Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made losses as euro area industrial production returned to growth in April thanks to a rebound in Ireland.
- Gilts made gains as an increase in UK GDP in April merely left it on a broadly sideways trend.
- The main event on Thursday will be the policy announcement by the ECB, who will hike the Deposit Rate by a further 25bps to 3.50%.

Daily bond market movements

Bond	Yield	Change
BKO 2.8 06/25	2.985	+0.042
OBL 2.4 10/28	2.491	+0.032
DBR 2.3 02/33	2.445	+0.028
UKT 0⅝ 06/25	4.793	-0.079
UKT 1⅝ 10/28	4.456	-0.059
UKT 3¼ 01/33	4.384	-0.041

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

Euro area

Euro area manufacturing output growth in April driven by extreme rebound in Ireland

As expected given the data published by the large member states, euro area industrial production returned to growth at the start of Q2, with the increase of 1.0%M/M marking the third rise out of the past four months. But while the decline in March was slightly smaller than previously estimated, at -3.8%M/M, it still marked the second-steepest drop since the onset of the pandemic. So, despite the pickup in April, industrial output was still more than 1% below the Q1 average. Furthermore, the rebound was once again driven by extreme developments in Ireland (+21.5%M/M), where data are frequently distorted by the activities of multi-national corporations based there for tax purposes. Indeed, when excluding Ireland, euro area industrial production slipped back slightly in April (-0.2%M/M) following a bigger drop in March (-2.3%M/M), with France the only other member state to make a positive contribution that month.

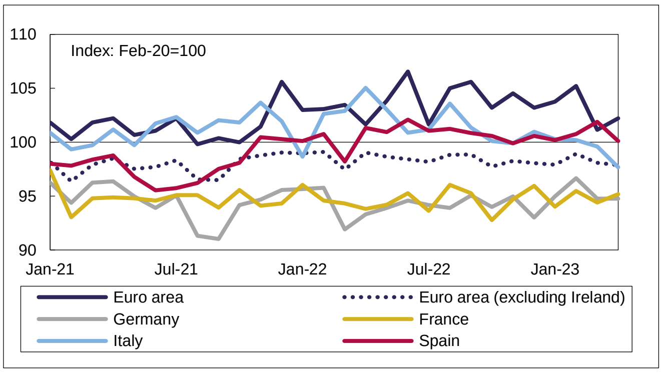
ICT output more than doubled in April while energy-intensive production continued to decline

The extraordinary Irish impact was illustrated within the sectoral detail, with growth in euro area ICT production more than doubling (107%M/M), to return back to normal following the temporary slump of more than 50%M/M in March. As a result, euro area manufacturing output rose 3.8%M/M in April following a drop of 5.8%M/M the prior month to be unchanged from the Q1 average. But, on the whole, production in most other subsectors started the second quarter on the back foot, with autos down more than 2%M/M and pharmaceuticals down more than 12%M/M. Led by Germany, the weakness in April was also due to an ongoing structural adjustment in the energy-intensive subsectors such as chemicals, metals and glassware. Indeed, output of such items in the euro area was down for the second successive month and by almost 1%M/M to its second-lowest level since the first wave of Covid-19 and more than 12% below the pre-Russian invasion peak in December 2021.

Underlying momentum in manufacturing likely to remain subdued

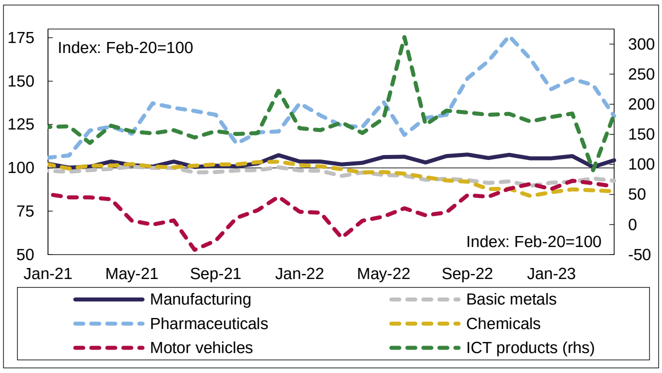
When excluding the energy-intensive sectors, euro area industrial output was up almost 2%M/M in April to be broadly flat compared with the Q1 average. But while the ongoing easing in supply constraints should provide support to some subsectors, surveys suggest that the share of manufacturers judging a lack of demand to be a constraint on production has risen in the current quarter to the highest since the start of 2021. Indeed, the latest Commission sentiment survey in May signalled that manufacturers' orders have declined sharply over the past year or so, to the lowest since late-2016 when excluding the height of the pandemic, while inventories have risen to their highest since the start of the pandemic and are now back above the historical norm. So, having been a drag on euro area GDP growth in Q1, there is a non-negligible risk

Euro area: Industrial production



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

Euro area: Manufacturing output by subsector



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

that manufacturing will provide no support to the recovery in Q2 too. Nevertheless, we continue to expect overall economic output to resume an upwards trend this quarter supported by ongoing demand for services.

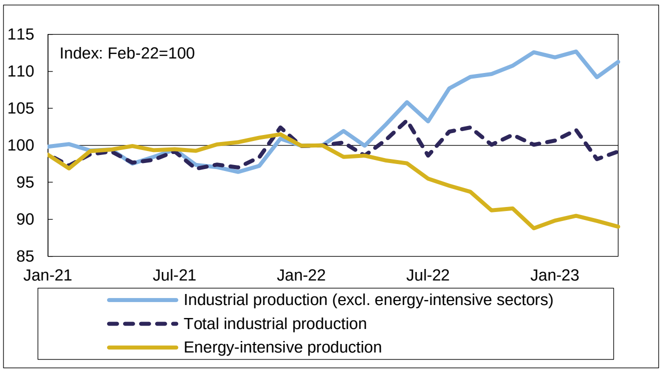
The day ahead in the euro area

The main event tomorrow will be the outcome from the ECB's Governing Council meeting. Recent public comments from President Lagarde and other key policymakers have made clear that interest rates will be hiked further. So, having slowed the pace of rate hikes to 25bps in May, another increase of that magnitude in all main interest rates – taking the deposit rate to 3.50% – seems inevitable. This will take the cumulative tightening since last July to 400bps. In terms of the ECB's balance sheet, the Governing Council will confirm that reinvestments of the proceeds of maturing APP securities will cease from the start of July, but reiterate that it will continue full reinvestments of proceeds of maturing PEPP bonds through to end-2024.

The ECB will also publish updated macroeconomic projections. Given the downward revision last week to the estimate of Q1 GDP to suggest a mild recession at the turn of the year, we expect the ECB to revise down its full-year growth forecast for 2023 (currently 1.0%), perhaps by about 0.3ppt, and its forecast for 2024 (currently 1.6%) more marginally. The downside surprise to the flash May estimate of inflation means that the ECB's forecast of 6.0%Y/Y for Q2 looks broadly on track. And given the steeper than expected drop in wholesale energy prices, signs of a softening in food inflation, stronger euro exchange rate and slightly weaker GDP outlook, the ECB's headline inflation projection of 5.1%Y/Y over 2023 as a whole could well be nudged lower. However, despite evidence of a further cooling in global goods prices, the Governing Council's hawks will remain concerned about stickiness in core prices, particularly in services where price momentum still appears strong. So, while it will continue to insist that policy will be data-dependent, the Governing Council's forward policy guidance is likely to signal that a further hike of 25bps is expected to come in July, but that the path for rates thereafter will be guided by the following set of macroeconomic projections due in September.

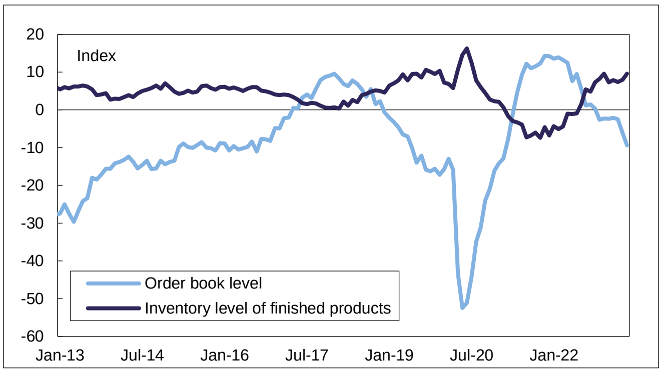
Data-wise, tomorrow will bring euro area goods trade report for April, which is expected to reveal a slight widening in the surplus on the back of firmer export and weaker import values. Thursday will also bring the latest euro area job vacancy data for Q1. Final French inflation figures for May are also due.

Euro area: Energy-intensive production



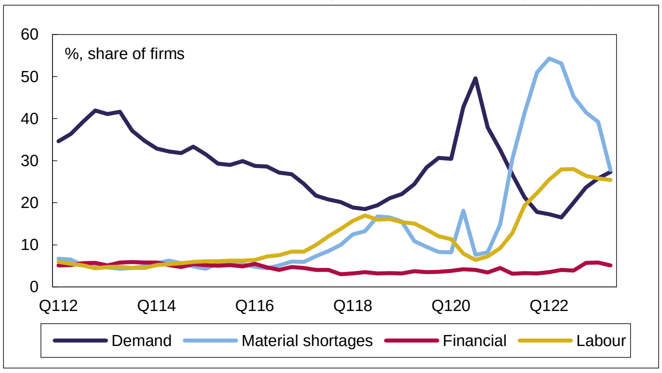
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Order books & inventories



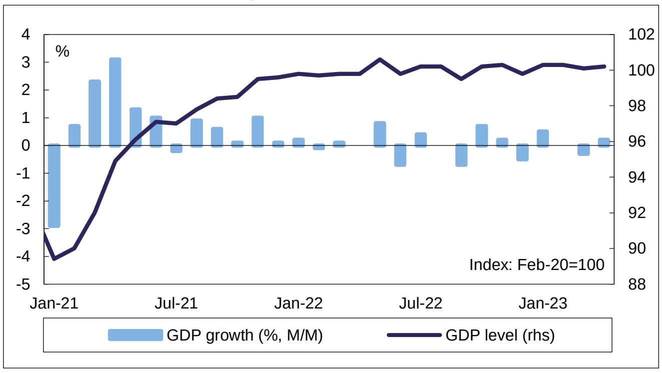
Source: EC, Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Factors limiting manufacturing output



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

UK: GDP level and growth



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK

Services rebound supports modest GDP growth in April, but trend remains little better than flat

While yesterday's data strongly suggested that the UK labour market remains very tight, today's figures provided a reminder that UK economic activity continues to do little better than flat-line. As expected, following the drop of 0.3%M/M in March, GDP rose just 0.2%M/M in April to be effectively unchanged from the average level in Q1 and up 0.1%3M/3M. It was also just 0.3% above the pre-pandemic level in February 2020, and below peaks that occurred both before and after the pandemic. Sectors that grew in March largely fell back in April, and vice versa, leaving the overall impression that momentum remains weak across the economy. For example, while services sector activity grew 0.3%M/M in April, that followed a drop of 0.5%M/M the prior month to leave it slightly below the Q1 average. Thanks to a rebound in eating out and auto sales, consumer-facing services rose a seemingly firm 1.0%M/M in April. But that followed a drop of 0.8%M/M in March and so they were still up just 0.1%3M/3M and a hefty 8.7% below the pre-pandemic level. And industrial action in the public sector again took its toll in April, as healthcare services subtracted from growth due to strikes by junior doctors.

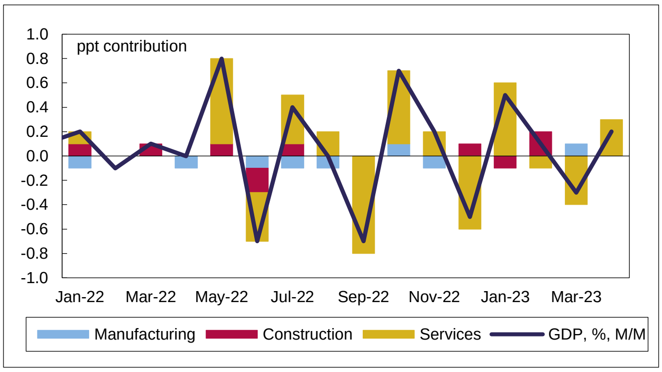
Manufacturing, mining and construction all down at start of Q2

In terms of the other major sectors, despite a pickup in car production, weakness in other manufacturing subsectors (not least pharmaceuticals and IT goods) meant that factory output fell 0.3%M/M in April to be just 0.2% above the Q1 average. With North Sea oil and gas extraction down 1.8%M/M to a 22-month 21.5% below the pre-pandemic level, overall industrial production similarly fell 0.3%M/M in April. But that followed growth of 0.7%M/M the prior month and also left production still 0.2% above the Q1 average and a whisker above the pre-pandemic level. Meanwhile, a renewed drop in new building work, which has remained subdued this year, more than offset a pickup in repair and maintenance, which has been extremely strong. So, construction output fell 0.6%M/M following growth of 0.2%M/M in March. But that left it 0.4% above the Q1 average and more than 7% above the pre-pandemic level.

Near-term growth outlook weakens as Bank Rate expectations continue to rise

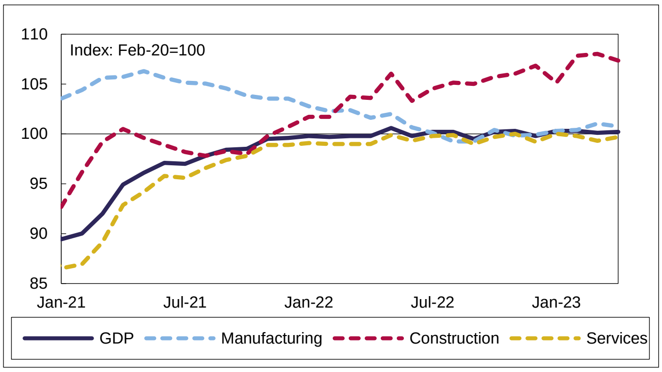
Given the extra bank holiday for the King's coronation, we think that GDP contracted (albeit very modestly) last month, just as it fell in September due in part to the Queen's funeral. And while much-improved weather will support a rebound in the current month, we maintain our forecast that GDP will fail to grow at all in Q2. But notwithstanding volatility caused by industrial action and other temporary factors, the underlying trend in UK services looks now to be positive, albeit still relatively underwhelming given the likelihood that consumer spending will remain subdued. In contrast, given falling new

UK: Contributions to GDP growth



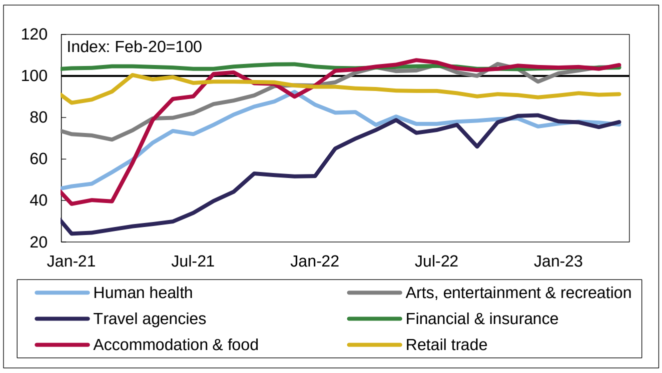
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP & sector output levels



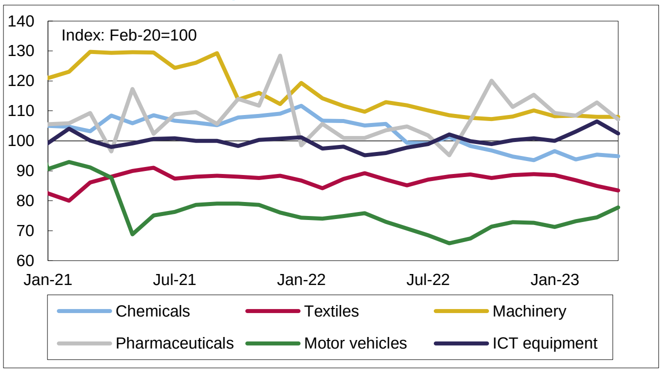
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Services output – selected subsectors



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output – selected subsectors



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

orders from at home and abroad and ample inventories, manufacturing output is likely to trend lower over the near term. And inertia in new building work seems likely to take a bigger toll on construction activity, particularly as mortgage rates remain under upwards pressure as market-implied expectations for the BoE's terminal rate are revised up. So, any pickup in GDP growth in the second half of the year is likely to be relatively modest. Despite yesterday's strong pay data, we do not think the BoE would dare to raise Bank Rate by year-end by the further 125bps or so currently priced by the swaps market. Indeed, that would be highly likely to induce recession next year. But a scenario of three further hikes of 25bps apiece over coming meetings does not seem unreasonable to us. And that would weigh heavily on both consumption and investment in 2024. So, unless inflation and pay growth suddenly cools more quickly than we or the markets expect, GDP growth next year will remain extremely subdued and – deliberately as far as the BoE is concerned – firmly sub-potential. We still expect GDP to rise just 0.3%Y/Y in 2023 but have nudged down our forecast for 2024 to 0.5%Y/Y.

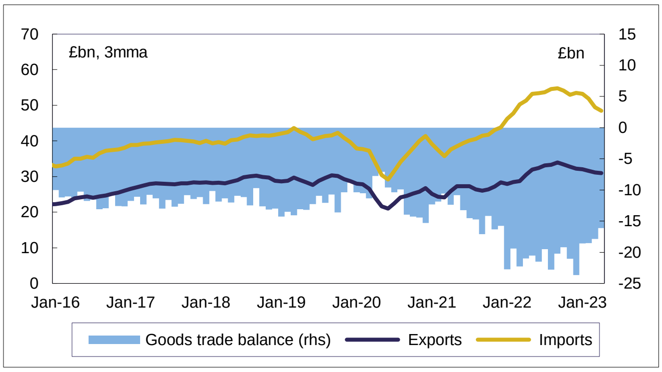
Trade deficit halves in three months as imports fall faster than exports.

Despite the weakness of external demand, however, net trade appears to have provided support to GDP growth at the start of Q2. Reflecting subdued domestic demand, goods imports dropped 1.4%M/M in April in value terms, and 0.4%M/M in volume terms (i.e. after stripping out the effect of inflation). So, in the three months to April compared with the previous three-month period, goods and services imports dropped a little more than 7%3M/3M in both value and volume terms. With export volumes and values down less than 2%3M/3M, the underlying deficit in goods and services trade (i.e. excluding non-monetary gold, which distorts the picture) more than halved over the same period, narrowing by £12.6bn to £12.3bn.

The day ahead in the UK

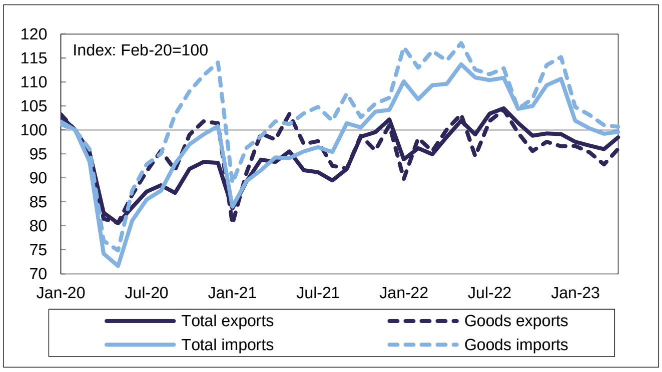
It should be a quiet day ahead, with no top-tier UK data due for release tomorrow.

UK: Trade balance, export & import values*



*Excludes precious metals. Source: Refinitiv, Eurostat and Daiwa Capital Markets Europe Ltd.

UK: Export & import volumes*



*Excludes precious metals. Source: ONS and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ _Daiwa forecast_	Previous	Revised
Euro area		Industrial production M/M% (Y/Y%)	Apr	**1.0 (0.2)**	_1.0 (0.8)_	-4.1 (-1.4)	-3.8 (-1.4)
UK		GDP M/M% (3M/3M%)	Apr	**0.2 (0.1)**	0.2 (0.1)	-0.3 (0.1)	-
		Industrial production M/M% (Y/Y%)	Apr	**-0.3 (-1.9)**	0.0 (-1.7)	0.7 (-2.0)	-
		Manufacturing production M/M% (Y/Y%)	Apr	**-0.3 (-0.9)**	-0.2 (-0.9)	0.7 (-1.3)	-
		Index of services M/M% (3M/3M%)	Apr	**0.3 (-0.1)**	0.3 (-0.1)	-0.5 (0.1)	-
		Construction output M/M% (Y/Y%)	Apr	**-0.6 (3.6)**	0.0 (4.3)	0.2 (4.1)	-
		Total trade balance (goods trade balance) £bn	Apr	**-1.5 (-16.2)**	-3.7 (-16.5)	-2.9 (-16.4)	-

Auctions

Country		Auction
Germany		sold €3.34bn of 2.3% 2033 bonds at an average yield of 2.43%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ _Daiwa forecast_	Previous
Euro area		10.00	Trade balance €bn	Apr	17.5	17.0
		13.15	ECB Deposit (Refi) Rate %	Jun	_3.50 (4.00)_	3.25 (3.75)
France		07.45	Final HICP (CPI) Y/Y%	May	_6.0 (5.1)_	6.9 (5.9)
Spain		09.00	Trade balance €bn	Apr	-	-0.2

Auctions and events

Country		BST	Event
Euro area		13:15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds press conference following the Governing Council meeting
France		09.50	Auction: 2.50% 2026 bonds
		09.50	Auction: 0.75% 2028 bonds
		09.50	Auction: 2.75% 2029 bonds
Spain		09.30	Auction: 2.80% 2026 bonds
		09.30	Auction: 5.15% 2028 bonds
		09.30	Auction: 3.90% 2039 bonds
UK		16.35	BoE Deputy Governor Cunliffe scheduled to speak

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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