

Euro wrap-up

Overview

- Despite further evidence of softening activity and price pressures in manufacturing, Bunds were little changed as the flash euro area PMIs suggested firm growth in services and persistent inflation in that sector.
- As BoE Governor Bailey admitted mistakes in forecasting the extent and persistence of the rebound in price pressures, Gilts sold off as the flash UK PMIs also signalled solid growth and sticky inflation in services.
- Wednesday will bring UK inflation data for April and the German ifo business survey for May.

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Daily bond market movements

Bond	Yield	Change
BKO 2.8 12/25	2.798	+0.006
OBL 2.2 04/28	2.449	+0.007
DBR 2.3 02/33	2.468	+0.013
UKT 0 $\frac{1}{2}$ % 06/25	4.114	+0.091
UKT 1 $\frac{1}{2}$ % 10/28	3.987	+0.096
UKT 3 $\frac{1}{4}$ % 01/33	4.160	+0.103

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

Source: Bloomberg

Euro area

Flash PMIs signal firm GDP growth in Q2 despite further weakening in manufacturing

Given the remarkable strength of the April survey, it was not surprising that the flash euro area PMIs for May were somewhat softer. Nevertheless, the drop in the euro area composite output PMI was relatively modest at just 0.8pt and left it at a respectable 53.3, still the third-highest level in twelve months. As a result, the average for the first two months of Q2 stood at 53.7, 1.7pts above the Q1 average and a level that, before the pandemic, would have been consistent with relatively firm GDP growth of roughly 0.4%Q/Q this quarter. As in recent months, however, the flash PMIs also flagged the uneven nature of the current recovery phase. While the further release of pent-up pandemic demand appeared to extend the expansion in services, the continued fading of both domestic and global demand for goods meant that manufacturers continue to retrench. In particular, the euro area services activity PMI edged down just 0.3pt from April's twelve-month high to a still-elevated 55.9, leaving the average level for Q2 so far more than 3pts above the Q1 average. While somewhat less vigorous than in April, new business in services also seemingly continues to grow at a pace above the long-run average. In marked contrast, the manufacturing output PMI fell more than 2pts to a six-month low of 46.3, a level undoubtedly consistent with contraction. And falling new orders and diminishing work backlogs raise further concerns about the outlook for the sector.

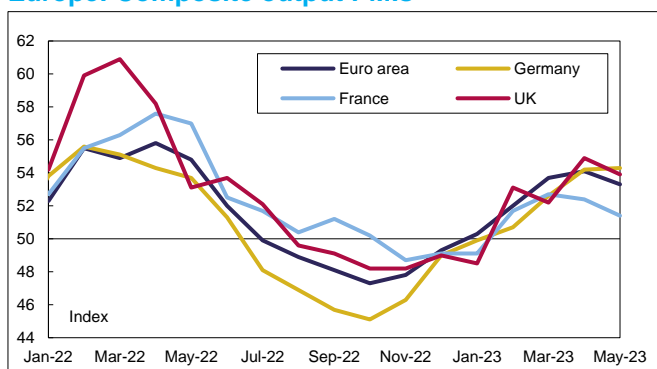
Germany's services sector (surprisingly) picks up the baton of growth

At the country level, perhaps surprisingly given the notable weakness of its economy in Q4 and Q1, Germany's flash PMIs suggested the firmest economic growth in May, with its composite activity index up 0.1pt to a thirteen-month high of 54.3, firmly above the long-run average. As for the euro area as a whole, however, the expansion in Germany was limited to services, where growth was reportedly the strongest since August 2021. In contrast, the survey suggested that German factory output contracted at the sharpest pace in six months as new goods orders fell at the sharpest pace since the first wave of Covid-19. Meanwhile, consistent with recent weakness flagged in the Commission survey, the flash PMIs suggested the softest pace of expansion in France in four months, with services growth the least vigorous since January and manufacturing continuing to contract. S&P Global also reported that activity in the rest of the euro area – which has recently led growth in the region thanks not least to the rebound in Southern Europe – expanded at the softest pace since February.

Rise in services output price PMI likely to reinforce concerns among ECB hawks

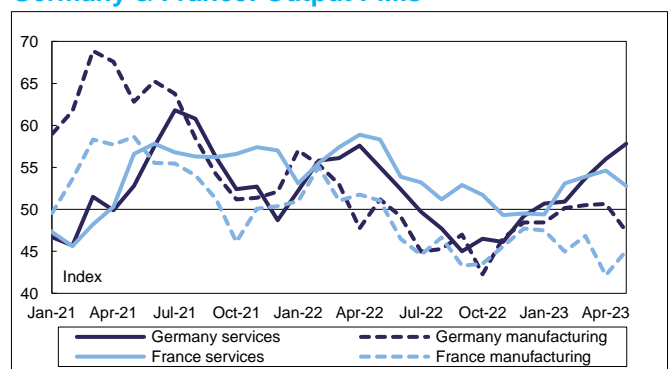
From the perspective of the ECB, what probably mattered most in the flash PMIs were the cost and pricing indices. At face value, with the composite input cost index down almost 3pts (58.0) and output price index down slightly too (56.5), these

Europe: Composite output PMIs



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

Germany & France: Output PMIs



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

might have offered some comfort that the trend is in the right direction. But they remain well above their long-run averages. And, as for the activity indices, there was a marked contrast in pricing conditions between the two main sectors. With other survey detail suggesting a further easing of supply-chain strains, and consistent with recent declines in wholesale energy and commodity markets and global freight costs, as well as a notable weakening in industrial producer price inflation, the PMIs flagged the steepest decline in manufacturing input prices in the euro area for more than seven years. And, with goods demand weak, the factory output price PMI also fell below 50 for the first time since September 2020. Meanwhile, inflation of input costs in services was reportedly the least vigorous since August 2021. However, the rate of increase in prices charged in the sector accelerated for the first time since January, suggesting that solid demand continues to enable services to pass on costs to consumers and, indeed, perhaps boost margins too. With persistence in services inflation having for a while been identified as key to the ECB rates outlook, the May flash PMIs will have underscored the likelihood of hikes at each of the next two monetary policy meetings.

The day ahead in the euro area

The focus tomorrow remains on economic sentiment surveys with the publication of Germany's ifo survey for May. While the Bloomberg survey suggests that the indices for current conditions and expectations are both expected to edge lower, today's flash PMIs suggest otherwise. Certainly, we expect the sectoral data to point to stronger sentiment in services, even if the manufacturing indices point to stagnation or worse.

UK

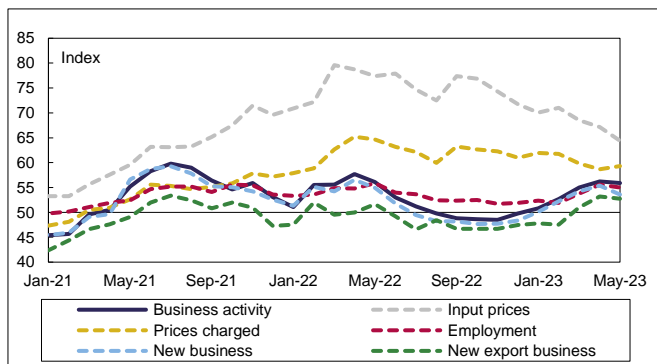
Flash PMIs still consistent with moderate expansion centred on services

Like the euro area survey results, the UK's flash PMIs for May were consistent with a respectable pace of economic expansion, albeit slightly softer than at the start of the quarter. Also, like the euro area, the flash PMIs suggest that growth in the UK is increasingly reliant on services, with manufacturing output seemingly in significant retreat. In particular, the composite output PMI fell 1.0pt to 53.9, the second-highest level in thirteen months. As a result, the average for the first two months of Q2 stood at 54.4, 3.1pts above the Q1 average and a level that, before the pandemic, would have been consistent with GDP growth of 0.3%Q/Q or more this quarter. While consumer-facing services such as travel, leisure and hospitality reported strong growth, a softening in demand for business-related services meant that overall the services activity PMI fell 0.8pt to 55.1. That, nevertheless, was still above the long-run average and the second-highest since April 2022, with an above-average index for new orders pointing to ongoing growth in the sector over the near term at least. In contrast, the manufacturing output PMI fell 0.9pt to 47.4 to be consistent with contraction for a third successive month. According to CIPS and S&P Global, firms in the factory sector blamed the drop in production on declining new orders not least from abroad, destocking and, in some cases, the extra bank holiday this month for the King's Coronation.

Jobs, costs and price PMIs are unlikely to deter the BoE from hiking again

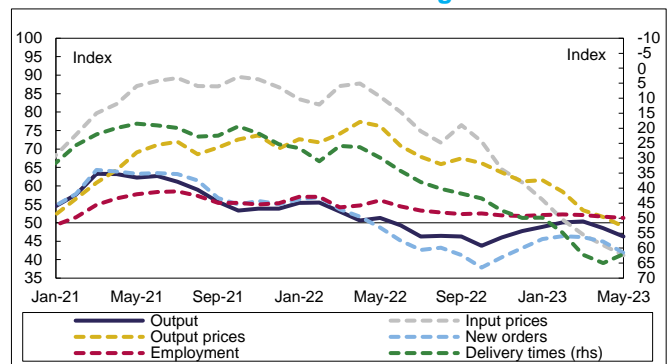
In terms of those indicators of greatest relevance to near-term BoE decision-making, the flash UK PMIs reported a minimal increase in private sector employment in May, close to the average pace in the first four months of the year. That was well down on the pace implied by the employment PMIs throughout last year, suggesting that labour market momentum remains cooler despite the firm growth in services. Moreover, with supply-chain strains continuing to ease, and so supplier delivery times and work backlogs falling significantly, manufacturing input costs reportedly fell the most in more than seven years. But services firms bemoaned a strong rise in wage pressures which meant that their input costs rose the most in three months. While the rise in manufacturing output prices was the softest since late 2020 so that the composite output price PMI fell to 60.7, the lowest since August 2021, that remained very high by historical standards. And importantly, the pace of increase in selling prices in services was effectively unchanged from April and a touch above the Q1 average suggesting no let-up in inflation persistence in the sector. Overall, therefore, with Governor Bailey again today publicly mindful of the risks of inflation

Euro area: Selected services PMIs



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

Euro area: Selected manufacturing PMIs



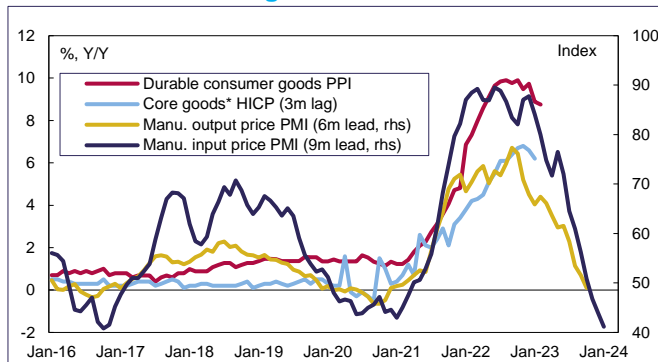
Source: S&P Global, Refinitiv and Daiwa Capital Markets Europe Ltd.

remaining high for longer still, the May PMIs – which will be the last set to be released before the next MPC meeting – are unlikely to deter the BoE from raising Bank Rate again next month.

The day ahead in the UK

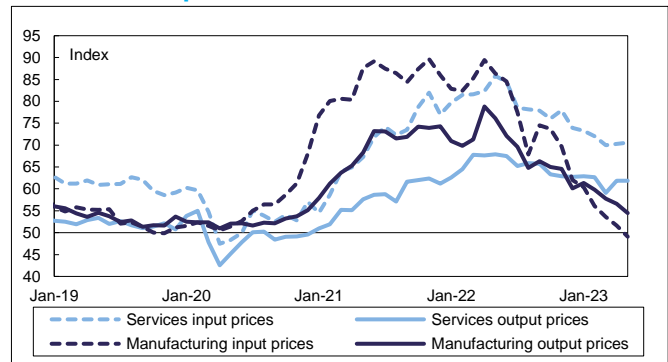
Tomorrow brings this week’s key UK data release, the April consumer price inflation report. A significant decline in the headline CPI rate, by around 2ppts, seems highly likely. But that will be due to base effects associated with the spike in wholesale energy prices after the Russian invasion of Ukraine and the associated jump in Ofgem’s household energy price cap in April 2022. Indeed, we expect energy inflation to fall almost 30ppts from 40.5%Y/Y in March. However, like in the euro area, food price inflation should also pass its peak, reflecting the recent downtrend in wholesale and producer price data for the sector. But core inflation is likely to have remained stickier, with the risks to our forecast for a slight moderation – down 0.1ppt to 6.1%Y/Y – skewed to the upside due to persistence in services, which will likely remain the main focus of the BoE. Overall, however, we expect headline CPI inflation to drop 2.1ppts to 8.0%Y/Y. Meanwhile, the producer price data are expected to flag the easing in pipeline inflationary pressures in the industrial sector, with input price inflation forecast to slow 2.8ppts in April to 4.8%Y/Y, which would be the lowest in more than two years. Factory output price inflation is also expected to slow by about 3ppts to the lowest since August 2021. Finally, the CBI’s industrial trends survey for May will provide additional insight into firms’ price expectations.

Euro area: Selected goods inflation indices



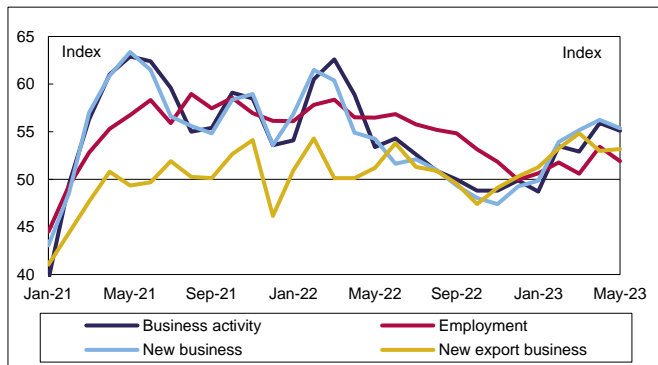
*Non-energy industrial goods. Source: S&P Global, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected price PMIs



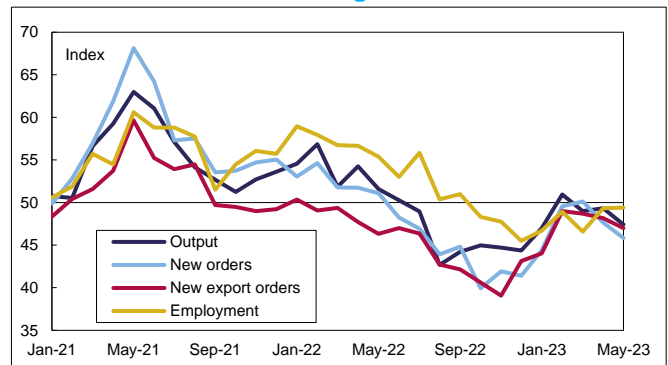
Source: S&P Global, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Selected services PMIs



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

UK: Selected manufacturing PMIs







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



European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area 	Preliminary manufacturing (services) PMI	May	44.6 (55.9)	46.0 (53.5)	45.8 (56.2)	-
	Preliminary composite PMI	May	53.3	53.5	54.1	-
Germany 	Preliminary manufacturing (services) PMI	May	42.9 (57.8)	45.0 (55.0)	44.5 (56.0)	-
	Preliminary composite PMI	May	54.3	53.4	54.2	-
France 	Preliminary manufacturing (services) PMI	May	46.1 (52.8)	46.0 (54.0)	45.6 (54.6)	-
	Preliminary composite PMI	May	51.4	52.0	52.4	-
UK 	Public sector net borrowing (ex banks) £bn	Apr	24.7 (25.6)	15.6 (19.1)	20.7 (21.5)	20.0 (20.8)
	Preliminary manufacturing (services) PMI	May	46.9 (55.1)	48.0 (55.3)	47.8 (55.9)	-
	Preliminary composite PMI	May	53.9	54.6	54.9	-



Auctions

Country	Auction
Germany 	sold €4.89bn of 2.800% 2025 bonds at an average yield of 2.82%
UK 	sold £750mn of 0.125% 2051 index-linked bonds at an average yield of 1.105%


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Germany 	09.00	ifo business climate index	May	93.0	93.6
	09.00	ifo current assessment (expectations) balance	May	94.5 (91.7)	95.0 (92.2)
UK 	07.00	CPI (core CPI) Y/Y%	Apr	8.0 (6.1)	10.1 (6.2)
	07.00	PPI output (input) prices Y/Y%	Apr	5.8 (4.8)	8.7 (7.6)
	09.30	House price index Y/Y%	Mar	4.5	5.5
	11.00	CBI industrial trends survey, total orders (selling prices)	May	-19 (21)	-20 (23)

Auctions and events

Germany 	10.30	Auction: €1.50bn of 1.000% 2038 bonds
	10.30	Auction: €1.00bn of 4.750% 2040 bonds
UK 	11.30	Auction: £3.00bn of 0.875% 2033 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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