Euro wrap-up

Overview

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- Bunds followed USTs higher while data showed a continued decline in euro area labour market slack, albeit with ample spare capacity in some member states.
- Gilts made modest gains at the short end of the curve despite another upside surprise to UK inflation.
- Thursday will bring the ECB's latest policy announcements, which will see the Governing Council respond to the recent extreme jump in inflation, deterioration in economic sentiment and tightening of financial conditions.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	0.051	-0.012
OBL 0 04/27	0.537	-0.026
DBR 0 02/32	0.756	-0.029
UKT 1 04/24	1.498	-0.013
UKT 1¼ 07/27	1.558	-0.007
UKT 4¼ 06/32	1.807	+0.005

*Change from close as at 4:00pm BST.
Source: Bloomberg

Euro area

Labour force participation rises further in Q4

Ahead of tomorrow's ECB announcements, today's quarterly Labour Force Survey results provided an update on the extent of euro area labour market slack, which will have a bearing on wage growth and hence domestically generated inflation over coming quarters. Despite the pandemic wave that picked up across the euro area in the final quarter of last year, today's data suggested that labour force participation continued to rise. Indeed, contrasting with the US and UK where the size of the labour force remains well down on pre-pandemic levels, the activity rate of people aged 15-74 years rose 0.2ppt to a record-high 64.8%, some 2.5ppts above the trough at the start of the pandemic. And activity rates for those age groups of 40 years and above rose further in Q4 too. So, the decline in the unemployment rate last quarter, down 0.3ppt to 7.0%, was underpinned by another solid increase in employment, which took the rate up 0.5ppt to 60.2%, also a new series high.

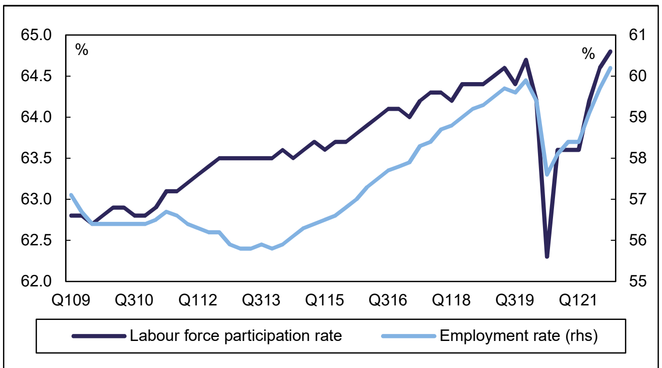
Labour market slack narrows to new low, but still ample in certain member states

As such, overall labour market slack – which includes workers who would like to work longer hours as well as all those available for work, job seeking and classified unemployed – fell significantly towards the end of 2021, by 0.5ppt to 14.5%, 2ppts lower than the pandemic peak and ½ppt lower than the previous low in Q419. Of course, there remained significant important differences among member states. For example, slack was unsurprisingly lowest in Germany (7.2%). But while at series lows in France (15.3%), Italy (21.2%) and Spain (22.4%), the respective figures still implied large amounts of spare capacity. The normalisation of economic activity following the latest pandemic wave should allow for further increases in employment in certain services sub-sectors, and so might well bring a corresponding decline in labour slack. Nevertheless, with the economy to fall well short of full employment, and business and household confidence having deteriorated in the wake of the war in Ukraine, wage pressures, and hence second-round effects on inflation, are highly likely to remain limited.

BoF revises down Q1 GDP growth forecast to just ¼%Q/Q amid rising economic uncertainty

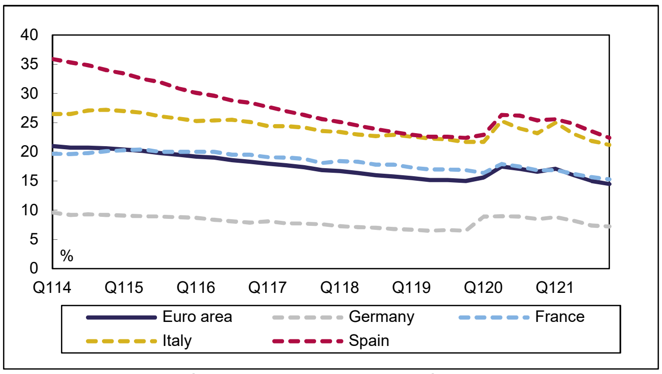
The Bank of France's business survey for March suggested that, despite the impact of the Ukraine conflict on confidence, prices and supply chains, activity in French industry and construction fell only slightly last month. And this impact was largely offset by a continued pickup in services, particularly in hospitality and recreation following the lifting of pandemic restrictions. Nevertheless, given a clearer picture of previous months, the BoF revised down its estimate for Q1 GDP growth by ½ppt to ¼%Q/Q. And while it suggested that the picture for April remained relatively positive, the outlook for manufacturers and construction firms in particular looks more questionable. Certainly, the survey saw the headline manufacturing sentiment index fall 4pts to a six-month low as firms flagged increased supply challenges over the past month relating to both the

Euro area: Labour participation and employment*



*Ages 15-74 years. Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Labour market slack*



*Ages 20-64 years. Source: Eurostat and Daiwa Capital Markets Europe Ltd.

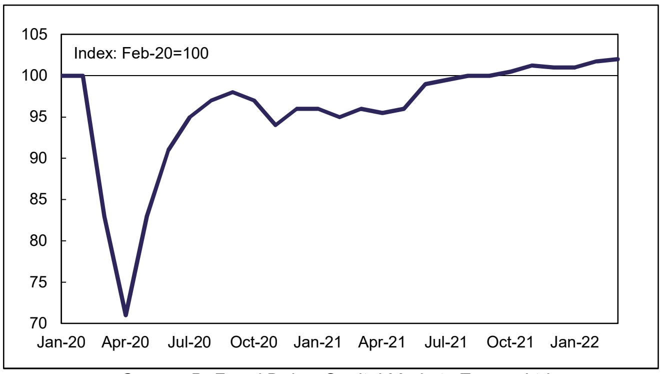
Ukraine war and renewed Covid restrictions in China. Indeed, 60% of manufacturers – the highest share since the question was first asked in May 2021 – assessed supply bottlenecks to be a limiting factor on production, with almost 90% of auto producers and 59% of firms in the agri-food industry adversely affected due not least to their exposures to Ukraine and Russia.

The day ahead in the euro area

The main event tomorrow will be the Governing Council's latest policy announcements. Since its last meeting in March, the economic outlook has clearly deteriorated, with CPI inflation having risen to a new record high of 7.5%Y/Y, while the anticipated near-term profile would put inflation closer in line with the ECB's adverse scenario (5.9%Y/Y) than its baseline (5.1%Y/Y) for this year as a whole. At the same time, the further eroding of real disposable incomes has already brought a substantial worsening in consumers' expectations of their personal finances, with business confidence weakened too. Over coming months, firms seem bound to be further impacted by supply shortages and higher cost burdens, which will continue to restrain the post-pandemic economic recovery and add to downside risks to the medium-term inflation outlook. With still significant slack in the labour market, second-round effects on inflation from wages will likely remain lacking. However, with markets having priced-in a series of rate hikes by the ECB over coming quarters, financial conditions have tightened significantly since the 9-10 March meeting, with bond yields and spreads higher and yesterday's bank lending survey signalling a substantial tightening in lending standards to come this quarter.

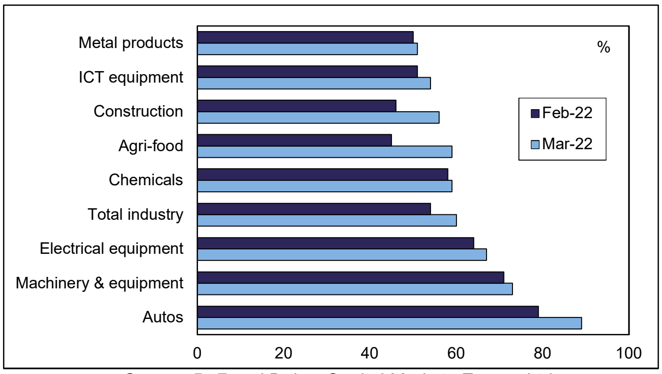
So, while the jump in inflation suggests that the hawks are likely to continue to have the upper hand tomorrow, the Governing Council will again acknowledge significant two-sided risks to the economic outlook. Importantly, its current forward guidance already makes clear that the profile of the ECB's asset purchases in Q3 will be data dependent. And as the decision on policy next quarter will not be taken until June, when updated economic projections will be available, the forward guidance should remain unchanged this week. As such, arguably of most interest tomorrow will be Lagarde's post-meeting press conference, which will be closely watched for how the balance of views on the Council might have shifted if at all since last meeting. In light of recent spread widening and the upwards shift in nominal Bund yields of recent months, however, it will also be interesting to see whether Lagarde alludes to any willingness to amend the Council's preferred sequencing of policy normalisation to allow for a continuation of net asset purchases beyond the first rate hike to help to reduce the risks of an excessive tightening of financial conditions as and when rate lift-off occurs.

France: BoF monthly GDP estimate



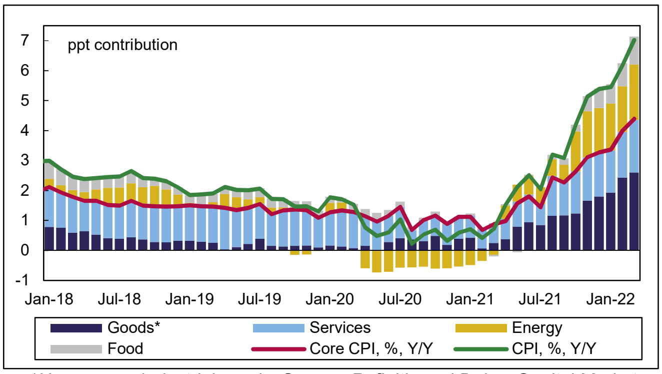
Source: BoF and Daiwa Capital Markets Europe Ltd.

France: Share of firms reporting supply difficulties



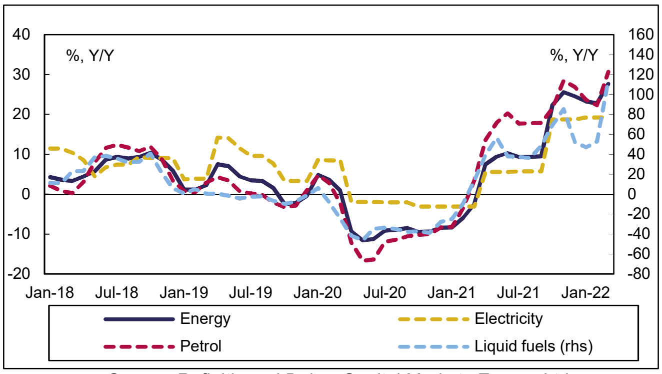
Source: BoF and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation



**Non-energy industrial goods. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.*

UK: Energy CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

UK CPI inflation again beat expectations with headline and core CPI at fresh 30-year highs

UK inflation once again exceeded expectations, with the headline CPI rate rising a hefty 0.8ppt in March to 7.0%Y/Y, a new 30-year high. The biggest contribution to the rise in inflation inevitably came from energy prices, as petrol prices rose almost 10%M/M to see the respective annual rate accelerate more than 8ppts to 30.7%Y/Y, with prices of liquid fuels for heating up a whopping 44%M/M (113.9%Y/Y). But pressures were again broad-based, with inflation of food and non-alcoholic beverages up 0.8ppt to 5.9%Y/Y, the highest in more than a decade. Services inflation was also significantly stronger, up 0.5ppt to a nine-year high of 4.0%Y/Y, with hospitality up 1.9ppts to 6.9%Y/Y and transport services up 0.8ppt to 4.8%Y/Y on increased train fares, although both components were likely flattered by base effects given tighter restrictions in place this time last year. Moreover, inflation of non-energy industrial goods also rose 0.5ppt, to a new series high of 7.9%Y/Y, with clothes and footwear prices up almost 10%Y/Y and prices of furniture and other household items up a little more than 10%Y/Y, as retailers continued to pass on cost pressures to consumers. So, the monthly increase in prices of core items (0.9%M/M) was last higher as far ago as April 1993, to leave the annual rate up 0.5ppt to 5.7%Y/Y, also a 30-year high.

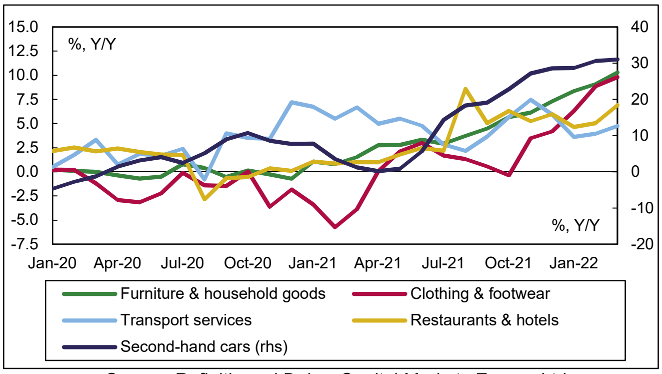
Headline inflation to jump above 8½%Y/Y in April

Looking ahead, while the rise in petrol prices will be significantly smaller in April – so far this month they are on average up a little more than 1% compared with March despite the government's cut in fuel duty – the jump in the household energy price cap by more than 50% will likely see energy inflation leap above 50%Y/Y in April. And with pipeline pressures continuing to mount (input producer price inflation rose 4.1ppts to 19.2%Y/Y in March with the output PPI rate up almost 2ppts to 11.9%Y/Y), UK inflation now looks set to rise firmly above 8½%Y/Y this month. High energy inflation will keep headline inflation at an elevated rate (likely above 7%Y/Y) for the remainder of the year too. But we continue to expect base effects associated with the recent spike in prices of energy and certain other items affected by recent supply disruption eventually to become a drag, allowing inflation to fall back sharply next year to below the BoE's 2% target by year-end. Indeed, there were already hints in today's data that certain supply-side price pressures that evolved during the pandemic have started to wane, with prices of used cars down for the second successive month in March. With real disposable incomes falling sharply, and the economy highly dependent on consumer spending, the probability of a significant weakening in UK economic growth – and indeed outright recession – over coming quarters continues to rise, an eventuality which would also weigh heavily on the medium-term inflation outlook.

The day ahead in the UK

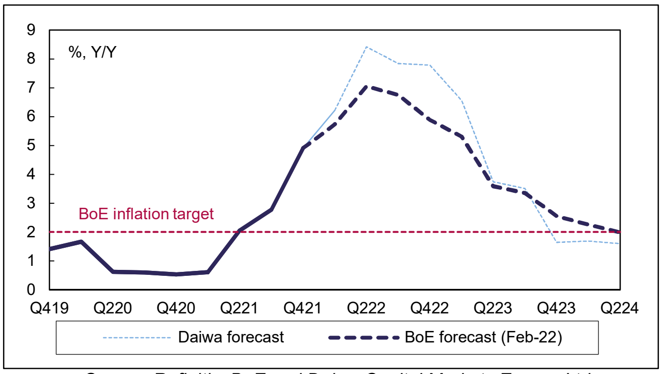
A relatively quiet end to the week for UK top-tier data releases brings the latest RICS residential market survey for April, which is expected to show that the persisting supply-demand imbalance continues to result in strong house price growth despite the recent pickup in mortgage rates. The BoE's latest credit conditions survey is also due to be published.

UK: Selected CPI components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: CPI forecast



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

European calendar

Today's results

Economic data							
Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
France	Bank of France industrial sentiment	Mar	**103**	104	107	-
Italy	Industrial production M/M% (Y/Y%)	Feb	**4.0 (3.3)**	1.4 (0.9)	-3.4 (-2.6)	-
Spain	Final CPI (EU-harmonised CPI) Y/Y%	Mar	**9.8 (9.8)**	*9.8 (9.8)*	7.6 (7.6)	-
UK	CPI (core CPI) Y/Y%	Mar	**7.0 (5.7)**	*6.8 (5.5)*	6.2 (5.2)	-
	PPI input (output) prices Y/Y%	Mar	**19.2 (11.9)**	15.1 (11.1)	14.7 (10.1)	**15.1 (10.2)**
	House price index Y/Y%	Feb	**10.9**	10.1	9.6	**10.2**

Auctions	
Country	Auction
Germany	sold €3.27bn of 0% 2032 bonds at an average yield of 0.83%
Italy	sold €3.75bn of 1.2% 2025 bonds at an average yield of 1.32%
	sold €1.5bn of 0.45% 2029 bonds at an average yield of 2.04%
	sold €1bn of 3% 2029 bonds at an average yield of 2.04%
	sold €750mn of 3.1% 2040 bonds at an average yield of 2.69%
	sold €1bn of 2.15% 2052 bonds at an average yield of 2.89%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	12.45	ECB refinancing rate %	Apr	*0.00*	0.00
	12.45	ECB deposit rate %	Apr	*-0.50*	-0.50
UK	00.01	RICS house price balance %	Mar	75	79

Auctions and events		
Euro area	12.45	ECB monetary policy announcement
	13.30	ECB President Lagarde speaks at post-Governing Council meeting press conference
UK	09.30	BoE publishes Credit Conditions Survey for Q1

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.