Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

- Bunds sold off and BTPs significantly underperformed as the ECB pre-committed to a 25bps rate hike in July and signalled the strong likelihood of a 50bps hike in September and further tightening thereafter.
- Gilts also made significant losses but a UK housing survey suggested a moderation of momentum in the market.
- Tomorrow will bring data for Italian IP and UK surveys on inflation expectations and jobs, while next week's data highlights include UK GDP for April and the BoE seems bound to raise rates again.

Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	0.802	+0.123
OBL 0 04/27	1.185	+0.113
DBR 0 02/32	1.426	+0.077
UKT 1 04/24	1.843	+0.091
UKT 1¼ 07/27	1.969	+0.100
UKT 4¼ 06/32	2.340	+0.095

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

Euro area

ECB to raise rates by 25bps in July, 50bps penciled-in for September, and more likely thereafter

As expected, the ECB today set out its plans for monetary policy normalisation. But those plans, which were unanimously agreed, were somewhat more hawkish than anticipated, providing additional impetus to the sell-off in euro area bond markets. While the Governing Council left its main interest rates unchanged in June, it pre-committed to increasing them by 25bps in July. And it made clear that, unless the medium-term inflation outlook in its updated projections is judged to have improved then, it will raise its key rates by a larger amount – presumably 50bps – in September. It also stated that "a gradual but sustained path of further increases" is likely thereafter, raising the likelihood of at least 50bps – and perhaps 75bps or more – of hikes in Q4 and additional tightening in 2023. As a result, futures markets priced-in 150bps of hikes by year-end. Meanwhile, the ECB's decision to end the special conditions on the TLTRO III loans on 23 June, which as expected was confirmed today, means that the interest rate on that long-term liquidity will rise 50bps to -0.50% from that date. Thereafter, the rate will rise further in line with increases in the deposit rate.

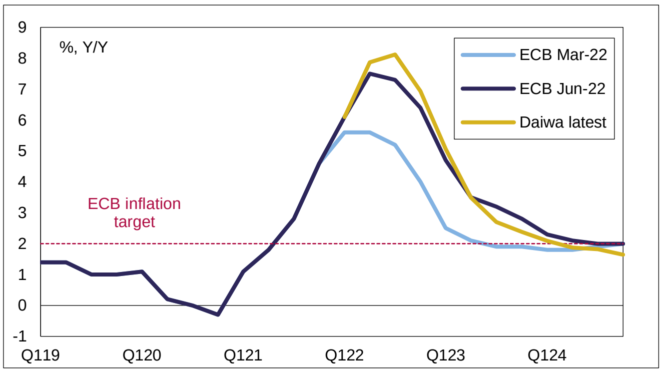
QE to end on 1 July, PEPP reinvestments to address fragmentation risks, new tools possible too

Given the pledge to raise rates aggressively over coming months, it was perhaps a little odd (although ultimately of little consequence) that the ECB today maintained its commitment to buy an extra net €20bn of assets this month, before ceasing those net purchases on 1 July. It also maintained its earlier commitment to keep reinvesting in full the principal payments from maturing assets purchased under the regular APP programme for an extended period of time past the date when it starts raising rates. Additionally, it confirmed that it intends to reinvest proceeds of maturing PEPP assets until at least the end of 2024. And it repeated that, if tighter monetary policy triggers fragmentation risks for certain sovereigns, the ECB will adjust reinvestments of PEPP maturing assets, shifting them towards those troubled markets and bringing such reinvestments forward in time if necessary. But no further details were provided about how such reinvestments would be conducted, nor was there any agreement on additional tools that might be used to tackle fragmentation risks. So, the markets were unimpressed, and BTPs significantly underperformed other euro area government bonds. Nevertheless, in her press conference, President Lagarde insisted that the ECB might yet create new instruments to ensure that the monetary policy transmission mechanism isn't impaired by market pressures towards fragmentation.

Inflation projection revised up sharply, with 2024 projection key

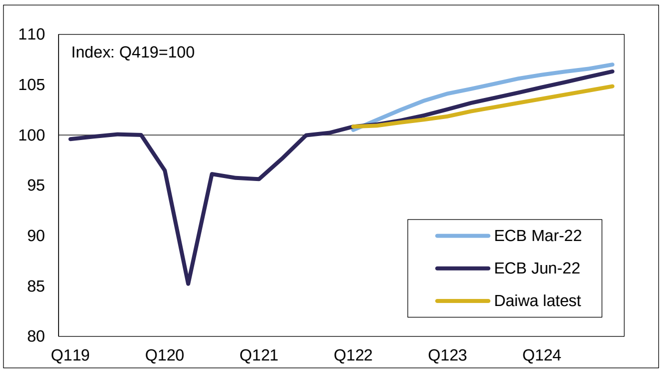
The ECB justified its hawkishness by its updated economic projections, which inevitably revised up significantly its inflation outlook but revised down significantly its GDP outlook. In particular, the ECB now thinks that inflation will peak in the current

Euro area: Inflation forecasts



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

Euro area: GDP forecasts



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

quarter at 7.5%Y/Y, almost 2ppts above the peak in its previous projection, before declining very gradually. Indeed, it expects inflation to average almost 6½%Y/Y in the final quarter of this year and remain close to 3%Y/Y even by the end of 2023. Only by the second half of 2024 does it expect inflation to return to the 2.0%Y/Y target. On a full-year basis, it expects inflation to average 6.8%Y/Y this year, 3.5%Y/Y next year and still an above-target 2.1%Y/Y in 2024. It also expects that core inflation will remain above target – on average 2.3%Y/Y – in 2024. And it sees the risks to its inflation forecast to be skewed to the upside. Crucially, only if those inflation forecasts for 2024 are revised down to 2.0%Y/Y or less will the ECB not raise rates by 50bps in September. And not least given the relentless uptrend in oil prices and concerns about energy supply amid signs that Russia's war in Ukraine will be protracted and increasingly damaging, such a downwards revision currently looks highly unlikely. So, we now fully expect a 50bps rate hike in September, and – just as in Q3 – there must be a decent chance that rates will be hiked by a further 75bps in Q4 too.

ECB expects recession to be avoided, unlike consequences of Ukraine war intensify

Only if economic activity heads into reverse will the ECB's hawkishness start to diminish. As far as its baseline projection is concerned, however, recession is expected to be avoided, with GDP growth slowing to just to 0.2%Q/Q but edging higher thereafter as the economic impact of the pandemic diminishes further, consumption patterns normalize, supply bottlenecks ease and – the bravest assumption perhaps – the intense phase of the war in Ukraine is over by the end of 2022. In such circumstances, the ECB expects GDP to rise 2.8%Y/Y this year (down almost 1ppt from its previous forecast) and 2.1%Y/Y in 2023 and 2024 (down 0.7ppt and up 0.5ppt respectively). Our forecast for GDP growth this year is very similar to that of the ECB. But we are more downbeat about next year, not least seeing risks of more damaging consequences of events in Ukraine. Indeed, the ECB also published projections for a downside scenario, whereby the hit from Russia is much more severe, resulting in a complete halt to Russian energy exports to the euro area starting from Q3, a rationing of gas supply, significantly higher energy and commodity prices particularly in 2023, intensified supply-chain challenges, lower trade and financial turbulence. In such circumstances, the ECB projects that GDP might fall 1.7% in 2023, pushing unemployment 1.5ppts higher to 8.3% next year and further into 2024. As a result, while in this scenario it also projects that headline inflation would be higher this year and next at 8.3%Y/Y and 6.4%Y/Y respectively, it would expect inflation to fall back to 1.9%Y/Y in 2024, with core inflation also returning to the 2.0% target that year. And, in due course, that would eventually justify a less aggressive tightening of monetary policy.

The week ahead in the euro area

Tomorrow should be relatively uneventful for economic data from the euro area, with Italian industrial production figures probably most notable. After growth stalled in March, a drop in production of around 1.0%M/M is expected for April. In addition, final Spanish inflation data for May are expected to confirm the flash estimates, which saw the national CPI rate rise 0.4ppt to 8.7%Y/Y, still more than 1ppt down from the March high.

The coming weekend then brings some noteworthy political events, in France and Italy. In particular, the first round of the French legislative elections comes on Sunday, ahead of the second round one week later. Opinion polls suggest that President Macron's party, Renaissance (formerly known as La République En Marche!), and its allies including the Democratic Movement (MoDem), have a good chance of retaining majority control of the National Assembly. However, the polls also suggest that a majority is not guaranteed due not least to the positive momentum currently enjoyed by the main left-wing parties – including Jean-Luc Mélenchon's La France Insoumise, the former establishment Socialists, and Greens – grouped as the New People's Ecologist and Social Union (NUPES). A poll by Elabe last week suggested that Macron's group might gain somewhere between 275-315 seats, with 289 seats required for a majority. Marine Le Pen's National Rally (RN) right-wing populists also look set to increase their representation in the assembly, albeit remaining very much a minority presence. And the former establishment centre-right looks set to lose dozens of seats from its current total of 100.

In Italy, meanwhile, Sunday will bring a referendum on five judicial reforms, required as conditions for unlocking EU recovery funds, as well as local elections. Among other things, a strong showing in the latter for the Brothers of Italy could strengthen the hand of their leader Giorgia Meloni relative to the Lega's Matteo Salvini as they tussle for the right to be perceived as de facto leader of any populist "centre-right" bloc ahead of the next general election due within the next twelve months. A second round of the local elections will be held on 26 June.

Looking ahead, next week will be relatively light on potential market-moving data from the euro area. Final inflation figures for May – from Germany (Tuesday), France (Wednesday), Italy (Thursday) and euro area (Friday) – are expected to confirm the preliminary estimates, for which the euro area HICP rate rose 0.7ppt to 8.1%Y/Y with the core rate up 0.3ppt to 3.8%Y/Y. Sentiment-wise, like this week's Sentix indices, the ZEW investor survey for June (Tuesday) is likely to report a modest pickup in investor confidence, albeit with expectations still in recession territory. Production in Germany (1.3%M/M, excluding construction) and Spain (2.1%M/M) might suggest positive growth in euro area IP in April (Wednesday). However, France was broadly flat (-0.1%M/M), and an extreme drop in Ireland (-9.6%M/M) points to a second successive drop of 1%M/M or more for the euro area as a whole. Among other aggregate data due, as suggested by recent negotiated wage data, labour cost figures for Q1 (Thursday) will report a pickup from 1.9%Y/Y in Q4. And despite positive growth in France (1.2%M/M), euro area construction output figures for April (Friday) will likely post a first decline since December weighed not least by the decline of 2.1%M/M in Germany as supply-chain pressures take their toll.

UK

Survey signals slight easing in housing market demand and softer outlook too

The RICS residential market survey for May signalled a slight softening in new demand for properties and a broadly flat trend for sales. And sentiment with respect to sales twelve months ahead was also weaker in the face of various headwinds such as falling real pay and rising interest rates. Nevertheless, home prices, which were up 11.2%Y/Y on the Nationwide index last month, are still predicted to keep rising, albeit at a more moderate pace than of late. In particular, the net balance for new buyer enquiries fell 15ppts to -7%, the first negative reading in nine months. The equivalent index for near-term sales expectations dropped 9ppts to 1%, but the longer-term expectations balance for activity fell 20ppts to -24%, the weakest since October 2020. Given still tight supply, a net 73% of those surveyed – down 7ppts from April but close to the average of the past six months – reported an increase in house prices last month. But the net balance regarding the price rises in twelve months' time dropped 36ppts to +42%, still pointing upwards albeit by the least since January 2021.

The week ahead in the UK

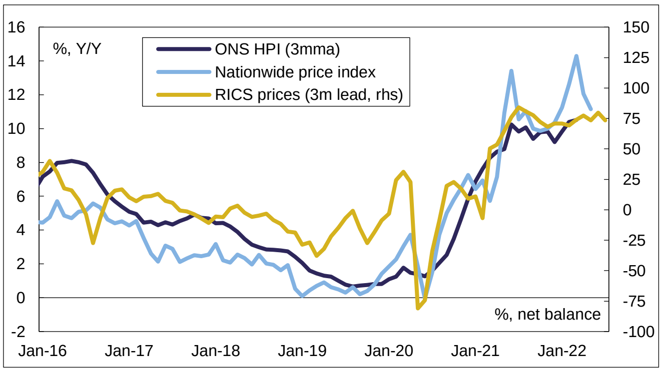
It should be a relatively quiet end to the week for UK economic data, although the BoE's latest Inflation Attitudes survey results seem likely to report a further rise in expectations for the coming twelve months from the near-14-year high of 4.3% registered three months ago. The latest KPMG/REC report on jobs will also provide insights into the tightness of the labour market.

The main event in the UK in the coming week will be the BoE's latest MPC meeting, the policy statement and minutes from which will be released on Thursday. At the [MPC's last meeting](#) in May, the BoE raised Bank Rate by 25bps to 1.00%, with all nine members of the Committee voting to tighten policy. Moreover, three (external) members of the Committee voted for a larger hike of 50bps. And "most" members of the Committee judged that "some degree of further tightening in monetary policy may still be appropriate in the coming months". However, the BoE's updated projections suggested that the terminal interest rate for this cycle would be below the level priced into markets.

Since that meeting, UK economic activity appears to have panned out broadly as the BoE anticipated, with subdued spending but no clear-cut evidence of a sudden shift into recession territory. Moreover, the rise in CPI inflation in April to 9.0%Y/Y was also in line with its expectation. However, the UK government's major fiscal policy U-turn on 26 May provided significant additional support to households – worth a little more than ½% of GDP – in the final quarter to cope with higher energy prices, funded in part by increases taxes on energy firms. In light of that policy shift, the BoE will now expect GDP in Q4 to be stronger than it previously feared. At the same time, while the ONS has yet to provide its opinion, the subsidies could well reduce the peak in inflation in October to below the 10%Y/Y level that the BoE previously anticipated, even though prices have maintained their upwards trend. Looked in the round, the majority (and perhaps all) of the MPC members are likely to see the case for a further rate hike on Thursday. And while we think the Committee will vote for an increase in Bank Rate of 25bps to 1.25% rather than the 50bps increments currently preferred by the Fed, BoC and RBA, we expect it to maintain its guidance that "some degree of further tightening in monetary policy may still be appropriate in the coming months". The MPC will not take any decisions about whether to start active Gilt sales at this meeting – that is a debate to be held at the August meeting instead.

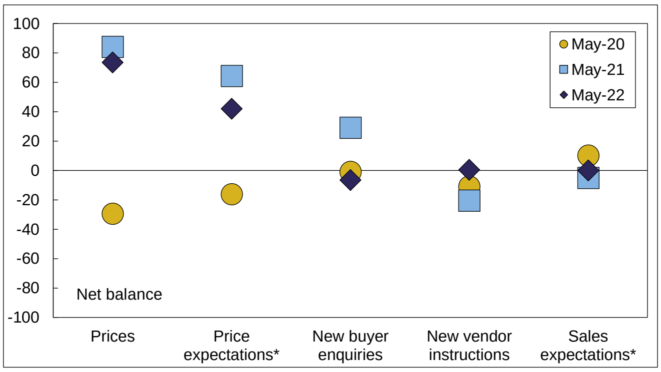
With respect to next week's economic data, the monthly GDP report for April comes on Monday. Having fallen in March, high frequency data suggest that private sector services activity trended moderately higher into the second quarter. Indeed, retail sales rose 1.4%M/M in April, while the service sector PMIs for the same month continued to point to expansion, albeit with some loss of momentum. As such, while we may well see some further weakness in the April IP data, not least due to persisting supply bottlenecks, we expect to see a moderate increase in GDP at the start of Q2 – more than reversing the modest 0.1%M/M decline posted in March – to be up around 4%Y/Y, more than 1% above its pre-pandemic level, and suggestive of modest growth over Q2 as a whole despite the extra bank holiday in June. Further insight into spending in Q2

UK: House price indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: RICS residential survey indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

will come on Friday when retail sales data for May will be published and are likely to report adverse payback – perhaps more than 1%M/M – for the surprising jump in April. Also to be watched in the coming week will be Tuesday's employment report, which will likely point to ongoing tightness in the labour market – we expect a drop of 0.1ppt in the unemployment rate in the three months to April to 3.6%, which would be the lowest since 1974. In addition, the number of job vacancies in the three months to May will remain above the number of unemployed workers. That will in part reflect the continued high level of economic inactivity, while the number of people in employment will remain roughly 500k down from the pre-pandemic level. However, due in part to base effects, we expect growth in nominal average weekly earnings to slow slightly from 4.2%3M/Y (excluding bonuses) and 7.0%3M/Y (including bonuses) and thus be negative in real terms.

The next edition of the Euro wrap-up will be published on 13th June 2022

Daiwa economic forecasts

	2021	2022				2023	2022	2023	2024
	Q4	Q1	Q2	Q3	Q4	Q1			
GDP			%, Q/Q					%, Y/Y	
Euro area	0.2	0.6	0.1	0.3	0.3	0.3	2.8	1.4	1.6
UK	1.3	0.8	0.1	0.2	-0.3	0.0	3.6	-0.1	0.9
Inflation, %, Y/Y									
Euro area									
Headline HICP	4.6	6.1	7.9	8.1	6.9	5.1	7.3	3.4	1.9
Core HICP	2.4	2.7	3.6	3.6	3.1	2.8	3.2	2.5	2.0
UK									
Headline CPI	4.9	6.2	9.1	9.2	9.2	8.2	8.4	4.7	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	0.75	1.25	1.50	1.25	1.75	1.75
Deposit Rate	-0.50	-0.50	-0.50	0.25	0.75	1.00	0.75	1.50	1.50
BoE									
Bank Rate	0.25	0.75	1.25	1.75	2.00	2.00	2.00	2.00	2.00

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

Daiwa Capital Markets

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ _Daiwa forecast/actual_	Previous
			Monday 13 June 2022			
Italy		09.00	Unemployment rate %	Q1	-	9.1
UK		07.00	GDP M/M% (3M/3M%)	Apr	_0.3 (1.0)_	-0.1 (0.8)
		07.00	Industrial production M/M% (Y/Y%)	Apr	-	-0.2 (0.7)
		07.00	Manufacturing production M/M% (Y/Y%)	Apr	-	-0.2 (1.9)
		07.00	Index of services M/M% (3M/3M%)	Apr	-	-0.2 (0.4)
		07.00	Construction output M/M% (Y/Y%)	Apr	-	1.7 (4.7)
		07.00	Goods trade balance £bn	Apr	-	-23.9
			Tuesday 14 June 2022			
Germany		07.00	Final CPI M/M% (Y/Y%)	May	_0.9 (7.9)_	0.8 (7.4)
		07.00	Final EU-harmonised CPI M/M% (Y/Y%)	May	_1.1 (8.7)_	0.7 (7.8)
		10.00	ZEW current assessment (expectations)	Jun	(-30.0)	-36.5 (-29.5)
UK		07.00	Unemployment claimant count rate % (change '000s)	May	-	4.1 (-56.9)
		07.00	ILO unemployment rate 3M%	May	_3.6_	3.7
		07.00	Employment change '000s, 3M/3M	Apr	-	83
		07.00	Average earnings including (excluding) bonuses 3M/Y%	Apr	-	7.0 (4.2)
			Wednesday 15 June 2022			
Euro area		10.00	Industrial production M/M% (Y/Y%)	Apr	_-1.1 (-2.7)_	-1.8 (-0.8)
		10.00	Trade balance €bn	Apr	-	-17.6
France		07.45	Final CPI M/M% (Y/Y%)	May	_0.6 (5.2)_	0.4 (4.8)
		07.45	Final EU-harmonised CPI M/M% (Y/Y%)	May	_0.7 (5.8)_	0.5 (5.4)
			Thursday 16 June 2022			
Euro area		07.00	EU27 new car registrations Y/Y%	May	-	-20.6
		10.00	Labour costs Y/Y%	Q1	-	1.9
Italy		09.00	Final CPI M/M% (Y/Y%)	May	_0.9 (6.9)_	-0.1 (6.0)
		09.00	Final EU-harmonised CPI M/M% (Y/Y%)	May	_0.9 (7.3)_	0.4 (6.3)
Spain		09.00	Trade balance €bn	Apr	-	-4.6
UK		12.00	BoE Bank Rate %	Jun	_1.25_	1.00
			Friday 17 June 2022			
Euro area		10.00	Final CPI M/M% (Y/Y%)	May	_0.8 (8.1)_	0.6 (7.4)
		10.00	Final core CPI Y/Y%	May	_3.8_	3.5
		10.00	Construction output M/M% (Y/Y%)	Apr	-	0.0 (3.3)
UK		07.00	Retail sales including auto fuel M/M% (Y/Y%)	May	-	1.4 (-4.9)
		07.00	Retail sales excluding auto fuel M/M% (Y/Y%)	May	-	1.4 (-6.1)

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 13 June 2022
			- Nothing scheduled -
			Tuesday 14 June 2022
Germany		10.30	Auction: €5.5bn of 0.2% 2024 bonds
Italy		10.00	Auction: 3Y and 7Y bonds
			Wednesday 15 June 2022
Euro area		13.30	ECB's De Cos scheduled to speak at online academic event
		14.00	ECB's Panetta gives introductory statement at European Parliament hearing on digital euro
		14.15	ECB's Knot scheduled to speak at online academic event
		17.00	ECB President Lagarde participates in an event at London School of Economics
			Thursday 16 June 2022
Euro area		08.45	ECB's Villeroy scheduled to speak at online academic event
		08.50	ECB's Panetta scheduled to speak at European Payments Council event
		09.30	ECB's De Guindos scheduled to speak at online academic event
		10.30	ECB's Knot scheduled to speak at online academic event
		10.30	ECB's Centeno scheduled to speak at online academic event
		10.30	ECB's De Cos scheduled to speak at online academic event
France		09.50	Auction: Fixed-rate bonds
		10.50	Auction: Inflation-linked bonds
Spain		09.30	Auction: Fixed-rate bonds
UK		12.00	BoE monetary policy announcement, summary and minutes to be published
		12.00	BoE publishes Agents' summary of business conditions – Q222
			Friday 17 June 2022
			- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		ECB refinancing rate %	Jun	**0.00**	*0.00*	0.00	-
		ECB deposit rate %	Jun	**-0.50**	*-0.50*	-0.50	-
UK		RICS house price balance %	May	**73**	76	80	-

Auctions

Country	Auction
	- Nothing to report -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
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	-1.1 (0.1)	0.0 (3.0)

Auctions and events

Country		BST	Event
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