

Euro wrap-up

Overview

- As speculation about the next steps for ECB policy persisted, Bunds followed other major government bond markets lower despite a sharp drop in German retail sales.
- Gilts also weakened again following another strong UK shop price survey and bigger-than-expected rise in house prices.
- Thursday will bring euro area producer price data for April with retail sales figures for the same month due on Friday.

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Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.520	+0.033
OBL 0 04/27	0.879	+0.050
DBR 0 02/32	1.172	+0.054
UKT 1 04/24	1.646	+0.086
UKT 1½ 07/27	1.744	+0.065
UKT 4½ 06/32	2.141	+0.042

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

Source: Bloomberg

Euro area

German retail sales plummet at start of Q2 on high inflation and weak confidence

With high inflation eroding real incomes and consumer confidence close to the series low, German retail sales in April plunged 5.4%M/M, the most in a year, to the lowest level since the lockdowns of February 2021. While they had grown for the prior two months, the drop sent sales in April back below the pre-pandemic level and some 4.8% below the Q1 average. Food sales slumped 7.7%M/M, the most on the series dating back almost three decades. Non-food sales dropped 4.4%M/M, with sales of clothing and textiles down 4.3%M/M and department store sales down 7.0%M/M. Of course, the German retail sales data are extremely volatile at the best of times, with the timing of the Easter holiday adding a further complication to seasonal adjustment in April. And with sales in nominal terms down 4.7%M/M, high inflation is unlikely to have been the sole reason for the weakness in April. Regardless, while spending on services is likely to have been much firmer, the retail data suggest the likelihood of a decline in private consumption for the third successive quarter in Q2.

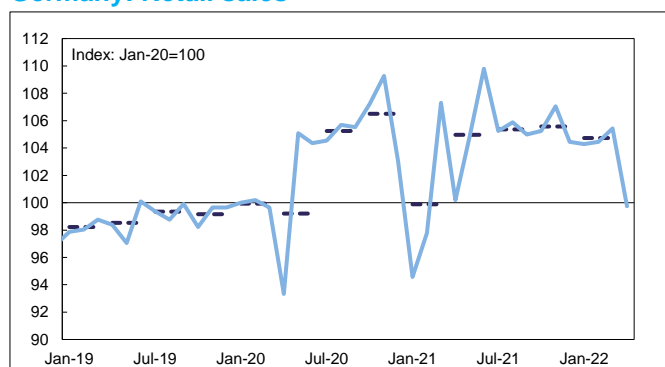
Euro area unemployment rate steady at series low in April

As was the case in [Germany](#), the unemployment rate in the euro area was stable in April, with the region's jobless rate remaining at the series low of 6.8% for a third successive month. The number of people out of work but actively seeking a job dropped a further 96k, in line with average since the start of the year albeit about 50k less than the average last year. That left the number of unemployed workers at a new euro-era low of 11.18mn, almost 1mn below the pre-pandemic trough. More than one third of the decline from March was explained by Spain, where the unemployment rate reversed the prior month's 0.2ppt rise, back to 13.3%, as the tourism season picked up. The unemployment rates in France (7.2%), the Netherlands (3.2%) and Ireland (4.8%) also fell.

Labour market slack still well in excess of job openings

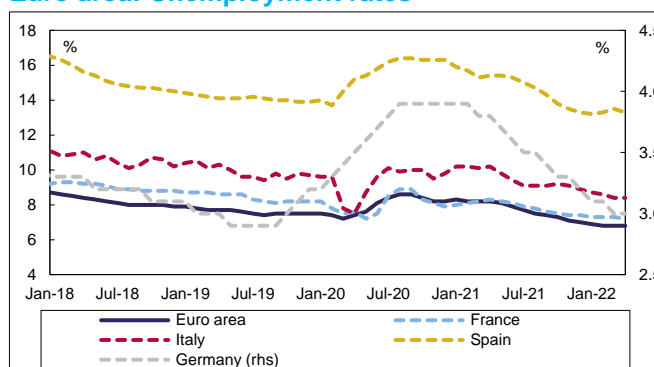
Unlike in the US and UK, the recent marked drop in the unemployment rate in the euro area cannot in part be attributed to lower labour force participation, as employment surpassed the pre-pandemic level in Q421 and continued to rise in Q122. That reflects the success of the euro area's pandemic job support schemes, which by design prevented mass lay-offs and reduced risks of new labour and skills mismatches in the recovery phase while also limiting disincentives to work. With capacity constraints binding in many sectors, job demand remains firm, with surveys suggesting business employment intentions are at historically high levels. But while the euro area's job vacancy rate in Q1 had also risen to a series high, at 3.1% of all jobs and up 0.9ppt from before the pandemic, the level of openings (roughly 5¼mn) remains significantly less than half the total number of unemployed workers. And with total slack (including underemployed part-time workers as well

Germany: Retail sales*



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rates



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

as those available but not seeking work or seeking but not available for work) at 14.5% of the extended labour force in Q421 (13.9% for workers aged 20-64yrs), the labour market in the euro area remains far less tight than in the US and UK, and thus likely far less prone to the ECB's nightmare scenario of a wage-price spiral.

Italy's manufacturing PMIs point to contraction, but steady output or modest expansion elsewhere

There were few surprises from today's final manufacturing PMIs for May. A very slight upwards revision to the euro area's output index from the flash estimate left it up just 0.6pt from April at 51.3. While that was consistent with very modest growth, supported by hints of an easing of supply constraints, it left the average in the first two months of Q2 more than 3½pts below the Q1 average, suggesting a notable deterioration in conditions in the sector this quarter. The euro area new orders index was also marginally better than previously thought, but at 48.7 was 7pts below the Q1 average and consistent with a drop in demand. And at the country level, the Italian manufacturing output PMI – published for the first time – fell almost 3pts from April to 48.4, the first contractionary reading in two years. More happily, the equivalent indices for all other reporting member states remained above 50. And while the German and French output PMIs were confirmed close to the euro area figure, Spain's was a little firmer (up more than 2pts to 52.8), with Ireland (54.3) and the Netherlands (53.1) leading the way.

GDP outlook “adverse”, inflation outlook “severe”

While the retail sales figures provide a reminder of the downside risks to the economic growth outlook, and the ECB will agree that slack persists in the labour market, today's data won't change anything for the ECB when the Governing Council meets next week. For a start, it will continue to expect economic growth to remain in positive territory, supported by ongoing normalisation of services activity. However, the Eurosystem's updated GDP forecast should more closely resemble its previous “adverse” scenario of growth of 2.5% this year and 2.7% next, rather than its current baseline projection of growth of 3.7% and 2.8%. More importantly – particularly in light of the ECB's Treaty-based price stability mandate – yesterday's big upside surprise to [May's inflation data](#) meant that the average headline rate in the first two months of the current quarter was more than 2ppts above the ECB's forecast for Q2. So, its updated inflation projection will shift significantly higher and more closely resemble its “severe” scenario of an average of 7.1% this year and 2.7% in 2023 than its baseline forecast of 5.1% and 2.1%. That will still, however, likely suggest that inflation is likely to return back to the 2% target over the medium term. And the risks will be two-sided. Nevertheless, the skew is likely to be very much to the upside given the possibility of disruption to energy supply as well as an apparent recent shift in firms' pricing behaviour.

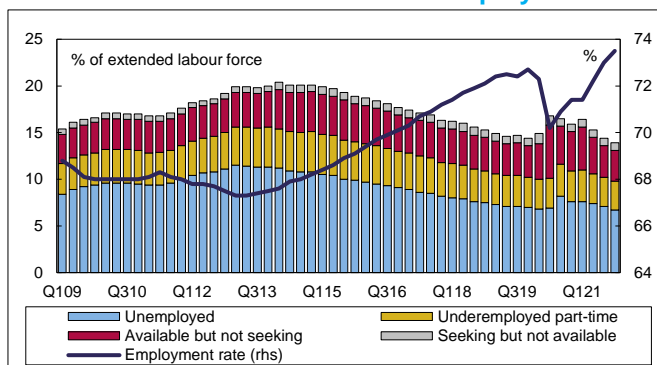
ECB strategy for monetary policy normalisation to be set out on 9 June

In light of that marked deterioration in the inflation outlook, when the Governing Council's meeting concludes on 9 June, it seems highly likely to spell out in more detail its plans for pressing ahead with monetary policy normalisation. However, its options currently appear limited by its forward guidance, which merely states that it expects to conclude its net asset purchases in the third quarter – after a further €20bn of purchases over the course of June – and raise rates sometime after that. As suggested by President Lagarde last week, if it remains faithful to that guidance, the Governing Council would agree to end those net purchases at the start of Q3 and signal its strong expectation that rates will be hiked at the following two meetings on 21 July and 8 September, allowing it 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 into (unspecified) neutral territory, likely in practice to be somewhere between 1-2%.

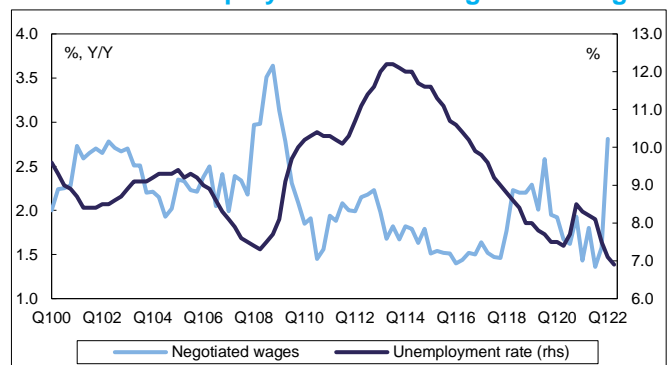
Hikes of 25bps from July on remain our baseline despite risks of aggressive tightening

Our baseline forecast 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. That would be in line with most (if not all) of the recent comments from Governing Council members, including today's statement from Maltese Governor Scicluna that, in the absence of

Euro area: Labour market slack & employment*



Euro area: Unemployment rate & negotiated wages



surprises in the ECB's projections, there would be no "general support for a 50bps hike". As the doves on the Governing Council will certainly argue against disruptive policy shifts, and the updated projections will likely continue to suggest that inflation will eventually return to target over the medium term, pressures from the hawks for an initial hike in July of 50bps are likely to be resisted even if next week Lagarde opens the door to the possibility of such a move. And while we also cannot rule out that the Governing Council disregards entirely its forward guidance and agrees to an immediate end to net asset purchases and emergency rate hike as early as next week, we also attach a relatively low probability to that outcome, which would certainly have adverse consequences for periphery bonds.

The remainder of the week in the euro area

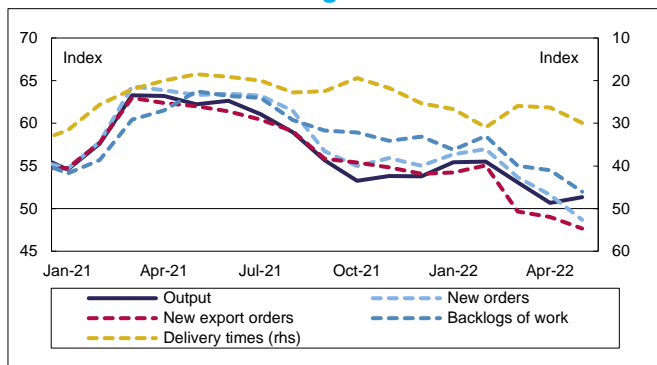
With inflation firmly in focus, the most noteworthy release from the euro area over the remainder of the week will be tomorrow's PPI inflation numbers for April. These seem bound to show that price pressures at the factory gate remain extremely elevated. While energy, commodities and food will continue to account for the lion's share of producer price inflation, the rates of intermediate, capital and durable consumer goods are all at series highs. And expectations are for headline PPI inflation to have risen roughly 2ppts from March's record high of 36.8%Y/Y. Friday, meanwhile, will bring euro area retail sales figures for April. Spending in Germany and France fell at the start of Q2, and so while there was a surge in sales in Spain (5.3%M/M), the aggregate euro area figure is likely to drop for a second successive month and below the Q1 average. Friday will also bring final services and composite PMIs from the euro area and member states. The flash survey saw the headline euro area services PMI fall 1.4ppts in May, albeit remaining at a still-lofty 56.3. And following an improvement in the Commission's services sentiment indicator earlier this week, we might well see the activity PMI revised a touch higher. Finally, Friday will bring German auto production and sales numbers for May.

UK

UK shop price inflation at highest in more than a decade

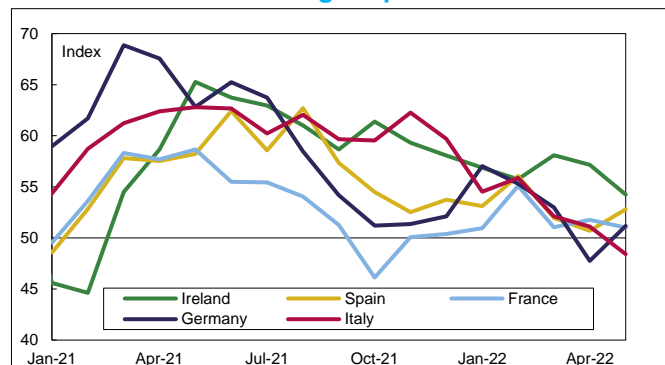
Like in the euro area, the UK's economic news flow continues to be dominated by inflation. And today's BRC shop price index for May inevitably flagged elevated price pressures on the High Street, with the headline rate up a further 0.1ppt to 2.8%Y/Y, the highest since the summer of 2011. This reflected an intensification of fresh food inflation last month, up 1.1ppt to 4.5%Y/Y, the highest for more than a decade as global food prices continue to be pushed higher by the impact of the war in Ukraine. And despite retailers offering discounts on clothing, inflation of other items continued to strengthen. As such, the survey measure of non-food inflation eased only slightly in May, by 0.2ppt to 2.0%Y/Y, still the second-strongest reading since the series began in 2006. The BRC again warned of further price rises on the High Street to come, with cost pressures

Euro area: Manufacturing PMIs



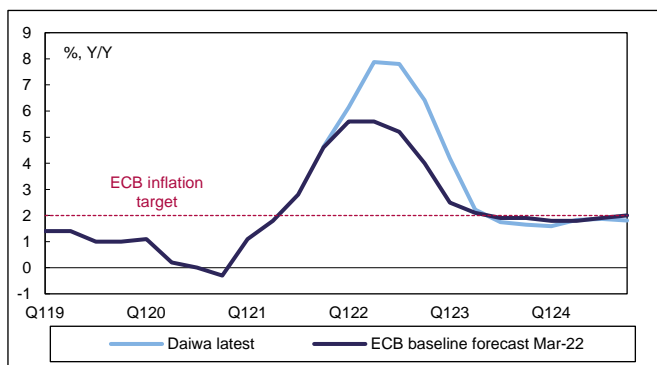
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output PMIs



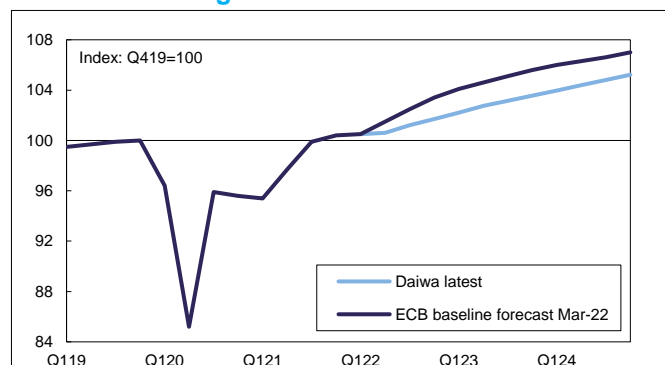
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation forecasts



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

Euro area: GDP growth forecasts



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

likely to be increasingly passed on to consumers of a wider range of goods over coming months. Indeed, the latest ONS business insights survey today suggested that roughly 37% of retailers and wholesalers expected to increase prices in June. While the share of hospitality firms expecting to increase prices this month eased slightly, it was still a sizeable 42%, with the equivalent share of manufacturers jumping 9ppts to 44.5%. Of course, 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. And, after headline CPI jumped to 9.0%Y/Y in April, the latest BoE's decision maker panel survey suggested that businesses on average expect inflation to be 6.9%Y/Y in a year's time and 3.8%Y/Y in three years' time.

Nationwide house prices continue to surprise on the upside, for now

While yesterday's [BoE lending](#) data suggested a slight slowing in mortgage growth as interest rates rise, the first house price data for May delivered an upwards surprise, with the Nationwide house price index up for the tenth consecutive month and by 0.9%M/M. While this saw a further slight slowing in the annual rate, it remained very strong at 11.2%Y/Y, with the persisting demand-supply imbalance maintaining upwards pressures on prices. As such, the ratio of house prices to earnings looks on track to rise further in Q2, from the record high 6.8x recorded in Q1. But with consumer confidence at a record low, household incomes being increasingly squeezed by higher inflation, and likely pinched further as mortgage rates rise alongside BoE tightening, we continue to expect the housing market to slow further over coming quarters. Declines in UK house prices, however, still seem unlikely in the absence of a sharp rise in unemployment, not least given the non-negligible share of properties owned outright or by holders of mortgages with plenty of time remaining on historically low fixed rates.

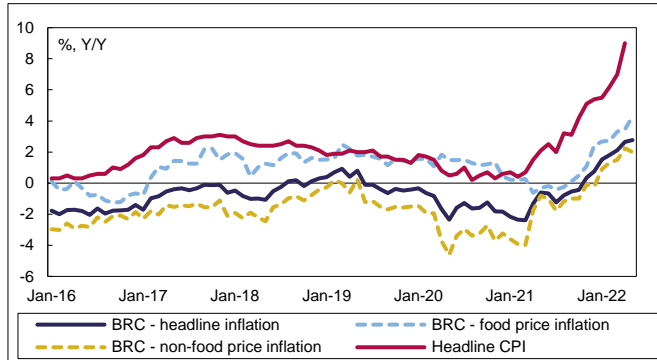
Final manufacturing PMIs flag ongoing challenges

The final manufacturing PMI survey today again illustrated the impact on the sector of the recent slowdown in demand. Indeed, the final output index was revised a touch lower from the flash to 51.6, down 2.7pts on the month and its lowest level since October. Most notable was the sizeable contraction implied by the consumer goods sub-indices, as the respective output PMI fell a sharp 4.9pts to 45.8, a sixteen-month low. And while supply-chain disruption continues to hinder output in the sector, S&P Global also reported that respondent firms attribute subdued new orders growth to weak client confidence, signs of broader economic slowdown and reduced export orders.

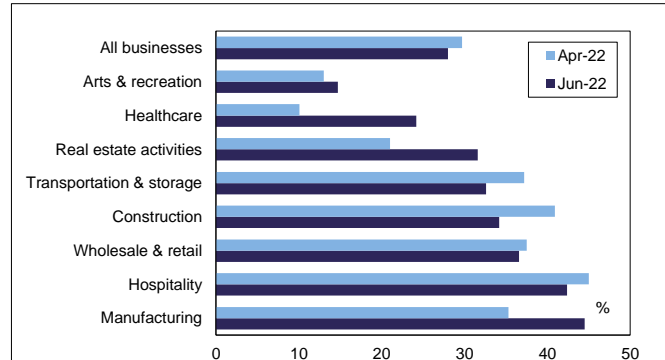
The remainder of the week in the UK

It will be a very quiet end to the week for UK economic news, with markets closed for the Queen's Platinum Jubilee Bank Holidays.

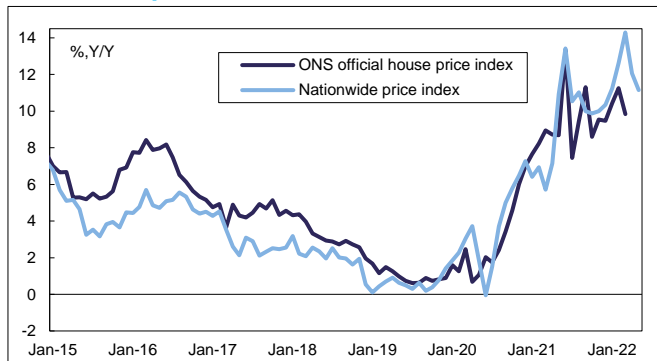
UK: Consumer and shop price inflation



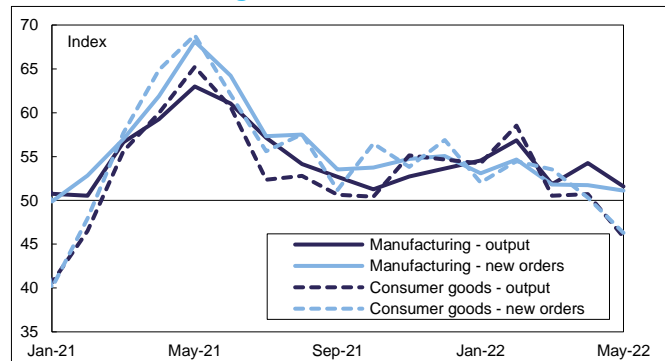
UK: Share of firms expecting to increase prices*












UK: House price indicators



UK: Manufacturing PMIs



Daiwa economic forecasts











		2021	2022				2023	2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1			
GDP		%, Q/Q						%, Y/Y		
Euro area		0.3	0.3	0.1	0.6	0.5	0.5	2.7	1.9	1.6
UK		1.3	0.8	-0.1	0.3	-0.3	0.0	3.5	-0.1	0.9
Inflation, %, Y/Y										
Euro area										
Headline HICP		4.6	6.1	7.9	7.8	6.4	4.2	7.1	2.4	1.8
Core HICP		2.4	2.7	3.7	3.6	3.0	2.0	3.2	1.9	1.8
UK										
Headline CPI		4.9	6.2	9.0	8.9	9.0	7.9	8.3	4.4	1.7
Core CPI		3.9	5.1	6.1	6.0	5.7	4.7	5.7	3.3	1.7
Monetary policy, %										
ECB										
Refi Rate		0.00	0.00	0.00	0.25	0.75	1.00	0.75	1.00	1.00
Deposit Rate		-0.50	-0.50	-0.50	0.00	0.50	0.75	0.50	0.75	0.75
BoE										
Bank Rate		0.25	0.75	1.25	1.50	1.75	1.75	1.75	1.75	1.75

Source: Bloomberg, ECB, BoE 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	 Final manufacturing PMI	May	54.6	54.4	55.5	-
	 Unemployment rate %	Apr	6.8	6.8	6.8	-
Germany	 Retail sales M/M% (Y/Y%)	Apr	-5.4 (2.5)	-0.4 (4.4)	0.9 (-4.4)	-
	 Final manufacturing PMI	May	54.8	54.7	54.6	-
France	 Final manufacturing PMI	May	54.6	54.5	55.7	-
Italy	 Manufacturing PMI	May	51.9	53.7	54.5	-
Spain	 Manufacturing PMI	May	53.8	52.2	53.3	-
UK	 BRC shop price index	May	2.8	-	2.7	-
	 Nationwide house price index M/M% (Y/Y%)	May	0.9 (11.2)	0.6 (10.5)	0.3 (12.1)	0.4 (-)
	 Final manufacturing PMI	May	54.6	54.6	55.8	-

Auctions

Country	Auction
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- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on 8 June 2022


















European calendar

The coming week's key data releases

Country	BST	Release	Period	Market consensus/ <i>Daiwa</i> <i>forecast/actual</i>	Previous
Thursday 02 June 2022					
Euro area 	10.00	PPI M/M% (Y/Y%)	Apr	2.3 (38.6)	5.3 (36.8)
Spain 	08.00	Unemployment change '000s	May	-	-86.3
Friday 03 June 2022					
Euro area 	09.00	Final services (composite) PMI	May	56.3 (54.9)	57.7 (55.8)
	10.00	Retail sales M/M% (Y/Y%)	Apr	0.3 (5.4)	-0.4 (0.8)
Germany 	07.00	Trade balance €bn	Apr	1.6	13.1
	08.55	Final services (composite) PMI	May	56.3 (54.6)	57.6 (54.3)
France 	07.45	Industrial production M/M% (Y/Y%)	Apr	0.2 (0.5)	-0.5 (0.1)
	07.45	Manufacturing production M/M% (Y/Y%)	Apr	-	-0.3 (1.5)
	08.50	Final services (composite) PMI	May	58.4 (57.1)	58.9 (57.6)
Italy 	08.45	Services (composite) PMI	May	54.5 (53.8)	55.7 (54.5)
Spain 	08.15	Services (composite) PMI	May	56.1 (54.5)	57.1 (55.7)
Monday 06 June 2022					
UK 	09.00	New car registrations Y/Y%	May	-	-15.8
Tuesday 07 June 2022					
Euro area 	08.30	Construction PMI	May	-	50.4
	09.30	Sentix investor confidence	Jun	-	-22.6
Germany 	07.00	Factory orders M/M% (Y/Y%)	Apr	-	-4.7 (-3.1)
	08.30	Construction PMI	May	-	46.0
France 	08.30	Construction PMI	May	-	50.
Spain 	08.00	Industrial production M/M% (Y/Y%)	Apr	-	-1.8 (0.1)
UK 	00.01	BRC retail sales monitor, like-for-like sales Y/Y%	May	-	-1.7
	09.30	Final services (composite) PMI	May	51.8 (51.8)	58.9 (58.2)
Wednesday 08 June 2022					
Euro area 	10.00	Final GDP Q/Q% (Y/Y%)	Q1	<u>0.3 (5.1)</u>	0.3 (4.7)
	10.00	Final employment Q/Q% (Y/Y%)	Q1	<u>0.5 (2.6)</u>	0.4 (2.1)
Germany 	07.00	Industrial production M/M% (Y/Y%)	Apr	-	-3.9 (-3.5)
France 	07.45	Trade balance €bn	Apr	-	-12.4
Italy 	09.00	Retail sales M/M% (Y/Y%)	Apr	-	-0.5 (5.6)
UK 	09.30	Construction PMI	May	-	58.2
Thursday 09 June 2022					
Euro area 	12.45	ECB refinancing rate %	Jun	<u>0.00</u>	0.00
	12.45	ECB deposit rate %	Jun	<u>-0.50</u>	-0.50
UK 	00.01	RICS house price balance %	May	-	80
Friday 10 June 2022					
Spain 	08.00	Final CPI M/M% (Y/Y%)	May	0.8 (8.7)	-0.2 (8.3)
	08.00	Final EU harmonised CPI M/M% (Y/Y%)	May	0.7 (8.5)	-0.3 (8.3)
Italy 	09.00	Industrial production M/M% (Y/Y%)	Apr	-	0.0 (3.0)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
Thursday 02 June 2022			
Euro area		07.45	ECB's Villeroy scheduled to speak
		16.15	ECB's Hernandez de Cos scheduled to speak
France		09.50	Auction: 0% 2032 bonds
		09.50	Auction: 1.25% 2036 bonds
		09.50	Auction: 0.75% 2052 bonds
Spain		09.30	Auction: 4.65% 2025 bonds
		09.30	Auction: 0.8% 2029 bonds
		09.30	Auction: 0.1% 2031 bonds
		09.30	Auction: 0.65% 2027 index-linked bonds
Friday 03 June 2022			
- Nothing scheduled -			
Monday 06 June 2022			
- Nothing scheduled -			
Tuesday 07 June 2022			
UK		10.00	Auction: £3.0bn of 0.25% 2025 bonds
Wednesday 08 June 2022			
Euro area		10.00	OECD publishes economic outlook
Germany		10.30	Auction: €4.0bn of 0% 2032 bonds
UK		10.00	Auction: to sell 1% 2032 bonds
Thursday 09 June 2022			
Euro area		12.45	ECB Governing Council policy announcement
		13.30	ECB President Lagarde speaks at post-Governing Council meeting press conference
Friday 10 June 2022			
UK		00.01	REC/KPMG report on jobs
		09.30	BoE inflation attitudes survey

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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