

Euro wrap-up

Overview

- Bunds made gains as the flash euro area PMIs slipped back in May, albeit still pointing to solid expansion and substantial price pressures, while negotiated wages accelerated in Q1.
- Gilts made sizeable gains as the flash UK PMIs slumped in May amid weakening demand amid higher living costs and Brexit.
- The sentiment focus tomorrow turns to households, with the German GfK and French INSEE consumer surveys due for release.

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.346	-0.041
OBL 0 04/27	0.666	-0.067
DBR 0 02/32	0.946	-0.066
UKT 1 04/24	1.433	-0.129
UKT 1½ 07/27	1.546	-0.117
UKT 4½ 06/32	1.868	-0.101

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

Euro area

Flash PMIs consistent with steady economic growth in Q2

In yesterday's blog article that signalled two ECB rate hikes in Q3, Christine Lagarde acknowledged the uncertainty of the euro area GDP growth outlook. But she took comfort from tailwinds from post-pandemic reopening, high household savings and new fiscal support. And judging from today's flash May PMIs, those positive forces are helping to sustain economic growth in positive territory in Q2. While the euro area composite output PMI dropped almost 1pt in May, at 54.9 it was still more than ½pt above the Q1 average, suggesting that growth this quarter might yet exceed the rates of 0.3%Q/Q in both Q4 and Q1. Admittedly, the survey detail flagged a marked deterioration in external demand, with new export orders dropping the most since the first wave of Covid-19 in Q220. But, while growth in total new business slipped below the Q1 average pace, the respective index was still consistent with expansion ahead. So, while business optimism for the coming twelve months softened slightly to the second-lowest of the past eighteen months, it was also still broadly positive. And that confidence was reflected in the rise in the survey's measure of employment growth to the highest in ten months. With firms having upped capacity somewhat, the indicator of work backlogs eased slightly. But while the survey measures of input costs and output prices also edged lower, they were still respectively the third- and second-highest readings on the series.

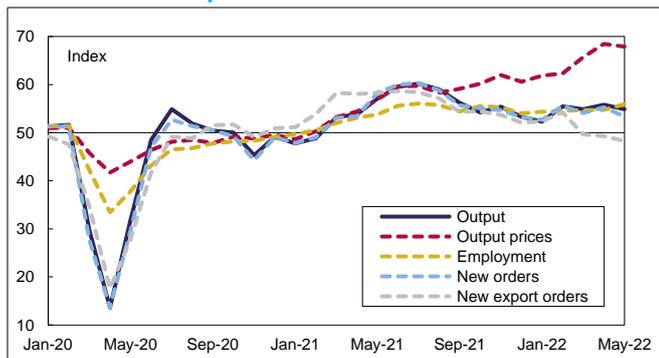
Services growth firm, manufacturing output ticks up as supply restraints ease slightly

At the sectoral level, the flash PMIs inevitably suggested that growth in May continues to be led by services. Although the respective PMI dropped for the first time since January, at 56.3 it was still the second-highest since August. S&P Global reported that growth was especially robust in tourism and recreation services, but that financial and industrial services were more subdued. Notably, employment growth in services was the strongest in almost fifteen years. Manufacturing production appears to have ticked up following April's near-stagnation (the sector's output PMI rose to 51.2) but still seems on track for the weakest quarter since Q220. Supply-side restraints in manufacturing reportedly eased slightly from the prior two months – with delivery times up by the second-lowest amount of the past year – which gave support in particular to auto sector output. But with uncertainty high, and some rotation of spending away from goods towards services, manufacturing new orders fell for the first time in almost two years.

German and French flash PMIs suggest positive growth in Q2

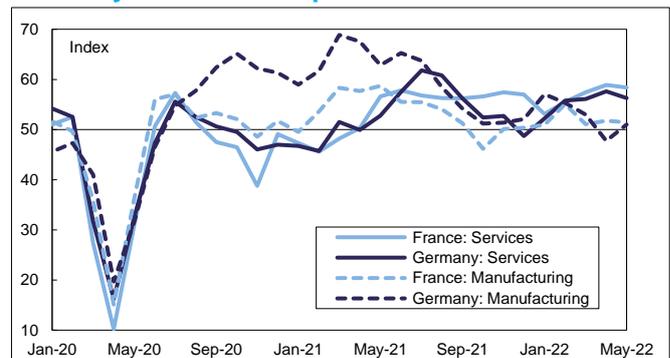
Among the member states, the flash PMIs tallied with yesterday's improved ifo indices to suggest a pickup in activity in Germany back close to the pace in Q1 (the composite output PMI rose 0.3pt to 54.6), with firm growth in services

Euro area: Composite PMIs



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

Germany & France: Output PMIs



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

accompanied to a return to growth in manufacturing output. And while the French survey suggested a slight moderation in growth from April, the composite PMI (down 0.5pt to 57.1) was still the second-highest in eleven months as the services sector continued to get a boost from pent-up demand from the pandemic. As a result, so far in Q2, the PMIs suggest a return to growth in French GDP after it stalled in Q1. (Today's INSEE survey similarly suggested that French business sentiment was steady and broadly positive in May with improvements in services and retail but a loss of momentum in manufacturing.) Finally, while no detailed data were published, S&P Global reported that growth in the rest of the euro area slowed to the softest in four months as services activity surprisingly slowed and manufacturing growth near-stalled.

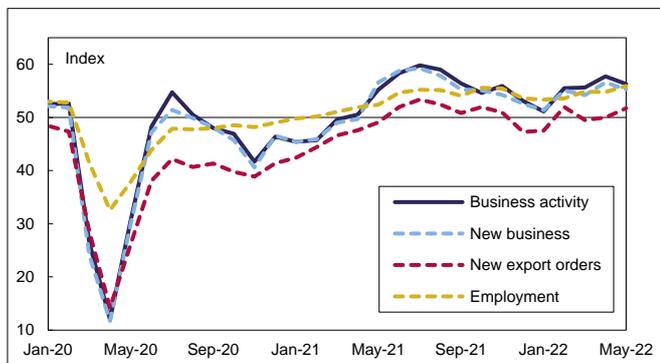
Negotiated wages accelerate ahead of expectations

The solid employment PMIs in May suggest that labour market conditions in the euro area continue to tighten ahead of expectations. Until now, that improvement was principally reflected in the earlier-than-anticipated return of employment to the pre-pandemic level, record high vacancies, a decline in the unemployment rate to a series low, and increasing complaints from businesses of skill and labour shortages. However, today brought evidence that workers are starting to benefit in terms of higher labour earnings. Indeed, negotiated wages accelerated above expectations in Q1, with growth up 1.2ppts to 2.8%Y/Y, the strongest in more than a decade. Of course, in real terms, such wage growth remains negative and so hardly consistent with booming household demand. Moreover, to some extent it likely represents catch-up for the weakness throughout the pandemic – indeed, the rate of 1.4%Y/Y in Q321 marked the joint-lowest on the series since 1991. Nevertheless, a glance at the Phillips curve suggests that the trade-off between negotiated wages and unemployment has shifted back close to the downwards-sloping relationship that existed ahead of the euro crisis, from the extremely flat one that existed from 2012 on. And with wages typically responding with a lag of several quarters to events in the labour market, and minimum wages rising significantly in several member states, negotiated wage growth seems bound to pick up further over coming quarters as unions exploit their greater bargaining power and take their opportunity to seek compensation for high inflation. For numerous reasons related to the factors that weighed on wage growth over the past decade, this seems highly unlikely to translate into a full-blown wage-price spiral. However, wage growth of 3½%Y/Y this year does not seem unlikely. And rates above levels consistent with a return to inflation to 2% over the medium term can hardly be ruled out, underscoring why the ECB will be determined to hike rates for as long as unemployment fails to rise.

The coming two days in the euro area

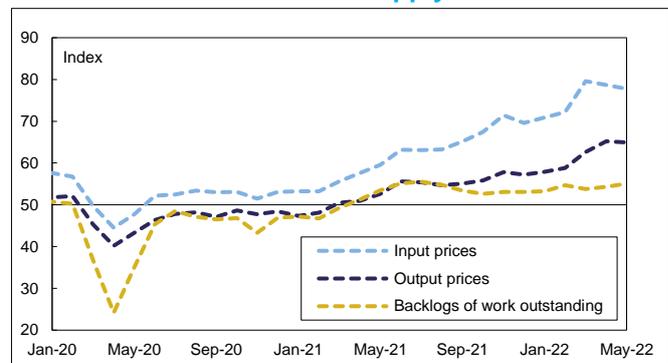
The sentiment focus tomorrow turns to consumers, with the release of the German GfK and French INSEE consumer confidence reports, followed by the Italian consumer and business confidence indices from ISTAT on Thursday. Contrasting with the business surveys, households have become extremely downbeat in the face of series-high inflation. In particular, the

Euro area: Services PMIs – demand side



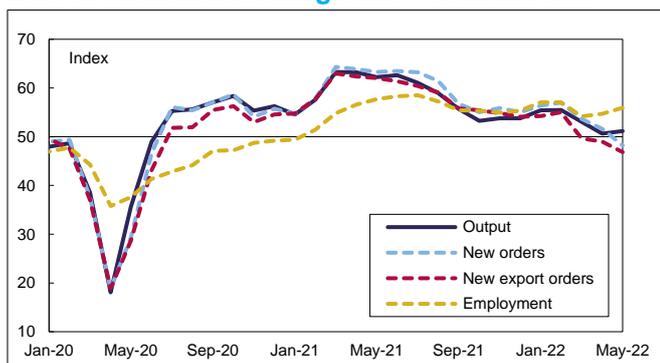
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Services PMIs – supply side



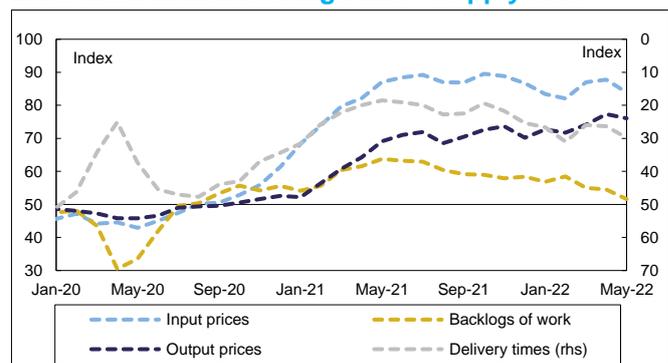
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing PMIs – demand side



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

Euro area: Manufacturing PMIs – supply side



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

headline German GfK consumer confidence index dropped to a record low of -26.5 in May, while the INSEE index fell to its weakest since the yellow-vest protests in 2018. Updated German Q1 GDP numbers are also due tomorrow, which will include a detailed expenditure breakdown of growth, and are expected to confirm that output rose 0.2%Q/Q in Q1 (4.0%Y/Y), supported principally by private sector capex including investment in buildings and structures. Meanwhile, the ECB will publish its latest bi-annual Financial Stability Review tomorrow, while various Governing Council members are due to speak publicly, including ECB President Lagarde at Davos, ECB Chief Economist Lane in Madrid and Executive Board member Panetta in Frankfurt.

UK

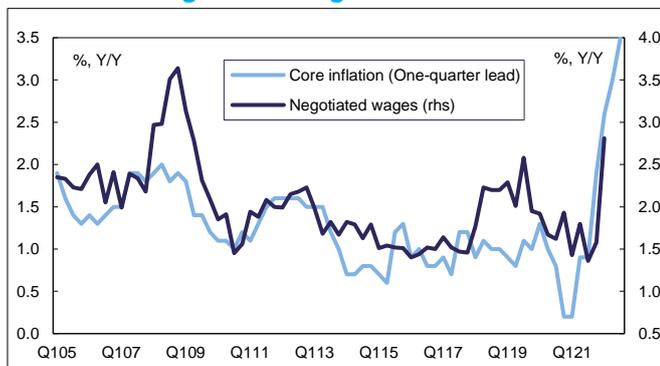
Flash PMIs slump as higher living costs hit demand and Brexit weighs on overseas demand

Given the surge in UK living costs over recent months, sentiment surveys were widely expected to signal a deterioration in economic conditions in May. But the extent of weakening in today's flash PMIs was nevertheless significantly larger than the consensus forecast, with the composite output PMI down a whopping 6.4pts, the fourth largest decline on record and one that exceeded any fall seen prior to the pandemic. This left the index at 51.8, the lowest since March 2021 and on track to be some 4½pts lower than the Q1 average, supporting our view that the UK's economy will contract slightly in Q2.

The loss of momentum was most evident in the services sector, with the respective activity PMI down 7.1pts to 51.8, similarly a fifteen-month low. And while some businesses in the travel sector were boosted by a revival in tourism, services firms on the whole reported a further slowdown in demand to the softest rate since February 2021. The manufacturing survey also reported ongoing challenges, with the output PMI falling 2.4pts to 51.8, as growth remained limited by ongoing supply chain disruption, geopolitical uncertainty and rising cost burdens. But demand also slowed again in May, with overseas orders remaining a considerably drag as Brexit-related trade frictions took their toll, with S&P Global referencing new customs rules, extra documentation requirements and other complexities with EU trade.

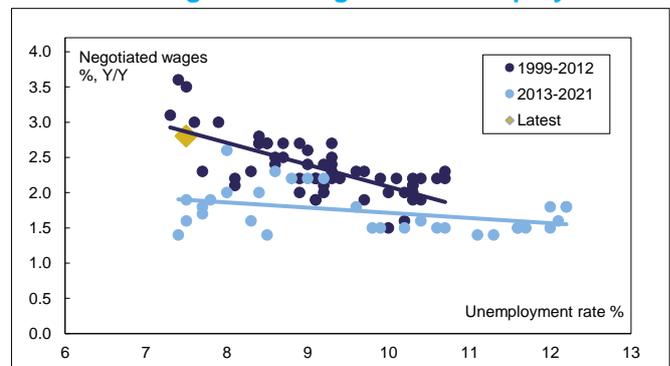
So, while input cost growth remained elevated – the services input price PMI rose to a series high in May amid higher wage bills, energy costs and fuel prices – firms appeared somewhat more cautious in passing on these burdens, with a slight easing in the composite output price PMI from the peak recorded in April. With profit margins being squeezed, and given the fragile outlook for near-term demand, firms were the least optimistic about activity over the coming year since May 2020, suggesting that further weakening in momentum is on the horizon.

Euro area: Negotiated wages and core inflation*



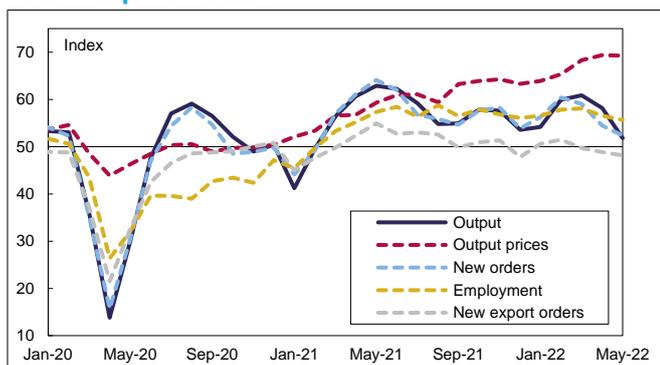
*Core HICP inflation; forecast for Q222.
Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Negotiated wages and unemployment*



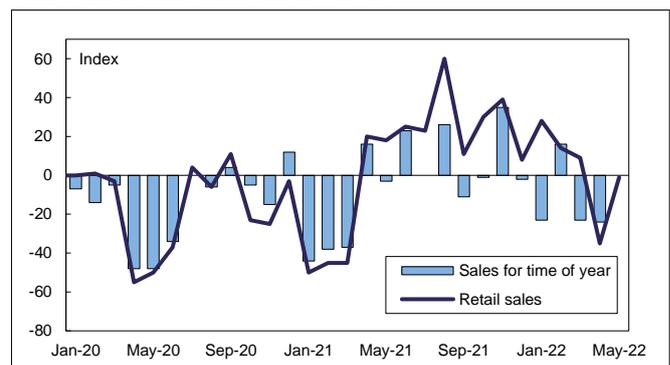
*Negotiated wages have 4-quarter lag.
Source: ECB, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Composite PMIs



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

UK: CBI retail sales indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

CBI survey flags weak retail expectations while Ofgem signals further sharp energy tariff hike

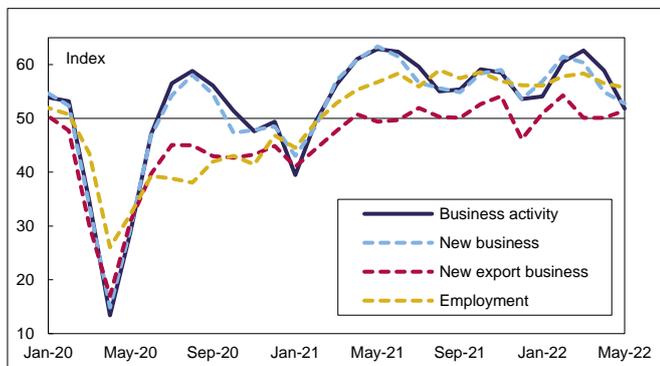
After the surprise pickup in retail sales in April, today's CBI distributive trades survey results similarly beat expectations. But while the survey's headline indicator rose 34pts on the month to -1 in May, it was merely consistent with stagnant sales, with the index the second-weakest reading since the lifting of lockdown measures in April 2021. According to the CBI, internet sales volumes in the year to May fell by the most since the question was first asked in August 2009. The survey also suggested that retailers expect overall sales to fall back below seasonal trends in June. And so, retailers also expect their business situation to deteriorate significantly over the coming three months, with the quarterly sentiment indicator falling a further 10pts to -13, the lowest since November 2020. Against this backdrop, retailers' investment intentions for the coming twelve months also fell sharply (-34), to the weakest for two years. With the head of the UK's energy regulator Ofgem today suggesting that the household energy price cap will need to rise about 42% in October, on top of the 54% increase in April, retail sales (and indeed private consumption as a whole) seem highly likely to contract significantly by year-end in the absence of additional fiscal support for consumers.

The coming two days in the UK

It should be a relatively quiet couple of days for UK economic news, with no top-tier data due for release.

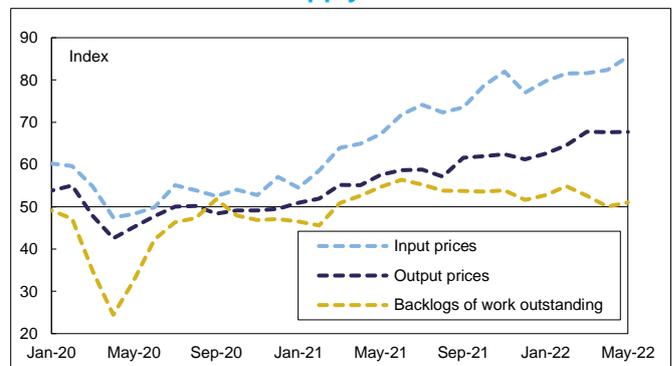
The next edition of the Euro wrap-up will be published on 26 May 2022

UK: Services PMIs – demand side



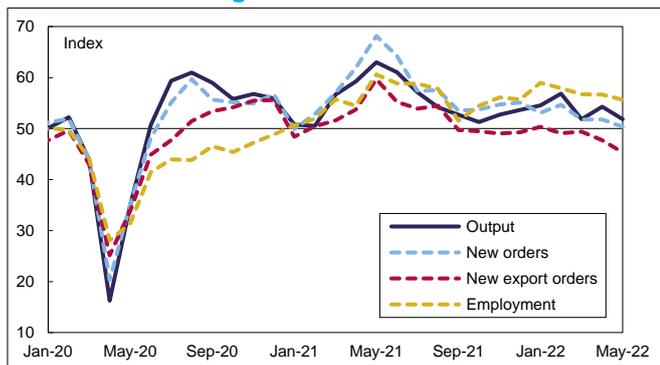
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services PMIs – supply side



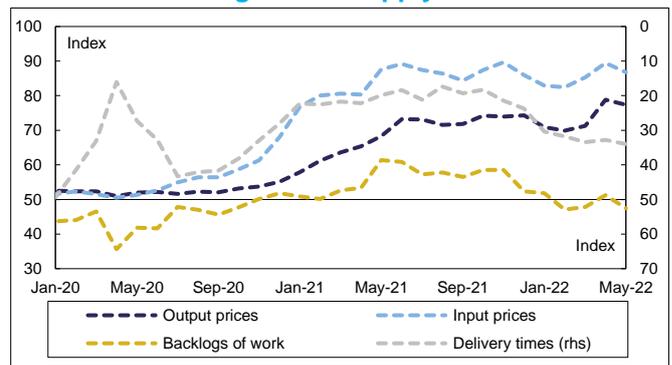
Source: Refinitiv, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing PMIs – demand side



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

UK: Manufacturing PMIs – supply side



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

European calendar

Today's results

Economic data						
Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Preliminary manufacturing (services) PMI	May	54.4 (56.3)	54.7 (57.5)	55.5 (57.7)	-
	 Preliminary composite PMI	May	54.9	55.1	55.8	-
Germany	 Preliminary manufacturing (services) PMI	May	54.7 (56.3)	54.0 (57.2)	54.6 (57.6)	-
	 Preliminary composite PMI	May	54.6	53.8	54.3	-
France	 INSEE business confidence	May	106	105	106	-
	 INSEE manufacturing confidence (production outlook)	May	106 (-9)	107 (-7)	108 (-5)	- (-4)
	 Preliminary manufacturing (services) PMI	May	54.5 (58.4)	55.2 (58.5)	55.7 (58.9)	-
UK	 Preliminary composite PMI	May	57.1	57.0	57.6	-
	 Public sector net borrowing, excluding banks £bn	Apr	18.6	18.9	18.1	14.7
	 Preliminary manufacturing (services) PMI	May	54.6 (51.8)	55.2 (57.0)	55.8 (58.9)	-
	 Preliminary composite PMI	May	51.8	56.5	58.2	-
	 CBI distributive trades survey, reported sales	May	-1	-30	-35	-

Auctions

Country	Auction
UK	 sold £750mn of 0.125% 2039 index-linked bonds at an average yield of -1.67%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany		07.00 GDP – second estimate Q/Q% (Y/Y%)	Q1	0.2 (4.0)	-0.3 (1.8)
		07.00 GfK consumer confidence	Jun	-25.5	-26.5
France		07.45 INSEE consumer confidence	May	89	88
Spain		08.00 PPI M/M% (Y/Y%)	Apr	-	6.6 (46.6)

Auctions and events					
Euro area		08.00 ECB's Panetta scheduled to speak on the 'Normalisation of Monetary Policy'			
		09.00 ECB President Lagarde to participate in World Economic Forum, Davos			
		10.45 ECB Chief Economist Lane to participate in panel – 'Macroeconomic policies in a time of disruption'			
		- ECB publishes Financial Stability Review			
Germany		10.30 Auction: €2bn of 1% 2038 bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Thursday's releases

Economic data					
Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Italy		09.00 ISTAT business (manufacturing) confidence	May	- (109.0)	105.5 (110.0)
		09.00 ISTAT consumer confidence	May	99.9	100.0

Auctions and events					
Italy		10.00 Auction: €2.25bn of 0% 2023 bonds			
		10.00 Auction: €1.25bn of 0.1% 2033 index-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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