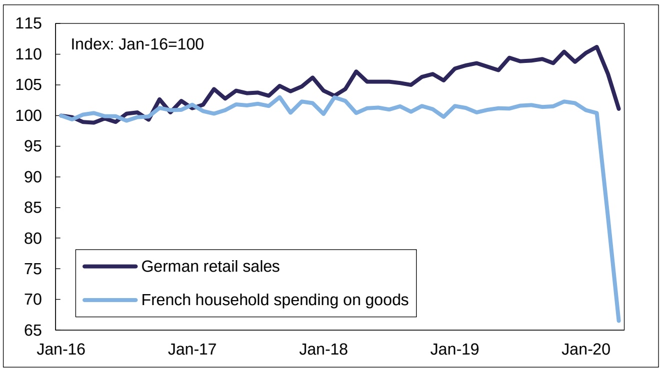
With firms facing funding challenges in light of restrictions on activity and weak demand, today's ECB monetary data unsurprisingly reported another notable increase in the flow of new loans to non-financial corporations, with the €73bn jump in April only exceeded by the €118bn surge in March. Once again, France accounted for the largest share (33%), followed by Spain and Germany, but all member states posted an increase in lending. But in contrast to March, all new loans were for

Euro area: Inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Germany and France: Spending indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

maturities of more than 1Y, with almost half for maturities of more than 5Y. Overall, this left the stock of new loans to businesses up 6.6%Y/Y, the strongest annual rate since early 2009. In contrast, the monthly net flow of new loans to households continued to fall in April, down a steeper €6bn on an adjusted basis. That reflected a notable weakening in consumer credit (down €14bn, the most since the series began), leaving the stock of such loans up just 1.3%Y/Y, the weakest for almost five years. In contrast, demand for loans for house purchases continued to rise last month, although this seems highly likely to fall back in due course as the economic downturn weighs on the housing market.

German retail sales fell by less than expected in April

With social distancing measures in place, and tallying with the further drop in demand for consumer credit, today's April expenditure figures from the euro area's largest two member states were weak. But the 5.3%M/M drop in Germany's retail sales was smaller than feared and only marginally larger than the 4%M/M fall recorded in March, as certain 'non-essential' stores were allowed to reopen from 20 April. Admittedly, this still left sales down 6½%Y/Y, the steepest annual drop since February 2009. And certain store types continued to suffer to a much greater degree – i.e. sales of clothing and footwear were down 39%M/M – while sales of food and pharmaceutical products fell having risen in March.

But French household spending dropped at a record rate

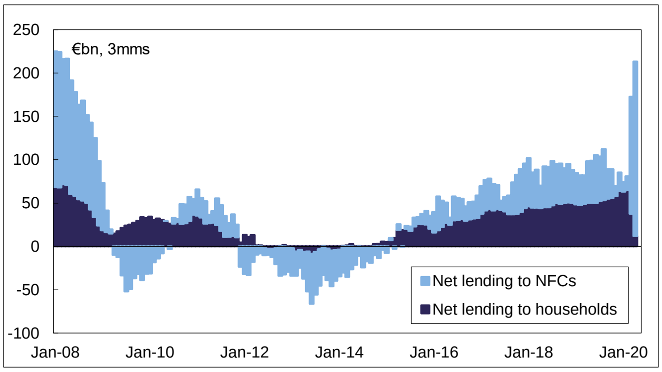
French consumer spending on goods, however, dropped more abruptly, down 20.2%M/M following a fall of 16.9%M/M in March. And the near-40%M/M decline in spending on durable goods reflected exceptionally low sales of autos, as well as further weakness in spending on furniture and household appliances. There was also another sharp fall in clothing sales. And spending on food reversed roughly half the near-9%M/M increase seen in March. Overall, French household spending on goods was down a whopping 34.1%Y/Y, the steepest annual drop on record. The jump in the French household savings rate (up 4½ppts to 19.6% in Q1, the highest since 1978) suggests that consumers have funds available to support a rebound in spending in coming months. And, indeed, earlier this week INSEE reported stronger spending in the week after the reopening of non-essential stores on 11 May. However, as households will remain uneasy about unemployment risks and restrictions will continue to affect many services sectors, we expect them to remain cautious with their spending habits for a while yet.

The coming week in the euro area and US

The highlight of the coming week will be Thursday's ECB meeting at which we fully expect the Governing Council to agree an increase in asset purchases. In particular, we expect the PEPP total to be increased by a further €500bn, with the programme extended into 2021, perhaps as far as September 2021 to match the timescale of the recent changes to collateral rules. The ECB might also announce that the principal payments from maturing PEPP bonds will be reinvested for an extended period of time. In light of the European Commission's proposal to issue €750bn of bonds to fund recovery, the ECB might also signal its readiness to increase the share of the PEPP programme taken by supra-national bonds. And the Governing Council could also signal a willingness to buy bonds of fallen angels within the context of its corporate bond purchase programme.

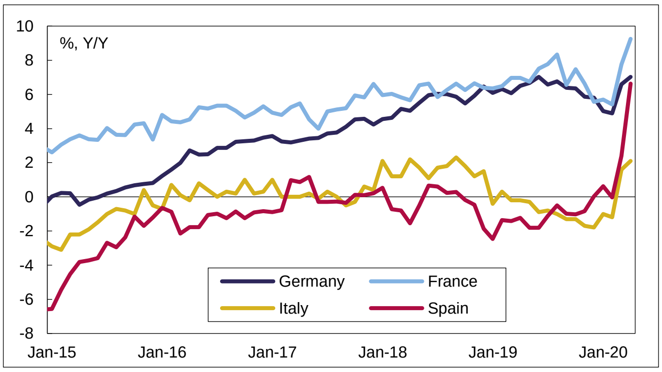
By the end of last week, the ECB had bought €211.9bn under the PEPP programme, out of the current target of €750bn. But the justification for increasing and extending the programme further will be provided by the ECB's latest set of staff forecasts. Following the April Governing Council meeting, the ECB published three illustrative scenarios, whereby GDP would drop by around 5%, 8% and 12% respectively under the "mild", "medium" and "severe" assumptions. The account of that meeting, however, suggested that even last month the Governing Council members judged the "mild" scenario to be unrealistic. And, according to recent comments by ECB President Christine Lagarde, the ECB's updated forecast is likely to show a path for output somewhere between the "medium" and the "severe" scenario, which would also be broadly in line with our own baseline projection. Even assuming no second wave of pandemic and lockdowns, it would also imply that GDP would not be

Euro area: Lending flows to households and NFCs



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Lending to NFCs by member state



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

expected to return to the pre-pandemic level before end-2022 or beyond. So, underlying inflation would remain weak over the full forecast horizon.

Datawise, the final manufacturing and service sector PMIs for Germany, France and the euro area will feature at the start of the week, coming on Monday and Wednesday respectively, with the equivalent survey results for Italy and Spain to be released for the first time. With restrictions on activity having been gradually eased, these are expected to confirm the main findings of the flash estimates that economic activity picked up slightly in May, albeit remaining well down from the pre-crisis level. The headline euro area composite measure, which will be published alongside the service sector figures on Wednesday, is expected to match the flash estimate of 30.5, up from a record low of 13.6 in April but still firmly below the key 50 level. And the equivalent construction PMIs will be released on Thursday.

The labour market also features at the start of the week with Spanish May jobless claims figures out on Tuesday, followed by German data for the same month and the aggregate euro area unemployment numbers for April on Wednesday. But with tens of millions of workers on government-supported furlough schemes, the full labour market impact of the crisis will not be fully reflected in the unemployment figures. Indeed, the euro area unemployment rate is expected to rise less than 1ppt from the March level of 7.4%, and thus remain well down on the high of 12.1% reached in 2013.

In terms of the latest activity data, national car production and registration data for May will be released through the week, starting with the Italian registrations figures on Monday. The coming week will also bring the release of euro area retail sales figures for April on Thursday. Consumer spending figures out of the worst affected member states, such as those from France today, have been dire and this will be reflected in the aggregate euro area measure, which is expected to show a further fall of more than 12%M/M following the drop of 11.2%M/M in March. And on Friday, German factory orders data for April are expected to show a further decline of about 20%M/M reflecting widespread factory closures as well as slumping demand both at home and from abroad. In the markets, Germany will auction index-linked bonds on Tuesday and €4bn of 2025 bonds on Wednesday, while France and Spain will sell fixed-rate bonds on Thursday.

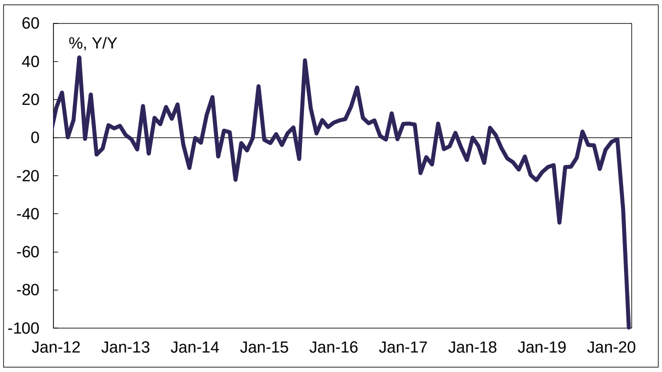
In the US, the coming week kicks off with the release of the final manufacturing PMI and ISM manufacturing indices for May on Monday, which will be followed by the release of the non-manufacturing indices on Wednesday. Tuesday will bring May vehicle sales figures. Also published on Wednesday will be final factory orders data for April as well as the ADP employment report for May. The usual weekly initial claims figures will be published on Thursday, alongside trade figures for April and final productivity and costs data for Q1. But the main event of the week will come on Friday with the release of the May employment report, which is expected to show a jump in the unemployment rate close to 20%, while nonfarm payrolls are expected to drop by several millions following the decline of more than 20mn in April.

UK

Car production comes to a halt

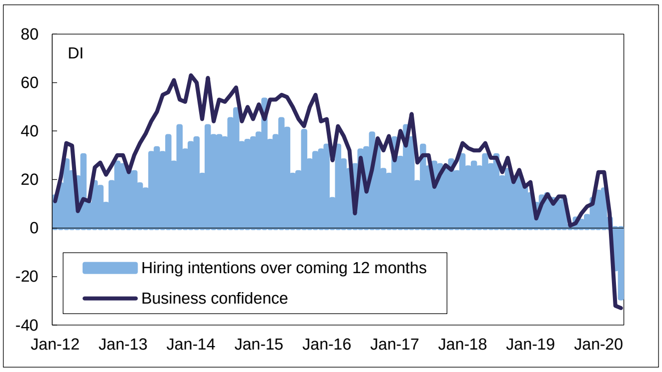
With the UK's economy having been largely in lockdown during April, today's car production figures for that month were unsurprisingly extremely weak. Indeed, according to the Society of Motor manufacturers and Traders (SMMT), firms produced just 197 units in April, the lowest monthly output since the Second World War and down 99.7% compared with a year earlier. The tiny number produced were premium cars, which received finishing touches after having been assembled before plants closed for the lockdown. This left production in the year to date down 27.6%YTD/Y. And while car manufacturing plants have now started to resume production, with strict social distancing measures in place, factories will likely continue to run well short of capacity for some time to come. Meanwhile, today's Lloyds business barometer suggested only a modest tick up in sentiment among manufacturing, retailers and services. And with construction sector sentiment having fallen sharply, the overall business barometer edged slightly lower in May to -33%, the lowest since December 2008.

UK: Car production



Source: SMMT, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Business confidence and hiring intentions



Source: Lloyds business barometer, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Economic optimism about the outlook fell further, while assessments of trading prospects remained at a record low. And firms indicated that their hiring intentions fell to a nine-year low in May, with almost 40% of firms expecting no wage increases over the coming twelve months either.

The coming week in the UK

There is little in the way of new top-tier UK economic data scheduled for release in the coming week. Of most note will be Tuesday's lending figures from the Bank of England which are expected to show a further surge in bank loans to business to meet emergency liquidity needs but a continued reduction in net borrowing by consumers in April as households refrained from spending during the lockdown. The final PMIs for the manufacturing and services sectors will be published on Monday and Wednesday respectively, with the construction PMI following on Thursday. Like in the euro area, the UK's preliminary PMIs suggested that the pace of decline in economic activity eased somewhat this month as social distancing rules were relaxed very gradually. In particular, the composite output PMI rose 13.8pts to 28.9. But this was still the second-lowest reading on the series and almost 10pts below the trough during the GFC to suggest ongoing extremely deep contraction at an unprecedented pace. Thursday will also bring new car registrations figures for May, which seem bound to have remained extremely weak as car dealerships remained closed. On Friday, the final GfK consumer confidence survey for May will be published. In the markets next week, the DMO will sell £3.25bn of 2026 bonds and £3bn 2030 bonds on Tuesday, followed by more long-dated bonds on Wednesday.

Daiwa economic forecasts

	2019		2020				2019	2020	2021
	Q3	Q4	Q1	Q2	Q3	Q4			
GDP growth, %, Q/Q									
Euro area	0.3	0.1	-3.8	-14.0	6.3	3.5	1.2	-10.2	5.7
Germany	0.3	-0.1	-2.2	-7.5	3.0	2.0	0.6	-5.9	3.0
France	0.3	-0.1	-5.3	-18.0	9.0	5.5	1.5	-13.5	8.9
Italy	0.1	-0.2	-5.3	-18.0	7.0	2.0	0.3	-15.1	4.3
Spain	0.4	0.5	-5.2	-18.0	9.0	5.0	2.0	-13.0	8.2
UK	0.5	0.0	-2.0	-20.0	10.0	4.0	1.4	-11.7	5.8
Inflation, %, Y/Y									
Euro area									
Headline CPI	1.0	1.0	1.1	0.1	-0.1	-0.3	1.2	0.2	0.7
Core CPI	0.9	1.2	1.1	0.8	0.3	0.1	1.0	0.6	0.4
UK									
Headline CPI	1.8	1.4	1.7	0.6	0.2	0.2	1.8	0.7	0.8
Core CPI	1.7	1.6	1.6	1.3	0.9	0.5	1.7	1.1	0.5
Monetary policy									
ECB									
Refi Rate %	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deposit Rate %	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Net asset purchases*	0	20	107	107	107	107	20	107	20
BoE									
Bank Rate %	0.75	0.75	0.10	0.10	0.10	0.10	0.75	0.10	0.10
Net asset purchases**	0	0	36	58	58	58	0	58	0

**Monthly target €bn, end of period. **Monthly target £bn, end of period.*
Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		M3 money supply Y/Y%	Apr	**8.3**	8.2	7.5	-
		CPI estimate (core CPI) Y/Y%	May	**0.1 (-0.1)**	0.1 (0.8)	0.4 (0.9)	-
Germany		Retail sales M/M% (Y/Y%)	Apr	**-5.3 (-6.5)**	-12.0 (-14.0)	-5.6 (-2.8)	-4.0 (-1.2)
France		Preliminary CPI (EU-harmonised CPI) Y/Y%	May	**0.2 (0.2)**	0.3 (0.3)	0.3 (0.4)	-
		Consumer spending M/M% (Y/Y%)	Apr	**-20.2 (-34.1)**	-14.7 (-32.2)	-17.9 (-18.1)	-16.9 (-17.0)
		Final GDP Q/Q% (Y/Y%)	Q1	**-5.3 (-5.0)**	-5.8 (-5.4)	-0.1 (0.9)	-
Italy		Final GDP Q/Q% (Y/Y%)	Q1	**-5.3 (-5.4)**	-4.7 (-4.8)	-0.2 (0.1)	-
		Preliminary CPI (EU-harmonised CPI) Y/Y%	May	**-0.1 (-0.2)**	-0.1 (-0.2)	0.0 (0.1)	-
UK		Lloyds business barometer	May	**-33**	-	-32	-
Auctions							
Country		Auction					
Italy		Auction: €2.5bn of 1.85% 2025 bonds at an average yield of 0.91%					
		Auction: €1bn of 2023 floating-rate bonds at an average yield of 0.53%					
		Auction: €4bn of 0.95% 2030 bonds at an average yield of 1.42%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 01 June 2020			
EMU		09.00	Final manufacturing PMI	May	39.5	33.4
Germany		08.55	Final manufacturng PMI	May	36.8	34.5
France		08.50	Final manufacturing PMI	May	40.3	31.5
Italy		08.45	Manufacturing PMI	May	35.3	31.1
		17.00	New car registrations Y/Y%	May	40.9	-97.6
Spain		08.15	Manufacturing PMI	May	37.8	30.9
UK		09.30	Final manufacturing PMI	May	40.6	32.6
			Tuesday 02 June 2020			
Spain		08.00	Unemployment change '000s	May	244.0	283.9
UK		07.00	Nationwide house price index M/M% (Y/Y%)	May	-1.0 (2.8)	0.7 (3.7)
		09.30	Net consumer credit £bn (Y/Y%)	Apr	-3.7 (-)	-3.8 (3.7)
		09.30	Net mortgage lending £bn (approvals '000s)	Apr	1.4 (22.8)	4.8 (56.2)
			Wednesday 03 June 2020			
EMU		09.00	Final services (composite) PMI	May	28.7 (30.5)	12.0 (13.6)
		10.00	Unemployment rate %	Apr	8.1	7.4
		10.00	PPI Y/Y%	Apr	-1.5 (-3.7)	-1.5 (-2.8)
Germany		08.55	Final services (composite) PMI	May	31.4 (31.4)	16.2 (17.4)
		08.55	Unemployment rate % (change '000s)	May	6.2 (194)	5.8 (373)
France		08.50	Final services (composite) PMI	May	29.4 (30.5)	10.2 (11.1)
Italy		08.45	Services (composite) PMI	May	26.0 (28.0)	10.8 (10.9)
		09.00	Unemployment rate %	Apr	9.2	8.4
Spain		08.15	Services (composite) PMI	May	25.0 (-)	7.1 (9.2)
UK		00.01	BRC shop price index Y/Y%	May	-	-1.7
		09.30	Final services (composite) PMI	May	27.8 (28.9)	13.4 (13.8)
			Thursday 04 June 2020			
EMU		10.00	Retail sales M/M% (Y/Y%)	Apr	-15.0 (-20.7)	-11.2 (-9.2)
		12.45	ECB Main refinancing rate %	Jun	0.00	0.00
		12.45	ECB Marginal lending facility %	Jun	0.25	0.25
		12.45	ECB Deposit facility rate %	Jun	-0.50	-0.50
Germany		08.30	Construction PMI	May	-	31.9
UK		09.00	New car registrations Y/Y%	May	-	-97.3
		09.30	Construction PMI	May	30.0	8.2
			Friday 05 June 2020			
Germany		07.00	Factory orders M/M% (Y/Y%)	Apr	-17.5 (-27.0)	-15.6 (-16.0)
Italy		09.00	Retail sales M/M% (Y/Y%)	Apr	-10.0 (-)	-20.5 (-18.4)
Spain		08.00	Industrial production M/M% (Y/Y%)	Apr	-	-11.9 (-12.2)
UK		00.01	Final GfK consumer confidence	May	-34	-33

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 01 June 2020
Euro area		-	Public holiday in certain member states – Whit Monday
			Tuesday 02 June 2020
Germany		10.30	Auction: €500mn of 0.5% 2030 index-linked bonds
UK		10.00	Auction: £3.25bn of 0.125% 2026 bonds
		11.30	Auction: £3bn of 0.375% 2030 bonds
			Wednesday 03 June 2020
Germany		10.30	Auction: €4bn of 0% 2025 bonds
UK		10.00	Auction: £3.25bn of 2.25% 2023 bonds
		11.30	Auction: £1.5bn of 1.625% 2054 bonds
			Thursday 04 June 2020
EMU		12:45	ECB monetary policy announcement
		13:30	ECB President Lagarde's policy meeting press conference
France		09.50	Auction: 0% 2030 bonds
		09.50	Auction: 2.5% 2030 bonds
		09.50	Auction: 0.75% 2052 bonds
Spain		09.45	Auction: 0% 2023 bonds
		09.45	Auction: 0% 2025 bonds
		09.45	Auction: 0.5% 2030 bonds
		09.45	Auction: 1.85% 2035 bonds
		09.45	Auction: 0.15% 2023 index-linked bonds
			Friday 05 June 2020
Germany		-	German sovereign debt to be rated by DBRS

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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