Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds reversed yesterday's gains as euro area GDP growth in Q1 was revised up and German industrial production registered positive growth in April.
- Gilts also made losses as the UK construction PMIs signalled ongoing growth, albeit moderating, in the sector.
- Thursday should see the ECB set out its plan for monetary policy normalisation over coming months, with net asset purchases to be brought to an end and rate hikes to be pencilled in for Q3 and probably beyond.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.679	+0.035
OBL 0 04/27	1.072	+0.050
DBR 0 02/32	1.347	+0.060
UKT 1 04/24	1.749	+0.029
UKT 1¼ 07/27	1.866	+0.033
UKT 4¼ 06/32	2.239	+0.027

*Change from close as at 4:00pm BST.
Source: Bloomberg

Euro area

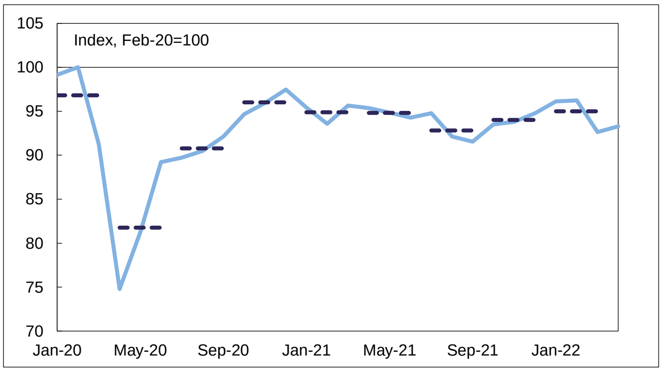
Modest rise in German IP in April leaves level well below the Q1 average

While yesterday's factory orders data for April reported a third successive and steep decline to the lowest level since January 2021, today's German industrial production numbers for the same month at least reported positive growth. However, the rise in industrial production (including construction) of 0.7%M/M was smaller than expected and barely made a dent in the drop of 3.7%M/M the prior month, leaving the level 1.8% below the Q1 average and 6.7% below the pre-pandemic level in February 2020. Within the detail, manufacturing output rose just 0.4%M/M to be a steep 2.2% below the Q1 average. Growth was strongest for output of durable consumer goods, which rose 4.0%M/M to be more than 3% above the respective Q1 level. But while capital goods production was also stronger it was still 3.8% below the Q1 average and more than 16% below the pre-pandemic level. And motor vehicle production was up 6.8%M/M but almost 5% below the average last quarter and roughly one third below the pre-pandemic level. While chemicals output fell for a second successive month, overall intermediate goods output ticked up 0.4%M/M to be 1.8% below the Q1 level. Beyond the manufacturing sector, consistent with recent surveys, construction output dropped for a third successive month and by 2.1%M/M to be 2.6% below the Q1 average. But thanks to a timely boost to wind-generated output, energy production rebounded an extraordinary 16.1%M/M to be up almost 9% from the Q1 average and at the highest level since January 2019.

Chinese restrictions among several restraints on German production

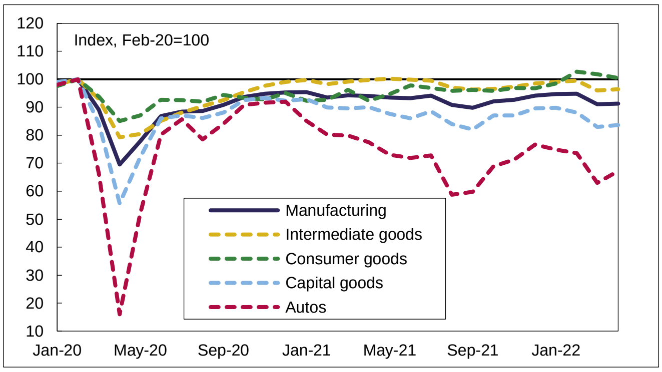
Overall, the data illustrate the ongoing impact of cost pressures and, in particular, supply-chain disruption on German manufacturing output. While those supply challenges are related to numerous factors, not least events in Ukraine, a recent survey published by the ifo institute highlighted the impacts of Chinese pandemic restrictions on various sub-sectors. More than half of all manufacturers (53.4%) questioned last month judged that the recent lockdowns in China – which is Germany's number one source of imports – had exacerbated their supply constraints, with the share of affected firms highest in the autos sub-sector (82.6%), and a large majority of producers of IT and electrical equipment also impaired. More than two-thirds of all wholesalers also cited supply disruption from China as did 63% of retailers. Encouragingly perhaps, however, surveys also suggest a modest improvement in supply bottlenecks over the past month. And Germany's manufacturing output PMI rose more than 3pts in May to 51.2 to suggest a further slight pickup in production in the middle of Q2. However, certain other survey indicators (including the sector's ifo indices) and high-frequency data such as truck-toll

Germany: Industrial production*



*Includes construction. Dashed lines represent quarterly average.
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing production by sub-sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

mileage point to a softer picture. And given the marked recent downtrend in German factory orders, as well as the persistence of cost and supply-side barriers, a non-negligible drop in German IP in Q2 still looks highly likely to us.

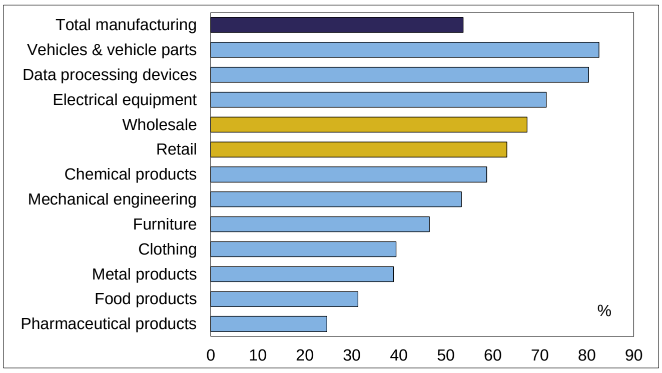
Euro area GDP revised up in Q1, with growth driven by net trade and inventories

Euro area GDP growth in Q1 was revised up 0.3ppt to 0.6%Q/Q, 0.4ppt stronger than in Q4 and also 0.4ppt stronger than the ECB's baseline forecast. The growth in Q1 took GDP 0.8% above the pre-pandemic level in Q419. With the initial estimate of growth in France having been revised down (0.2ppt to -0.2%Q/Q) largely offsetting the upwards revision for Italy (by 0.3ppt to 0.1%Q/Q), the principal cause for the upwards revision seems likely to be Ireland, where a steep drop of 6.2%Q/Q in Q4 was followed by an extreme rebound of 10.8%Q/Q in Q1 to account for about two-thirds of all euro area growth. Among the other member states, GDP growth was also above 2%Q/Q in Portugal, Greece and Latvia. But the larger member states all grew at a significantly softer pace than the euro area average. By expenditure component, GDP growth was driven in part by net trade, which contributed 0.4ppt as export volumes rose 0.4%Q/Q but imports dropped 0.6%Q/Q. The contribution from inventories was even larger still at 0.6ppt. However, despite strong growth in construction in Germany and Italy, fixed investment growth of 0.1%Q/Q made a negligible contribution and was still 6.7% below the pre-pandemic level, as capital spending on transport fell. Government consumption dropped for the first time in a year. And while accelerated growth in employment (up 0.2ppt to 0.6%Q/Q) and hours worked (up 1.3ppt to 1.3%Q/Q) to new series highs supported real incomes, household consumption fell 0.7%Q/Q, subtracting 0.3ppt from GDP growth and remaining 2.7% below the pre-pandemic level.

Euro area GDP growth to be softer in Q2

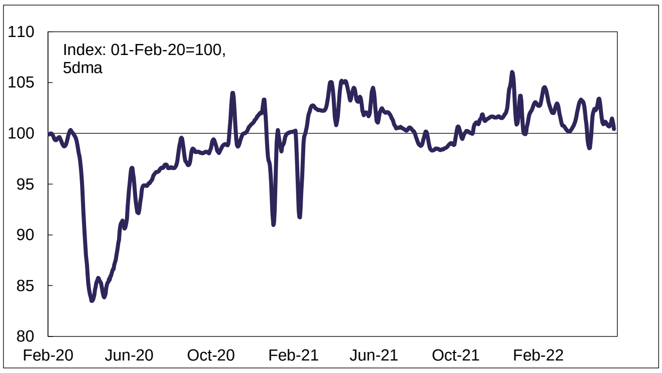
Despite the stronger-than-expected growth in euro area GDP in Q1, the ECB's baseline forecast of 1.0%Q/Q in Q2 looks set to be significantly undershot as private demand continues to be weighed by high inflation and continued supply-chain strains. While household consumption should be a touch firmer than in Q1 due to a rebound in services, the contribution from net trade will be weaker and inventories are likely to subtract from growth. Among the member states, the large contribution to GDP growth in Q1 from Ireland is highly unlikely to be repeated in Q2, when negative payback for that strength might well be substantive. And while a rebound in tourism should continue to benefit certain countries in Southern Europe, we fear that growth will be negative in Italy and Germany, and highly subdued in France and Spain. Overall, we currently forecast euro area GDP growth of just 0.1%Q/Q in the current quarter.

Germany: Impact of Chinese restrictions



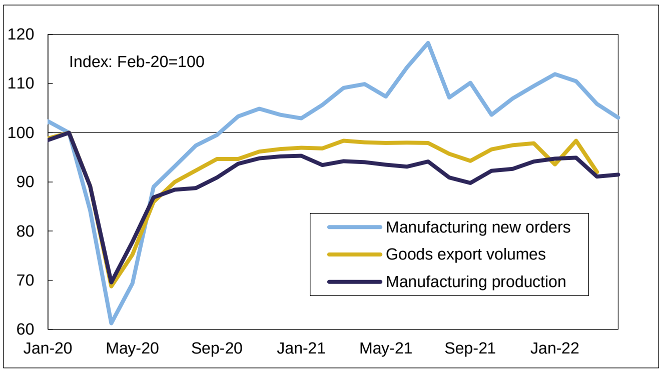
Source: ifo institute and Daiwa Capital Markets Europe Ltd.

Germany: Truck toll mileage index



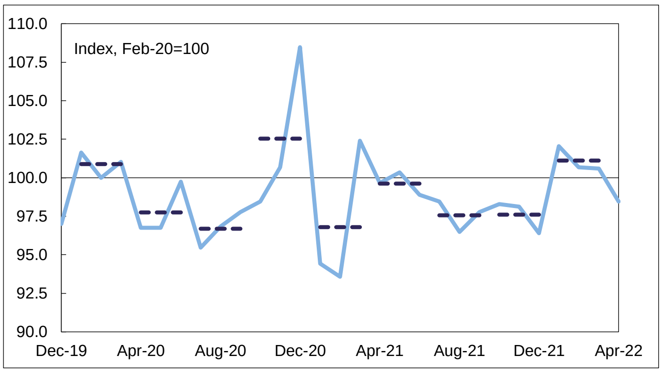
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing output, orders & exports



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: Construction output*



**Dashed lines represent quarterly average.*
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

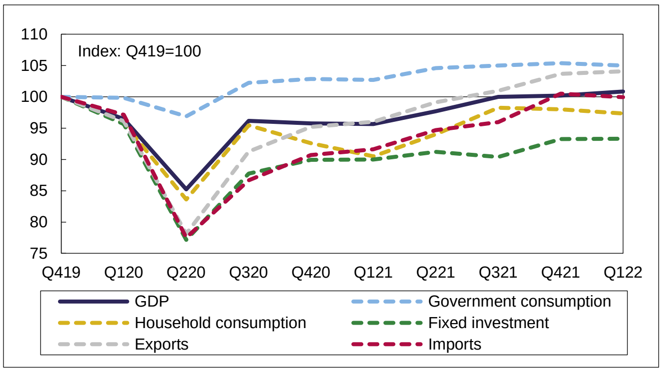
All eyes tomorrow will be on the conclusion of the ECB's latest Governing Council meeting. With euro area inflation continuing to surprise on the upside – more than four times the ECB's target at 8.1%YY in May, and on track to be more than 2ppts above the ECB's forecast for Q2 published just three months ago – the ECB will set out its plan for monetary policy normalisation. We strongly expect the ECB to signal that successive rate rises from July are on the cards – while leaving open the size of first hike – and that net purchases will end this month. And the establishment of a new instrument to address fragmentation risks might also be endorsed too.

According to its current forward guidance, the Governing Council expects to conduct a further €20bn of net asset purchases this month before ending them in the third quarter and raise rates sometime after that. But given the extreme leap in inflation, the announcement of an immediate end to those purchases tomorrow might now seem appropriate. A clear signal of rate lift-off at the 21 July policy meeting and further hike at the following meeting on 8 September, allowing it to exit negative rates by end-Q3, would now appear all but inevitable. The Governing Council will also highly likely signal that, subject to the incoming data, it expects to keep increasing rates thereafter until they are eventually back into (unspecified) neutral territory, likely in practice to be somewhere between 1-2%.

In due course, however, we expect rates to be hiked in increments of 25bps. Indeed, one member of the Governing Council noted last week that, in the absence of surprises in the ECB's projections, there would be no "general support for a 50bps hike". But in her press conference on Thursday, ECB President Lagarde would seem likely to leave the door open to hikes of 50bps apiece if the incoming data demand them, and there will be several Governing Council members in favour of such moves.

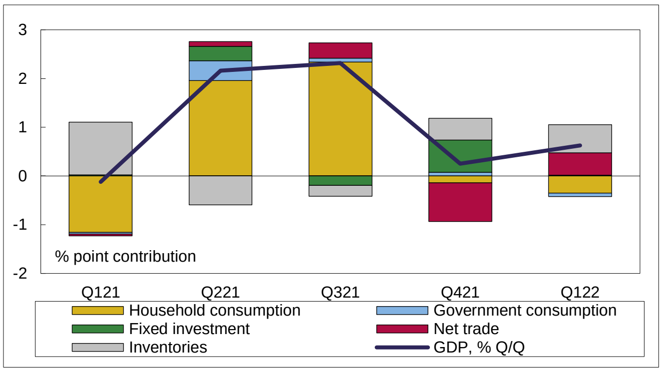
While the regular asset purchase programme is set to come to an end, with the spread of 10Y BTPs over Bunds now roughly 200bps, most Governing Council members appear ready to support the establishment of a new policy instrument that would be ready to step in to support certain stressed sovereign bond markets if and when fragmentation risks emerge. Whether the ECB announces any substance tomorrow remains to be seen, however, with the mechanics of any new instrument open to debate. The FT reported that the Governing Council could agree that, in certain circumstance, reinvestments of maturing proceeds of PEPP bonds might be brought forward ahead of schedule and redirected to stressed markets. If so, we would expect the monetary impact of such purchases to be sterilised. The nature of any conditionality attached is also uncertain. Of course, the hawks on the Governing Council will argue that a new instrument is unnecessary in light of the existence of the Outright Monetary Transactions (OMTs), which are nevertheless conditional on the existence of an ESM programme.

Euro area: GDP & expenditure components



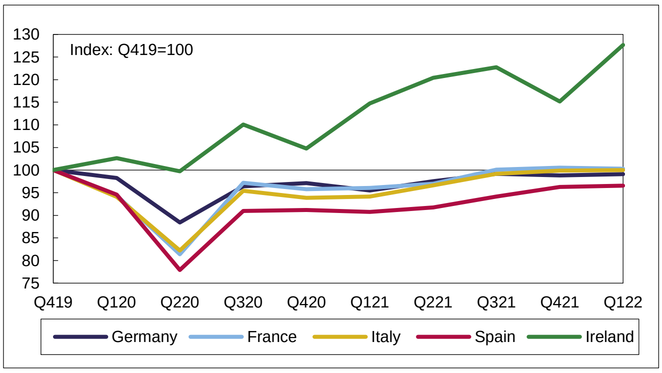
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP & expenditure contributions



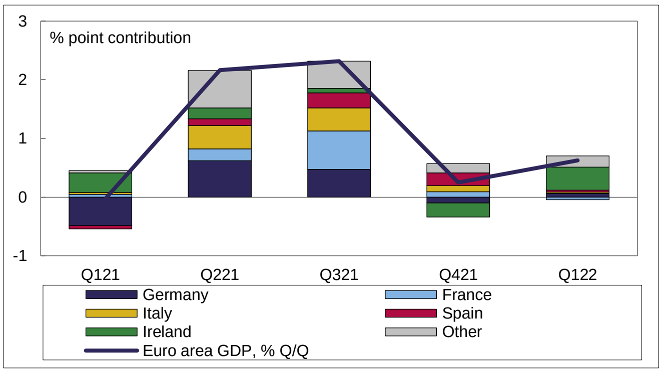
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP by country



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: GDP growth & country contributions



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

The Governing Council's decisions on policy this week will be guided by its updated projections, which will revise up sharply its expected profile of inflation from its previous baseline projection published in March. The new inflation forecast will more closely resemble its previous "severe" scenario of an average of 7.1% this year and 2.7% in 2023 than its baseline of 5.1% and 2.1%. The projections will still, however, likely suggest that inflation is expected to return back to the 2% target over the medium term. And the risks will be two-sided. But 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. Despite the stronger-than-anticipated euro area GDP growth in Q1, we expect the growth projections to be revised down from the current baseline of 3.7% in 2022 and 2.8% in 2023.

There are no top-tier economic data scheduled for release in the euro area tomorrow.

UK

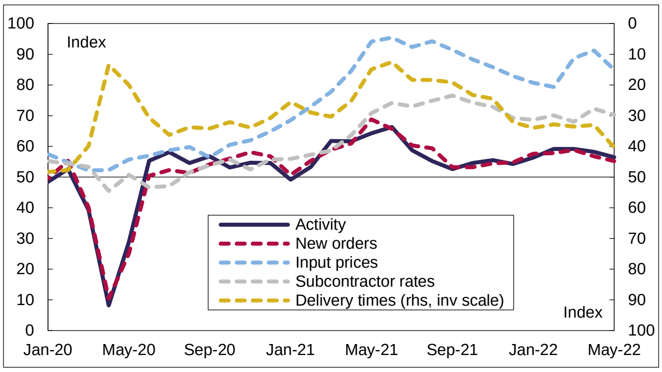
Construction survey suggests moderation in momentum, particularly in housing

Like yesterday's services PMIs, the UK's construction PMIs remained consistent with ongoing positive, albeit slowing, growth in May. In particular, the headline construction activity index dropped 1.8pts from April to a four-month low of 56.4, to leave the average in the first two months of Q2 almost 1pt below the Q1 average. All major categories of work slowed somewhat, with the loss of momentum most marked in housing activity, for which the respective PMI dropped more than 2pts to a two-year low of 50.7 suggestive of stagnation. While still consistent with relatively firm expansion, the indices for commercial and infrastructure work fell to the lowest levels in three and four months respectively. And the construction new orders index dropped to the lowest so far this year. More happily perhaps, the survey suggested a further modest improvement in supply constraints, with supplier delivery times lengthening the least since the onset of Covid-19, subcontractor availability and quality slightly improved, and input costs reportedly rising the least in three months.

The day ahead in the UK

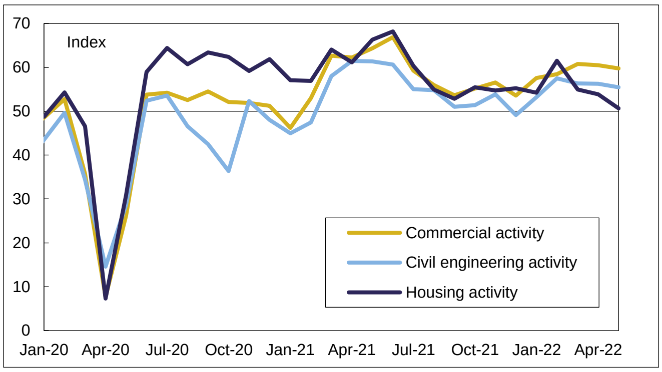
Tomorrow will be another relatively quiet day for UK economic data, with only the RICS residential survey for May due. This survey is expected to suggest another strong month of house price growth due to the ongoing supply-demand imbalance, albeit with the relevant index expected to fall back somewhat from April's ten-month high of 80%.

UK: Construction PMIs



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

UK: Construction PMIs by sub-sector



Source: S&P Global, Bloomberg 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		Final GDP Q/Q% (Y/Y%)	Q1	**0.6 (5.4)**	*0.3 (5.1)*	0.3 (4.7)	**-**
		Final employment Q/Q% (Y/Y%)	Q1	**0.6 (2.9)**	*0.5 (2.6)*	0.4 (2.1)	**-**
Germany		Industrial production M/M% (Y/Y%)	Apr	**0.7 (-2.2)**	1.2 (-2.4)	-3.9 (-3.5)	**-3.7 (-3.1)**
France		Trade balance €bn	Apr	**-12.2**	-	-12.4	**-12.6**
Italy		Retail sales M/M% (Y/Y%)	Apr	**0.0 (8.4)**	0.1 (-)	-0.5 (5.6)	**-0.6 (5.6)**
UK		Construction PMI	May	**56.4**	56.6	58.2	**-**
Auctions							
Country		Auction					
Germany		sold €3.27bn of 0% 2032 bonds at an average yield of 1.33%					
UK		sold £2.5bn of 1% 2032 bonds at an average yield of 2.30%					

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases						
Economic data						
Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		12.45	ECB refinancing rate %	Jun	*0.00*	0.00
		12.45	ECB deposit rate %	Jun	*-0.50*	-0.50
UK		00.01	RICS house price balance %	May	76	80
Auctions and events						
Euro area		12.45	ECB Governing Council policy announcement			
		13.30	ECB President Lagarde speaks at post-Governing Council meeting press conference			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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