Euro wrap-up

Overview

- Gilts followed other major markets lower but outperformed as UK GDP unexpectedly fell in April.
- Bunds made significant further losses while BTPs significantly underperformed as investors continued to bet on more aggressive ECB tightening before year-end.
- Tuesday will bring the latest UK labour market data as well as the ZEW investor survey for June and final German inflation figures for May.

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Daily bond market movements

Bond	Yield	Change
BKO 0.2 06/24	1.125	+0.173
OBL 0 04/27	1.477	+0.153
DBR 0 02/32	1.617	+0.105
UKT 1 04/24	2.074	+0.055
UKT 1¼ 07/27	2.192	+0.060
UKT 4¼ 06/32	2.501	+0.057

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

UK

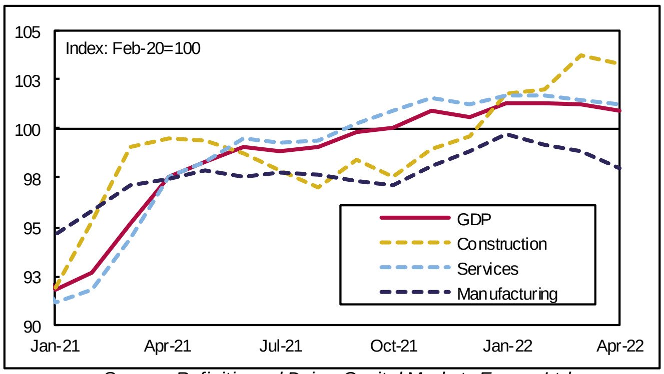
GDP falls in April as activity in all sectors contracts

Contrasting the signals from survey indicators such as the PMIs, which suggested ongoing positive growth, and also contrary to the consensus expectation, UK GDP fell for a second successive month in April. Total economic output contracted 0.3%M/M, the most in fifteen months, to be 0.4% below the Q1 average and just 0.9% above the pre-pandemic level in February 2020. Unusually, activity in all main sectors declined in April. Services output fell 0.3%M/M to be a similar amount below the Q1 average but 1.3% above the pre-pandemic level. Most notably, a sharp decline in healthcare (-7.6%M/M) due to the phasing out of pandemic-related test-and-trace activity more than fully offset the (likely temporary) boost from wholesale and retail trade (up 2.7%M/M) and growth in other consumer-facing services. Meanwhile, restrained by ongoing supply-chain challenges and despite a second consecutive month of growth in the motor vehicle sub-sector, manufacturing output dropped for a third successive month and 1.0%M/M to be 1.3% below the Q1 average and 2.0% below the pre-pandemic level. Finally, also likely restrained by shortages of materials and labour, construction fell for the first time since October, declining 0.4%M/M from March's series high, which had been boosted by repair and maintenance following inclement weather. Nevertheless, construction output in April was still 0.8% above the Q1 average and 3.3% above the pre-pandemic level.

Contraction in Q2 looks likely despite stronger signals from surveys

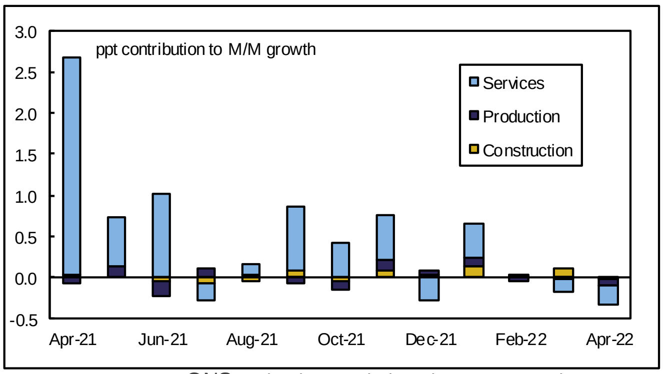
The drop in GDP in April raises significant doubts about the reliability of the current signals on the strength of output coming from surveys, perhaps because high inflation is significantly boosting the value of activity even as volumes remain subdued. Indeed, while the average composite output PMI in the first two months of Q2 was more than 2pts above the long-run average at a seemingly robust 55.6, today's figures significantly raise the likelihood of a contraction in GDP over Q2 as a whole. Data due for release on Friday are likely to confirm that retail activity was much weaker in May, perhaps down around 1.0%M/M or more as high inflation, particularly of necessities such as energy and food, encouraged consumers to cut back on spending on discretionary items. Healthcare activity, which was still 5.9% above the pre-pandemic level in April, is likely to decline further as the impact of the spring booster vaccination programme and other Covid-related spending fades. And with spending on hospitality and recreation having already risen back above the pre-pandemic level, while an extra national holiday and public transport strikes will likely have hit output in several sub-sectors in June, we have reinstated our original forecast of a drop in GDP over Q2 as a whole – perhaps by about 0.3%Q/Q – compared to the BoE's forecast of growth of 0.1%Q/Q. Of course, the government's big fiscal policy U-turn last month substantially increased support for many households to cope with the next increase in household energy bills in October and will therefore have persuaded many

UK: GDP and output by sector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Contributions to GDP growth



Source: ONS and Daiwa Capital Markets Europe Ltd.

MPC members that GDP in Q4 might not be as weak as they previously feared. However, today's data raise significant questions regarding underlying momentum in the UK economy and might therefore lead a majority of members to favour a hike in Bank Rate of 'just' 25bps on Thursday, as opposed to the 50bps hike that might otherwise have been the cases.

Exports to EU rebound in April, but trade deficit still the second-largest on record

While the April GDP data were a disappointment, the trade report for that month was at face value a little brighter. Driven by a rise of 8.1%M/M in shipments to the EU to a series high, and despite a drop in shipments to Russia to the lowest since the rouble crisis of 1998-9, the value of goods exports (excluding precious metals) rose 7.4%M/M. In contrast, goods imports were down 1.6%M/M on the same basis. So, the goods trade deficit declined about £3.0bn to a four-month low of £20.9bn. With exports and imports of services both up about ½%M/M, the overall trade deficit also narrowed by about £3.0bn to a four-month low of £8.5bn. However, the trade data are notoriously volatile. And looking through the recent volatility, the cumulative trade deficit excluding precious metals in the three months to April narrowed by just £0.8bn on the month to £24.3bn, the second highest on the series after March. Adjusting for shifts in prices, the volume of goods exports was also stronger in April, up 7.1%M/M, while imports fell 3.0%M/M. But, once again, the picture was starkly different on a three-month basis, with exports up just 0.5%3M/3M and imports up a whopping 9.3%3M/3M. So, the real-terms deficit in the three months to April was similarly the second-largest on the series. Export volumes on the national accounts basis dropped a steep 4.9%Q/Q in Q1 while imports leapt 9.3%Q/Q, and so net trade subtracted a whopping 4.1ppts from GDP growth last quarter. It was therefore no surprise that today's data suggest that there will be no repeat of that massive drag from trade on GDP in Q2. However, having missed out on last year's global post-pandemic recovery in trade volumes, there remains little to suggest a markedly improved performance in 2022.

The day ahead in the UK

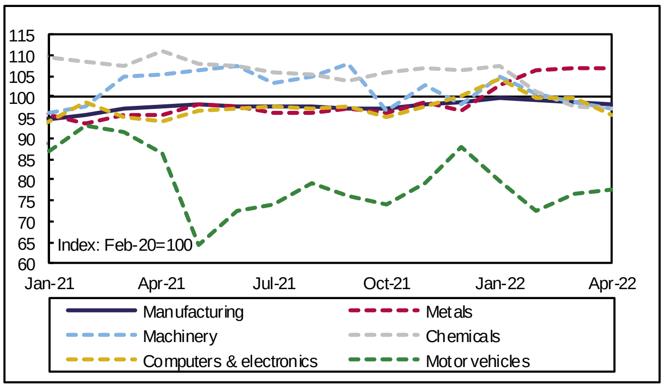
The focus in the UK tomorrow will be on the latest employment report, which will likely point to ongoing tightness in the labour market. We expect a further drop of 0.1ppt in the unemployment rate in the three months to April to 3.6%, which would be the lowest since 1974. In addition, the number of job 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.

Euro area

Disappointment for Macron as probability of hung National Assembly rises

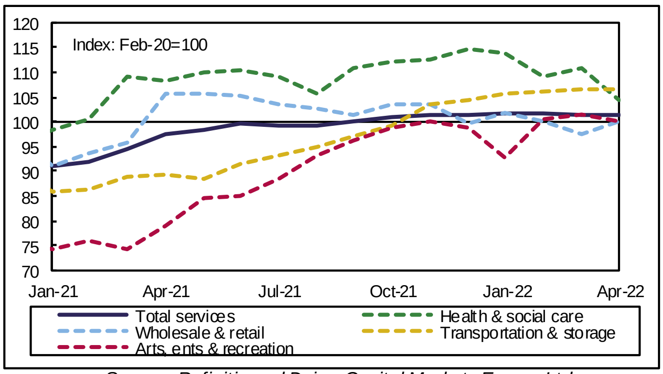
A poor showing for Emmanuel Macron's "Ensemble!" alliance in yesterday's first round of France's National Assembly election – which brought a record low turnout of just 47.5% – suggests that the President's coalition might struggle to retain its majority after the second-round in a fortnight's time. In particular, Ensemble won 25.75% of the vote, less than 0.1ppt above the share taken by the new left-wing alliance NUPES (the New Popular Ecological and Social Union) of Jean-Luc Mélenchon's France Unbowed party as well as the former establishment centre-left Socialists and the Greens. Marine Le Pen's far-right National Rally won just under 18.7%, while the former establishment centre-right Les Républicains and its allies took just over 13.6%. Based on the result, an initial projection by Elabe suggested that the President's coalition might win between 260-295 seats in the new National Assembly, down from 350 in the last Assembly, with 289 seats required for a majority. NUPES are projected to win between 160-210 seats, up from fewer than 60 for its constitutent parties in the last Assembly, which suggests significant scope to impede legislative progress on planned reforms to pensions among other things. Finally, Les Républicains are predicted to win between 50-65 seats, down from 130 in the last Assembly, with National Rally forecast to win between 19-44.

UK: Manufacturing output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services activity



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The day ahead in the euro area

Following a quiet start to the week with no top-tier euro area economic data to report today, tomorrow brings the latest German ZEW investor sentiment survey for June, which is expected to report a modest pickup in investor confidence (+9pts to -27.5), albeit with expectations still in recession territory (-7pts to -31.5). Also due to be published tomorrow are German final inflation figures for May, which are expected to confirm the preliminary release according to which the EU-harmonised HICP measure rose 0.9ppt to 8.7%Y/Y with the national CPI measure up 0.5ppt to 7.9%Y/Y, the highest since the first oil crisis in the winter of 1973. Continuing to reflect price pressures associated with the war in Ukraine, the upwards shift was due principally to higher prices of fuel and food, with energy inflation up 3ppts to 38.3%Y/Y, largely reversing April's drop.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Italy	Unemployment rate %	Q1	**8.6**	-	9.1	**9.0**
UK	GDP M/M% (3M/3M%)	Apr	**-0.3 (0.2)**	*0.3 (1.0)*	-0.1 (0.8)	-
	Industrial production M/M% (Y/Y%)	Apr	**-0.6 (0.7)**	0.3 (1.8)	-0.2 (0.7)	-
	Manufacturing production M/M% (Y/Y%)	Apr	**-1.0 (0.5)**	0.3 (1.9)	-0.2 (1.9)	-
	Index of services M/M% (3M/3M%)	Apr	**-0.3 (0.0)**	0.2 (0.1)	-0.2 (0.4)	-
	Construction output M/M% (Y/Y%)	Apr	**-0.4 (3.9)**	-0.5 (3.8)	1.7 (4.7)	-
	Goods trade balance £bn	Apr	**-20.9**	-	-23.9	-

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
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	-27.5 (-31.0)	-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	106	83
	07.00	Average earnings including (excluding) bonuses 3M/Y%	Apr	7.0 (4.0)	7.0 (4.2)

Auctions and events

Euro area	18.00	ECB's Schnabel scheduled to speak
Germany	10.30	Auction: €5.5bn of 0.2% 2024 bonds
Italy	10.00	Auction: 3Y and 7Y bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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