Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made significant losses as the ECB raised rates by 25bps, signalled the likelihood of further tightening to come, and revised up its forecast for core inflation.
- Shorter-dated Gilts followed Bunds lower on a quiet day for UK economic data.
- Friday will bring euro area inflation and labour cost figures, along with a UK household inflation attitudes survey.

Daily bond market movements

Bond	Yield	Change
BKO 2.8 06/25	3.096	+0.111
OBL 2.4 10/28	2.585	+0.094
DBR 2.3 02/33	2.495	+0.049
UKT 0⅝ 06/25	4.885	+0.092
UKT 1⅝ 10/28	4.528	+0.072
UKT 3¼ 01/33	4.384	0.000

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

Euro area

ECB hikes by 25bps and signals more tightening to come

As expected, the ECB today hiked all of its policy interest rates by 25bps. That took the deposit rate to 3.50% and the cumulative tightening since last July to 400bps. As additionally anticipated, the Governing Council's policy statement signalled the likelihood of more tightening to come, repeating that future decisions will ensure that rates "will be brought" to "sufficiently restrictive" levels. And in her press conference, President Lagarde was unambiguous, stating that the Governing Council still had "further ground to cover" and that a "material change" to the ECB's baseline outlook would be required to prevent it hiking again in July. There were also no surprises with respect to policy decisions related to the ECB's balance sheet. The Governing Council confirmed the end to reinvestments of maturing proceeds of APP bond-holdings from the start of July, which will reduce the balance sheet by almost €240bn over the coming nine months. And while banks will repay a whopping €477bn of TLTRO-iii loans later this month, the Governing Council made clear that it would merely monitor the impact and would not take any new policy action to mitigate the impact on liquidity.

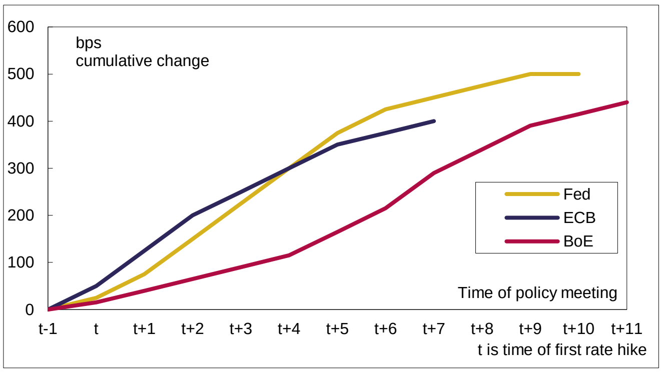
GDP forecast revised down, but core inflation projection revised significantly higher

The ECB's updated economic projections provided the justification for the ECB's desire to signal further hikes to come. Admittedly, with a strong near-term outlook for services tempered by recognition of weakness in manufacturing and construction, the forecasts for GDP growth in 2023 and 2024 were nudged down slightly from the previous set, by 0.1ppt in each year to 0.9%Y/Y and 1.5%Y/Y. And we note that this projection failed to take account of the 0.2ppt downwards revision to the estimate of growth in Q1, to -0.1%Q/Q, announced last week, and so overstates expected growth this year. But while it is expected to decline steadily from now on to below 5.0%Y/Y in Q3 and below 3.0%Y/Y from Q4 on, the outlook for headline consumer price inflation was revised up by 0.1ppt in each year through to 2025. Indeed, headline inflation is now expected to remain above the 2.0% target throughout 2025. And as pressures from energy and food are now expected to ease more rapidly, the ECB revised up significantly its forecast for core inflation, by 0.5ppt in 2023 and 2024 (to 5.1%Y/Y and 3.0%Y/Y respectively). And while the core inflation projection for 2025 was revised up a much smaller 0.1ppt, at 2.3%Y/Y it was judged too high. Indeed, the ECB also now expects core inflation to remain above the 2.0% target into 2026.

Lagarde wary of labour market developments but sees no second-round effects so far

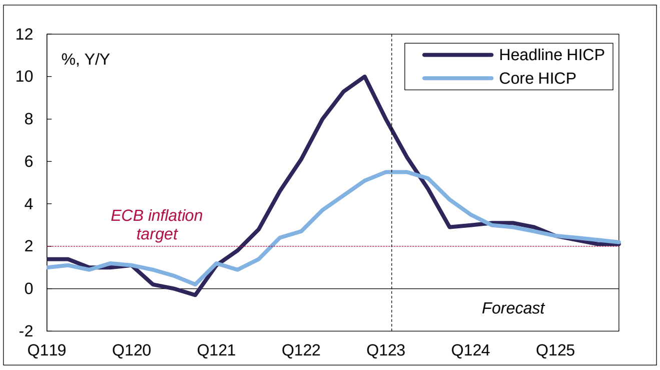
In part, the ECB's upwards revision to its forecast for core inflation reflected recent upside surprises in the price data, particularly in April. But it also reflected a revised judgement with respect to the labour market. Encouraged by job gains in Q1 and evidence of still-firm labour demand despite subdued economic activity, the ECB revised its forecast for the

ECB, BoE, Fed: Cumulative policy tightening



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: ECB baseline inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

unemployment rate, which is now expected to edge down over the horizon to a new historical low of 6.3% in 2025. As a result, and also reflecting recent strength in negotiated wages, the ECB also revised up its forecast for unit labour cost growth across the horizon, to suggest greater risks of inflation persistence, particularly in services. At the same time, however, Lagarde insisted that so far there are no significant second-round inflation effects from the labour market, let alone a wage-price spiral. And hinting that its concerns might be overdone, we note that the skew to the ECB's inflation forecast is very slightly to the downside.

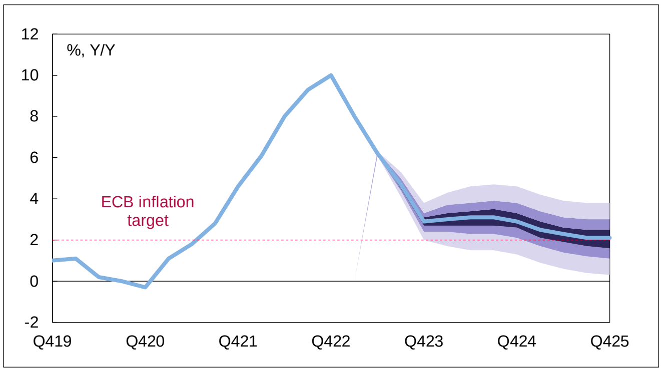
September rate decision to depend on inflation over the whole of the summer

Given the ECB's updated projections and guidance, another rate hike next month is clearly now as good as a done deal. But the path of policy from September onwards is still data-dependent and things could go either way. Indeed, in the absence of an upwards surprise in the June inflation figures, the Governing Council is unlikely next month to have sufficient new information on which to give a clear steer with respect to the likely policy decision in September. That decision will hinge on the ECB's next set of projections, which themselves will depend on the economic data between now and the end of the summer, including inflation figures for July and August. If, as we suspect, those data come in weaker than the ECB expects, while other information including surveys point to a further tightening of financial conditions, the Governing Council would have good reason to pause the tightening cycle in September. If, on the other, the ECB feels that information between now and then validates its current projections, another hike in September and possibly beyond would seem likely.

Euro area trade balance surprisingly shifts into deficit at the start of Q2

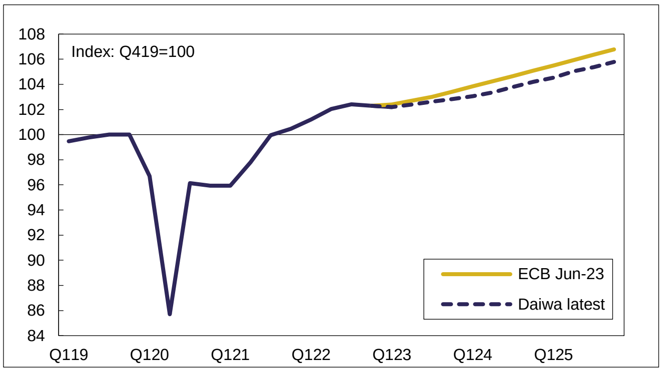
In her press conference, President Lagarde acknowledged the worsening outlook in the manufacturing sector. In part, that reflects the impact of the tightening of financial conditions on demand for business fixed investment, durable goods and construction. And it also reflects softer external demand, with the ECB revising down its outlook for export growth across the horizon. Indeed, today's euro area goods trade report for the start of Q2 fell well short of expectations, with the trade balance narrowing a substantial €21.1bn in April to report a surprise deficit of €7.1bn. Admittedly, this likely reflected payback for temporary shifts in March, which brought about the largest surplus in two years. Indeed, when smoothing recent monthly volatility, the trade balance on a three-month basis still recorded a modest goods trade surplus (€1.7bn), some €43bn above the trough in September and the largest for eighteen months.

Euro area: Euro area headline inflation forecast*



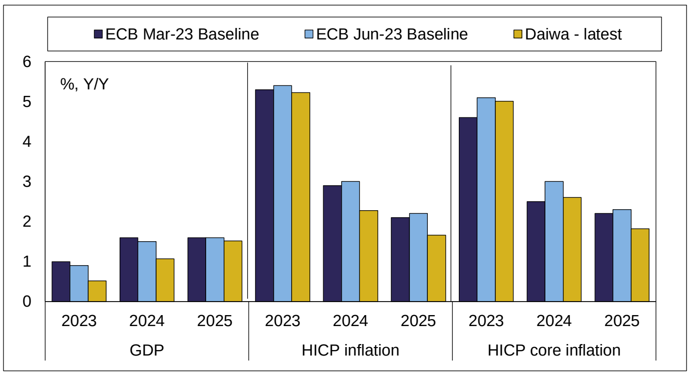
Bands from darkest to lightest depict 30%, 60% and 90% probabilities that inflation will fall within the respective intervals. Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ECB GDP forecast



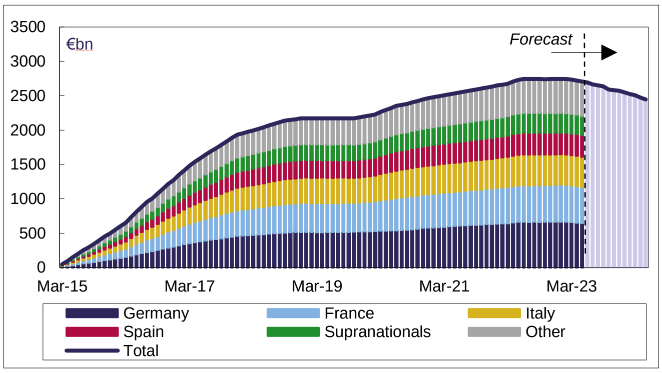
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ECB full-year GDP & inflation forecasts



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ECB PSPP bond holdings



Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area exports fall sharply flagging deterioration in external demand

The deterioration in the euro area's trade balance in April partly reflected a second-successive decline in the value of exports (-3.2%M/M), with shipments down to the US, UK and Japan but some stabilisation in shipments to China. This left them down more than 3½%Y/Y and some 3% below the Q1 average. At the same time, the value of imports rose for the first month in eight, by 5.9%M/M, to leave the level broadly unchanged from the Q1 average. With import prices having declined further in April (-1.5%M/M), the increase in euro area import volumes at least hinted at firmer domestic demand. But, having fallen to an eight-month low in March in line with the steady softening in global demand, euro area export volumes seem unlikely to have provided much (if any) support to GDP growth at the start of Q2, a trend that might well continue if and when the US economy weakens more significantly. Admittedly, the latest German trade data suggested that export volumes (1.8%M/M) outpaced imports (1.3%M/M) in April. But this appears to have reflected stronger demand from elsewhere in the euro area. And it followed a marked decline in March to leave export volumes some 0.7% below the Q1 average and import volumes some ½% higher.

The day ahead in the euro area

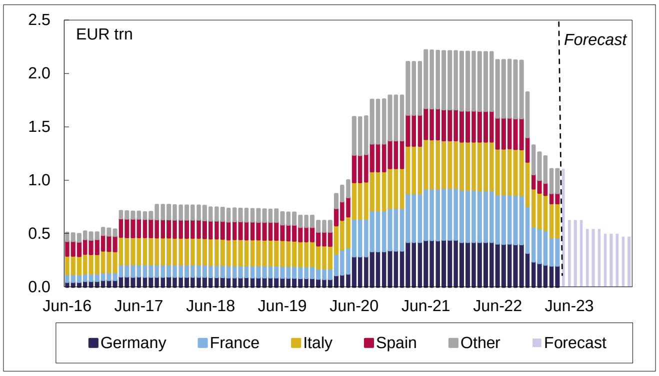
Tomorrow's euro area economic data include the final inflation estimates for May. With final readings from the larger member states having aligned with their respective preliminary releases, the headline euro area HICP rate is expected to confirm the 0.9ppt drop to a fifteen-month low of 6.1%Y/Y, in part reflecting the steepest fall in energy inflation since the start of 2021 as well as a moderation in food inflation to an eight-month low. The flash estimate of core inflation also surprised on the downside, falling 0.3ppt to a four-month low of 5.3%Y/Y. Tomorrow's numbers will provide a more granular breakdown, along with various measures of underlying price pressures watched by the ECB. Meanwhile, Friday's labour survey is likely to report that slack in the euro area remained close to a record low in the first quarter of the year. Meanwhile, having reached a record high at the end of 2022 (5.7%Y/Y), labour cost growth might well have moderated slightly in Q1, despite a pickup in negotiated wage growth.

UK

The day ahead in the UK

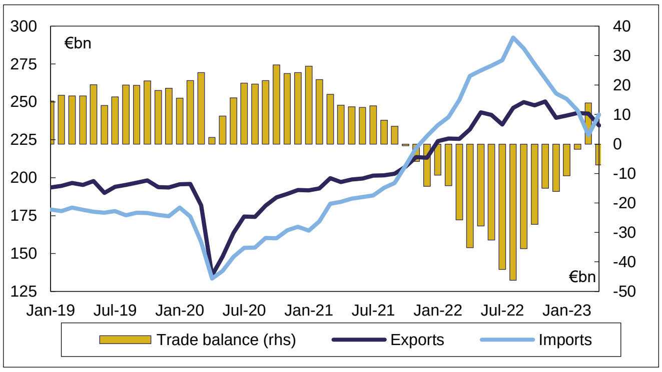
Ahead of the coming week's BoE policy decision, tomorrow's publication of the BoE's household inflation attitudes survey for the three months to May will be watched for developments in medium-term expectations, which in the three months to February eased to 3.0%Y/Y, the lowest for six quarters.

Euro area: ECB TLTRO loans outstanding



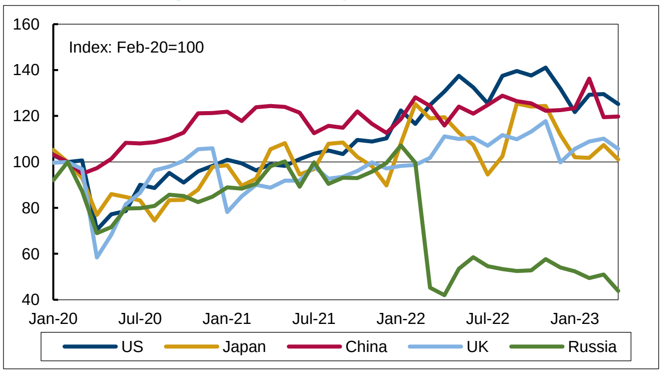
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Trade balance, export & import values



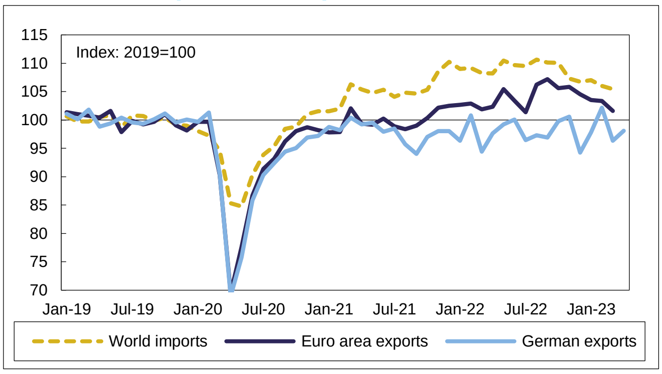
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Export values by destination



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Export and import volumes



Source: CPB, Refinitiv 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		Trade balance €bn	Apr	**-7.1**	17.5	17.0	14.0
		ECB Deposit (Refi) Rate %	Jun	**3.50 (4.00)**	*3.50 (4.00)*	3.25 (3.75)	-
France		Final HICP (CPI) Y/Y%	May	**6.0 (5.1)**	*6.0 (5.1)*	6.9 (5.9)	-
Spain		Trade balance €bn	Apr	**-4.4**	-	-0.2	-

Auctions

Country		Auction
France		sold €4.12bn of 2.50% 2026 bonds at an average yield of 3.03%
		sold €2.20bn of 0.75% 2028 bonds at an average yield of 2.85%
		sold €5.70bn of 2.75% 2029 bonds at an average yield of 2.89%
		sold €669mn of 0.1% 2029 index-linked bonds at an average yield of 0.52%
		sold €600mn of 0.1% 2031 index-linked bonds at an average yield of 0.46%
		sold €230mn of 0.1% 2053 index-linked bonds at an average yield of 0.62%
Spain		sold €2.03bn of 2.80% 2026 bonds at an average yield of 3.246%
		sold €1.34bn of 5.15% 2028 bonds at an average yield of 3.184%
		sold €1.58bn of 3.90% 2039 bonds at an average yield of 3.842%

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	Final (core) HICP Y/Y%	May	*6.1 (5.3)*	7.0 (5.6)
		10.00	Labour costs Y/Y%	Q1	-	5.7
Italy		09.00	Final HICP (CPI) Y/Y%	May	*8.1 (7.6)*	8.7 (8.2)

Auctions and events

UK		09.30	BoE publishes quarterly 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