Euro wrap-up

Overview

- Bunds followed USTs higher, even as the ECB's account suggested that some Governing Council members had initially preferred a 50bps hike at June's meeting.
- Gilts also made gains even as UK GDP contracted in May and a housing market survey signalled a marked deterioration in market conditions June.
- Friday will bring euro area goods trade data for May.

Emily Nicol
+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 2.8 06/25	3.131	-0.067
OBL 2.4 10/28	2.555	-0.086
DBR 2.6 08/33	2.469	-0.085
UKT 0⅝ 06/25	5.101	-0.097
UKT 1⅝ 10/28	4.548	-0.131
UKT 3¼ 01/33	4.413	-0.093

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

Euro area

Euro area manufacturing output trending well below Q1 average despite boost from autos

Today's euro area industrial production data broadly aligned with expectations in May, with output up for a second-successive month, albeit by a more modest 0.2%M/M. While this left production up around 2% compared with the pre-pandemic level in February 2020, it was still down more than 2%Y/Y and almost 1½% below the Q1 average in the first two months of Q2. The weakness in May largely reflected a third consecutive monthly decline in energy output (-1.3%M/M). In contrast, manufacturing output rose a stronger 1.2%M/M, with autos, food, general machinery and fabricated metal products contributing positively. But, led by Germany, the manufacturing recovery continues to be restrained by an ongoing structural adjustment in the energy-intensive subsectors such as coke and refined petroleum, glassware, paper and chemicals. Indeed, output of such items in the euro area was down for the third consecutive month (-0.6%M/M), taking it to its lowest level since the first wave of Covid-19 and almost 13% below the pre-Russian invasion peak in December 2021. Given also the negative carry over from a slump in March, total manufacturing output was trending more than 2% below the Q1 average, strongly suggesting that the sector will provide a drag on GDP growth in the second quarter.

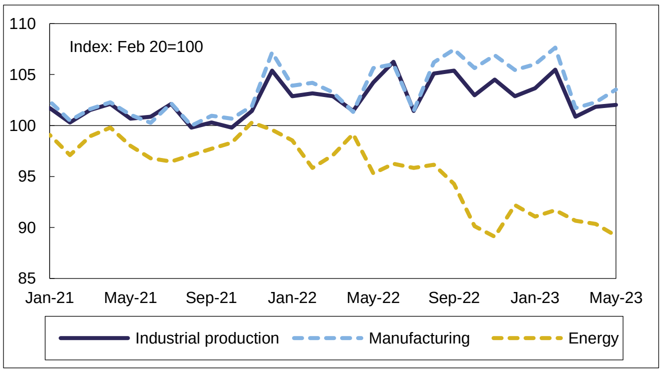
Outlook for manufacturing sector remains subdued

Admittedly, when excluding the energy-intensive sectors, euro area industrial production was trending broadly sideways compared with Q1. 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 to the highest since the start of 2021. Indeed, the latest European Commission sentiment survey in June also signalled that manufacturers' orders continued to decline, to the lowest since late-2016 (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, with concerns about the external economic environment rising, there is a non-negligible risk that the manufacturing sector will fail to grow significantly in the second half of the year too. While surveys point to a slowdown in services momentum towards the end of the second quarter, we continue to expect the sector to support a return to slightly positive euro area GDP growth in Q2 and through the second half of the year.

ECB account consistent with additional rate hikes as some initially preferred a 50bps hike in June

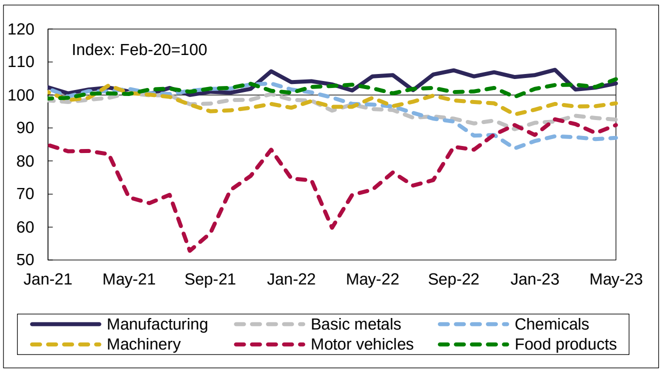
Notwithstanding commentary today from Bank of Greece Governor Stournaras, in which he again urged some caution in the near-term expectations for ECB monetary policy, noting the recent run of soft data, the account from the June meeting, published today, supported our view that the current tightening cycle is not yet over. While members generally agreed that

Euro area: Industrial production



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing production



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

interest rates had reached restrictive territory, it remained unclear at what point they would become sufficiently restrictive. Indeed, while there was a broad consensus in support of a 25bps hike in June, the minutes also indicated an initial preference (by an unspecified number of Governing Council members) for an increase of 50bps in view of the risk of high inflation becoming more persistent. And the account confirmed that the ECB's updated projections had assumed a further hike in July. Certainly, while the pickup up in core inflation in June reflected base effects associated with Germany's super-discounted public transport fares last summer, the strength in services inflation and resilience in the labour market will remain a concern. And while the ECB's bank lending survey (25 July) will likely further illustrate the already significant impact on credit supply and demand from the aggressive tightening this cycle, fear of finding themselves in a similar position to the BoE, whereby further significant upside surprises to inflation might prompt much louder criticism and a damaging loss of credibility for the ECB, will likely see the Governing Council go ahead with its signalled 25bps hike later this month and indicate that a further rate hike is likely too.

The day ahead in the euro area

On a relatively quiet end to the week, the data highlight tomorrow will be the publication of euro area trade figures for May. Like in Germany, euro area goods trade figures might well report a widening in the trade deficit amid subdued exports and firmer import values.

UK

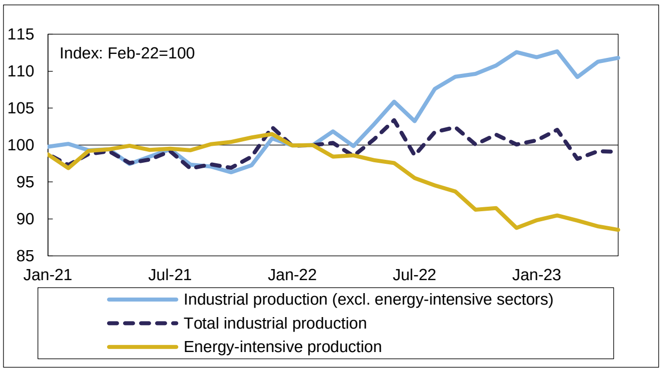
GDP beat expectations in May, but remains on a lacklustre sideways trend

Today's monthly GDP figures beat expectations and were seemingly negatively impacted by the additional bank holiday in May. While we might expect to see some bounce back in June as the adverse impact of the extra day off unwinds, the underlying message from today's release is that the UK's economic performance remains lacklustre and is on track to have merely moved sideways in the second quarter. Indeed, GDP contracted in May by (an admittedly smaller-than-expected) 0.1%M/M to leave it flat on a three-month basis, the first month that the economy has failed to grow on this basis since last August. And the level of output was just 0.2% above the pre-pandemic benchmark in February 2020.

Activity impacted by extra bank holiday and rising economic uncertainties

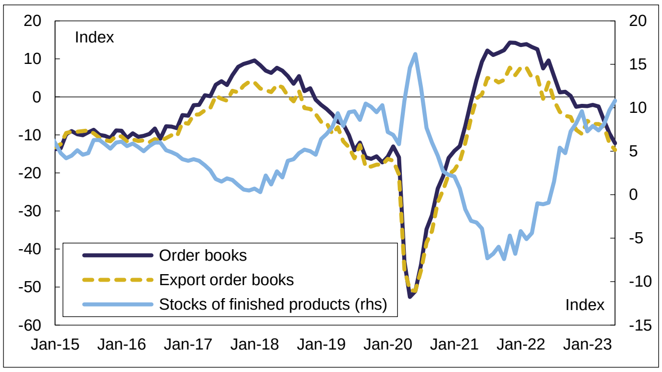
The weakness in May was principally driven by industry, for which production fell for the fourth month out of the past five, by 0.6%M/M, led by a sizeable drop in output of electricity and gas (-2.0%M/M). But the manufacturing sector also reported a second successive drop in production (-0.2%M/M), likely reflecting some payback for the strength in the first quarter of the

Euro area: Energy-intensive industrial production



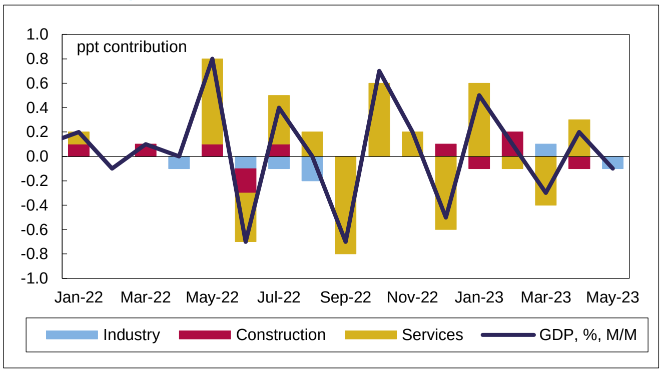
Source: Refinitiv, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing orders & inventories



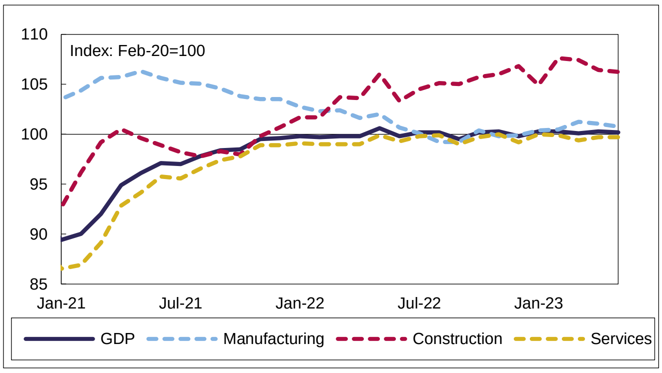
Source: EC, Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP growth and sector components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP level and sector components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

year. The adverse impact of the additional bank holiday also likely played a role, with eight out of thirteen subsectors recording negative growth, and the overall drop in manufacturing was only limited by a sharp rebound in the computer, electronic and optical sector (4.8%M/M). The loss of an extra working day seemingly impacted construction too, with activity down for the third consecutive month (-0.2%M/M), while private new housing work weakened to its lowest level since October 2021 amid rising economic concerns. Services output, meanwhile, moved sideways in May, with the fourteen subsectors evenly split between growth and contraction. Within the detail, healthcare reported the strongest growth following strike-related weakness in March and April, while entertainment and recreational activities benefitted from the extra bank holiday. In contrast, there were declines in wholesale, retail, hospitality, real estate and support services, with anecdotal evidence suggesting less demand for recruitment services. Overall, while consumer-facing services is trending some 0.6% above the Q1 average, total services activity is merely flat.

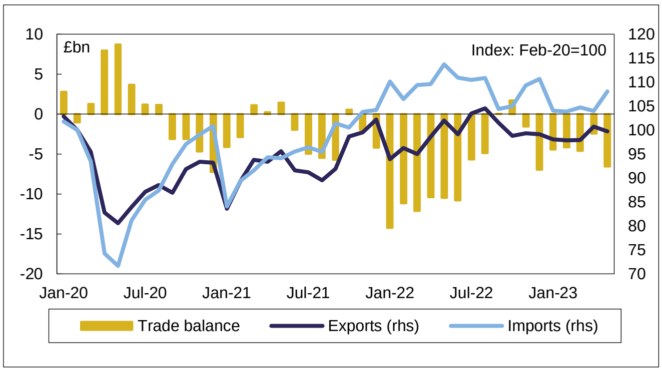
Trade deficit widens as exports fall and imports rise on easing supply constraints

Today's trade figures were also consistent with a negative contribution to GDP growth in the middle of Q2. Certainly, the monthly performance in May was disappointing, with the trade deficit widening more than £4bn to £6.6bn, the largest since December. This in part reflected a sizeable decline in the value of exports (-3.2%M/M), with goods exports down 6%M/M amid a sharp drop to the EU (-7.7%M/M). But the value of imports was also up more than 3%M/M, with the ONS flagging a rise in imports of cars from Germany amid an easing in supply chain disruptions. When adjusting for price effects, export volumes were down a more modest 2.2%M/M in May, largely reversing the increase in April, but leaving them on average so far in Q2 almost 1% above the Q1 average. When also excluding (highly volatile) precious metals, exports were down just 1.0%M/M, to leave them so far in Q2 trending some 2.3% above the Q1 average. But with import volumes also up more than 4%M/M in May, they were trending some 2.2% above the Q1 average.

Banks less willing to lend, while housing market conditions deteriorate sharply

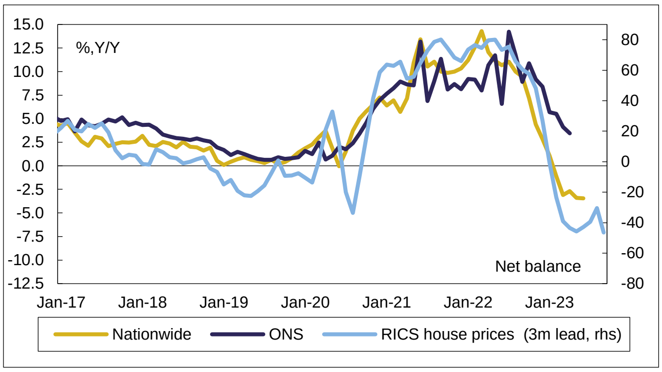
Given the weak economic outlook, lower expectations for house prices and tightening of wholesale funding conditions, today's BoE Credit Conditions Survey suggested that banks were unsurprisingly less willing to lend in the three months to May. The respective net balance of mortgage loan supply declined (-31.4) to its third-lowest level since the global financial crisis. And lenders expected the availability of secured credit to fall again in Q323, which would seem likely to compound the challenges in the residential property market. Indeed, while today's survey suggested that demand for secured lending jumped in the three months to May – likely taking advantage of a slight moderation in mortgage interest rates – banks expect this to drop back in Q3. Moreover, this survey was taken before the resurgence in mortgage rates. Certainly, the findings from the latest RICS residential survey pointed to a marked deterioration in housing market conditions in June. Surveyors

UK: Trade balance, export & import volumes



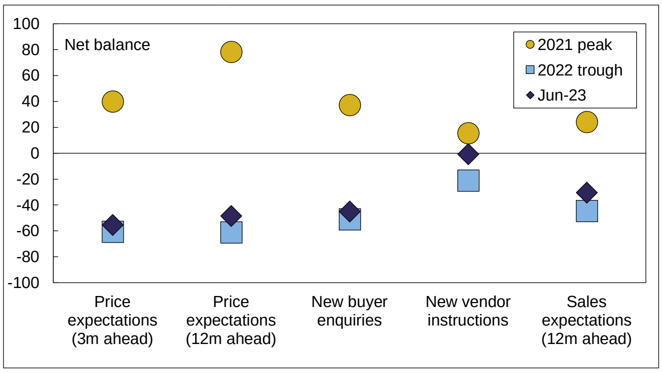
Source: ONS and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



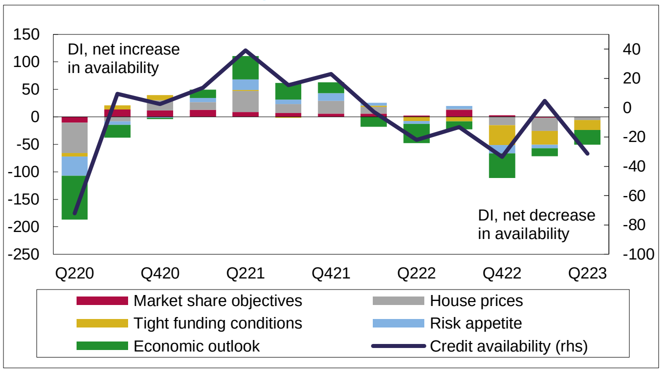
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: RICS housing market indicators



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Factors affecting secured credit availability



Source: BoE Credit Conditions Survey, Refinitiv and Daiwa Capital Markets Europe Ltd.

suggested that new buyer enquires fell sharply, with the net balance the lowest since the Truss-related collapse in October 2022. Agreed sales were also the weakest since December, while the respective balance for new vendor instructions slipped back below zero having briefly returned to positive territory in May for the first month in fourteen. And so, there was a notable decline in the survey's headline house price balance, by 15pts to -46%, the joint-lowest reading since the global financial crisis, with respondents notably more downbeat about price expectations over the coming year too.

The day ahead in the UK

The week ends on a quiet note in the UK, with no domestic economic data scheduled for release tomorrow.

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%)	May	**0.2 (-2.2)**	0.3 (-1.0)	1.0 (0.2)	-
France	Final HICP (CPI)	Jun	**5.3 (4.5)**	*5.3 (4.5)*	6.0 (5.1)	-
UK	RICS house price balance %	Jun	**-46**	-34	-30	-
	GDP M/M% (3M/3M%)	May	**-0.1 (0.0)**	-0.4 (-0.1)	0.2 (0.1)	-
	Industrial production M/M% (Y/Y%)	May	**-0.6 (-2.3)**	-0.4 (-2.3)	-0.3 (-1.9)	-0.2 (-1.6)
	Manufacturing production M/M% (Y/Y%)	May	**-0.2 (-1.2)**	-0.5 (-1.7)	-0.3 (-0.9)	-0.1 (-0.6)
	Index of services M/M% (3M/3M%)	May	**0.0 (0.0)**	-0.4 (-0.2)	0.3 (-0.1)	- (0.0)
	Construction output M/M% (Y/Y%)	May	**-0.2 (0.2)**	-0.3 (0.9)	-0.6 (3.6)	-0.9 (2.7)
	Total trade balance (goods trade balance ex precious metals) £bn	May	**-6.6 (-19.8)**	-1.5 (-)	-1.5 (-16.2)	-2.5 (-16.3)

Auctions

Italy	sold €4.50bn of 3.85% 2026 bonds at an average yield of 3.71%
	sold €3.00bn of 3.70% 2030 bonds at an average yield of 3.90%
	sold €1.25bn of 3.25% 2038 bonds at an average yield of 4.37%
	sold €1.25bn of 3.85% 2049 bonds at an average yield of 4.45%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain	Final HICP (CPI) Y/Y%	Jun	**1.6 (1.9)**	*1.6 (1.9)*	2.9 (3.2)	-

Auctions

Country	Auction
Germany	sold €4.12bn of 2.6% 2033 bonds at an average yield of 2.64%
UK	sold £3.5bn of 3.25% 2033 bonds at an average yield of 4.595%

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	10.00	Trade balance €bn	May	-	-7.1
Italy	09.00	Trade balance €bn	May	-	0.3

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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