Euro wrap-up

Overview

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- Bunds followed Treasuries lower, despite a big jump in German unemployment and a plunge in Italian employment.
- Gilts also made losses, even as the final UK services PMIs remained consistent with marked contraction and inflation on the high street fell sharply.
- Thursday brings the ECB policy announcement, where we expect the PEPP programme to be expanded and extended into 2021. Euro area retail sales and UK car registrations numbers are also due.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.649	+0.029
OBL 0 04/25	-0.585	+0.048
DBR 0 02/30	-0.352	+0.067
UKT 0½ 07/22	-0.011	+0.029
UKT 0⅝ 06/25	0.057	+0.033
UKT 4¾ 12/30	0.280	+0.059

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

Euro area

German unemployment rises above expectations

Government support programmes continue to limit the impact of the coronavirus on the euro area's labour market. Indeed, Germany's Labour Office today announced that firms registered 1.06mn workers for possible participation on the government's 'kurzabeit' subsidised short-time work programme in May, on top of the 10.66mn registered in the prior two months. And a survey by the ifo Institute published yesterday suggested that 7.3mn workers actually participated in the scheme. However, despite the assistance provided by the kurzabeit scheme, today's data also revealed a larger-than-expected rise of 238k in German jobless claims in May, taking the level to 2.875mn, 610k above the cyclical trough in February and March. That left the national claimant count unemployment rate up 0.5ppt from April to 6.3%, the highest since December 2015. Despite the easing of restrictions on economic activity over recent weeks, in due course, we expect hundreds of thousands of workers on the kurzabeit scheme to be made redundant. And with the number of job vacancies having declined again last month, down more than 40k to the lowest level since September 2015, we expect the claimant count rate to rise further over coming months.

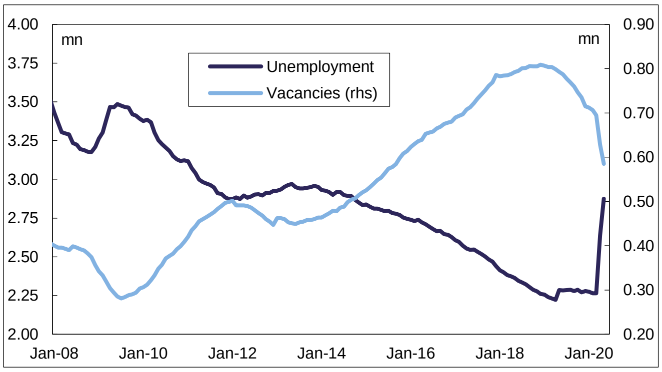
Italian employment plunges

By last week, Italy's equivalent to the kurzabeit scheme – the CIG – had seen more than 1.1mn firms register for the potential participation of more than 7.9mn workers. However, with the duration of the subsidies far shorter (the government will provide support for just nine weeks in Italy compared to up to a year in Germany), the impact on employment is likely to be less durable. Today's Italian labour market data reported a record drop of 274k in employment in April. Following the fall of 124k the prior month, this left the number of people in work down almost 500k from a year earlier to the lowest level since November 2016. Given the difficulty of being available for work during the lockdown, inactivity leapt almost 750k in April following a rise of 420k in March to be up almost 1.5mn from a year earlier. So, counter-intuitively, Italian registered unemployment fell 483k and the jobless rate dropped 1.7ppts to 6.3%, the lowest since 2007. With large swathes of those out of work having become unintentionally inactive rather than registered as unemployed, these data are highly unrepresentative of the true conditions in the Italian labour market.

Euro area unemployment rate to rise over coming months

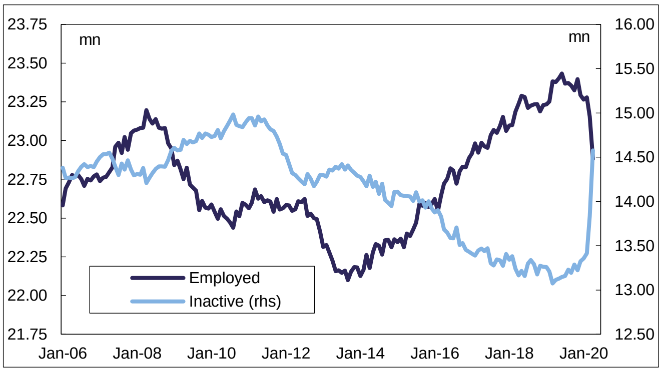
Elsewhere, the headline unemployment rate data were not quite so misleading with, e.g., increases of 1.1ppts in France to 8.7% and 0.6ppt in Spain to 14.8%. But these figures were also flattered by temporary government support policies. And the rise of 0.2ppt in the aggregate euro area unemployment rate to a three-month high of 7.3% certainly fails to provide an

Germany: Unemployment and vacancies



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Italy: Employment and inactivity



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

accurate gauge of the current extent of labour market slack. We fully expect to see a far more significant rise in the unemployment rate over coming months, both in Italy and the euro area as a whole.

PMIs nudged slightly higher, but remain extremely weak

The flash PMIs had pointed to some modest improvement in economic conditions in May as lockdown measures gradually started to ease across the euro area. And today's final release showed a modest upwards revision to the preliminary headline euro area composite PMI, by 1.4pts to 31.9, a three-month high and up 18.3pts from April's trough. The upwards revision was driven by the services activity PMI, which rose 18½pts on the month to 30.5, similarly a three-month high. But these indices still remained at historically low levels – the composite PMI was more than 4pts below the global financial crisis trough – and consistent with marked contraction. This was also true of the manufacturing output index, which despite the 17½pt increase in May stood at just 35.6. And while other survey components suggested that the worst has now passed, overall new business continued to fall sharply as economic uncertainty remained elevated and firms remained relatively pessimistic about the outlook for the coming twelve months.

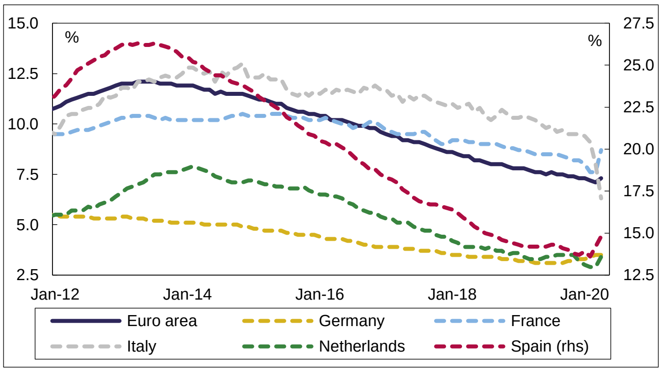
The picture was broadly the same in each of the largest four member states. The final German and French composite PMIs were both revised higher from the flash estimates, to 32.6 and 32.1 respectively, up about 15pts and 20pts on the month. And the Italian and Spanish indices were also more positive compared with April, perhaps inevitably so given the extreme weakness of the previous readings. Nevertheless, the services PMIs for these countries (28.9 and 27.9 respectively) remained below the levels of the larger two member states. But given the surprisingly strong Italian manufacturing PMI last month, this left that country's composite PMI up 23pts to 33.9, the highest of the member states. In contrast, the Spanish composite PMI remained the weakest at 29.2. Of course, given the recent extreme shock, it is difficult to interpret what the PMIs really imply for the level of activity over the past month. While they suggest that April likely marked the trough, output across the region will have undoubtedly declined sharply over the second quarter as a whole.

The day ahead in the euro area and US

All eyes tomorrow will be on the ECB meeting at which we fully expect the Governing Council to agree an increase in asset purchases. In particular, while the precise amount and timeframe is highly uncertain, 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 – figures published yesterday suggested that so far such bonds had accounted for 6% of PEPP purchases. The Governing Council could also hint at a willingness to buy bonds of fallen angels within the context of its corporate bond purchase programme. And the Governing Council could make amendments to other elements of its policy framework, e.g. via an adjustment in the tiering multiplier to exempt a larger share of banks' excess reserves held at the central bank from the negative policy rate.

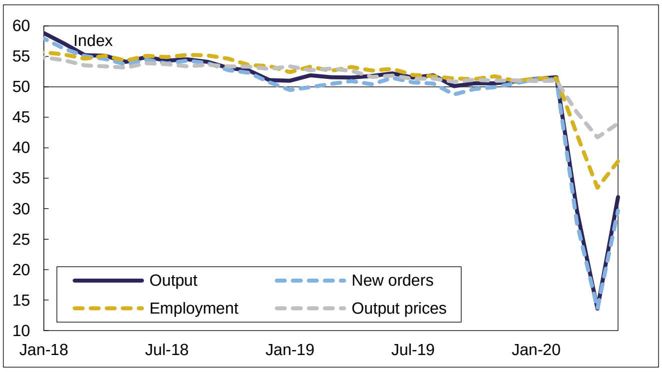
The justification for increasing and extending the programme further will be provided by the ECB's latest set of staff forecasts. Following the April Governing Council meeting, the ECB published three illustrative scenarios, whereby GDP would drop by around 5%, 8% and 12% respectively under the "mild", "medium" and "severe" assumptions. The account of that meeting, however, suggested that even then 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 expected to return to the pre-pandemic level before end-2022 or beyond.

Euro area: Unemployment rates



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Composite PMI



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

Datawise, Thursday sees the release of euro area retail sales data for April. Regional spending figures already published suggest that Germany's retailers have weathered the pandemic storm better than other member states, albeit with sales down 5.3%M/M in April. In contrast, French household consumption on goods and Spanish retail sales fell by more than 20%M/M in April, the most on record. Consequently, euro area retail sales are forecast to have fallen 15%M/M in April (and 20.6%Y/Y), as the lockdowns imposed across the region significantly impacted spending on non-essentials. Construction PMIs for May from members states, also due to be published tomorrow, will provide further evidence that the economic weakness remains broad-based. In the markets, France will auction a range of long-dated bonds, while Spain will hold both fixed-rate and index-linked bond auctions of various maturities.

Meanwhile, in the US, the usual weekly initial claims figures will be published, alongside trade figures for April and final productivity and labour costs data for Q1.

UK

Services PMI still at second-lowest reading on record

Like in the euro area, there was a modest upwards revision to the UK's final services PMI in May. In particular, the headline index was revised by 1.2pts from the flash estimate, leaving it more than 15½pts higher than April's figure at 29. But this still marked the second-lowest reading in the survey's 24-year history and the overall message remained extremely downbeat. For example, more than half of respondent firms indicated a further decline in activity in May, reflecting not least the severe lack of new business as spending slumped during the lockdown. Indeed, new orders continued to fall last month, albeit to a lesser degree than in April. As such, firms took further advantage of the government's job retention scheme and continued to scale back their workforces. But with expectations about the year ahead still extremely subdued, some services firms had inevitably made more permanent redundancies. Overall, taken together with the manufacturing survey, the composite PMI (30) still pointed to an exceptionally sharp contraction in activity, despite having more than doubled from its level in April. And the forward-looking components signalled significant uncertainty about the near term too.

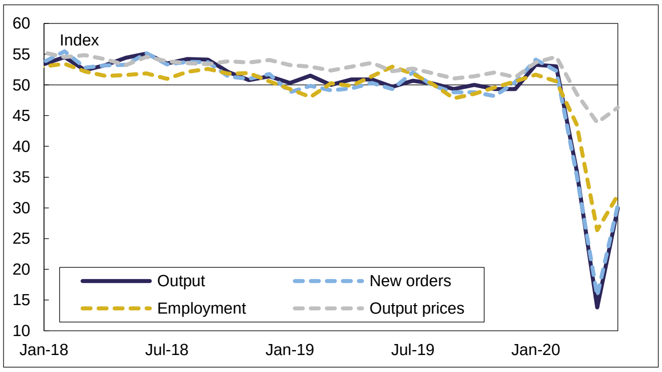
Inflationary pressures weaken

While some firms indicated heightened costs associated with rising supplier surcharges, on the whole input prices continued to fall on the back of lower wage and energy costs. And with services firms having reported another sharp decline in prices charged, overall the composite output price PMI remained firmly below 50 for the third consecutive month and the second-lowest reading for eleven years. The negative effect on inflation of the slump in demand last month was also evident in today's release of the BRC shop price survey. In particular, the survey measure of non-food prices was down 4.6%Y/Y in May – the steepest annual drop since the series began in 2006 – as retailers cut prices further to try to attract consumers as non-essential high street stores remained closed. And with food prices having eased back slightly too, the BRC's measure of overall shop price inflation fell considerably further in May, down 0.7ppt to -2.4%Y/Y, also the sharpest drop since the series began. While the BRC's inflation rate has repeatedly undershot the official CPI figures by a significant margin, today's release supports our view that headline and core inflation will fall back significantly over the near term.

The day ahead in the UK

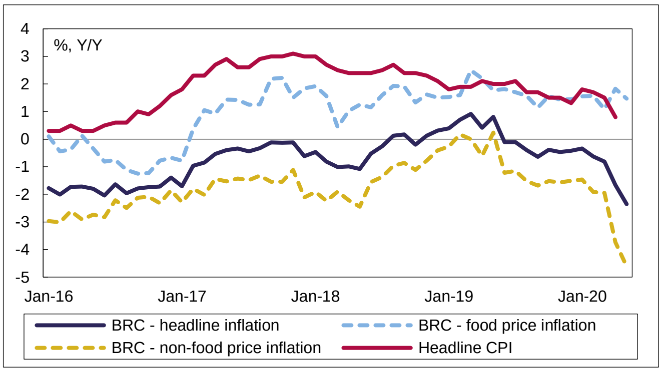
Following today's service sector PMI, tomorrow brings the release of the construction PMI for May, which is expected to reveal a sharp moderation in the pace of decline, with the headline index forecast to rise to 29.4, from 8.2 in April as construction workers returned to work, albeit under social distancing rules. Meanwhile, new car registrations data for May will likely remain extremely weak as showrooms remained closed until 1 June and demand remained muted against the backdrop of ongoing economic uncertainty.

UK: Composite PMI



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

UK: Measures of inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Final services (composite) PMI	May	**30.5 (31.9)**	28.7 (30.5)	12.0 (13.6)	-
		Unemployment rate %	Apr	**7.3**	8.2	7.4	**7.1**
		PPI Y/Y%	Apr	**-4.5**	-3.7	-2.8	-
Germany		Final services (composite) PMI	May	**32.6 (32.3)**	31.4 (31.4)	16.2 (17.4)	-
		Unemployment rate % (change '000s)	May	**6.3 (238)**	6.2 (190)	5.8 (373)	**- (372)**
France		Final services (composite) PMI	May	**31.1 (32.1)**	29.4 (30.5)	10.2 (11.1)	-
Italy		Services (composite) PMI	May	**28.9 (33.9)**	26.0 (28.0)	10.8 (10.9)	-
		Unemployment rate %	Apr	**6.3**	9.2	8.4	**8.0**
Spain		Services (composite) PMI	May	**27.9 (29.2)**	25.0 (-)	7.1 (9.2)	-
UK		BRC shop price index Y/Y%	May	**-2.4**	-	-1.7	-
		Final services (composite) PMI	May	**29.0 (30.0)**	27.8 (28.9)	13.4 (13.8)	-

Auctions

Country		Auction
Germany		sold €3.4bn of 0% 2025 bonds at an average yield of -0.62%
UK		sold £3.25bn of 2.25% 2023 bonds at an average yield of -0.002%
UK		sold £1.5bn of 1.625% 2054 bonds at an average yield of 0.612%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ Daiwa forecast	Previous
EMU		10.00	Retail sales M/M% (Y/Y%)	Apr	-15.0 (-20.6)	-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	29.4	8.2

Auctions and events

Country		BST	Auction / Event
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

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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