Euro wrap-up

Overview

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- While euro area retail sales and German exports and car output weakened, Bunds made modest losses and BTPs significantly underperformed after hawkish remarks from a key ECB Board member and the EU moved closer to an embargo on Russian oil.
- Gilts made a mix of modest gains and losses following some firm UK data on loans to households and high-street shop prices.
- Thursday will bring the latest BoE monetary policy announcement and forecast update along with data for German factory orders and French IP.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	0.256	-0.004
OBL 0 04/27	0.711	+0.010
DBR 0 02/32	0.968	+0.007
UKT 1 04/24	1.616	-0.010
UKT 1¼ 07/27	1.717	-
UKT 4¼ 06/32	1.964	+0.009

*Change from close as at 5.00pm BST.
Source: Bloomberg

Euro area

“We need to act”: Schnabel validates market pricing of ECB rate hikes

Ahead of next month’s key monetary policy meeting, the ECB’s Governing Council met in Frankfurt today to discuss “non-monetary policy” matters. We would not be surprised, however, if the policymakers held informal preparatory discussions on macroeconomic conditions and the policy outlook. If so, we suspect that the majority view will be the one presented by highly influential ECB Executive Board member Isabel Schnabel in an interview with Handelsblatt published yesterday evening. With inflation continuing to exceed expectations and becoming increasingly broad-based, Schnabel suggested a sense of urgency to normalise policy, arguing that “Talking is no longer enough, we need to act” to prevent high inflation from becoming entrenched in expectations. So, she stated that the ECB will be able to end net asset purchases at the end of June. And – while insisting that the decision would be data-dependent – she not only agreed that a rate increase in July is “possible”, but used the tone of her remarks to suggest that a July hike is probable. Indeed, she appeared keen to press ahead with a series of hikes, noting that real interest rates are still deeply negative close to historical lows and hence “quite far off” from neutral levels, some estimates of which she stated are now “well on the positive side”. Overall, therefore, she appeared more or less to validate current market pricing of at least three ECB rate hikes by year-end and, if economic activity allows, more in 2023.

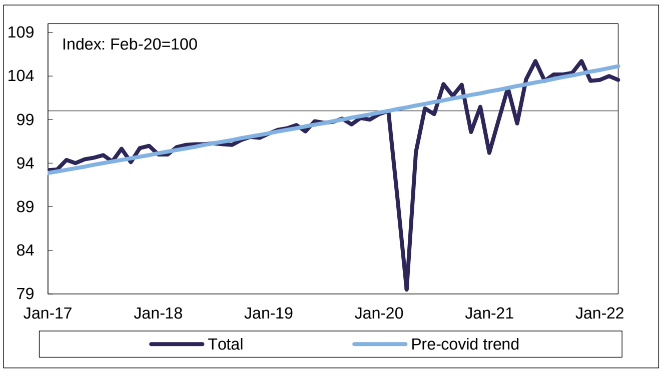
Retail sales fall in Q1 to below the pre-pandemic trend

While she noted that the ECB has a Treaty obligation to achieve price stability rather than support economic activity, Schnabel also judged that positive economic growth – rather than stagflation – was likely to continue. That, of course, remains to be seen. Certainly, plenty of data are already reflecting a negative impact on demand from high inflation and the war in Ukraine. For example, close to expectations, today’s euro area retail sales figures reported a real-terms drop of 0.4%M/M in March. That left sales down more than 2.0% from the peaks recorded last June and November. And it meant that sales declined 0.8%Q/Q in Q1 to below the pre-pandemic trend. The weakness in March, and over Q1 as a whole, reflected a fall in core sales (i.e. at non-food, non-fuel stores) of 1.2%M/M and 0.8%Q/Q, with sales of fuel down 2.9%M/M and 1.5%Q/Q. Despite greater opportunities to eat out, food and drink sales were up 0.8%M/M and 0.2%Q/Q. Among the large member states, sales were weakest in Q1 in Spain (-3.2%Q/Q) and Germany (-1.2%Q/Q).

German car production remains in reverse as supply bottlenecks persist

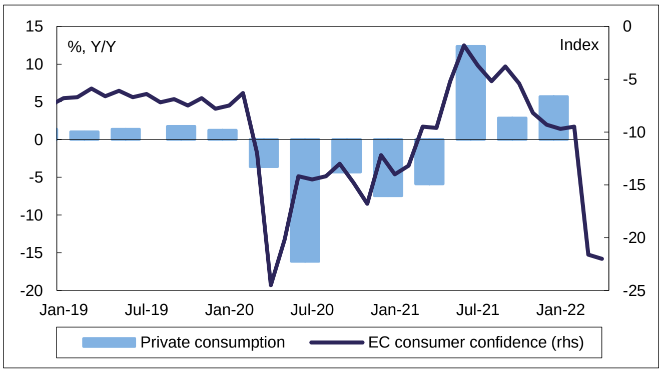
But even if demand was to be resilient, today’s German car production numbers illustrated the downside risks to activity from ongoing supply-chain disruptions. The latest ifo survey suggested that some 75% of all manufacturers continued to suffer

Euro area: Retail sales



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Consumption and consumer confidence



Source: Refinitiv, European Commission and Daiwa Capital Markets Europe Ltd.

supply challenges last month. That represented a drop of about 5ppts from March. But in some subsectors – e.g. metals, food and computers – the disruption has worsened due to the war, while in others supply challenges are still almost all-pervasive. With almost 90% of car manufacturers affected, the German automobile industry association (VDA) reported that car production remained weak in April, down 13%Y/Y. While this was a softer pace of decline than in March (-24%Y/Y), the number of cars produced in the first four months of the year was just 1.1mn, also some 13% lower than in the same period of 2021 and almost 35% lower than between January and April in 2019. The results of another ifo survey today also suggested that, not least due to the war in Ukraine, automakers have become more pessimistic about the near-term outlook, and suppliers in the sub-sector are now as downbeat as at the onset of the pandemic. Admittedly, car manufacturers are somewhat less gloomy about the current business situation, as they are maintaining profit margins by increasing prices. And they expect to increase prices further over coming months too. The survey also suggested that orders remain robust. So, if and when supply bottlenecks eventually ease, German auto output should rebound vigorously.

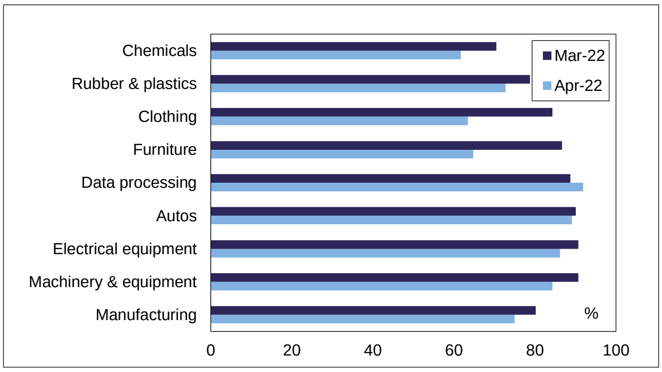
German exports fall most since first wave of Covid-19, trade surplus at two-decade low

While high inflation and supply-chain disruption is weighing on domestic sales and production, external demand has also softened. Today's full German goods trade report for March reported a drop in the value of exports of 3.3%M/M, the steepest since the first wave of Covid-19 in April 2020. Unsurprisingly, and as flagged in the earlier flash figures, the weakness was driven by a steep slump in shipments to Russia, down a whopping 62.3%M/M as sanctions took their toll. In addition, the value of exports to China fell by more than 4%M/M as renewed lockdowns in that countries likely constrained trade, while shipments to the UK were also down around 4%M/M. These negative impacts were offset to some extent by a solid rise in exports to the US (3.2%M/M) as well as growth to EU countries outside the euro area (0.9%M/M). But with the value of imports up 3.4%M/M, Germany's trade surplus narrowed by €7.9bn to €3.2bn, the smallest since 2000. Of course, the value of trade shipments continues to be boosted by higher prices. So, when adjusting for such effects, export volumes fell a more substantive 6.8%M/M in March, the most since April 2020, to leave them down 2.8%3M/3M. But with import volumes down 3.5%3M/3M, today's release suggested that net goods trade provided a modest boost to German GDP growth in Q1. When also including services, however, net trade was probably a modest drag.

Lower German reliance on Russian energy gives Commission green light for oil embargo

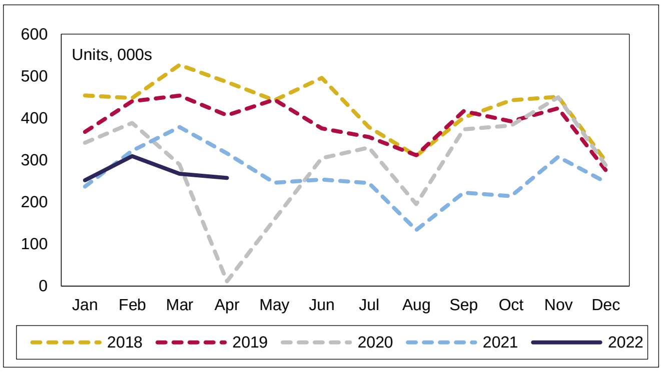
Of course, the sanctions are having a notable impact on imports as well as exports. Buoyed by higher prices, German imports from Russia dropped just 2.4%M/M in March. However, as highlighted by the German government in its latest energy security progress report, they are likely to have fallen back significantly in April. With increased purchases from Norway and the Netherlands, Russia accounted for around 35% of German natural gas imports in mid-April, down about

Germany: Share of firms with material shortages



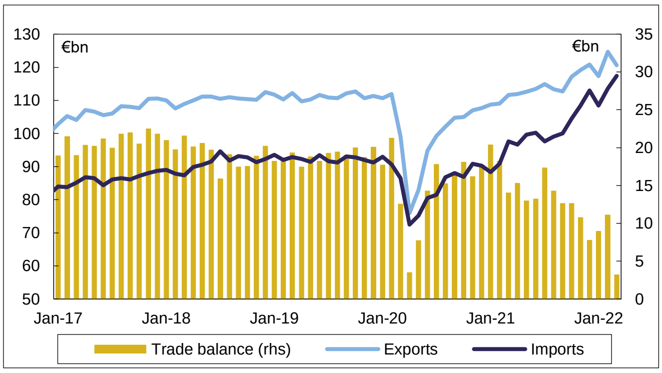
Source: ifo institute and Daiwa Capital Markets Europe Ltd.

Germany: Car production



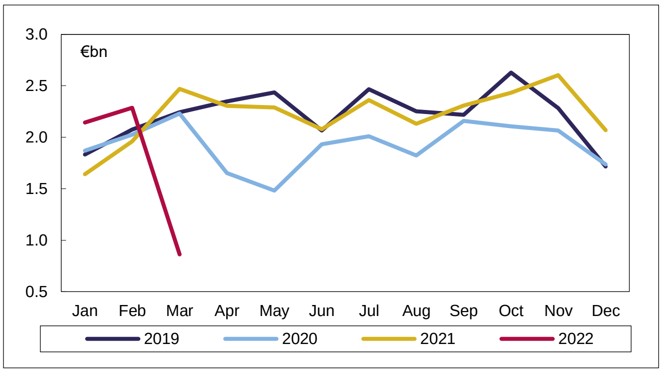
Source: Bloomberg, VDA and Daiwa Capital Markets Europe Ltd.

Germany: Trade, export and import values



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Exports to Russia



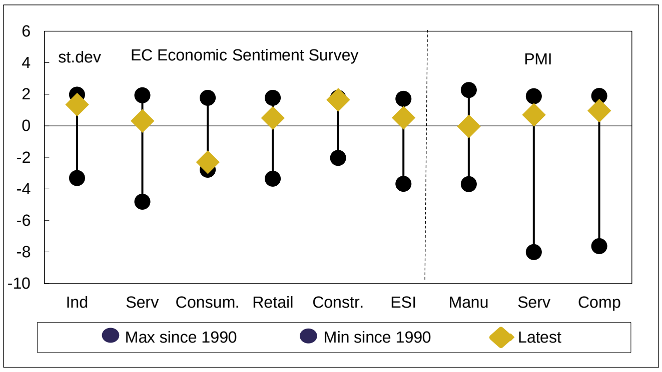
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

20ppts from the previous average. Russia's share of German hard coal consumption dropped some 42ppts to just 8%, with the ban on the new purchase and import of Russian coal having entered into force on 9 April and existing contracts to be fulfilled only until mid-August. Moreover, the share of German oil imports accounted for by Russia has fallen more than 20ppts to just 12%. And the German government now judges that, with the exception of Rosneft, all oil companies located in its territory will in due course be able to meet their needs without Russian crude. That gave the green light to the European Commission to propose today a new sanctions package requiring the phase out of Russian crude supply over the coming six months, with refined products banned by the end of the year. And while such action previously might have been expected to add upwards pressure on oil prices – and there was an upwards shift of more than $3 in the spot price to above $108.5 today – the Brent crude curve remains downwards-sloping, implying a drop below $100 per barrel by January when Russia's share of oil imports should have declined to zero. Given the infrastructure currently in place, however, achieving full independence from Russian natural gas without a marked impact on overall economic activity will prove far more challenging.

Surveys mixed, but final PMIs signal a pickup in GDP growth at the start of Q2

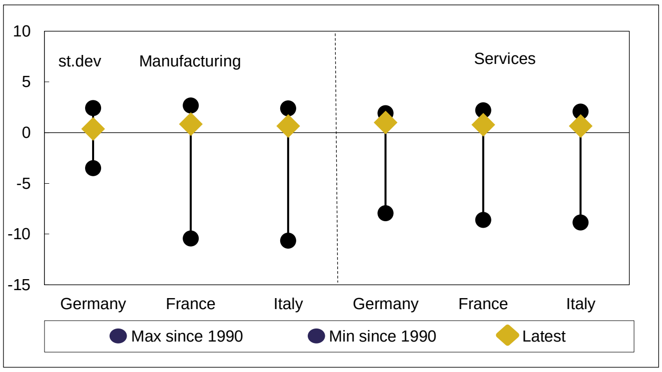
For the time being, with natural gas still flowing, Isabel Schnabel's assertion that positive GDP growth is ongoing remains broadly supported by the economic surveys. For example, today's final services PMIs for April reaffirmed that the sector continues to benefit from the relaxation of pandemic restrictions and a desire for normalisation. Indeed, the euro area activity PMI rose for the third consecutive month in April and by 2.1pts to an eight-month high of 57.7, up more than 3½pts above the Q1 average. There was also a further notable improvement in the new business component to the highest since August, despite still subdued demand from abroad. The improvement in conditions in the sector was reportedly widespread among member states, with the German and French activity PMIs up 1.5pts to 57.6 and 58.9 respectively, the former an eight-month high and the latter the strongest since the start of 2018. And there were more significant improvements in the respective Italian and Spanish services PMIs last month, with the activity indices up by more than 3½pts to 55.7 and 57.1 respectively. At the start of the week, the final manufacturing PMIs pointed to a stagnation in output in the sector (the respective index dropped to a 22-month low of 50.7). Nevertheless, the euro area composite PMI rose almost 1pt to a seven-month high of 55.8, firmly above the long-run average. Admittedly, the Commission's sentiment indices published at the start of the week were not quite so upbeat, even for the services sector. But currently only consumer and investor confidence indices – and certain national survey indicators such as the German ifo business climate index – are loudly sounding recession risks.

Euro area: Headline survey indicators



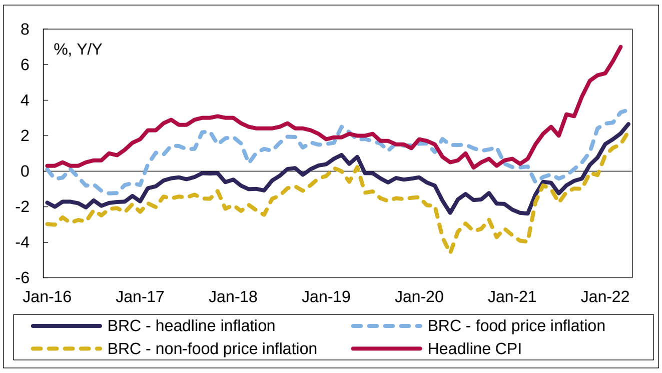
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: PMIs by country



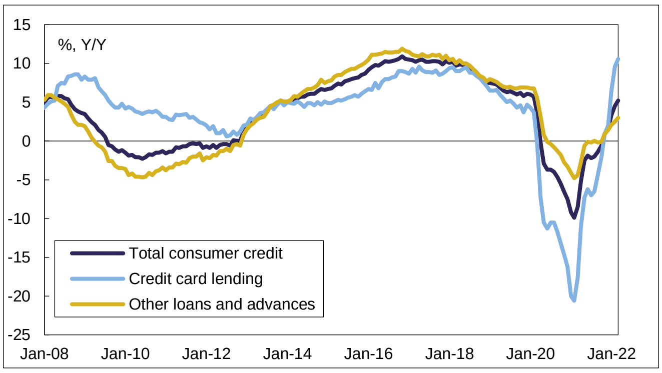
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Consumer and shop price inflation



Source: Refinitiv, ONS, BRC and Daiwa Capital Markets Europe Ltd.

UK: Consumer credit



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Tomorrow's economic data calendar brings the release of German factory orders for March and French industrial production numbers for the same month. German factory orders are expected to have fallen in March, by 1.1%M/M, albeit leaving total orders 3.1% higher in Q1 compared with Q4. Meanwhile, French IP is expected to have declined just 0.2%M/M in March, while manufacturing production is expected to have risen 0.3%M/M, leaving both categories higher on the quarter in Q1, by 0.8% and 1.7% respectively. Tomorrow will also see the publication of the latest construction PMIs for the euro area, Germany, France and Italy. ECB Chief Economist Lane's speech on the euro area economic outlook will also be worth watching. While normally dovish and still mindful of downside risks to activity, Lane's recent comments suggest that he would be unlikely to resist a rate hike in July.

UK

Prices on the UK high street up the most since 2011 despite competition on every-day essentials

Ahead of tomorrow's BoE monetary policy announcements, today's BRC shop price survey was the latest to suggest that UK businesses continue to pass on a share of their higher cost burdens to consumers, despite an apparent weakening of demand amid the increasing squeeze on household budgets. In particular, the BRC's measure of shop price inflation jumped 0.6ppt to 2.7%Y/Y in April, the highest since September 2011. According to the survey, there was a slight moderation in fresh food inflation on the High Street due to strong competition among supermarkets on every-day essentials. But overall food price inflation edged up, by 0.2ppt to 3.5%Y/Y, the most since the start of 2013, as global food prices reached a record high last month. And with supply bottlenecks exacerbated by the war in Ukraine and renewed lockdowns in China, there were also signs of more intense inflationary pressures elsewhere, with the survey's measure of non-food inflation up 0.7ppt to 2.2%Y/Y, the highest since the series began in 2006. The BRC also warned of more price rises ahead, with cost pressures likely to be increasingly passed on to consumers of a wider range of goods over coming months. However, not least due to the exclusion of prices of energy, cars and services, the BRC survey measure of shop price inflation will continue to track well below CPI inflation, which stood at 7.0%Y/Y in March and is likely to rise to above 8½%Y/Y in April.

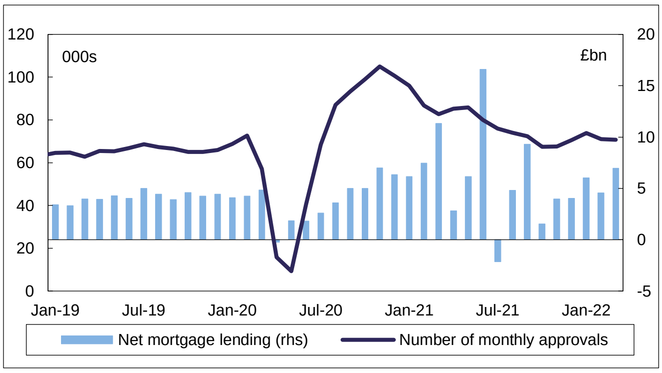
Demand for household lending boosted by credit card borrowing and robust housing activity

While retail sales remained particularly weak in March, given higher inflation and declining real disposable incomes, the BoE's latest bank lending numbers suggested that demand for consumer credit remained strong at the end of the first quarter. In particular, net unsecured lending increased £1.3bn in March, a touch softer than in February (£1.6bn) but nevertheless above the average of the previous six months (£1.0bn). And more than half was accounted for by a net increase in credit card borrowing (£0.8bn), which was almost double the pre-pandemic five-year average and 10.6% higher than a year earlier. Given the sharp decline in consumer confidence over recent months and higher secured borrowing costs – the effective interest rate on new mortgages jumped 17bps in March to 1.73%, albeit still below pre-pandemic levels – there was a somewhat surprising acceleration in demand for mortgage loans. In particular, net secured lending increased £7.0bn, above the average of the previous six months (£4.9bn) and almost twice the pre-pandemic five-year average. Looking ahead, mortgage approvals were little changed on the month (70.7k) suggesting ongoing robust mortgage growth over coming months too. Of course, with consumer confidence having fallen further in April, household budgets increasingly squeezed by higher energy bills and an increase in the national insurance contributions and the prospect that mortgage costs will rise further this month, we would expect demand for new mortgage lending to ease back in due course.

The day ahead in the UK

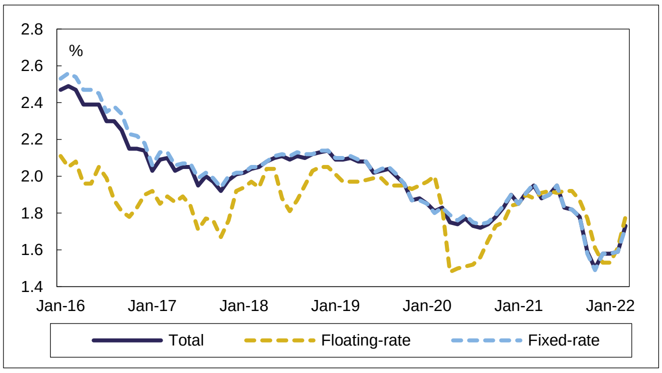
The main event in the UK tomorrow will be the BoE's MPC policy announcements and publication of the latest Monetary Policy Report. At the [previous policy meeting](#) on 17 March, the MPC tightened its monetary stance for the third successive meeting. In particular, the increase of 25bps in Bank Rate returned it to the pre-pandemic level and post-financial crisis peak of 0.75%. While eight members of the Committee backed the move, one member – Deputy Governor for Financial Stability

UK: Mortgage lending and approvals



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

UK: Effective interest rate on new mortgages



Source: BoE and Daiwa Capital Markets Europe Ltd.

Jon Cunliffe – voted for no change. And the MPC moderated slightly its forward guidance from February, stating that "some further modest tightening in monetary policy *might be* appropriate in the coming months" rather than "*is likely to be* appropriate". The policy decision at this meeting will have been dictated in large part by the Bank's updated macroeconomic projections to be published in the Monetary Policy Report, which are likely to suggest that, on unchanged monetary policy, inflation risks remain above target over the medium term. And therefore, we expect the majority of MPC members to vote for another 25bps hike in Bank Rate to 1.0%.

With that threshold met for Bank Rate, the Committee is also likely to agree to start a programme of active Gilt sales to smooth the profile of its balance sheet reduction for as long as the market is not disorderly. Comments from Deputy Governor Ben Broadbent earlier this year suggested that such sales would be "very gradual" so not to have a sudden significant market impact. And with only £37bn and £35bn of its Gilt holding scheduled to run off automatically this year and next from the current total of £847bn, even with an additional £10-15bn per month of active sales, the full process of reducing the size of the balance sheet – perhaps to the pre-pandemic level as a share of GDP – would take a number of years.

We expect the BoE's updated projections to suggest that inflation would fall below the target by the end of the horizon if rates and energy prices evolved in line with the paths implied by current market pricing. And given significant uncertainty regarding events in Ukraine, energy and commodity prices, as well as the substantive downwards skew to risks to domestic and external demand, we think that the MPC will maintain relatively cautious forward guidance, suggesting again merely that "some further *modest* tightening in monetary policy *might be* appropriate in the coming months".

Data-wise, UK new car registrations are likely to have remained very weak in April, reflecting both softer demand and increasing supply constraints. Similarly, the final service PMI is expected to confirm some loss of recovery momentum in the sector at the start of the second quarter, as the cost of living crisis and economic uncertainty related to the Ukraine war weighed somewhat on consumer demand. Indeed, the headline services activity index fell 4.3pts to 58.1, a three-month low, while the new business component was down a more striking 5.8pts to 54.6, the second-lowest reading for fourteen months

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Final services (composite) PMI	Apr	**57.7 (55.8)**	57.7 (55.8)	55.6 (54.9)	-
		Retail sales M/M% (Y/Y%)	Mar	**-0.4 (0.8)**	-0.3 (1.8)	0.3 (5.0)	**0.4 (5.2)**
Germany		Trade balance €bn	Mar	**3.2**	10.0	11.4	**11.1**
		Final services (composite) PMI	Apr	**57.6 (54.3)**	57.9 (54.5)	56.1 (55.1)	-
		New car registrations (production) Y/Y%	Apr	**-21.5 (-18.5)**	-	-17.5 (-29.3)	-
France		Final services (composite) PMI	Apr	**58.9 (57.6)**	58.8 (57.5)	57.4 (56.3)	-
Italy		Services (composite) PMI	Apr	**55.7 (54.5)**	54.3 (53.7)	52.1 (52.1)	-
Spain		Unemployment change '000s	Apr	**-86.3**	-74.0	-2.9	-
		Services (composite) PMI	Apr	**57.1 (55.7)**	55.9 (-)	53.4 (53.1)	
UK		BRC shop price index Y/Y%	Apr	**2.7**	-	2.1	-
		Net consumer credit £bn (Y/Y%)	Mar	**1.3 (5.2)**	1.4 (-)	1.9 (4.4)	**1.6 (4.5)**
		Net mortgage lending £bn (approvals '000s)	Mar	**7.0 (70.7)**	4.7 (70.0)	4.7 (71.0)	**4.6 (-)**

Auctions

Country		Auction
Germany		sold €1.46bn of 0% 2031 bonds at an average yield of 0.93%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		08.30	Construction PMI	Apr	-	52.8
Germany		07.00	Factory orders M/M% (Y/Y%)	Mar	-1.1 (-0.7)	-2.2 (2.9)
		08.30	Construction PMI	Apr	-	50.9
France		07.00	Industrial production M/M% (Y/Y%)	Mar	-0.2 (1.4)	-0.9 (2.4)
		08.30	Construction PMI	Apr	-	48.4
Italy		08.30	Construction PMI	Apr	-	62.9
UK		09.00	New car registrations Y/Y%	Apr	-	-14.3
		09.30	Final services (composite) PMI	Apr	58.3 (57.6)	62.6 (60.9)
		12.00	BoE Bank Rate %	May	*1.00*	0.75

Auctions and events

Country		BST	Event
Euro area		11.30	ECB Chief Economist Lane scheduled to speak on 'The euro area economic outlook'
Germany		10.30	Auction €1.5bn of 2031 green bonds
France		09.50	Auction: 0% 2032 bonds
		09.50	Auction: 0.5% 2040 bonds
		09.50	Auction: 0.75% 2053 bonds
Spain		09.30	Auction: 1.27% 2027 bonds
		09.30	Auction: 0.8% 2029 bonds
		09.30	Auction: 1.45% 2071 bonds
		09.30	Auction: 0.7% 2033 index-linked bonds
UK		12.00	BoE monetary policy announcement, summary, monetary policy report and minutes to be published
		12.30	BoE Governor Bailey presents BoE's monetary policy report
		-	BoE publishes monthly decision maker panel data for Apr-22

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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