# Euro wrap-up

## Overview

**Chris Scicluna**
+44 20 7597 8326

**Emily Nicol**
+44 20 7597 8331

- Gilts sold off as UK inflation data surprised on the upside due to persistence in the services component and public borrowing also exceeded expectations, while PM Sunak called a general election for 4 July.
- Bunds also made losses on a quiet day for economic data for the euro area.
- Thursday will bring the May flash PMIs as well as euro area Q1 negotiated wage data.

**Daily bond market movements**

| Bond | Yield | Change |
|---|---|---|
| BKO 2.9 06/26 | 3.003 | +0.040 |
| OBL 2.1 04/29 | 2.582 | +0.040 |
| DBR 2.2 02/34 | 2.533 | +0.036 |
| UKT 0⅛ 01/26 | 4.429 | +0.147 |
| UKT 0½ 01/29 | 4.130 | +0.125 |
| UKT 4⅝ 01/34 | 4.231 | +0.103 |

*Change from close as at 5.00pm BST.
Source: Bloomberg

# UK

### Inflation takes big step down but not as far as expected, leaving BoE June rate decision in balance

Consumer price inflation fell sharply in April, down 0.9ppt to 2.3%Y/Y, the lowest rate since May 2021. That represented the steepest drop in six months, and pushed inflation back within the 'acceptable' range – i.e. within 1 percentage point of the 2% target – that means that the BoE no longer needs to explain its errors to the Government. However, the decline in headline inflation in April was still 0.2ppt smaller than both the BoE's projection and the median forecast on the Bloomberg survey. And with the detail relatively disappointing, the data leave the MPC's next rate decision on 20 June in balance. In our view, it is likely to be determined by the May inflation figures, which will be released the day before that policy announcement.

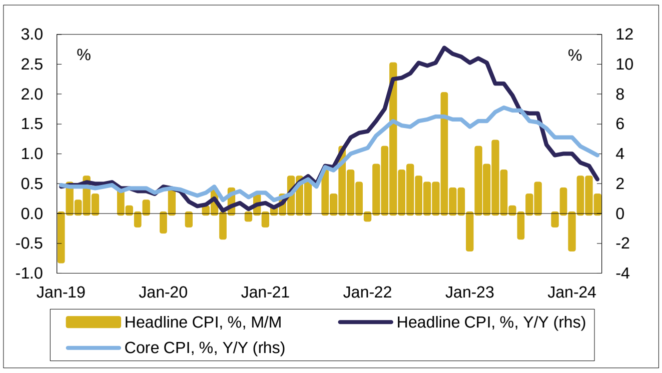
### Goods and non-core items explain most of the drop in inflation in April

Roughly half of the drop in inflation in April was due to Ofgem's 12% cut in the household energy price cap that month. Thanks to that decision, despite an increase in petrol prices, energy inflation weakened 4.0ppts to -16.7%Y/Y, the sharpest annual decline in six months. Among the other non-core items, inflation of food, alcohol and tobacco also fell sharply, down 1.8ppts to 4.2%Y/Y, the lowest since the start of 2022, to subtract a further 0.3ppt from headline inflation. In part, that reflected the Government's decision in its Spring Budget to eschew the usual increase in tobacco duty this April. But it was also due to the continued pass-through of lower wholesale food prices to consumers. And the continued easing of price pressures in the global factory sector – also reflected in weak UK producer price inflation – was reflected in a marked fall of 0.9ppt in core goods inflation to just 0.6%Y/Y, the lowest since February 2021. Reflecting the continued reversal of the supply shocks of recent years, prices of furniture and furnishings were down more than 3%Y/Y, the most in more than two decades. With prices of second-hand cars down 10%Y/Y, vehicle prices were down almost 5%Y/Y, the most since 2009. And clothing inflation moderated to 4.1%Y/Y, the softest since 2021.

### Services components still uncomfortably sticky to prompt a sell-off in Gilts

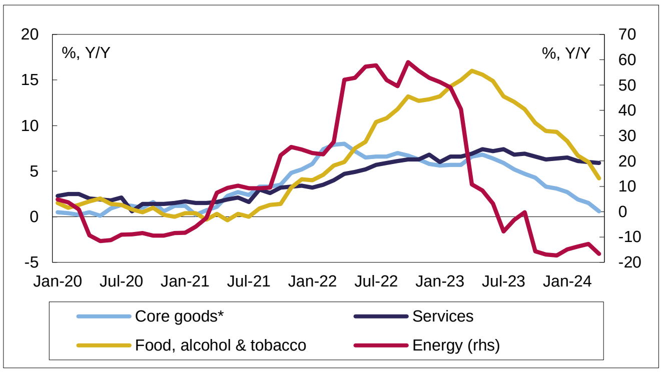
The BoE's MPC has singled out services inflation as most important in determining the future path of monetary policy. And that component was the principle source of disappointment in today's data to prompt a repricing of the market-implied path for Bank Rate and sell-off in Gilts and give a boost to sterling. Overall, services inflation fell just 0.1ppt to 5.9%Y/Y, the lowest since August 2022 but 0.4ppt above the MPC's projection and 0.5ppt above the median forecast on the Bloomberg survey. While Easter landed in March this year, a range of holiday-related services reported a pickup in inflation in April, including hospitality, recreation and culture, package holidays and airfares. In addition, prices of certain other items, including mobile

**UK: Consumer price inflation**




*Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

**UK: Key inflation components**




**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

phone tariffs and rents, rose sharply due to indexation to past inflation. And inflation of a range of non-holiday-related services – from water and sewerage to funerals and insurance – remained historically high. So, the declines in certain measures of core services inflation, such as those excluding holiday-related items, fell only modestly. And overall, core inflation fell 0.3ppt to 3.9%Y/Y, the lowest since October 2021 but still 0.3ppt above the Bloomberg median. However, the NIESR trimmed mean – which excludes the items with the highest and lowest 5% of inflation rates – fell a larger 0.6ppt to 2.5%Y/Y, suggesting that the cooling in underlying price pressures might be somewhat greater than the core rate suggests. And the share of items in the basket with inflation of 2.0%Y/Y or more fell more than 4ppts to 55.7%, the lowest since October 2021.

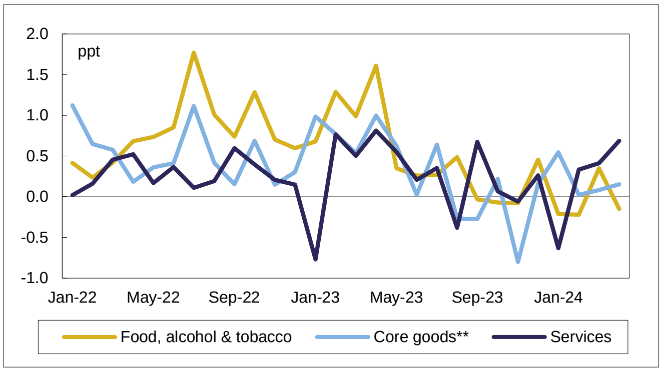
## Services inflation on track to exceed 5% over the next six months

The increase in services prices in April (1.5%M/M) was almost double the average for the month in the two decades ahead of the pandemic, and has only been exceeded by last year's figure since the turn of the century. However, we suspect that this in part reflects new monthly pricing patterns in certain consumer-facing categories. If so, the increase in services prices in May should be much closer to the norm for that month. We also expect some of the idiosyncratic pressures in certain categories – e.g. insurance – to fade over coming months in response to easing price pressures for cars and other categories. However, still-strong pay growth, including the 10% rise in the National Living Wage last month, will likely contribute to a degree of persistence in services inflation for a while yet. And there is now a significant risk that services inflation will remain high above 5%Y/Y over the next six months.

## Inflation to fall again in May, but big drop in services now required to allow a rate cut in June

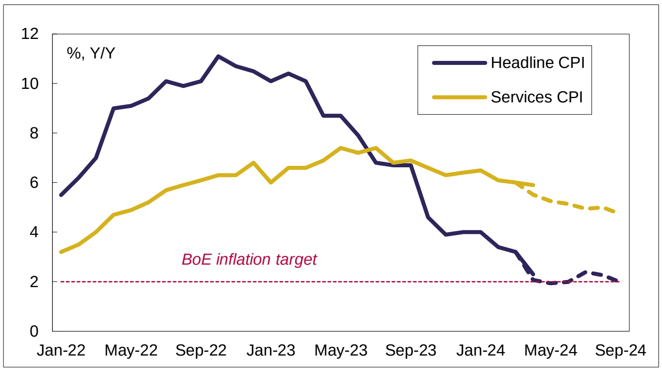
Beyond services, the categories for core goods, food and energy will remain subdued in May in part due to global trends. Indeed, core goods inflation could well fall to zero this month. But contrary to the BoE's baseline projection, inflation is now likely to (slightly) exceed 2.0%Y/Y on average in Q2. And due not least to less favourable energy base effects, headline inflation will likely move higher again in Q3 and Q4. Given the persistence in services, that profile might seem unlikely to justify a rate cut next month. However, with the current policy stance still restrictive, most MPC members should still expect the services component to moderate significantly in 2025 and headline inflation to fall below target by the end of the horizon, a profile that would in normal times merit an easing of monetary policy. And if – e.g. due to a new seasonal pricing pattern – we get significant payback for April's strength in services in the May data, and the next round of labour market data imply an easing in pay pressures, a rate cut in June would still be possible. On balance, however, the majority of MPC members might well now prefer to wait for updated projections in August before backing a first easing of policy. And that timing for a rate cut

### UK: Deviations from long-run price change*



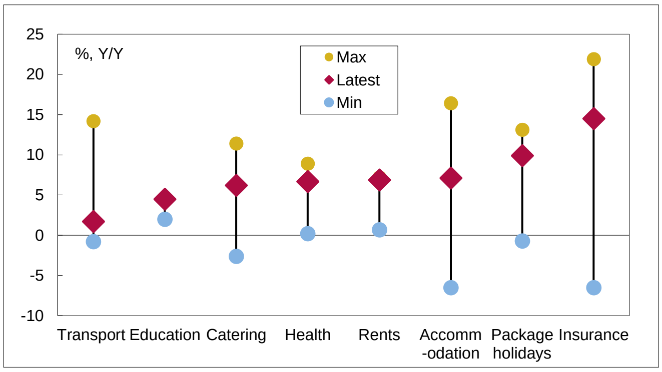

*Monthly change in prices compared to average for the month in the decade before the pandemic. **Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### UK: BoE inflation projections*



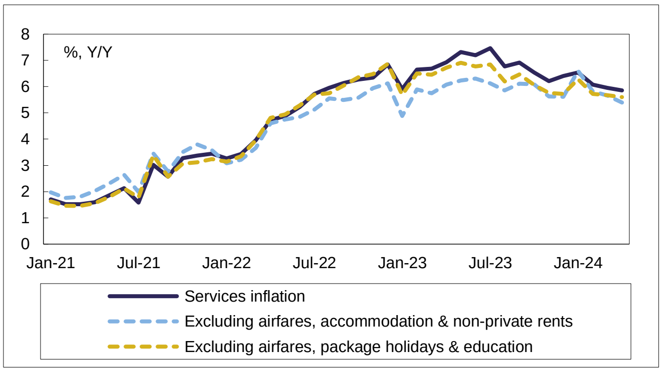

*Dashed lines represent BoE projections. Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

### UK: Selected services CPI components*




*Range since 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

### UK: Services inflation measures




Source: Macrobond and Daiwa Capital Markets Europe Ltd.

– which also looked more realistic following PM Sunak's decision to set the general election for 4 July (see below) – is now our baseline forecast.

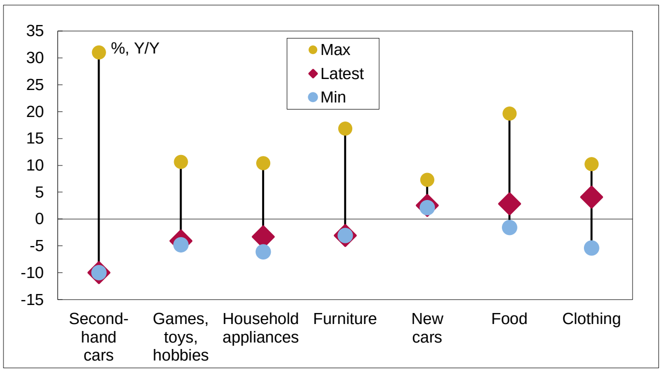
## Higher public sector borrowing removes any potential headroom for autumn fiscal giveaway

Today's public finance figures release provided a blow to the Government's hopes of delivering additional tax cuts later this year. In particular, public sector net borrowing came in at a stronger-than-expected £20.5bn in April, £1.5bn higher than a year ago and the fourth highest start to the financial year since records began in 1993. The April outturn was also £1.2bn (6.3%) above the OBR's projection at the time of the March Budget. Moreover, full-year borrowing in FY23/24 was revised up to £121.4bn, some £6.4bn less than in the previous financial year but nevertheless some £7.3bn more than was forecast by the OBR in March. The larger increase in net borrowing at the start of this financial year reflected a pickup in central government expenditure (up £4.4bn compared with a year earlier to £111.7bn), in part reflecting the inflation-linked uprating of benefit payments and higher departmental spending as inflation increased running costs. This offset a modest decrease in debt interest payments compared with a year earlier, although at £8.6bn this was still the highest monthly amount payable for ten months. Government revenues (up £1.2bn to £77.4bn) benefited from higher receipts of income tax, corporation tax and VAT, which were suggestive of an acceleration in economic recovery momentum. However, this boost was smaller than had been expected by the OBR and was partly offset by the impact of the decision to cut National Insurance Contributions, receipts of which fell to £12.7bn in April compared with £17.6bn in March.

## Sunak sets 4 July date for general election

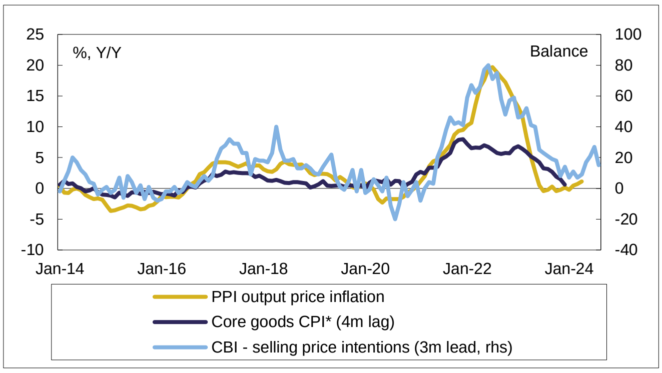
Prime Minister Sunak and Chancellor Hunt had previously made no secret of their desire to deliver a further pre-election fiscal giveaway – including an additional 2p cut to NICs which would cost more than £9bn in lost revenues – in an extra Budget this autumn. But today's figures, along with other recent developments such as the upwards shift in the Gilt yield curve and new public spending commitments, appear to have removed any potential headroom within the current fiscal rules for such a move. So, taken together with the diminished likelihood of a June Bank Rate cut following the release of the April inflation data, as well as the likelihood that inflation will be picking up somewhat in Q3 and Q4, Prime Minister Sunak late this afternoon confirmed that the general election will be held earlier than previously expected, on 4 July. While that might help to stem the extreme decline in his and his party's popularity ratings, it won't prevent a major defeat for Sunak and his Conservatives at the expense of Labour, which will inherit a host of major fiscal challenges – related not least to the dire state of public services, failing public infrastructure and low productivity and potential growth – unaddressed by the current Government.

### UK: Selected goods CPI components*



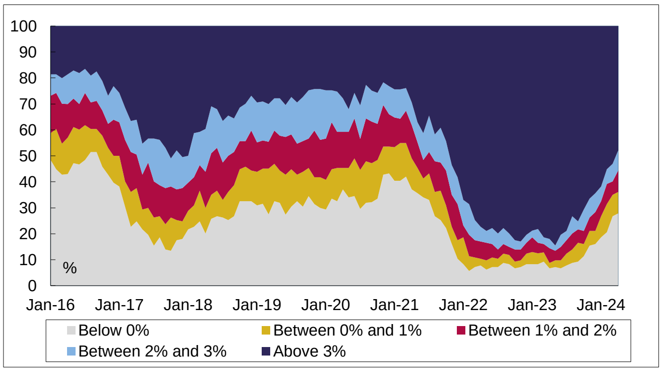

**Range since 2020. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

### UK: Goods price indices



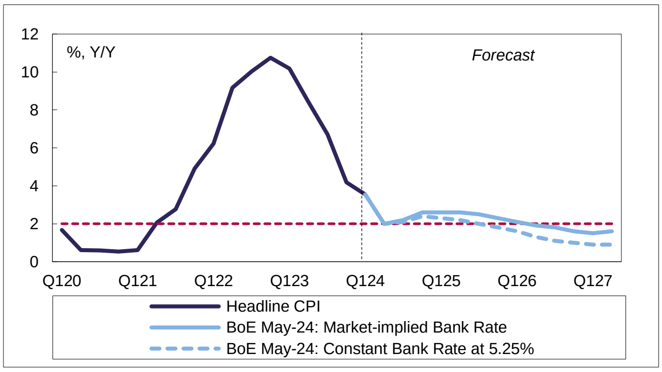

**Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

### UK: Share of CPI basket by inflation rate




*Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

### UK: BoE inflation projections*




**Market-implied path assumed Bank Rate at 4.5% in Q225, 4% in Q226 and 3.7% in Q227. Source: BoE and Daiwa Capital Markets Europe Ltd.*

## The day ahead in the UK

As in the euro area, focus in the UK tomorrow will turn to the flash PMIs for May. In terms of the activity indices, the composite output PMI might well ease back from April's 12-month high (54.1), albeit remaining consistent with ongoing solid recovery momentum in the middle of the second quarter as demand for consumer-facing services was likely boosted by the improved weather conditions. If yesterday's CBI industrial trends survey is to be believed, the manufacturing PMIs might also report a boost to output this month. Indeed, according to the CBI, the share of manufacturers reporting an increase in the volume of output in the three months to May (35%) was the highest since November 2023, with firms expecting a further modest rise next month too. But the survey still suggested that output rose in just 7 out of 18 sub-sectors, driven by cars and other transport equipment, chemicals and food, drink and tobacco subsectors. Moreover, it reported that the near-term outlook remained clouded by a further deterioration in new orders, with the net balance of firms reporting below normal order books (-33%) the second-lowest since January 2021. And roughly a fifth of firms still assessed stocks of finished goods to be more than adequate, which will likely further constrain production.

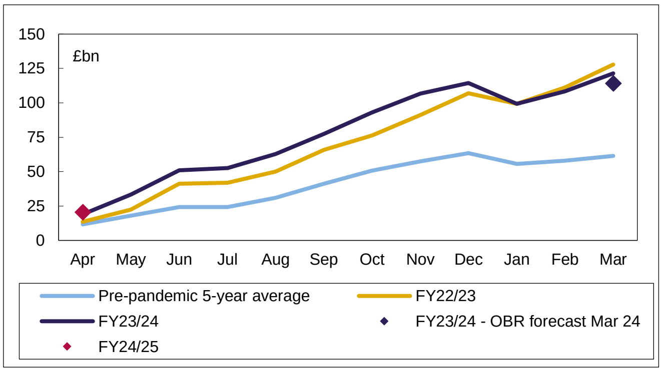
Against the backdrop of subdued demand, manufacturers moderated their selling price expectations in May, with a net 15% of firms planning to raise prices over the coming three months compared with 27% in April and the lowest share since January. Of course, the PMIs will provide additional insight into services price pressures in May and will be watched for signs of pass-through to consumers from the recent pickup in costs related not least to the near-10% hike in the National Living Wage. However, while the composite input price PMI rose 3.5pts to a nine-month high in April (65.3), the output price PMI edged down to a seven-month low (56.2).

# Euro area

Thursday will be a busy day for euro area releases, bringing the flash PMIs and Commission consumer confidence indicators for May, as well as the ECB's measure of negotiated wage growth for Q1. The euro area composite output PMI surprised to the upside in April rising to an eleven-month high of 51.7, some 2.5pts above the Q1 average and therefore suggestive of a further pickup in recovery momentum at the start of Q2. The improvement was led by services (53.3), but the PMIs also implied the softest contraction in the manufacturing sector (47.3) in a year. While the European Commission's business sentiment indices were less upbeat at the start of Q2, expectations are for the composite PMI to move broadly sideways in May, therefore signalling that the euro area economy is on track for another quarter of steady GDP growth. Meanwhile, the Commission's consumer confidence index is forecast to rise for a fourth consecutive month to its highest level since February 2022 as households benefit from rising real disposable incomes and the improved economic outlook.

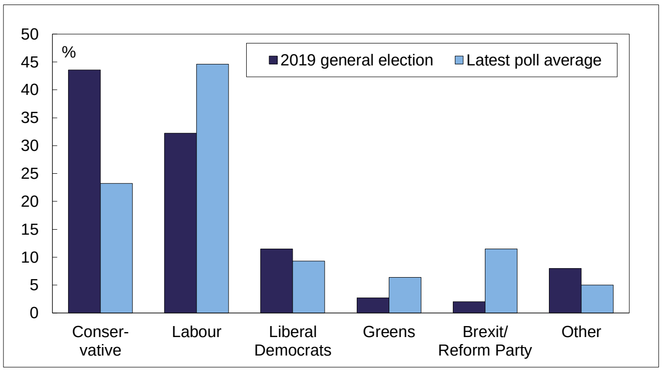
The PMI survey's price indices will also be watched closely. In April, the composite input and output price PMIs ticked slightly higher to 58.2 and 53.7, but remained comfortably below the respective averages in 2023 and well down on the highs recorded in 2022. Moreover, the sizeable gap between the two indices suggested relatively limited scope for firms to pass costs onto customers. Meanwhile, ECB policymakers will also pay attention to its negotiated wage growth indicator for Q1. Like yesterday's labour costs figures, these are likely signal still elevated growth, not least reflecting significant one-off payments in Germany to compensate for past high inflation. Indeed, data published by the Bundesbank today showed that German negotiated wage growth accelerated 2.9ppts to 6.2%Y/Y in Q1, the most since the post-reunification boom in the early 1990s. When excluding one-off payments, German negotiated wages were up a more modest 3.0%Y/Y. Despite a drop in France and Italy, we currently expect to see little change to the euro area rate of 4.5%Y/Y registered in Q4.

### UK: Public sector net borrowing




*Source: OBR, Macrobond and Daiwa Capital Markets Europe Ltd.*

### UK: Political party ratings




*Source: Average of past 10 polls 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 | | New car registrations Y/Y% | Apr | **12.8** | - | -4.9 | - |
| UK | | Headline (core) CPI Y/Y% | Apr | **2.3 (3.9)** | *2.1 (3.5)* | 3.2 (4.2) | - |
| | | Output (input) PPI Y/Y% | Apr | **1.1 (-1.6)** | 1.1 (-1.5) | 0.6 (-2.5) | - |
| | | Public sector net borrowing £bn | Apr | **19.6** | 18.5 | 11.0 | 12.1 |
| | | House price index Y/Y% | Mar | **1.8** | - | -0.2 | - |

| Auctions | | |
|---|---|---|
| Country | | Auction |
| Germany | | sold €3.28bn of 2.2% 2034 bonds at an average yield of 2.53% |
| UK | | sold £4.0bn of 4.125% 2029 bonds at an average yield of 4.199% |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Tomorrow's releases

| Economic data | | | | | | |
|---|---|---|---|---|---|---|
| Country | | BST | Release | Period | Market consensus/ *Daiwa forecast* | Previous |
| Euro area | | 09.00 | Preliminary manufacturing (services) PMI | May | 46.1 (53.6) | 45.7 (53.3) |
| | | 09.00 | Preliminary composite PMI | May | 52.0 | 51.7 |
| | | 10.00 | Negotiated wages Y/Y% | Q1 | - | 4.5 |
| | | 15.00 | Preliminary Commission consumer confidence indicator | May | -14.2 | -14.7 |
| Germany | | 08.30 | Preliminary manufacturing (services) PMI | May | 43.5 (53.5) | 42.5 (53.2) |
| | | 08.30 | Preliminary composite PMI | May | 51.0 | 50.6 |
| France | | 08.15 | Preliminary manufacturing (services) PMI | May | 45.8 (51.7) | 45.3 (51.3) |
| | | 08.15 | Preliminary composite PMI | May | 51.1 | 50.5 |
| UK | | 09.30 | Preliminary manufacturing (services) PMI | May | 49.5 (54.7) | 49.1 (55.0) |
| | | 09.30 | Preliminary composite PMI | May | 54.0 | 54.1 |

| Auctions and events |
|---|
| - Nothing scheduled - |

*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

## Access our research blog at:
## https://www.uk.daiwacm.com/ficc-research/recent-blogs