Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Despite some weak German factory orders data and commentary from a few ECB doves, Bunds made significant losses.
- Gilts made significant gains at the shorter end of the curve as the BoE hiked Bank Rate by 25bps but published extremely downbeat economic projections and, contrary to expectations, failed to agree a programme of active Gilt sales.
- Friday will German and Spanish industrial production data and further commentary from ECB and BoE policymakers.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/24	0.271	+0.014
OBL 0 04/27	0.756	+0.046
DBR 0 02/32	1.041	+0.089
UKT 1 04/24	1.524	-0.092
UKT 1¼ 07/27	1.663	-0.055
UKT 4¼ 06/32	1.970	+0.005

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

UK

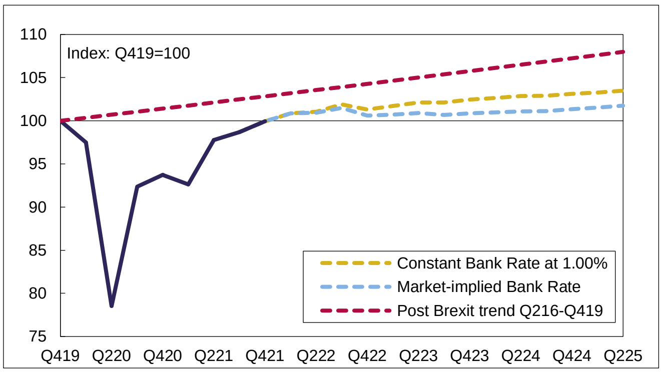
BoE delivers a dovish rate hike

As expected, the BoE raised Bank Rate by 25bps to 1.00% today. Unlike at the last meeting in March when one member voted for no change, this time around all nine members of the Committee voted to tighten policy. Moreover, three (all of whom are external members) voted for a larger hike of 50bps. However, overall, today's announcements from the BoE pointed to a significantly less hawkish outlook for monetary policy than has been priced into the market. While most members of the MPC judged that "some degree of further tightening in monetary policy may still be appropriate in the coming months", they recognised the two-sided risks to that judgement. Moreover, some members appear simply unconvinced by the case for another rate hike. While the BoE's updated forecast of the near-term path for CPI inflation was revised sharply higher, its updated outlook for GDP was (appropriately) extremely weak. And as a result, inflation is expected to fall back sharply from the start of 2023. Indeed, assuming a market-implied path for Bank Rate – that rises to around 2½% by mid-2023, before falling to 2% by the end of the projection period – the BoE projects that inflation would likely fall well below target to less than 1½%Y/Y by the first half of 2025. Also assuming a market-implied (i.e. downward-sloping) path for wholesale energy prices, the BoE projects inflation to drop to below 1%Y/Y over the same timeframe.

Inflation expected to rise above 10%Y/Y by year-end, with hints of second-round effects

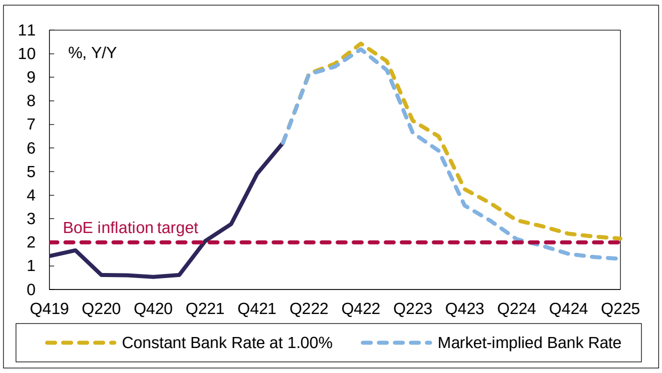
The decision to raise rates today was in part explained by the further upwards revision to the near-term profile of inflation. Given wholesale energy market developments since the previous Monetary Policy Report in February, BoE staff now assume that the regulated household energy price cap will rise a further 40% in October, on top of the rise of 54% last month. With the labour market now tighter than the BoE previously expected, wage growth has been stronger than it anticipated, and underlying pay growth is expected to rise further as the year goes on as some firms consider further increases in pay settlements or one-off bonuses to compensate for high inflation. So, domestically-generated price pressure – with hints of second-round effects – are expected to compound the massive external price shock from energy, food and other imported goods markets. Indeed, the BoE noted that companies expect their selling prices to rise strongly over coming months, with a significant share seeking to rebuild margins. As a result, inflation is now projected to peak above 10%Y/Y in Q4. And while base effects should allow inflation to fall back from Q1 on, assuming no change to monetary policy rates the BoE judged that it would likely remain above the 2% target over the projection horizon.

UK: BoE GDP forecast*



**Market-implied Bank Rate to rise to 2.5% by mid-2023 and fall to 2.0% by mid-2025. Source: BoE and Daiwa Capital Markets Europe Ltd.*

UK: BoE inflation forecast*



**Market-implied Bank Rate to rise to 2.5% by mid-2023 2023 and fall to 2.0% by mid-2025. Source: BoE and Daiwa Capital Markets Europe Ltd.*

GDP forecast to take a step down in Q4 and contract over 2023 as a whole

Given exceptionally high inflation this year, the BoE now expects real household disposable income to decline a sharp 1¾%Y/Y this year – ½ppt more than it previously thought and the second-largest amount since records began in 1964. As a result, while households are expected to run down the stock of savings accumulated during the pandemic – indeed, the savings rate is projected to drop by Q4 to the lowest level since 1999 – consumer spending is expected to slow markedly. Business investment is expected eventually to fall back once the current tax incentives end. Housing investment is anticipated to go into retreat. And net trade is projected to continue to subtract from growth. So, GDP is forecast to slow markedly from this quarter. And with a notable contraction forecast for Q4 when the hit to real incomes will be largest, and minimal growth anticipated early next year, the BoE's baseline forecast (assuming market-implied rates) sees GDP in H123 below the level in H122 and declining ¼%Y/Y overall in 2023. Therefore, after an initial further decline over the near term, in due course the unemployment rate is forecast to rise steadily to about 5½% by the end of the projection period. And a negative output gap is expected to emerge and eventually rise to more than 2%, pushing down on underlying inflation. As a result, the BoE's baseline forecast projects CPI inflation in Q225 at just 1.3%Y/Y, and its forecast based on a market-implied path for energy prices at 0.7%Y/Y that quarter. As such, we continue to believe that market pricing of future hikes in Bank Rate is way overdone. Indeed, while we acknowledge the extraordinary uncertainty over the outlook and accept that the MPC will rightly respond to new events as they unfold, we maintain our forecast of another hike of 25bps to 1.25% in August, no further hikes thereafter, and a cut of 25bps to 1.00% in Q423.

Active Gilt sales put on ice at least until the autumn as BoE works out its strategy

The BoE did not surprise the market only via its downbeat economic forecasts today. In terms of quantitative tightening, contrary to expectations and despite its earlier guidance, the MPC decided not yet to launch a new programme of active Gilt sales. Instead, it asked Bank staff to work on a strategy for how those sales might be conducted. And as it stated that it will provide an update at its August meeting, and will make a decision on whether to commence such sales only at a subsequent meeting, there will be no active sales before September at the earliest. Indeed, with the MPC also underscoring that the decision to commence sales will depend on economic circumstances and market conditions, in light of the expectation of a significant drop in GDP in Q4, Gilt sales might well not start before next year. Today the BoE did, however, set out some information on its programme of corporate bond sales, which will start in September with the aim to complete sales at the end of 2023 or in early 2024. Detail on the frequency of such corporate bond sales, however, will be set out in August.

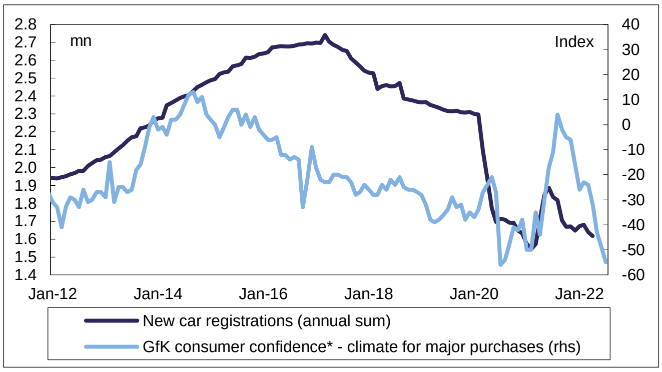
UK car registrations remain in reverse as supply bottlenecks persist

In terms of economic data, the UK's auto trade association SMMT suggested that, amid supply-constrained weakness in production, car registrations fell again in April despite the low base a year ago when car showrooms remained shut for the first half of the month. The drop of 15.8%Y/Y took the number of registrations to just 119k units, the second-weakest April outturn since 1980. So, despite a more positive start to this year as supply bottlenecks temporarily eased somewhat, registrations in the first four months of the year were still almost 5½% lower than in the same period in 2021 and almost 40% lower than between January and April in 2019. With supply constraints tighter again, and consumer confidence having plummeted over recent months as the cost-of-living crisis intensified, new car sales are likely to remain very subdued for the time being. Indeed, SMMT revised its 2022 outlook down from 1.89m units to 1.72m – which would represent an increase of just 4.4% compared with 2021 – as parts shortages continue to restrain supply.

Final services PMIs revised a touch higher, but still point to slowing momentum

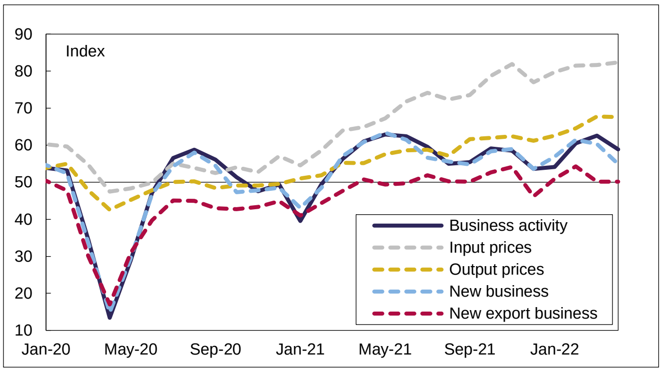
The recent softening of demand was also illustrated by today's final services PMIs, which confirmed some loss of momentum in the sector at the start of the second quarter. Indeed, despite being upwardly revised from the flash estimate, the headline services activity index fell 3.7pts in April to 58.9, a three-month low, while the new business component was down a more striking 5.5pts to 54.9, despite improved opportunities for overseas travel. And while firms anticipated the post-Covid

UK: Car registrations and consumer confidence



*Three-month lead. Source: Refinitiv, GfK, SMMT and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

recovery to continue, amid substantial cost pressures and ongoing uncertainty not least related to the Ukraine conflict, firms were the least optimistic about the outlook for activity over the coming year since the end of 2020.

The day ahead in the UK

A quiet end to the week for UK data releases brings the construction PMI survey for April, which is likely to signal ongoing solid expansion despite persistent supply constraints and price pressures. Friday will also see BoE Chief Economist Pill brief BoE agents' contacts about today's Monetary Policy Report and policy decision. External MPC members Mann (a hawk) and Tenreyro (often a dove) will also speak at separate events.

Euro area

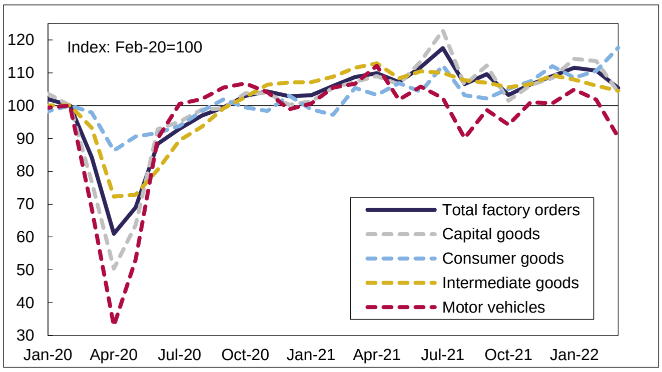
ECB doves flag stagnation risks

In line with the recent trend, today brought some further hawkish commentary from a member of the ECB's Governing Council, with the previously dovish Finnish Governor Rehn suggesting that the deposit rate should be hiked by 25bps in both July and September so that it is back to zero "when autumn comes". However, there was also some rather more cautious commentary from a few of the traditional doves on the Governing Council – Chief Economist Lane, Executive Board member Panetta and Portuguese Governor Centeno. Indeed, among other things, the former flagged early signs of a hit to labour demand since the Russian invasion of Ukraine. And the latter pair both expressed concerns that the euro area economy is now stagnating.

German factory orders fall sharply as foreign demand slumps

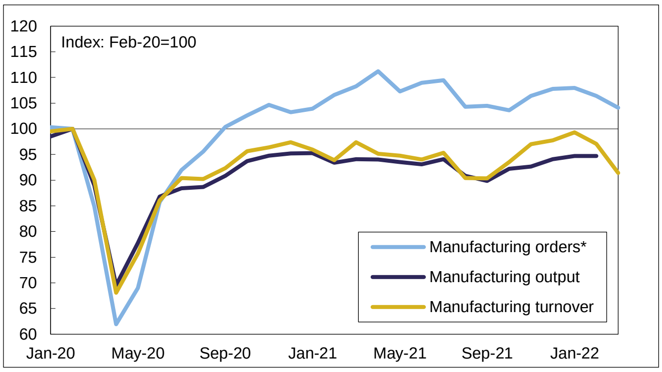
Those fears of economic stagnation might have been given further credence by today's German factory orders data for March, which fell well short of expectations. Admittedly, given the hit to confidence, demand and supply since the Russian invasion, surveys had already pointed to a softening in German manufacturing sentiment that month. Nevertheless, the drop in orders of 4.7%M/M was much larger than expected (-1.1%M/M) and marked the biggest monthly fall since October. Perhaps unsurprisingly, the weakness principally reflected a 6.7%M/M decline in overseas orders, with new orders from non-euro area countries down by more than 13%M/M. Domestic orders were also down, by 1.8%M/M. The weakness was in part exacerbated by a plunge in large-scale orders – indeed, excluding these, total orders fell a somewhat more modest 2.2%M/M, to be broadly flat over the first quarter as a whole. Looking at product-type, there was a sizeable decline in orders for capital goods orders (-8.3%M/M) suggesting an increasing reluctance to invest, while intermediate goods orders were also down for the third consecutive month (-1.5%M/M). Among other things, domestic orders of autos slumped (-16.2%M/M)

Germany: Manufacturing orders



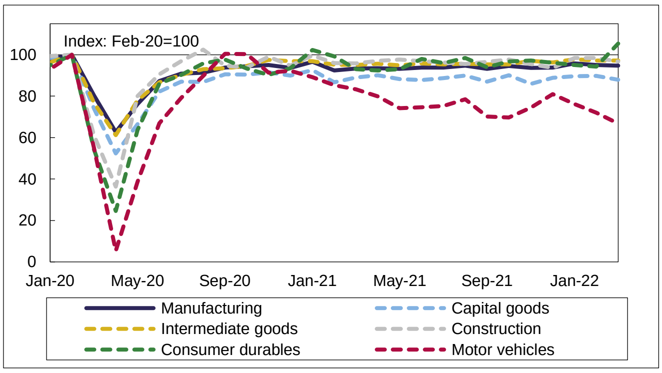
Source: Refinitiv, Destatis and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output, orders & turnover



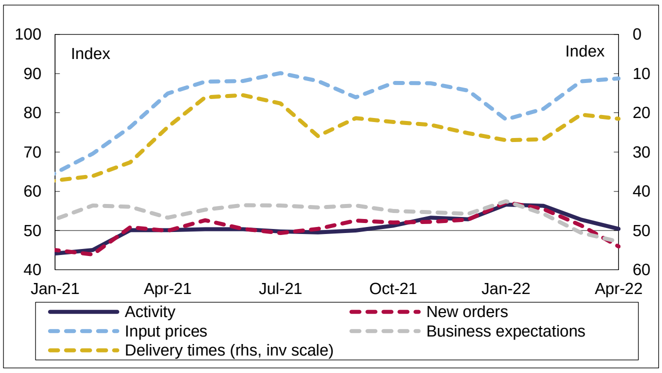
**Excluding major orders. Source: Refinitiv, Destatis and Daiwa Capital Markets Europe Ltd.*

France: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Construction PMIs



Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

to their lowest level since May 2020, with foreign orders down more than 8%M/M too, while orders for basic metals and chemicals also maintained a downwards trend. In contrast, consumer goods orders jumped (6.4%M/M) on the back of solid domestic and external demand.

Slump in German turnover points to weak IP in March, drop in French output more modest

While factory orders have maintained a steady downwards trend since last summer, they remain some 5½% above the pre-pandemic level suggesting that, as and when supply bottlenecks eventually ease, manufacturers should offer support to Germany's recovery. But for now, at least, the outlook for production remains subdued. Certainly, today's manufacturing turnover numbers reported a much steeper-than-expected drop of 5.9%M/M in March, the largest since April 2020. And this followed a downwards revision in February, with turnover estimated to have declined 2.2%M/M. And so, while these data were a less reliable guide to German manufacturing output in February (0.0%M/M) than is usually the case, they still suggest that risks to the Bloomberg consensus forecast decline in German industrial production of 1.3%M/M are skewed to the downside. While today's French industrial production figures fell slightly short of expectations, they at least suggested that the hit to manufacturers at the end of the first quarter was significantly less severe than in Germany, with French output down just 0.5%M/M in March. And although this followed a steeper-than-previously-estimated drop in February (-1.2%M/M), IP was still ½% higher over the first quarter as a whole, with manufacturing output up by more than 1%Q/Q after only a modest 0.3%M/M drop in March. This was in spite of a further drop in autos production, which fell for the third consecutive month (-7.3%M/M) to the lowest level since June 2020, to leave it still around one third lower than the pre-pandemic level.

Construction PMIs suggest a subdued start to the second quarter

While Germany's economic recovery was given a boost by the construction sector at the start of the year (5.9%M/M), activity slowed slightly in February (-0.7%M/M). And today's PMIs for April would suggest a further notable deterioration in the sector at the start of the second quarter, with the headline activity index falling in April by a 4.9pts to 46, an eight-month low and almost 9pts below February's two-year high. This in part reflected severe supply-side pressures, but also a slump in new orders – the relevant index fell more than 9pts to 36.6, the lowest April 2020. In contrast, the French construction PMI rose in April by 2.2pts to 50.6, although this was merely consistent with very subdued growth. But while the Italian activity index remained consistent with ongoing solid expansion, at 59.0 it was 3.9pts lower than in March and the softest since October. And so, overall, the euro area construction activity PMI declined for the third consecutive month, by 2.4pts to 50.4, implying little to no expansion in the sector. Moreover, the new orders component implied the steepest decline in fourteen months as elevated prices and the Ukraine war weighed on confidence. Indeed, the input price PMI rose to the second highest on the series (88.8), with supplier disruptions adding to cost burdens. And overall, firms' confidence about the outlook over the coming twelve months deteriorated to its most downbeat since November 2020.

The day ahead in the euro area

The euro area data focus tomorrow remains on the manufacturing sector, with the aforementioned German industrial production release likely to report a marked decline in output in March, due to declines in manufacturing and construction activity alike. But more consistent with today's French numbers, Spanish IP figures are also expected to report a more modest drop at the end of Q1. Italian retail sales data for March are also due. In terms of ECB commentary, Friday will be dominated by hawks, with Bundesbank Governor Nagel, Executive Board member Elderson and, once again, Finnish Governor Rehn speaking along with the (typically balanced) French Governor Villeroy.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Construction PMI	Apr	**50.4**	-	52.8	-
Germany		Factory orders M/M% (Y/Y%)	Mar	**-4.7 (-3.1)**	-1.1 (-0.7)	-2.2 (2.9)	**-0.8 (4.3)**
		Construction PMI	Apr	**46.0**	-	50.9	-
France		Industrial production M/M% (Y/Y%)	Mar	**-0.5 (0.1)**	-0.2 (1.4)	-0.9 (2.4)	**-1.2 (2.1)**
		Manufacturing production M/M% (Y/Y%)	Mar	**-0.3 (1.5)**	0.3 (-)	-0.5 (3.4)	**-0.9 (2.9)**
		Construction PMI	Apr	**50.7**	-	48.4	-
Italy		Construction PMI	Apr	**59.0**	-	62.9	-
UK		New car registrations Y/Y%	Apr	**-15.8**	-	-14.3	-
		Final services (composite) PMI	Apr	**58.9 (58.2)**	58.3 (57.6)	62.6 (60.9)	-
		BoE Bank Rate %	May	**1.00**	*1.00*	0.75	-

Auctions

Country		Auction
France		sold €6.28bn of 0% 2032 bonds at an average yield of 1.51%
		sold €2.27bn of 0.5% 2040 bonds at an average yield of 1.83%
		sold €2.45bn of 0.75% 2053 bonds at an average yield of 1.96%
Spain		sold €2.74bn of 0% 2027 bonds at an average yield of 1.387%
		sold €1.05bn of 0.8% 2029 bonds at an average yield of 1.694%
		sold €1.24bn 1.45% 2071 bonds at an average yield of 2.851%
		sold €574mn of 0.7% 2033 index-linked bonds at an average yield of -0.456%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany		07.00	Industrial production M/M% (Y/Y%)	Mar	-1.3 (-0.4)	0.2 (3.2)
Italy		09.00	Retail sales M/M% (Y/Y%)	Mar	-	0.7 (4.3)
Spain		08.00	Industrial production M/M% (Y/Y%)	Mar	-0.5 (2.8)	0.9 (3.0)
UK		09.30	Construction PMI	Apr	58.0	59.1

Auctions and events

Country		BST	Event
Euro area		08.30	ECB's Villeroy de Galhau scheduled to give keynote speech at Global Interdependence Center Central Banking Series
		10.30	ECB's Nagel scheduled to speak on "War, crises, inflation: What must monetary policy do now?"
		14.00	ECB's Elderson scheduled to participate in a Twitter Q&A session
		16.00	ECB's Rehn scheduled to speak at a seminar about how to shape economic policies in times of crises and uncertainty
UK		10.15	BoE's Mann scheduled to speak
		12.15	BoE's Pill to give economic update at National Agency briefing
		16.00	BoE's Tenreyo scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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