Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made further big losses, and Southern European bonds underperformed, as the flash estimate of euro area inflation in May rose above 8% adding to risks of aggressive monetary tightening ahead.
- Gilts also made losses as a UK survey hinted at improved conditions in manufacturing and construction while consumer credit picked up further.
- Wednesday will bring new data for euro area unemployment and German retail sales as well as the final manufacturing PMIs for May.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.485	+0.055
OBL 0 04/27	0.833	+0.068
DBR 0 02/32	1.119	+0.069
UKT 1 04/24	1.590	+0.111
UKT 1¼ 07/27	1.694	+0.083
UKT 4¼ 06/32	2.107	+0.117

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

Euro area

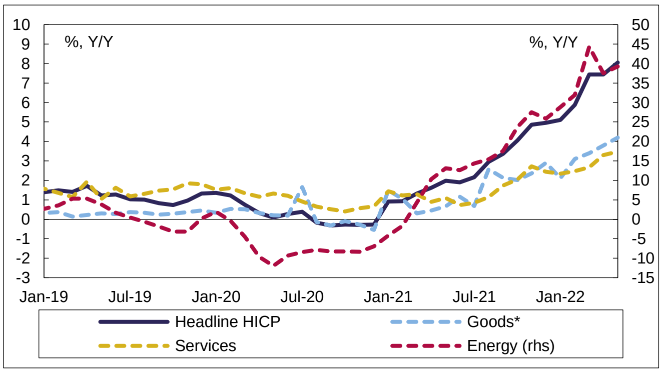
Extreme inflation heaps pressure on ECB ahead of next week's policy meeting

Given yesterday's upside surprises in Germany and Spain, today's flash euro area consumer price inflation data for May were bound to be extremely strong, placing immense pressure on the ECB ahead of next week's policy meeting. In the event, the headline HICP rate rose 0.7ppt to a new series high of 8.1%Y/Y. And the pressures were broad-based, with every major component up. After energy prices had fallen back 4.0%M/M in April, rising petrol prices contributed to a rebound of 2.0%M/M in May to push the annual energy rate up 1.7ppts to 39.2%Y/Y, the second-highest on the series bar March. Food inflation rose 1.2ppts to a series high of 7.5%Y/Y. And while food and energy together accounted for 5.5ppts of all inflation, the core rate excluding those items rose 0.3ppt to a new high of 3.8%Y/Y. While the timing of Easter this year added some downwards pressure, services inflation rose 0.2ppt to a euro-era record 3.5%Y/Y. And, with cost pressures seemingly now being routinely passed on to consumers, prices of non-energy industrial goods rose the most in any May to push the annual rate up 0.4ppt to a record 4.2%Y/Y. Among the large euro area member states, today's data confirmed that inflation rose to new multi-decade highs in France (5.8%Y/Y) and Italy (7.3%Y/Y). But pressures are most extreme in the small Baltic states, with Estonia's inflation now above 20%Y/Y. And inflation rose in every member state bar the Netherlands, where the headline rate dropped 1.0ppt to 10.2%Y/Y as government measures knocked more than 15ppts off the annual rate of energy excluding auto fuels.

Inflation likely to rise again in June as oil prices continue to trend higher

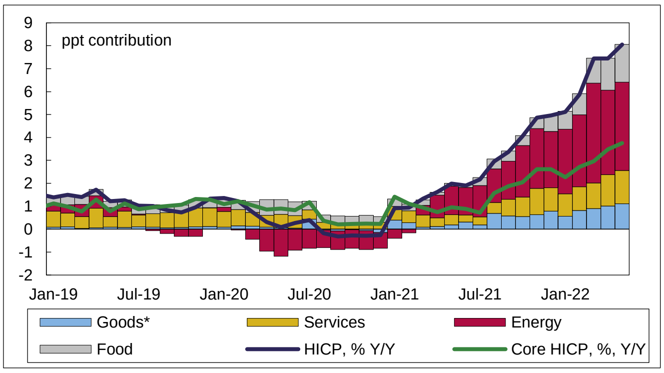
Following the rise in May, the average euro area inflation rate in the first two months of Q2 reached 7.75%Y/Y, more than 2ppts above the ECB's baseline forecast for the quarter (5.6%Y/Y). And with the price of Brent crude today exceeding $123 per barrel in the wake of the EU's decision to ban imports of Russian oil (with a temporary exemption for oil delivered by pipeline to Hungary, Slovakia and the Czech Republic), further increases in prices of auto fuel and food, among other items, seem likely to push headline inflation higher in June. While it would be tempting to call that as the peak this cycle, the outlook for inflation in the second half of the year and beyond remains extremely uncertain, with huge risks to both sides but the skew very much to the upside given the possibility of a major change to pricing behaviour. In the absence of further upside shifts in energy prices, headline inflation would still likely remain above 3%Y/Y into Q223, with core inflation close to or above 3%Y/Y through to the end of this year. While it will not need to adjust significantly its forecast of ongoing economic growth in the euro area, next week the ECB will need to revise sharply upwards its inflation projection. So, it seems highly likely to spell out in more detail its plans for pressing ahead with monetary policy normalisation. But, like the inflation outlook, how fast and how far the Governing Council will raise rates remains extremely uncertain.

Euro area: Consumer price inflation



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

Euro area: Consumer price inflation



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

Don’t rule out rate rises of 50bps apiece from July, or even an emergency June rate hike

To some extent, the Governing Council is hampered by its forward guidance, which – given the absence of a formal policy meeting in May – now looks out-of-date, stating merely that it expects to conclude its net asset purchases in the third quarter and raise rates sometime after that. As suggested by President Lagarde last week, if it remains faithful to that guidance at next week’s policy meeting the Governing Council would agree to end those net purchases at the start of Q3 and signal its strong expectation that rates will rise in July and September to exit negative rates by end-Q3. It would also signal that, subject to the incoming data, it would expect to keep increasing rates thereafter until they are eventually back in (unspecified) neutral territory, likely in practice to be somewhere between 1-2%. Our baseline forecast, therefore, continues to assume hikes in the deposit rate of 25bps apiece at each of the four monetary policy meetings in the second half of the year, to end 2022 at 0.50%, with further tightening in 2023 conditional in part on ongoing economic growth and favourable labour market conditions. However, while the doves on the Governing Council will argue against disruptive policy shifts, we cannot rule out an initial hike in July of 50bps. Indeed, next week Lagarde might well open the door wider to the possibility of such a move. And given the extent of the deterioration in the inflation outlook, we cannot even rule out an immediate end to net asset purchases and emergency rate hike as early as next week.

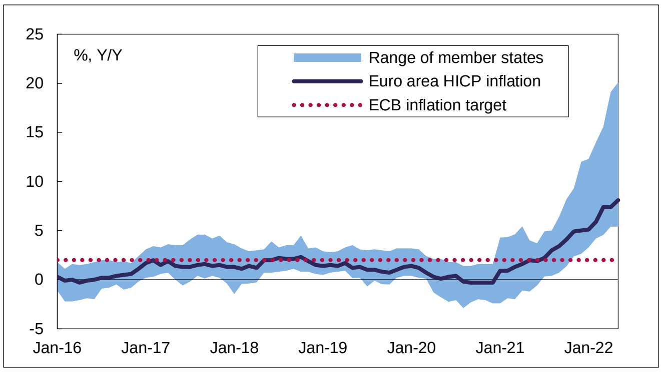
German claimant count steady at pre-pandemic level as vacancies reach new high

With inflation more than four times the ECB’s target, for the time being all other economic data are of secondary concern for the Governing Council. Nevertheless, today’s other top-tier releases were not without interest. The German labour market data certainly suggested no need to fret about a sudden deterioration in conditions as jobless claims dropped for the fifteenth successive month in May. Admittedly, the decline of just 4k was the smallest in thirteen months, and the claimant count rate remained unchanged at the pre-pandemic level of 5.0% for a third successive month. Similarly, the LFS unemployment rate was unchanged at 3.0% in April. Nevertheless, the labour market appears to have tightened a little further – after employment rose 53k (0.1%M/M) in April to be above the pre-pandemic level for the second successive month, the number of job vacancies rose 10k to a new high in May.

French GDP contracted in Q1 and spending on goods down again in April

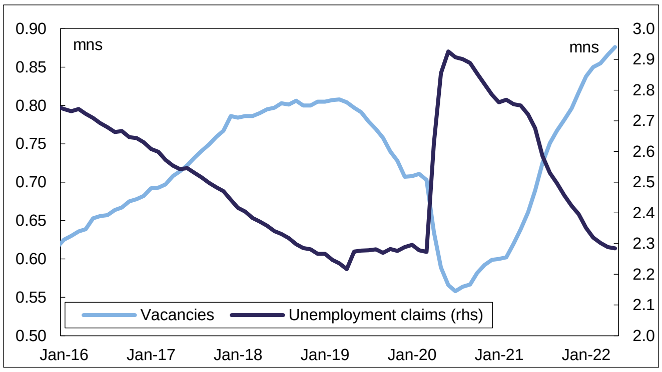
In terms of economic activity, however, the latest French data were disappointing. Q1 GDP in the euro area’s second-largest member state was revised down from the initial estimate – rather than being unchanged from Q4, it is now estimated to have contracted 0.2%Q/Q to be just 0.3% above the pre-pandemic level. The principal cause of the contraction was household consumption, which is now estimated to have dropped 1.5%Q/Q to the lowest level in three quarters. As real disposable

Euro area: Consumer price inflation



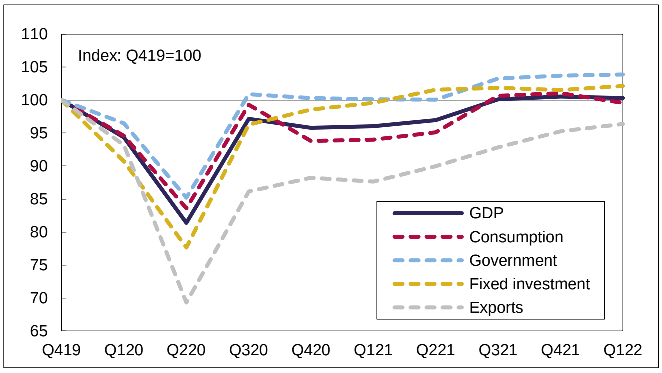
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Jobless claims and vacancies



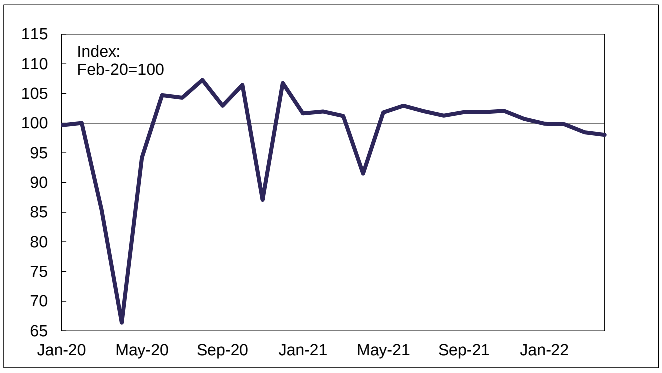
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: GDP and expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

France: Consumer spending on goods



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

incomes declined, spending on goods and services fell despite a drop in the savings rate. And the private spending data for April suggested that household consumption was weak again at the start of Q2 – expenditure on goods fell for the fifth successive month and by 0.4%M/M to be down 2.1%3M/3M. But more positively, fixed investment returned to growth (0.6%Q/Q) after a small dip in Q4.

Italian GDP revised up amid strong capex recovery

More happily, contrary to the earlier estimate of a contraction of 0.2%Q/Q, Italian GDP is now estimated to have grown 0.1%Q/Q to rise marginally above the pre-pandemic level. Private consumption dropped 0.6%Q/Q at the start of the year to be more than 4% below the level in Q419. But fixed investment maintained its strong recovery, rising 3.9%Q/Q to be more than 15% above the pre-pandemic level. While that growth was still led by investment in dwellings (up 5.7%Q/Q to be up more than 25% from Q419), investment in machinery and equipment was also strong (up 4.3%Q/Q and firmly above the pre-pandemic level).

The day ahead in the euro area

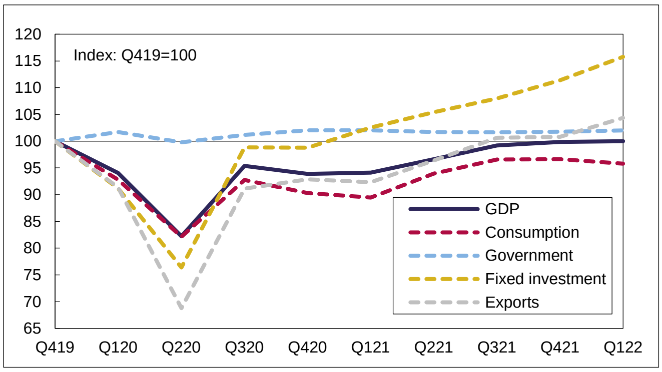
Wednesday will bring euro area labour market data for April, with the headline unemployment rate likely to be unchanged at the series low of 6.8%. In addition, German retail sales figures for the same month are expected to report a decline of close to ½%M/M following upwardly revised growth of 0.9%M/M in March, which was the strongest month since November. The final manufacturing PMIs for May are also due – the flash euro area output PMI rose 0.5pt from April to 51.2, suggesting still subdued activity despite hints of a slight easing of supply constraints, a modest moderation in cost pressures and still strong employment intentions.

UK

Demand for consumer credit rises even as interest rates jump

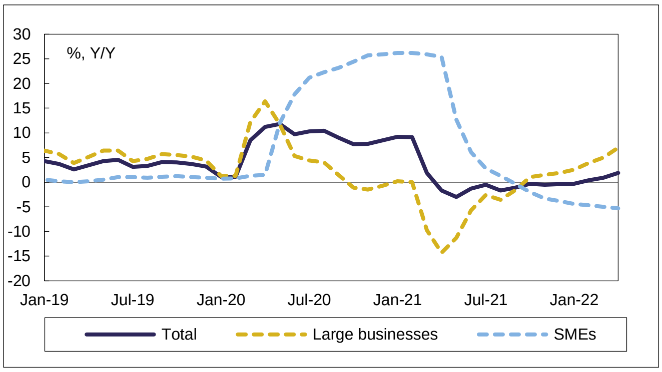
Given the steady tightening in BoE monetary policy since December – Bank Rate has been increased at the past four MPC meetings and by a cumulative 90bps – and anticipation of further tightening to come, UK banks have inevitably been passing on higher rates to new borrowers. Indeed, the effective interest rate on new unsecured loans to consumers jumped 60bps in April to 6.52%, the highest since February 2020 and more than 200bps above the pandemic trough in June 2020. This notwithstanding, demand for consumer credit continued to rise at the start of the Q2, no doubt reflecting the significant squeeze on household budgets amid high inflation. In particular, individuals borrowed an additional net £1.4bn last month,

Italy: GDP and expenditure components



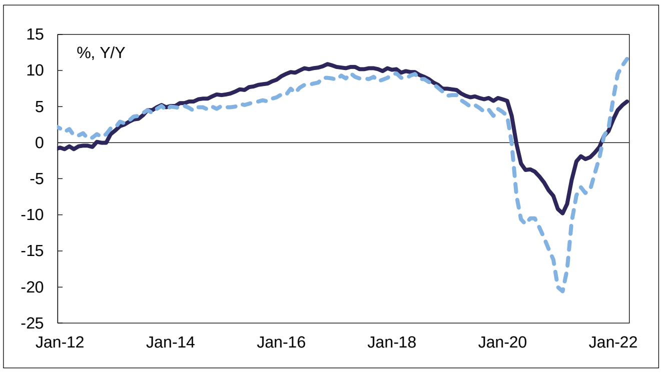
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Lending to NFCs



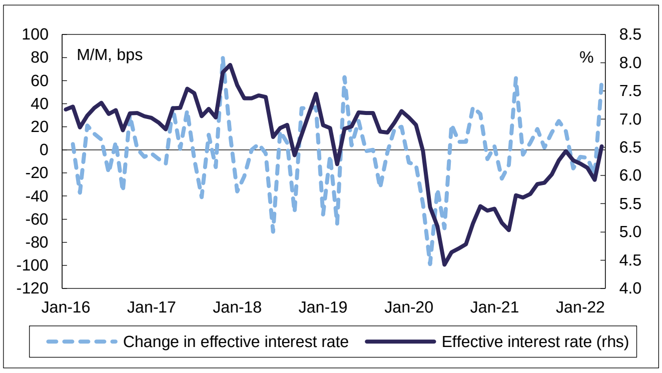
Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Consumer credit growth



Source: BoE and Daiwa Capital Markets Europe Ltd.

UK: Effective interest rate on consumer credit



Source: BoE and Daiwa Capital Markets Europe Ltd.

the third consecutive reading above the pre-pandemic twelve-month average (£1.0bn), of which half was accounted for by credit card lending. This left the outstanding stock of consumer credit up 5.7%Y/Y, with credit card debt growth (11.6%Y/Y) the strongest since 2005. Admittedly, these annual growth rates remain flattered by base effects, with the stock of such lending still some 10% and 15% lower the pre-pandemic levels. But given the higher cost of living, we would expect demand for credit to rise further over the months ahead. And while households continued to add to their deposits in April, the increase of £5.7bn was the smallest since December.

Mortgage lending slowed slightly in April, with approvals the weakest since June 2020

Demand for mortgage lending, meanwhile, slowed slightly in April, with signs of further moderation to come ahead. Indeed, net new lending secured on dwellings increased by £4.1bn in April, down from £6.4bn in March. But this was still broadly in line with the average in the previous six months and pre-pandemic twelve-month average (£4.3bn), to leave the stock of such lending up 4.3%Y/Y. But perhaps reflecting the increase in mortgage rates – e.g. a 2Y fixed-rate mortgage with a 75% LTV rose an additional 24bps in April to 2.35%, 115bps above November's trough and the highest since 2014 – as well as record low consumer confidence, there was a third consecutive drop in the number of new approvals in April. Indeed, at 66k, approvals were the lowest since June 2020 and 8.5k below the average of the past twelve months, albeit only a touch softer than the pre-pandemic twelve-month average (66.7k), to suggest the likelihood of some further slowing in mortgage lending over coming months.

Lending to large NFCs picked up in April, but still remains very weak to SMEs

Contrasting with the rise in interest rates on loans to individuals, the average cost of new borrowing by NFCs fell 53bps in April to an effective interest rate of 2.41%, which was back below the pre-pandemic rate (2.56%). Against this backdrop, net borrowing by large NFCs increased £2.7bn, up from £1.8bn in March and a touch firmer than the average in the previous six months (£2.3bn). But despite a larger drop in the effective interest rate on lending to SMEs (down 64bps in April to 3.44%), firms continued to repay their loans for the tenth consecutive month, by a net £0.5bn, to leave the stock of such lending down by more than 5%Y/Y. Perhaps reflecting increased costs, businesses on aggregate also withdrew a net £14.6bn from their deposits in April, compared with a net increase of £12.4bn in March.

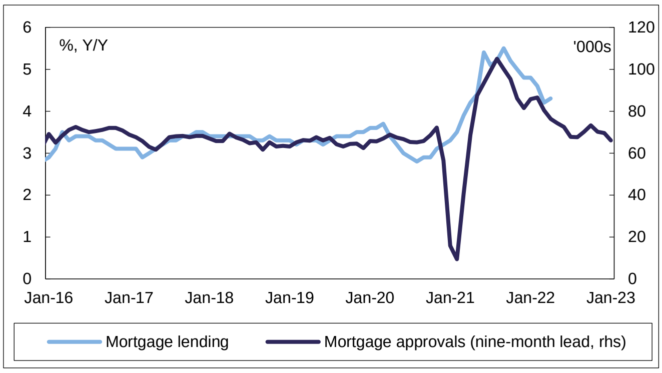
Lloyds survey suggest business conditions improved in May

The Lloyds Bank business barometer did, however, signal an improvement in business conditions in May, with the headline balance rising 5ppts to 38%, a three-month high benefiting from increases in both the current and future expectations balances. But while firms in the manufacturing and construction sectors were more upbeat, today's survey suggested that confidence among retailers had deteriorated to be the least favourable since March 2021 when non-essential shops were still closed due to pandemic restrictions. Within the other survey detail, the share of firms planning to raise prices was still at a substantial 57%, down just 1ppt from April. So, we expect conditions for consumer-facing firms to remain challenging for the foreseeable future as suppliers seek to pass on cost pressures but household disposable incomes continue to be squeezed.

The day ahead in the UK

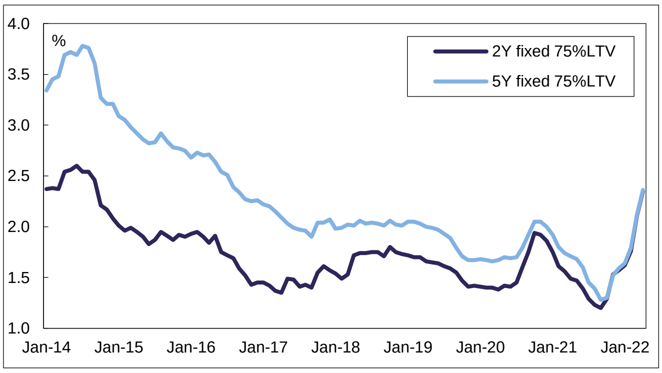
A relatively quiet day for top-tier UK economic data tomorrow brings the BRC's shop price index for May. This seems likely to flag elevated price pressures on the High Street, not least due higher food prices, with the headline rate likely to have risen further above April's 9½-year high of 2.7%Y/Y. The latest Nationwide house price indices are also due and are expected to report a further monthly increase in May (0.5%M/M), albeit this would leave the annual growth rate easing 1½ppts to 10.5%Y/Y. Finally, contrasting with today's Lloyds Bank business barometer, the final manufacturing PMIs for May are likely to signal that conditions remained challenging this month, with the flash output PMI having declined 2.4pts to just 51.8.

UK: Mortgage lending and approvals



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

UK: Mortgage interest rates



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

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary CPI M/M% (Y/Y%)	May	**0.8 (8.1)**	*0.7 (7.9)*	0.6 (7.4)	-
		Preliminary core CPI M/M% (Y/Y%)	May	**0.5 (3.6)**	*0.3 (3.6)*	1.0 (3.5)	-
Germany		Unemployment rate % (change '000s)	May	**5.0 (-4.0)**	5.0 (-15.0)	5.0 (-13.0)	-
France		Preliminary CPI M/M% (Y/Y%)	May	**0.6 5.2)**	0.5 (5.1)	0.4 (4.8)	-
		Preliminary EU-harmonised CPI M/M% (Y/Y%)	May	**0.7 (5.8)**	0.6 (5.6)	0.5 (5.4)	-
		Consumer spending M/M% (Y/Y%)	Apr	**-0.4 (7.2)**	1.0 (7.6)	-1.3 (-2.4)	**-1.4 (-2.7)**
		GDP – 2nd estimate Q/Q% (Y/Y%)	Q1	**-0.2 (4.5)**	0.0 (5.3)	0.7 (5.4)	**0.4 (4.9)**
Italy		GDP – 2nd estimate Q/Q% (Y/Y%)	Q1	**0.1 (6.2)**	-0.2 (5.8)	0.6 (6.2)	**0.7 (6.4)**
		Preliminary CPI M/M% (Y/Y%)	May	**0.9 (6.9)**	0.4 (6.3)	-0.1 (6.0)	-
		Preliminary EU-harmonised CPI M/M% (Y/Y%)	May	**0.9 (7.3)**	0.5 (6.7)	0.4 (6.3)	-
UK		Lloyds business barometer	May	**38**	-	33	-
		Net consumer credit £bn (Y/Y%)	Apr	**1.4 (5.7)**	1.2 (-)	1.3 (5.2)	-
		Net mortgage lending £bn (approvals '000s)	Apr	**4.1 (66.0)**	5.4 (70.5)	7.0 (70.7)	**6.4 (69.5)**

Auctions

Country		Auction
Germany		sold €2.46bn of 0% 2027 bonds at an average yield of 0.79%
Italy		sold €2.5bn of 2.5% 2032 bonds at an average yield of 3.1%
		sold €3bn of 1.1% 2027 bonds at an average yield of 2.16%
		sold €1.25bn of 0.4% 2030 floating-rate bonds at an average yield of 0.87%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		09.00	Final manufacturing PMI	May	54.4	55.5
		10.00	Unemployment rate %	Apr	6.8	6.8
Germany		07.00	Retail sales M/M% (Y/Y%)	Apr	-0.4 (4.4)	0.9 (-4.4)
		08.55	Final manufacturing PMI	May	54.7	54.6
France		08.50	Final manufacturing PMI	May	54.5	55.7
		-	New car registrations* Y/Y%	May	-	-22.6
Italy		08.45	Manufacturing PMI	May	53.7	54.5
		17.00	New car registrations Y/Y%	May	-	-33.0
Spain		08.15	Manufacturing PMI	May	52.2	53.3
		-	New car registrations* Y/Y%	May	-	-12.1
UK		00.01	BRC shop price index	May	-	2.7
		07.00	Nationwide house price index M/M% (Y/Y%)	May	0.6 (10.5)	0.3 (12.1)
		09.30	Final manufacturing PMI	May	54.6	55.8

Auctions and events

Euro area		09.00	ECB's Lagarde scheduled to speak at a BIS conference
		16.30	ECB's Lane scheduled to speak
UK		09.30	BoE publishes Monthly Decision Maker Panel data

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs